Statement on Monetary Policy

MAY 2011

Contents

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Overview

The global economy is continuing to grow, although conditions vary significantly across different regions. Growth in most of Asia, including China and India, remains strong and unemployment rates are generally low. The main exception is in Japan, where the mid-March earthquake is still having a major effect on domestic production and a significant impact on some global supply chains, and has led to a sharp drop in consumer spending. In contrast to the strong growth in the rest of Asia and in some others parts of the world, many of the North Atlantic economies continue to operate with substantial excess capacity, with unemployment rates remaining high.

Notwithstanding these differences, the world economy is expected to grow at an above-average pace over the next few years, albeit below the rate recorded in 2010. As a result, significant upward pressure on commodity prices has continued, with the expansion of global supply struggling to keep pace with the increase in demand. For some commodities, this pressure on prices has been exacerbated by adverse weather events and, in the case of oil, by political turmoil in the Middle East and North Africa.

The rise in commodity prices has led to an increase in headline inflation rates in many countries, with food and energy prices increasing significantly. In Asia, there are signs that more generalised inflationary pressures are building, with the high commodity prices flowing through to higher prices for final goods and many economies operating with limited spare capacity. Headline inflation rates have also increased in the North Atlantic countries although, in these countries, there are few domestically sourced inflationary pressures, with wage growth subdued and medium-term inflation expectations having increased only a little.

In response to the increase in inflationary pressures, monetary policy has been tightened in a number of countries over recent months, including in all the major economies in Asia (except Japan). In contrast, in the United States the Federal Reserve has continued to expand its balance sheet in line with its previously announced policy. Overall, for the world as a whole, monetary policy remains expansionary, and there is a growing risk that global inflation will rise further in the period ahead.

Over the past few months, the US dollar has depreciated significantly, partly reflecting the difference in the stance of monetary policy in the United States compared with most other countries. While the renminbi has been allowed to appreciate a little against the US dollar, on a trade-weighted basis it has depreciated back to around its level at end 2009. The currencies of most other emerging market economies have recorded significant appreciations against the US dollar over the past year, although many of these countries have introduced or extended capital controls in an effort to limit short-term capital inflows. A number of emerging economies also continue to accumulate foreign reserves at a rapid pace.

One ongoing source of uncertainty for the global economy is sovereign creditworthiness. Over the past year, Portugal, Ireland and Greece have sought assistance from the EU/IMF and investors remain concerned about the possibility of a debt restructuring. Since the previous *Statement*, the credit ratings of the United States and Japan have also been put on negative outlook, with both countries facing the difficult task of putting their public finances on a sounder footing. Despite these moves, longer-term sovereign bond yields in major markets have been broadly unchanged this year at low levels, though above the exceptional levels seen in the second half of 2010.

More generally, conditions in credit markets have continued to be favourable, with many credit spreads narrowing further, to be at levels seen around late 2007. Corporate bond issuance has also been quite strong in a range of markets, including Australia. The local securitisation market has continued to improve, with issuance picking up over recent months.

In Australia, the rise in commodity prices is providing a significant lift to real national income and is underpinning very strong investment plans in the resources sector, while also creating some of the same sorts of inflationary pressures seen elsewhere. Australia's terms of trade are likely to rise further in the June quarter, to be above the level assumed a few months ago – and at their highest level in at least 140 years – boosted in particular by high prices for iron ore and coal. While the prices of these commodities are generally expected to decline over the period ahead as new supply comes on line, strong growth in steel demand in Asia is expected to see them remain at historically high levels.

The strong terms of trade have been accompanied by a significant appreciation of the exchange rate. In trade-weighted terms, the real exchange rate is at its highest level since the mid 1970s. The appreciation has significantly lowered the price of imported goods for Australian consumers and businesses (see below), but has also adversely affected the competitive position of many firms, particularly in the manufacturing and tourism industries.

While the medium-term overall outlook for the economy remains positive, the summer floods and Cyclone Yasi have had a substantial effect on production over recent months. Coal production, in particular, has fallen significantly, and the recovery is taking longer than earlier expected due to ongoing difficulties in removing water from flooded mines. As a result, GDP is likely to have declined in the March quarter. Production should, however, recover over the months ahead, providing a boost to output in the June and September quarters.

In contrast to production, domestic demand appears to have grown at a reasonable pace so far in 2011. A number of large resource projects were announced over the past six months and investment is picking up. Survey-based measures of business conditions have also improved to be around their pre-flood levels. In addition, business credit has increased over recent months after declining during much of 2010, and there is some evidence of a greater willingness by banks to lend. Despite this, many commercial property developers continue to report that lending conditions are tight, and activity in this part of the economy is still subdued.

Households remain cautious in their spending and borrowing decisions. While there is general optimism about prospects for the economy, households are not as optimistic about their own finances. Higher prices for utilities, fuel and food, as well as higher mortgage rates, appear to be weighing on consumer confidence. Given the developments in asset markets over recent years, it is also likely that households view asset returns as more uncertain than they did a few years ago. Partly as a result, the household saving ratio has increased over recent years, to be at its highest level since the late 1980s.

In the housing market, conditions remain subdued. Credit growth has slowed and housing prices in most cities are either flat or lower over the past few months. New dwelling and home loan approvals have also softened in 2011, partly reflecting the fallout from the Queensland floods, although conditions have softened in most other states as well. Auction clearance rates in Sydney and Melbourne have been below average in recent months.

Employment growth remains solid, although its pace has moderated recently. Over the past year, the unemployment rate has declined by nearly ½ percentage point, to be just below 5 per cent. Over this period, there has been strong growth in employment in the mining sector and in a number of related business services. Employment growth has also been strong in the health and utilities sectors, while employment in the manufacturing sector has declined. Most leading indicators point to further growth in employment over the months ahead, although at a slower pace than in 2010.

As the labour market has gradually tightened, wage growth has picked up from the low outcomes recorded in 2009, to be slightly above its average pace over the past decade or so. With growth in labour productivity remaining low, unit labour costs have been growing quite quickly. Wage increases have tended to be highest in mining-related occupations and in Western Australia and Queensland. While there are some reports of shortages for specific occupations, most firms are not reporting unusual difficulties in hiring new workers. Average hours worked are lower than when the unemployment rate was last around 5 per cent (in early 2006), suggesting there may still be some additional capacity in the labour market. A further rise in the participation rate would be helpful in adding to that capacity.

The effects of the natural disasters in Australia earlier in the year, as well as high global energy prices, were clearly evident in the consumer price index for the March quarter, which increased by 1.6 per cent to be 3.3 per cent higher over the year. In the quarter, fruit and vegetable prices increased by 15 per cent, fuel prices rose by nearly 9 per cent, and there were large seasonal increases in the prices of health and education services. Electricity prices also rose by a further 5 per cent. In contrast, the prices of many imported retail goods continued to decline due to the appreciation of the Australian dollar. Over the year, the price indices for clothing, footwear, furniture, household appliances and audio-visual equipment all fell.

In underlying terms, year-ended inflation looks to have now troughed at around 2¼ per cent, down from a peak of a little over 4½ per cent in 2008. The March quarter outcome for underlying inflation was slightly higher than expected, although this followed a lower-than-expected outcome in the December quarter.

The Bank's medium-term central scenario for the economy remains similar to that discussed over the past year or so. For most of the forecast horizon, growth is expected to be at, or above, trend and the unemployment rate is expected to decline gradually. Compared with three months ago, the forecasts for growth in 2012 and into 2013 have been lowered a little, largely reflecting the recent appreciation of the exchange rate. In the short term, the quarterly profile for GDP will be significantly affected by the floods; as noted above, aggregate output is likely to have declined in the March quarter, but a bounce-back is expected in the June and September quarters. Through 2011, growth is expected to be above 4 per cent, although this partly reflects the weak starting point in late 2010 due to the disruption to coal production.

While GDP growth is expected to be at, or above, its trend pace over much of the forecast horizon, large differences in the performance of the different sectors are likely to continue. Some areas of the economy are expected to be very strong, while conditions will be quite difficult in others due to the appreciation of the exchange rate and subdued consumer spending. This challenging environment for parts of the economy reflects the very large changes in relative prices that are occurring at a time when spare capacity in the overall economy is relatively limited.

In underlying terms, inflation is expected to increase gradually over the next few years, after having troughed in the bottom half of the medium-term target band. While the recent appreciation of the exchange rate and a continuation of the relatively high saving ratio by households will help to offset some of the inflationary pressures associated with the resources boom, underlying inflation is expected to be in the top part of the target band over much of the next couple of years. By the end of the forecast horizon, underlying inflation is forecast to be above 3 per cent based on the technical assumption that the cash rate moves broadly in line with market pricing at the time this *Statement* was finalised. Headline inflation is forecast to remain above underlying inflation – and above 3 per cent – for the remainder of 2011, largely due to the increases in fruit and vegetable prices. It is then forecast to be below underlying inflation for much of 2012, as fruit and vegetable prices normalise.

As always, these forecasts are subject to a range of uncertainties. At the international level, developments in Asia are particularly important and, more broadly, it remains unclear as to how the pick-up in global inflation and the concerns about sovereign creditworthiness will ultimately be resolved. Domestically, the behaviour of the household sector will have a bearing on how the economy evolves, with there being plausible scenarios in which the saving ratio increases further and others in which it declines. The behaviour of the labour market in an environment of low unemployment will also be important, as will the effect of the higher exchange rate on both activity and inflation.

Since November last year, the Board has held the cash rate steady at 4.75 per cent. With interest rates on most loans a little above average, this represents a mildly restrictive stance of monetary policy, which the Board has viewed as appropriate over this period given the general outlook facing the Australian economy. Consistent with the Board's long-standing approach, it will continue to focus on the medium term in setting monetary policy and look through the volatility in inflation and economic activity as a result of the natural disasters during the summer. The central outlook sketched above suggests that further tightening of monetary policy is likely to be required at some point for inflation to remain consistent with the 2–3 per cent medium-term target. In the challenging economic environment that is likely to lie ahead, the Board will set policy to ensure a continuation of the low and stable inflation that has made an important contribution to Australia's strong economic performance over the past two decades. ✠

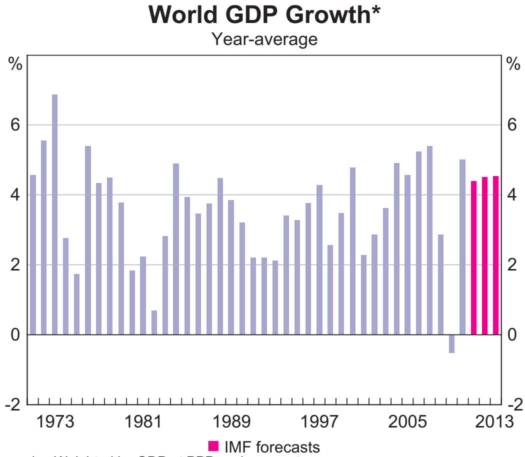
1. International Economic Developments

The global economy is continuing to grow at an above-average pace, although conditions vary significantly across different regions of the world. Growth in most of Asia remains strong, although below the rapid pace experienced earlier in the recovery. The main exception is Japan, where earthquake-related damage (including to power infrastructure) is having a significant effect on economic activity. In the North Atlantic economies, the recovery is continuing, with unemployment rates in a number of countries declining. Notwithstanding this, most of these economies continue to operate with large amounts of excess capacity and many still face the difficult challenge of putting their public finances on a sounder footing.

Overall, in 2010 the world economy grew by around 5 per cent, compared with average growth of 4 per cent over the decade to 2008. The International Monetary Fund (IMF) is forecasting growth to continue at an above-trend pace in the next few years, although below the rate recorded in 2010 (Graph 1.1). This forecast – which is consistent with the Bank's central scenario for the world economy – is broadly unchanged from that of three months ago, with downward revisions to the forecasts for Japan and the United States offset by upward revisions for the euro area and Latin America.

Over recent months, headline inflation rates have increased significantly in a number of countries, largely due to higher commodity prices (see 'Box A: Commodity Prices and Global Inflation'). Above-average growth in the world economy, combined with political unrest in North Africa and the Middle East has seen oil prices rise by 30 per cent

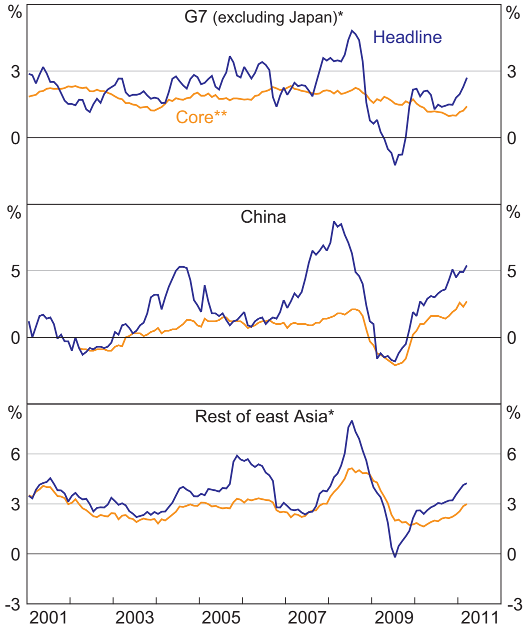
Graph 1.1



* Weighted by GDP at PPP exchange rates
Source: IMF

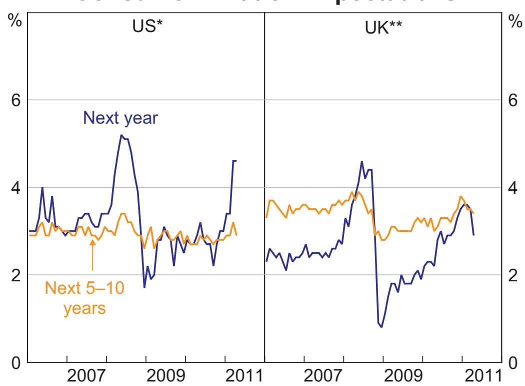
over the past year (in SDR terms), while prices of bulk mineral commodities have increased on average by around 36 per cent. Food prices have also been increasing rapidly, with weather-related disruptions affecting supply in an environment in which demand has been growing strongly. In Asia, where economies are operating at or close to full capacity, 'core' inflation rates have also risen and there are signs that higher commodity prices are flowing through to higher prices for some consumer goods (Graph 1.2). In most advanced economies there is little upward pressure on inflation from domestic factors, although global factors operating through commodity markets are leading to an increase in inflation rates. While the strength in commodity prices primarily reflects strong global demand, for some economies, it can be viewed as an adverse supply shock, and is having a negative impact on real household incomes.

Graph 1.2
Consumer Price Inflation
Year-ended



* Weighted by GDP at PPP exchange rates
** Excludes food and energy except for Germany, France, Italy and the UK which also exclude alcohol and tobacco, Canada which excludes eight of the most volatile components as well as the effect of changes in indirect taxes and China which includes energy
Sources: Bank Indonesia; CEIC; IMF; RBA; Thomson Reuters

Graph 1.3
Consumer Inflation Expectations



* University of Michigan Consumer Sentiment Survey; median response
** YouGov/Citigroup Inflation Tracker Survey; median response
Source: Thomson Reuters

In some countries, rising commodity prices and the resulting increase in headline inflation rates have led to a noticeable increase in inflation expectations for the year ahead, to above-average levels. Longer-term inflation expectations have risen, but by a considerably smaller amount and remain well within the range seen over the past decade or so (Graph 1.3).

Asia

Growth in the Chinese economy remains strong, with GDP increasing by 2.1 per cent in the March quarter to be 9.7 per cent higher over the year (Graph 1.4). Industrial production has continued to expand at a robust pace, with output of steel products increasing by more than 10 per cent over the past year (Graph 1.5). Power generation and cement production were also particularly strong in the March quarter.

The strength in the production of key building materials is consistent with robust growth in fixed asset investment over recent months. While growth in infrastructure investment has slowed from its extremely rapid stimulus-related pace in 2009, real estate investment has picked up recently and there has been continued solid growth in manufacturing investment. The rebound in real estate investment followed temporary weakness in the latter half of 2010, which was partly the result of measures to cool the property market. These policies appear to have had some effect on measured residential property price inflation, which has moderated significantly from the double-digit rate recorded in the first half of 2010.

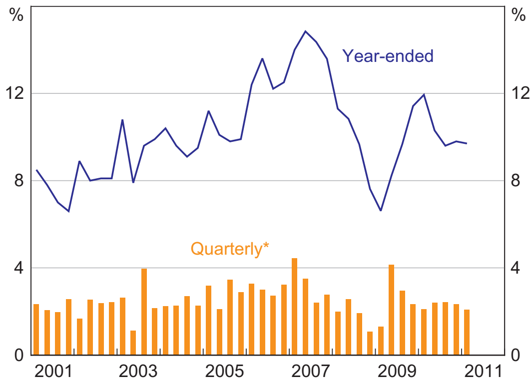
External demand has also grown solidly. Exports to all of China's major export destinations have increased over recent months, with particularly strong growth in exports to the United States and east Asia (excluding Japan). The value of imports from both major advanced economies and commodity exporters has also increased strongly, with higher commodity prices boosting import values. Consumption has continued to grow at a robust pace. Real retail sales have increased by around 15 per cent over the year, a pace similar to that recorded during 2010.

Year-ended consumer price inflation rose to 5½ per cent in March, up from 2½ per cent a year earlier. Food prices increased by nearly 12 per cent over the year and inflationary pressures are also being seen in non-food prices; in March, year-ended inflation in non-food prices reached its highest level in at least 10 years (Graph 1.6). Higher commodity prices are having a considerable effect on some consumer prices. Higher prices for grains are being seen in the prices of items such as alcoholic beverages, and higher cotton prices are being reflected in rises in clothing prices, which had fallen over the previous decade. Housing prices have also contributed significantly to inflation, with rental costs rising by 8 per cent over the year to March, their fastest pace in at least seven years.

Policymakers have responded to this rise in inflation with a number of measures, including higher interest rates and further steps to restrain credit growth. Since the February *Statement*, the People's Bank of China has raised its benchmark 1-year deposit and lending rates by 50 basis points, taking the cumulative increase to 100 basis points since October. The reserve ratios applying to banks have also been increased by 1.5 percentage points over the past three months, largely in an effort to offset the effects on liquidity from the continuing build-up in China's foreign exchange reserves. Credit controls have also been tightened, with credit growing at an annualised rate of 12 per cent over the first three months of 2011, significantly slower than its pace of expansion over 2010. Fiscal policy is, however, expected to remain stimulatory in 2011, with government expenditure expected to continue growing strongly.

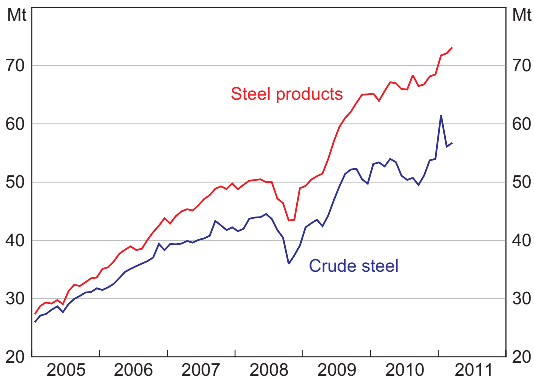
In Japan, the earthquake and accompanying tsunami devastated the Tohoku region. Beyond the human cost, the earthquake has significantly damaged the capital stock and impaired electricity generation assets, including some that supply the greater Tokyo region. Around one-quarter of the total electricity generation capacity in the Tokyo region was damaged, with 6 per cent lost permanently and about a further 6 per cent offline for an undetermined amount of

Graph 1.4
China – GDP Growth



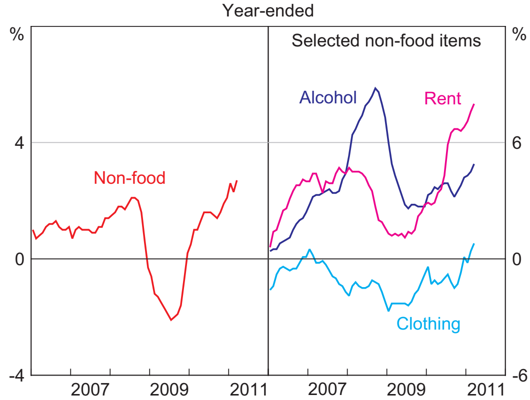
* RBA estimates
Sources: CEIC; RBA

Graph 1.5
China – Steel Production



Sources: CEIC; RBA

Graph 1.6
China – Consumer Price Inflation
Year-ended



Source: CEIC

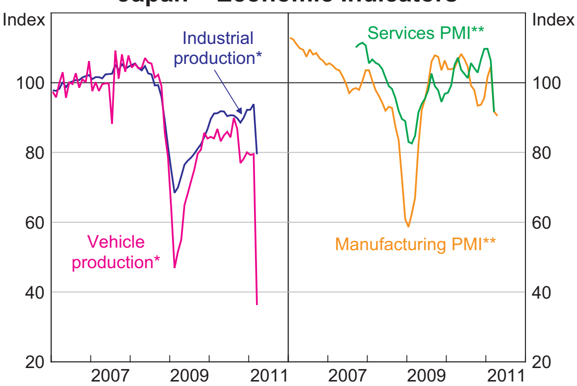
time. The loss of capacity is particularly significant since the electricity networks in the regions affected by the earthquake operate at a different frequency to the ones further south and there is only a very limited capacity to convert between frequencies. Damage to nuclear plants has also resulted in radiation leaks that have contaminated sea water and some agricultural produce.

Although economic indicators had been improving in January and February, data received for the month of March indicate that the earthquake caused a sharp contraction in activity in that month. Industrial production fell by 15 per cent in March as many production facilities immediately shut down, even outside the Tohoku region (Graph 1.7). In the weeks following the earthquake, many production facilities remained closed or operated at reduced capacity due to supply-chain disruptions and, in the Tokyo region, electricity supply issues. Motor vehicle production fell by over 50 per cent in March given the widespread shutdown of automakers in the month due to factory damage and electricity shortages. Housing starts and construction orders also fell in March, as did business activity in the services sector as measured by the services PMI survey. On the consumption side, consumer confidence and retail sales fell noticeably in March (Graph 1.8). Department store sales fell across almost all regions, with the largest falls occurring in the Tohoku and, to a lesser extent, Kanto (Tokyo) regions, while vehicle registrations fell by over 20 per cent in both March and April.

With blackouts officially suspended from early April, industrial production is expected to increase gradually as production facilities restart and production picks up in areas not directly affected by the earthquake or electricity supply issues; the low level of capacity utilisation in Japan prior to the earthquake and the fact that manufacturers tend to have factories in a number of regions is allowing the relocation of some production. Partly reflecting this, conditions in the manufacturing sector deteriorated only modestly in April, as measured by the manufacturing PMI survey. Following some shortages of electricity in the summer months, rebuilding efforts, an increase in production from repaired plants, and better supply and demand balance in the Tokyo region electricity market are likely to boost growth. However, there is considerable uncertainty about the resolution of the situation at the Fukushima Daiichi Nuclear Power Station and its effect on sentiment and activity in Japan.

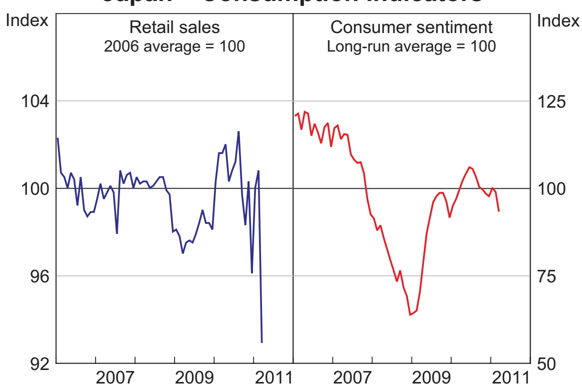
Currently, Japan accounts for around 6 per cent of world merchandise trade, ranking fourth after the United States, China and Germany, and is

Graph 1.7
Japan – Economic Indicators



* 2006 average = 100
** Long-run average = 100
Sources: CEIC; Markit Economics; Thomson Reuters

Graph 1.8
Japan – Consumption Indicators



Sources: CEIC; Thomson Reuters

an important producer of intermediate goods, particularly for the global automotive and IT sectors. With the widespread closure of manufacturing plants after the earthquake, Japanese export volumes fell by 8 per cent in March and import volumes fell by 1.5 per cent. As a result, there have been some disruptions to production in other economies, largely in the automotive sector. However, the ability of Japanese firms to switch production to other areas of the country (or the ability of competing firms in other economies to expand production) and the faster recovery of component production for export will limit the adverse effects on economic growth outside of Japan. In the medium term, the rebuilding effort in Japan is likely to provide a modest boost to growth in other economies in the Asian region.

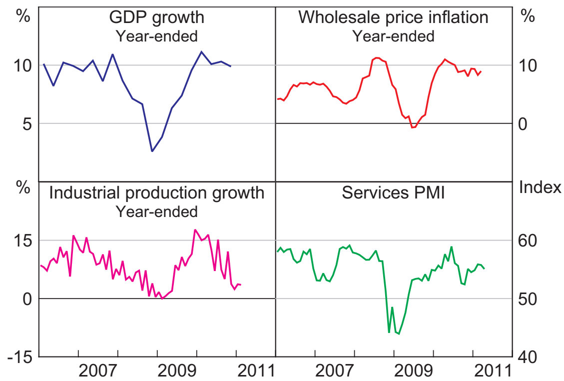
Conditions in the Indian economy remain robust, although some indicators suggest an easing recently. Trends in industrial production indicate that growth in the industrial sector of the economy has slowed since the middle of 2010. The value of exports, however, increased noticeably in the March quarter, while conditions in the services sector remained robust and vehicle sales continued to expand in the quarter. This followed strong GDP growth in the December quarter (Graph 1.9). Net exports and household consumption both contributed strongly to growth in the quarter, offsetting weakness in investment and government consumption. Output in the business services, agriculture, utilities and construction sectors all recorded solid growth over the year to the December quarter.

Inflation in India remains elevated, with the wholesale price index rising by 9 per cent over the year to March. While primary food price inflation has eased in recent months, inflation in primary non-food prices has continued to trend higher and non-food manufacturing inflation has picked up. The increase in prices partly reflects pass-through of higher commodity prices, particularly for oil and coal, into input costs, although demand pressures are also contributing to inflation. In response to these developments, the Reserve Bank of India has increased its policy rates by a cumulative 75 basis points since the February *Statement*.

After recovering rapidly from the global downturn, there are signs that the economies in the rest of east Asia are operating close to, or at, full capacity. In Malaysia, the Philippines and South Korea, indicators of capacity utilisation are now a little above pre-crisis levels and the unemployment rate in many economies has fallen significantly, although it has picked up recently in South Korea (Graph 1.10). Reflecting these trends, core inflation is increasing in a number of economies in the region, albeit from below-average levels. In response, most economies have begun tightening both monetary and fiscal policy.

Graph 1.9

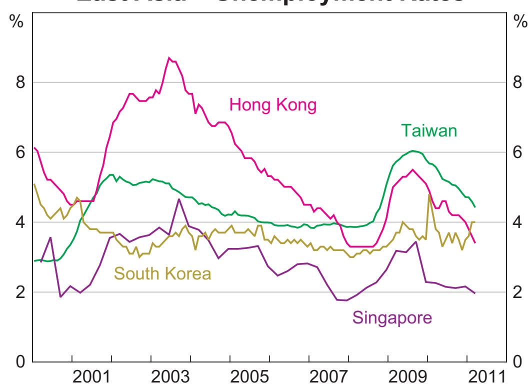
India – Economic Indicators



Sources: CEIC; Markit Economics; RBA

Graph 1.10

East Asia – Unemployment Rates



Source: CEIC

Timely indicators suggest growth in the region was robust in the March quarter. Domestic demand looks to have expanded further; retail sales volumes in January and February were 1 per cent above the December quarter average and, although indicators of investment suggest modest growth in that component, credit growth is accelerating in many countries and surveys indicate that business confidence is high. Industrial production has also increased strongly across the region, partly reflecting a continued expansion in trade. Exports to all major economies picked up in the March quarter, after significant growth in intra-regional trade in the December quarter (including with China).

North Atlantic

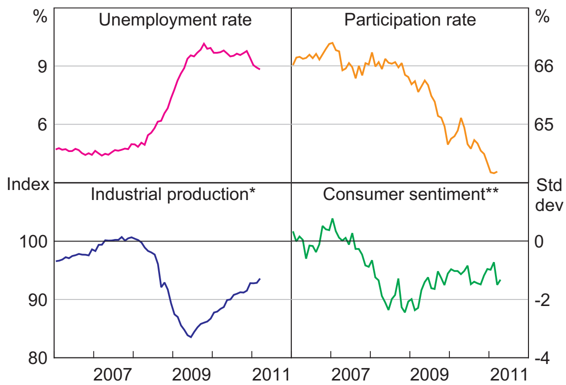
The recovery in the US economy has continued over recent months and output growth is expected to be around trend in 2011. Output grew by 0.4 per cent in the March quarter, a little slower than in the previous quarter as severe weather conditions hampered construction activity and the government reduced defence spending. Both business equipment investment and household consumption expanded further. Consumption growth in the December and March quarters was driven by large increases in purchases of motor vehicles, which had been quite weak since mid 2008. Consistent with this, consumer credit has increased in each month since October after falling significantly during the previous two years.

Although consumer sentiment remains well below average, households are benefiting from a gradual improvement in the labour market. Payrolls employment and the unemployment rate have improved somewhat in recent months, although employment has still only regained around 20 per cent of its peak-to-trough fall (Graph 1.11). Forward-looking indicators of labour demand, such as temporary help services employment, have also increased over the past three months. With business balance sheets generally in good shape and a relatively solid outlook for demand, employment is expected to continue to pick up, although the pace of decline in the measured rate of unemployment is likely to be slowed by reductions in underemployment and an increase in labour force participation from its recent lows.

The business sector continues to expand, particularly the manufacturing sector. Manufacturing production rose by 2.3 per cent in the March quarter and the ISM manufacturing index is around its highest level since mid 2004. With solid profits growth and relatively low levels of gearing, many firms are in a position to increase investment. Indicators of machinery & equipment investment have improved and firms are beginning to borrow again, helped by some relaxation of lending standards for larger firms. On the fiscal side, the tenor of recent budget negotiations suggests that Congress is becoming more concerned about the level of government debt. Given rising health care and social security spending, further debt increases are inevitable without significant fiscal consolidation efforts.

Construction activity and the housing market more generally remain weak in both the United States and Europe. Residential investment has fallen significantly as a share of GDP in both regions, especially in the United States (Graph 1.12). The fall in non-residential construction has also been sizeable, though less severe than for residential construction.

Graph 1.11
United States – Economic Indicators



* 2007 average = 100
** University of Michigan Survey; standard deviation from long-run average
Source: Thomson Reuters

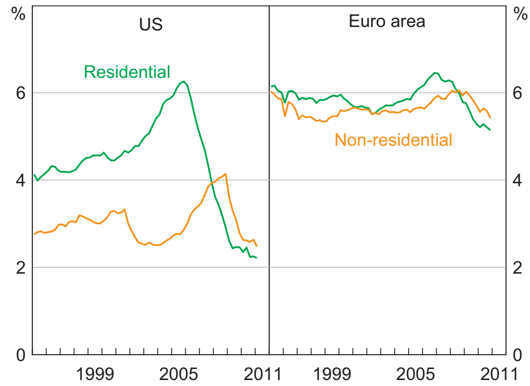
In both cases, construction booms, particularly in the residential sector, have led to an oversupply of properties and vacancies remain high, most notably in the United States. After stabilising throughout the year to mid 2010, house prices in the United States have fallen further and are now more than 30 per cent below their peak in early 2006. House prices in some European countries also continue to fall.

The economic recovery is also continuing in the euro area, although there remains a wide disparity in conditions across the region. The recovery has been led by the export sector, particularly in Germany, France and Spain (Graph 1.13). Growth is broadening in Germany and France, but economic conditions remain very weak in a number of countries where public and private debt problems are prominent. Over the period ahead, planned fiscal consolidation efforts will weigh on growth in most of these countries.

In the March quarter, output in the euro area looks to have increased moderately. Exports growth remained strong, with export values increasing by an average of 2.5 per cent in January and February to be almost 25 per cent higher over the year. Germany, in particular, has benefited from demand growth in China and emerging Europe, with the largest increases in exports over the past year in machinery and transport equipment goods to these economies. Increasingly, however, there are signs that the recovery is broadening into other sectors of the economy. Leading indicators of machinery & equipment investment picked up further in the March quarter and surveys of business conditions continue to improve. Consumer sentiment remains at above-average levels.

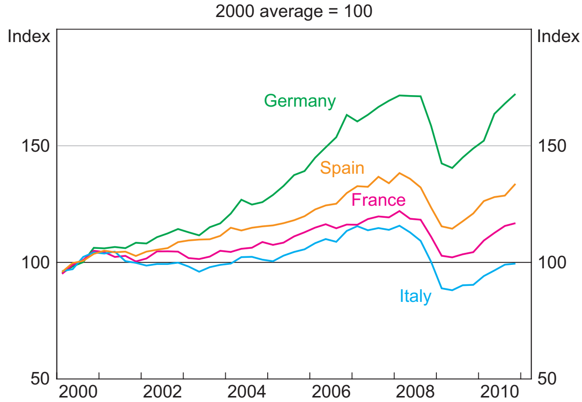
Reflecting the general pick-up in business conditions, the labour market has improved slightly over recent months. Year-ended growth in employment across the euro area as a whole is now positive for the first time since mid 2008, driven largely by gains in Germany and France. This has led to slight falls in the aggregate unemployment rate in recent months, although unemployment rates remain particularly high in Spain and Ireland. The European Central Bank (ECB) has expressed concern about increasing energy and commodity prices fuelling higher inflation expectations and wage demands. Reflecting this, in April the ECB increased its policy rate by 25 basis points to 1.25 per cent.

Graph 1.12
Construction Investment
Share of nominal GDP



Source: Thomson Reuters

Graph 1.13
Euro Area – Export Volumes
2000 average = 100



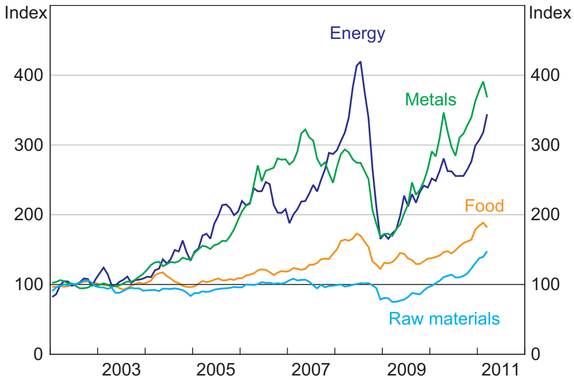
Source: Thomson Reuters

Commodity Prices

As noted above, global commodity prices have risen strongly since mid 2010; over this period, the IMF All Primary Commodities Index has risen by around 30 per cent (Graph 1.14, Table 1.1). With the global economy expanding at an above-trend pace and real incomes rising in Asia, there has been strong demand for commodities, with capacity constraints tightening in a range of markets. In some cases, these constraints have been amplified by disruptions to production because of extreme weather events.

In the oil market, crude oil prices moved steadily higher over the second half of 2010 as global demand for oil rose strongly. More recently, political unrest in some oil-producing countries in the Middle East and North Africa has led to concerns about oil supply, adding to the upward pressure on oil prices. The most widely

Graph 1.14
Global Commodity Prices
SDR terms, 2002 average = 100



Sources: IMF; RBA

Table 1.1: Commodity Price Growth
Per cent, SDR terms

	Change since previous *Statement*	Change over the past year
Oil[(a)]	19	30
– US$ terms	22	39
Base metals		
– Aluminum	8	22
– Copper	–9	24
– Lead	–7	16
– Nickel	–5	3
– Zinc	–12	–2
Gold	10	20
Rural		
– Beef	–6	10
– Cotton	–16	79
– Sugar	–34	31
– Wheat	–9	61
– Wool	9	62
Bulk commodities[(b)]		
– Iron ore	14	33
– Coking coal	39	47
– Thermal coal	14	26

(a) Average of WTI and Tapis crude oil prices
(b) Average Australian monthly export prices, RBA estimates for recent months
Sources: Bloomberg; RBA

cited benchmark, West Texas Intermediate (WTI) crude, has risen around 23 per cent over the past year (in SDR terms). The increases have been more pronounced for the other crude oil benchmarks such as Tapis crude, which is more relevant to Australia. Exchange-traded mineral commodity prices have also risen sharply since mid 2010, with particularly large increases in the prices of lead and copper. The price of gold reached a record high in the past month.

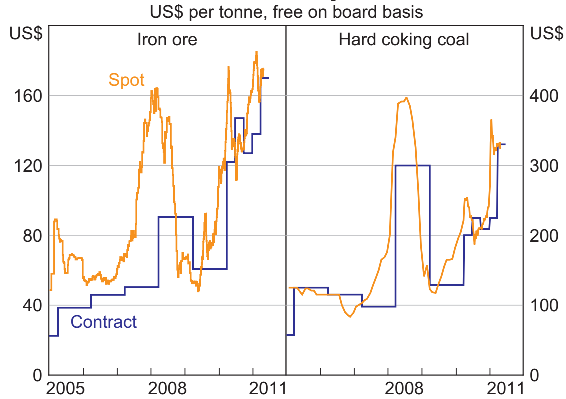
There have also been significant increases in the prices of iron ore and coal – Australia's two largest exports – as global steel production has continued to rise. Looking through some volatility in prices in recent months, spot prices for iron ore and coking coal have risen 58 per cent and 73 per cent since mid 2010 (Graph 1.15). In line with these higher spot prices, Australian exporters are receiving higher contract prices for the June quarter. Iron ore contract prices are estimated to have been set 23 per cent higher than their March quarter levels. Coking coal contract prices for the June quarter appear to have been settled around 45 per cent higher than they were in the March quarter, largely reflecting the impact on global coal trade from the heavy flooding and the subsequent loss of production in the coal mining regions of Queensland. Contract prices for thermal coal for the Japanese financial year 2011/12 have reportedly been settled around 33 per cent above the 2010/11 contract price. The strong growth in export prices for bulk commodities has been a major factor in the rise in the terms of trade in recent years, with the terms of trade expected to reach a record high in the June quarter.

Global food prices, as measured by the IMF Food Price Index, are around 28 per cent higher over the past year and slightly higher than the levels reached in mid 2008. Price increases have been relatively broad-based, with particularly large increases in wheat, corn, sugar and soybeans prices. Strong income and population growth in developing countries – where the income elasticity of food demand is typically higher than in developed countries – has supported demand for grains and increasingly also for protein sources such as meat. The spike in some food prices also reflects weather-related disturbances. Wheat production has been affected by drought in the Black Sea region and dry winter conditions in China, while sugar production has been constrained by supply disruptions in key sugar-producing countries including Brazil and Australia. While weather-related disruptions may be temporary, there have been longer-run supply factors constraining food production. Growth in crop productivity declined over the 1990s and 2000s following the gains made from productivity-enhancing technological advances in earlier decades (Graph 1.16). Declining relative food prices over that time may have reduced the incentive to invest in agriculture, although recent increases in food prices are likely to encourage an expansion in food production.

Graph 1.15

Bulk Commodity Prices

US$ per tonne, free on board basis

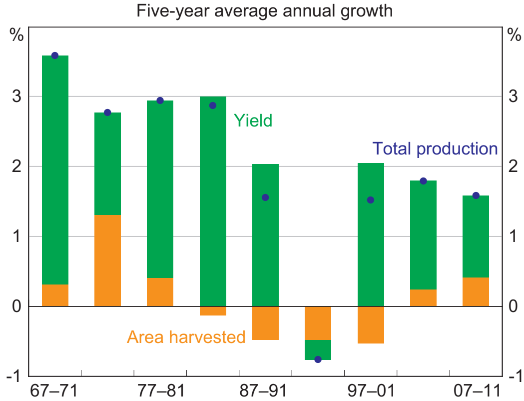


Sources: ABARES; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

Graph 1.16

Global Grain Production

Five-year average annual growth



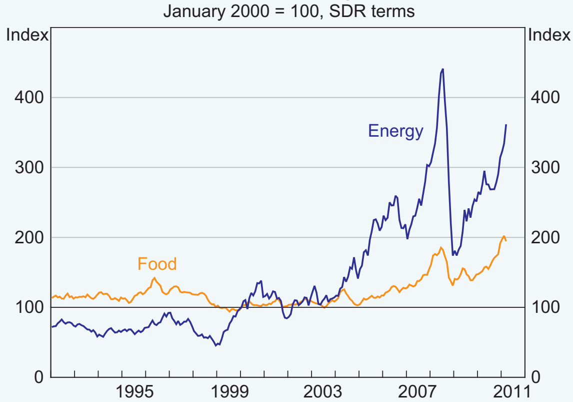
Sources: RBA; United States Department of Agriculture

Box A

Commodity Prices and Global Inflation

Over the past year, global food and energy prices have increased significantly. During this period, the IMF Food Price Index – which measures the prices of 22 key food commodities in global markets – has increased by 28 per cent in SDR terms, while the price of crude oil has risen by 30 per cent (Graph A1). These increases are putting upward pressure on headline inflation rates in a wide range of countries. This is particularly the case in Asia, where food typically accounts for around one-quarter of the Consumer Price Index (CPI) basket, compared with under 16 per cent of the CPI basket in the North Atlantic economies (Table A1).[1] Energy – including fuel for vehicles and household energy needs – also accounts for a larger share of the CPI in many lower-income economies in Asia than in developed economies.

Graph A1
Global Commodity Prices
January 2000 = 100, SDR terms



Sources: IMF; RBA

Table A1: Weight of Commodities in the CPI[(a)]
Per cent

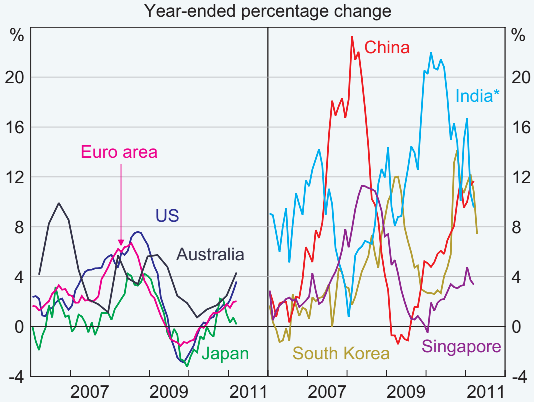
	Food[(b)]	Household energy	Vehicle fuel
Australia	12	3	4
China[(c)]	31	6½	½
India	45	9½	na
Japan	19½	5½	2½
East Asia (excl China and Japan)[(c)]	19	4½	5½
Euro area	15½	5½	4½
United Kingdom	12	4½	4½
United States	8	4	4½

(a) Effective weights for 2011 or nearest available year
(b) Food and non-alcoholic beverages; excludes food consumed away from the home in all economies except China
(c) Estimates
Sources: ABS; CEIC; Eurostat; Office for National Statistics; RBA; US Bureau of Labor Statistics

1 Food is defined as food consumed in the home.

While the price of agricultural commodities has risen significantly over the past year, the impact of this on the food component of the CPI has varied considerably across economies (Graph A2).[2] The fastest increases in consumer food prices have occurred in Asia, with food prices increasing by around 10 per cent or more over the year to March in China, India, Indonesia and South Korea. In addition to the global factors influencing food prices, these economies have all experienced economy-specific disruptions to food supplies, including floods, droughts and, in the case of South Korea, an outbreak of foot and mouth disease. Food prices have increased more moderately in the North Atlantic economies and in Japan, with inflation averaging around 2½ per cent over the year to March, though some of this reflects consumption tax increases. In part, the less rapid increases in food prices in the CPIs of these economies are likely to reflect the smaller relative importance of raw commodity inputs in the overall retail price of food; households in higher-income economies tend to consume more processed and prepared food in the home, with distribution and advertising costs also likely to be higher in developed economies.

Graph A2
Food Prices in the CPI
Year-ended percentage change



* Primary food component of the wholesale price index
Sources: ABS; CEIC; Thomson Reuters

2 We look specifically at Australia, Canada, China, euro area, Hong Kong, India, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, United Kingdom and United States.

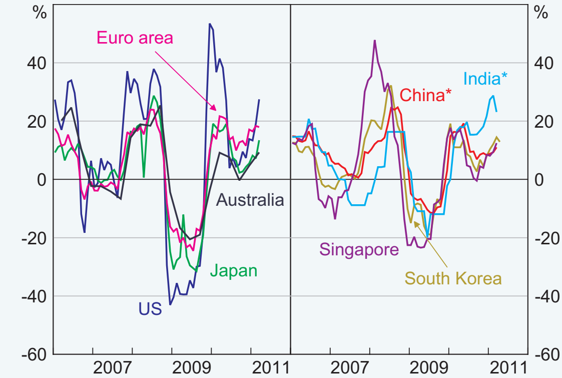
In many countries, the direct pass-through of higher global food prices to measured food price inflation in the CPIs has so far been lower in the current episode than occurred in 2007–2008, particularly in the North Atlantic economies and Japan. When year-ended inflation in the global price of food commodities reached 35 per cent in 2008, food prices in the CPI were increasing by an average of around 5 per cent across these economies. Although global food prices were recently rising at a similar pace, food price inflation in the CPI was typically around half of what it had been at the equivalent point in that earlier episode. To a significant extent, this reflects the spare capacity that exists in many developed economies, which is otherwise dampening the retail price of food. In contrast, in 2007–2008 a whole range of input costs were increasing quite quickly.

The impact of higher oil prices on the CPI is most evident in higher prices for automotive fuel (Graph A3). Although crude oil is internationally traded and priced on world markets, there is significant variation in how movements in the US dollar crude oil price affect retail fuel prices across the globe. Over the past year, fuel prices have increased the fastest in the United States, at almost 30 per cent over the year to March; these increases have also been significant in other developed economies, particularly in the euro area and the United Kingdom. In contrast, fuel price increases have been under 10 per cent in Australia and in many Asian economies over the past year. One reason for these differences is movements in exchange rates against the US dollar. A second reason is that the pass-through of movements in the price of crude oil in the domestic currency to the final fuel price is influenced by distribution costs and taxes and subsidies. Excise taxes are common in developed countries, with rates particularly high in Europe, while fuel subsidies are common in Asia, applying to at least some oil-based fuels in China, India, Indonesia, Malaysia and Thailand.

Higher prices for oil and other energy commodities also contribute to headline inflation through their impact on the price of energy used in the home. Inflation in the prices of electricity, gas and other household fuels has risen in most economies, although cross-country inflation rates for these components can also diverge significantly. For example, among Australia's major trading partners, current rates of inflation in electricity prices range from around –2 per cent (Thailand) to 10 per cent (Hong Kong), with differences in electricity generation technologies used and retail price regulation among the reasons for the disparity. Inflation in household gas prices has also picked up in many countries and the price of heating oil has risen rapidly in the North Atlantic economies.

Higher food and energy prices also affect consumer prices indirectly, since they are key inputs into the production of many goods and services. One clear example is clothing prices, which have been influenced by a trebling in the price of cotton since early 2009. In China, clothing prices are increasing at their fastest pace in a decade and this is contributing to higher prices of exported clothing (Graph A4). Higher rates of headline CPI inflation can also lead to an increase in inflation expectations and thus to a pick-up in the pace of wage inflation. Measures of inflation expectations over the year ahead have picked up in a range of economies in recent months and are considerably higher than the average over the past decade. In contrast, there has been relatively little change in measures of longer-term inflation expectations. ✠

Graph A3
Automotive Fuel Prices in the CPI
Year-ended percentage change



* Wholesale price index component for India; retail price index component for China
Sources: ABS; CEIC; Thomson Reuters

Graph A4
China – Merchandise Export Prices*
January 2006 = 100

* RBA estimates
Sources: CEIC; RBA

2. International and Foreign Exchange Markets

Central Bank Policy

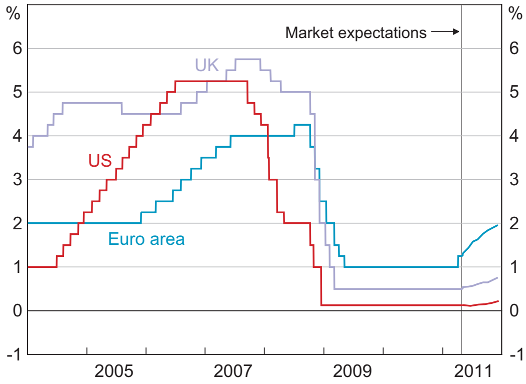
Monetary policy tightening commenced or continued in a number of jurisdictions over recent months (Table 2.1). The European Central Bank (ECB) increased its policy rate by 25 basis points to 1.25 per cent in April from the 1 per cent level it had been at since May 2009. Financial markets have brought forward the expected timing of further policy rate increases with at least two more expected by year end (Graph 2.1). The Bank of England is expected to commence its tightening phase around the end of this year.

Table 2.1: Policy Rates

	Current level Per cent		Most recent change	Cumulative increase Basis points
Euro area	1.25	↑	Apr 11	25
Japan	0.05	↓	Oct 10	–
United States	0.125	↓	Dec 08	–
Brazil	12.00	↑	Apr 11	325
Canada	1.00	↑	Sep 10	75
China	6.31	↑	Apr 11	100
India	7.25	↑	May 11	250
Indonesia	6.75	↑	Feb 11	25
Israel	3.00	↑	Mar 11	250
Malaysia	2.75	↑	Jul 10	75
Mexico	4.50	↓	Jul 09	–
New Zealand	2.50	↓	Mar 11	–
Norway	2.00	↑	May 10	75
Russia	8.25	↑	Apr 11	50
South Africa	5.50	↓	Nov 10	–
South Korea	3.00	↑	Mar 11	100
Sweden	1.75	↑	Apr 11	150
Switzerland	0.25	↓	Mar 09	–
Taiwan	1.75	↑	Apr 11	50
Thailand	2.75	↑	Apr 11	150
United Kingdom	0.50	↓	Mar 09	–

Source: central banks

Graph 2.1
Policy Rates



Sources: Bloomberg; central banks

The central banks of China and India have increased their policy interest rates twice since February; the People's Bank of China has also further raised banks' reserve requirement ratios. The Monetary Authority of Singapore tightened policy by increasing the centre of its exchange rate policy band, its main policy instrument. In contrast, the Reserve Bank of New Zealand lowered its policy rate by 50 basis points following the Christchurch earthquake in February.

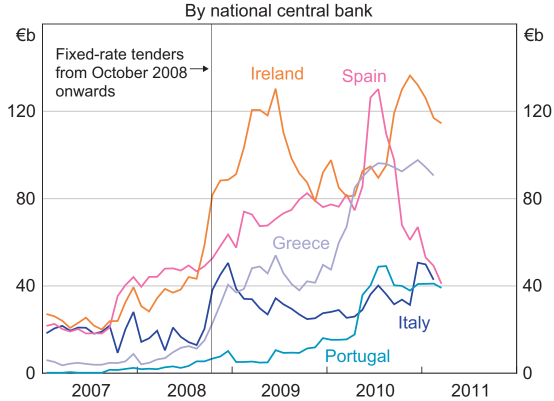
Two major central banks have continued to ease monetary policy. Following the Japanese earthquake on 11 March, the Bank of Japan (BoJ) undertook several measures to help support the Japanese economy. It provided banks with significant short-term liquidity and increased the size of its Asset Purchase Program by ¥5 trillion (1 per cent of GDP). The BoJ and other G7 central banks also intervened in the foreign exchange market to stabilise the yen after it appreciated significantly following the earthquake (see the section on Foreign Exchange).

In addition, the BoJ announced a support program for financial institutions in earthquake disaster areas: up to ¥1 trillion of one-year loans will be available against eligible collateral at a rate of 0.1 per cent. These policies have expanded the BoJ's balance sheet which, relative to the size of its economy, is already much larger than those of other major central banks.

The US Federal Reserve's balance sheet has also continued to expand due to its large-scale asset purchases. About three-quarters of the planned US$600 billion purchases of US Treasuries announced in November 2010 have been conducted with the balance to be completed by the end of June. In his inaugural press conference following the recent Federal Open Market Committee meeting, Chairman Bernanke stated that the Fed will maintain the size of its securities holdings after the end of June.

In contrast, the ECB's balance sheet has contracted in recent months. Liquidity provided to banks through its market operations fell to the lowest level since early 2008. Spanish banks have become less reliant on ECB liquidity as they have been able to utilise market sources of funding (Graph 2.2). Nevertheless, lending to Portuguese and Irish banks remains at high levels as they are virtually unable to obtain market funding. The fall in lending to Irish banks via ECB operations appears to have been fully offset by funds provided by the Central Bank of Ireland; Irish banks' aggregate central bank funding accounts for more than one-fifth of their total liabilities.

Graph 2.2
ECB Lending to Banks*
By national central bank



* Lending provided through monetary policy operations only
Source: central banks

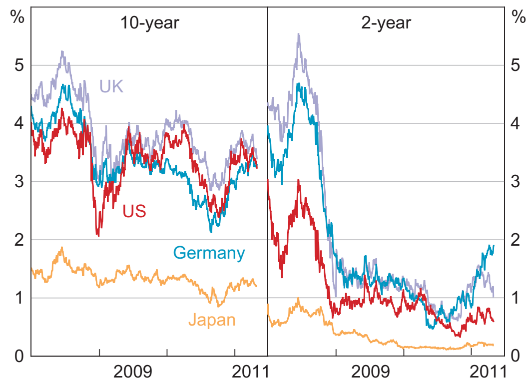
Sovereign Debt Markets

Longer-term sovereign bond yields in most major advanced economies have been broadly unchanged this year after rising significantly from around their historic lows in the second half of 2010 (Graph 2.3). Yields fell at times due to tensions in the Middle East and North Africa, the Japanese earthquake and concerns regarding the euro area periphery. At other times, yields rose in response to concerns about rising inflation. US and Japanese yields were largely unaffected by moves to place their credit ratings on negative outlook. German bond yields have increased as financial markets brought forward the expected timing of monetary policy tightening by the ECB, with the 2-year yield reaching its highest level since December 2008.

Spreads between yields on Portuguese government bonds and German Bunds have widened sharply in recent months amid heightened concern about the state of Portugal's government finances. Following the resignation of Portugal's Prime Minister in March after the parliament rejected further austerity measures, Portuguese longer-term bond yields increased sharply to more than 8 per cent (Graph 2.4). In early April, the caretaker administration requested financial assistance from the European Union (EU) and the International Monetary Fund, and announced in early May that Portugal will receive €78 billion. Portugal's credit rating was downgraded by Standard & Poor's (S&P) and Fitch to BBB- and by Moody's to the equivalent of BBB+, all with negative outlooks.

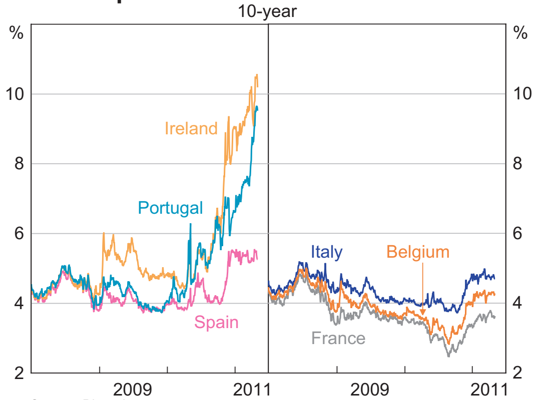
Prior to mid April, Spanish spreads narrowed in conjunction with measures to shore up its banking system and the implementation of austerity measures, and despite Moody's downgrading Spain's sovereign credit rating to the equivalent of AA. Irish sovereign spreads had narrowed by more than 100 basis points following the release of Irish banks' stress test results. Notwithstanding this, Moody's downgraded Ireland's sovereign credit

Graph 2.3
Government Bond Yields



Source: Bloomberg

Graph 2.4
European Government Bond Yields
10-year



Source: Bloomberg

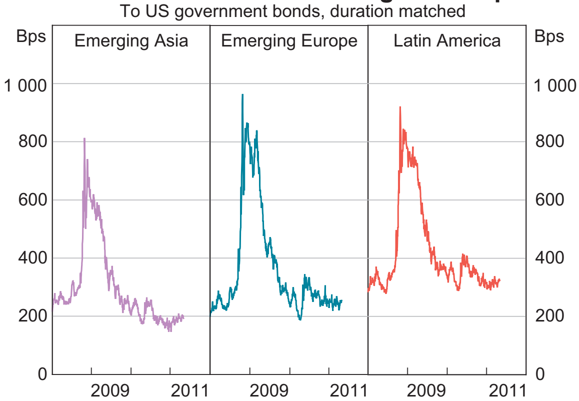
rating by two notches to the equivalent of BBB-; S&P had previously downgraded it by one notch to BBB+. Peripheral euro area sovereign bond spreads then widened significantly in the second half of April due to heightened speculation about the possibility of a Greek sovereign debt restructuring. The exception was Spain whose spreads had little net change.

Concerns about the euro area periphery and tensions in the Middle East and North Africa have generally had little effect on spreads of emerging market US dollar-denominated sovereign debt (Graph 2.5). While emerging Asian sovereign spreads

Graph 2.5

US Dollar-denominated Sovereign Debt Spreads

To US government bonds, duration matched



Source: Thomson Reuters

have widened somewhat this year they remain at low levels. In April, S&P raised Indonesia's credit rating to BB+ and Fitch raised Brazil's sovereign credit rating to BBB.

Government Financial Policy

In March, euro area leaders announced a package of measures to further strengthen the financial stability of the euro area:

- the effective lending capacity of the euro area's current stability facility, the European Financial Stability Facility (EFSF), will be raised to €440 billion from around €250 billion. The details of how this will be achieved are expected to be announced in June, having been delayed, in part, by rising political opposition in some European countries;
- the effective lending capacity of the European Stability Mechanism (ESM), which will replace the current facilities (the EFSF and the €60 billion European Financial Stabilisation Mechanism (EFSM)) from mid 2013, will be €500 billion. It will be backed by €80 billion of paid-in capital and €620 billion of callable capital and guarantees from euro area countries (the current EFSF is backed solely by guarantees);
- the EFSF and ESM will be allowed to purchase, on the primary market, bonds of governments under assistance programs;
- the interest rate paid on €80 billion of bilateral loans from the euro area to Greece will be lowered by 100 basis points and the maturity of these loans will be lengthened to 7.5 years from 3 years, in line with the country's IMF loans; and
- each euro area country will announce concrete national commitments annually to improve its competitiveness and economic convergence in the euro area.

The European Banking Authority provided details on the parameters for its stress test of EU banks, the results of which will be published in mid June. The adverse scenario will test the ability of banks to withstand a negative macroeconomic shock, including falling property and equity prices and higher interest rates, over a two-year horizon. The 'core' Tier 1 capital benchmark will be set at 5 per cent of risk-weighted assets, with core Tier 1 capital confined to ordinary shares or similar instruments issued by participating banks.

Following its recent stress test, four of Ireland's banks will be required to raise a combined €24 billion (16 per cent of GDP) in capital in order to meet both a minimum 10.5 per cent core Tier 1 capital ratio and an additional protective buffer. The Irish Government will provide capital to the extent that the banks cannot raise funds privately. These banks will also be required to sell assets to reduce their loan-to-deposit ratios from around 180 per cent to around 120 per cent. The Government also announced a restructuring of the banking system which, through mergers of some banks and wind-downs of others, will result in just two full-service domestic 'pillar' banks.

The Spanish Government announced further measures to restructure its banks. From September 2011, all banks will be required to meet a minimum core Tier 1 capital ratio of

8–10 per cent, which is higher than the 7 per cent required by 2019 under Basel III. According to Bank of Spain calculations, a number of lenders will need to raise capital up to a total of €17 billion by 30 September 2011 to meet the new requirements. Those banks that are unable to cover their capital shortfalls from private sources will receive an equity injection from a state-financed fund.

In the United Kingdom, the Independent Commission on Banking released an interim report outlining possible reforms to improve stability and competition in the UK banking sector. The Commission proposed that large banks hold equity capital of at least 10 per cent of risk-weighted assets, together with genuinely loss-absorbent debt. This would apply to the business as a whole and separately to retail banking operations, which would be 'ring-fenced' from wholesale and investment banking operations in a stand-alone subsidiary. To improve competition, particularly in the retail transaction account market, the Commission proposed that Lloyds divest more assets than the 600 branches it is already required to sell as an EU condition of government support. The Commission's final report will be issued in September.

The US Federal Reserve completed a review of 19 large US banks' capital adequacy and distribution policies, including the ability to absorb losses under several scenarios. As a result, the Fed allowed some, but not all, of these banks to increase or restart dividend payments. The Fed will review the capital plans for the largest banks on an annual basis.

The US Administration released a plan to reform the housing finance market, including a number of proposals to wind down Freddie Mac and Fannie Mae and to increase the role of private capital in providing housing finance. US authorities also announced enforcement orders against the largest mortgage servicers after a review found a pattern of misconduct and negligence related to mortgage loan servicing and foreclosure processing.

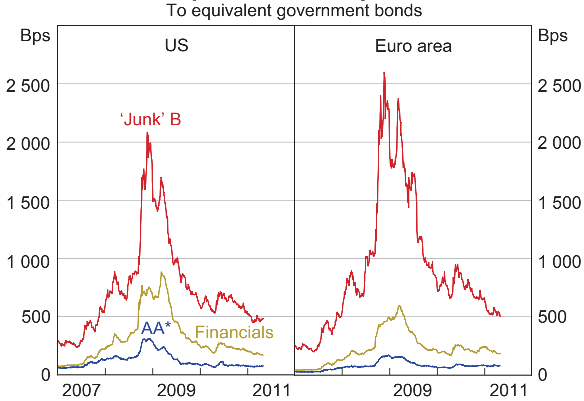
The US Securities and Exchange Commission proposed new 'limit up-limit down' rules to address extraordinary market volatility in US equity markets. For most listed equities, trades will not occur if the price is 5 per cent above or below the average price over the preceding five minutes; the bands will be doubled during the opening and closing periods, and broader price bands would apply to stocks priced below US$1. All trading centres, not just exchanges, would have to comply with the proposals.

Credit Markets

Conditions in money markets have continued to be generally favourable in recent months. Spreads between interbank unsecured lending rates (LIBOR) and expected policy rates, which provide measures of the perceived riskiness of banks, remained low.

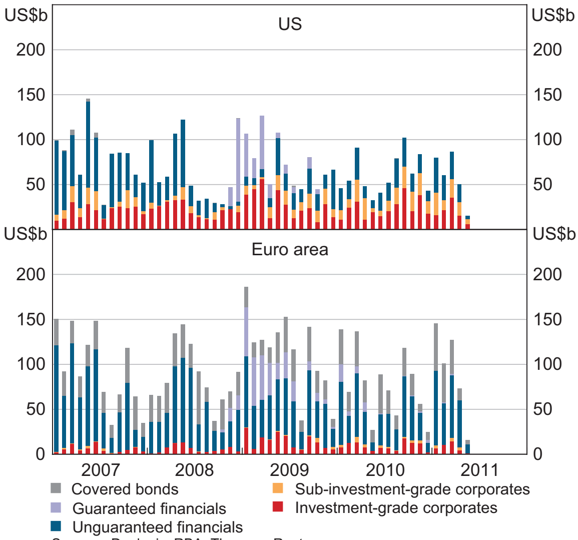
Borrowing conditions for corporates have also remained favourable. Spreads between yields on financial corporate bonds and equivalent government securities have narrowed over the past few months, with those in the United States reaching the lowest level since late 2007 (Graph 2.6). Spreads on highly rated non-financial corporate bonds have been unchanged and remain at relatively low levels, particularly in the United States.

Graph 2.6
Corporate Bond Spreads
To equivalent government bonds



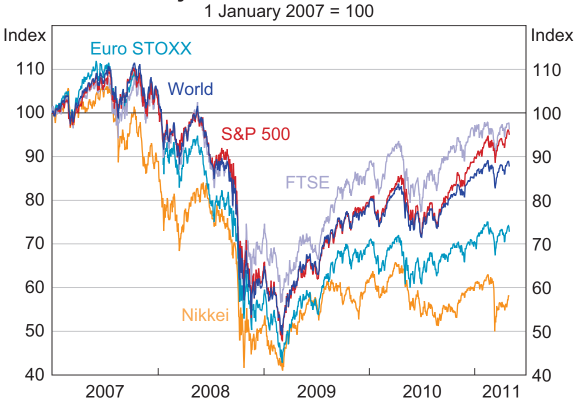
* Non-financial corporates
Sources: Bank of America Merrill Lynch; Bloomberg; RBA

Graph 2.7
Corporate Bond Issuance



Sources: Dealogic; RBA; Thomson Reuters

Graph 2.8
Major Share Price Indices
1 January 2007 = 100



Source: Bloomberg

Corporate bond issuance in the United States and euro area has been strong this year (Graph 2.7). In the United States, issuance of sub-investment-grade bonds has been encouraged by yields on these bonds falling to be below pre-crisis levels as credit quality has improved and as investor appetite for higher yielding assets has increased. Issuance by US banks has remained relatively subdued amid ongoing balance sheet deleveraging. In the euro area, part of the pick-up in bank bond issuance has been to roll over maturing debt. A large share of that issuance has been in covered bonds, because some institutions have been unable to issue unsecured debt as their government-guaranteed debt has matured and due to investor expectations that regulators will write down the value of unsecured debt in the event of bank restructurings.

Equities

Global equity prices have been unchanged in net terms over recent months but volatility increased during this period (Graph 2.8, Table 2.2). Following a period of rising equity prices, most equity markets fell from mid February as political tensions in the Middle East and North Africa rose. There were particularly sharp falls following the Japanese earthquake. Equity markets mostly retraced these falls; the S&P 500 reached its highest level since June 2008, in part due to generally better-than-expected US corporate earnings reports for the March quarter. The Japanese equity market remains 4 per cent below its pre-earthquake level, having fallen by 11 per cent on one day after the earthquake, its third largest fall in at least 30 years.

Table 2.2: Changes in International Share Prices

Per cent

	Past year	Since previous *Statement*
United States		
– Dow Jones	16	6
– S&P 500	15	3
– NASDAQ	17	3
Euro area		
– STOXX	11	–1
United Kingdom		
– FTSE	11	0
Japan		
– Nikkei	–10	–4
Canada		
– TSE 300	13	–1
Australia		
– ASX 200	0	–1
China		
– China A	1	2
MSCI Indices		
– Emerging Asia	14	2
– Latin America	3	–5
– Emerging Europe	19	1
– World	**9**	**0**

Source: Bloomberg

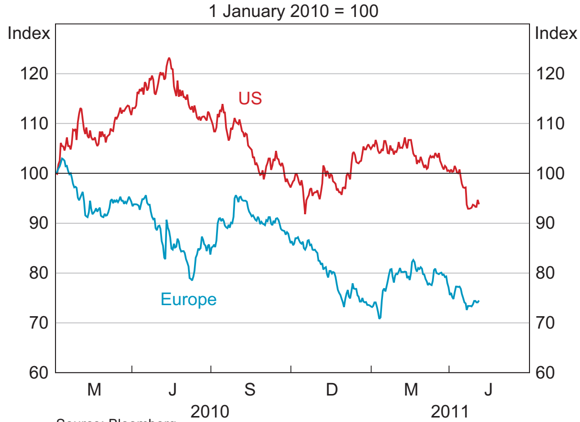
Banks' share prices have fallen significantly in recent months, in part due to ongoing uncertainty about the effect of regulatory changes on their profitability and, in Europe, on renewed concerns about bank exposures to sovereign debt issued by countries with weak government finances. Since early February, banking sector equity prices have fallen by around 8 per cent in the United States and euro area (Graph 2.9). Earnings of large US banks in the March quarter mostly met or exceeded analysts' expectations but overall revenue growth was weak and the composition of earnings disappointed markets. While quarterly earnings were supported by further reductions in loan-loss provisions and generally higher trading income, higher costs related to mortgage-servicing and foreclosure practices weighed on some banks' earnings. Most large European banks' earnings reported for the March quarter have exceeded expectations, in part supported by higher trading income.

Emerging market equity prices have been mixed in recent months (Graph 2.10). In emerging Asia, broad-based gains in equity prices since mid March followed a period of underperformance from the start of the year. Chinese equity prices have risen by 2 per cent this year and remain around their level of a year ago. In emerging Europe, Russian equity prices have been supported by higher oil prices. Equity prices in Latin America have declined, in part due to concerns that government efforts to contain inflation may dampen economic growth.

Graph 2.9

Banks' Share Prices Relative to Market

1 January 2010 = 100

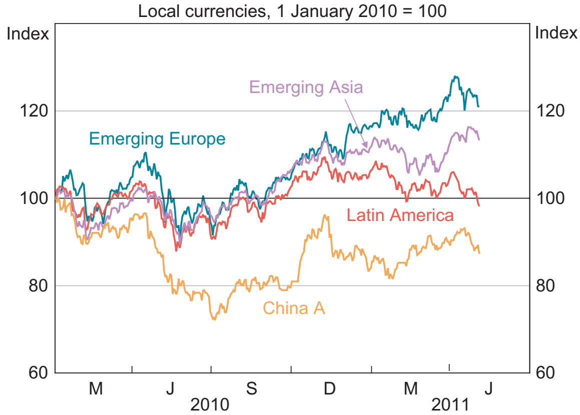


Source: Bloomberg

Graph 2.10

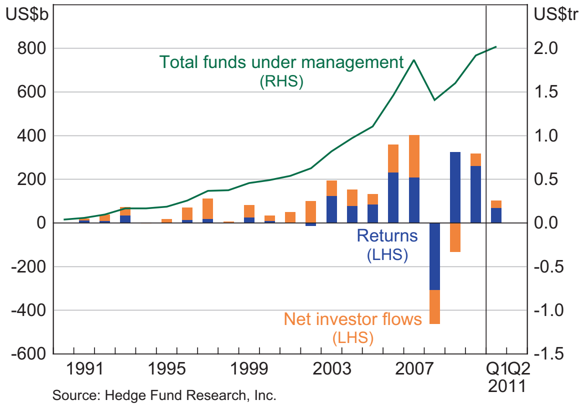
Emerging Market Share Price Indices

Local currencies, 1 January 2010 = 100



Sources: Bloomberg; MSCI

Graph 2.11
Global Hedge Funds

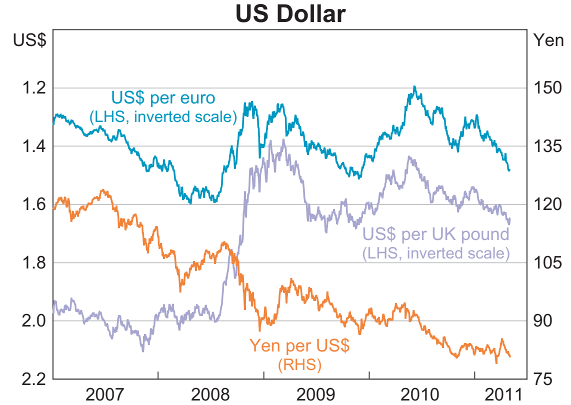


Source: Hedge Fund Research, Inc.

Graph 2.12
US Nominal TWI
March 1973 = 100

Source: Board of Governors of the Federal Reserve System

Graph 2.13
US Dollar



Source: Bloomberg

Hedge Funds

Hedge funds have performed in line with global share markets over the year to March 2011, returning an average of 9 per cent (Graph 2.11). Investors have also increased their net capital contributions to hedge funds. In the March quarter 2011, US$33 billion of new capital was injected into the industry, the largest quarterly inflow in more than three years. Reflecting these inflows and positive investment returns, funds under management have increased to more than US$2 trillion.

Foreign Exchange

The past few months have been a relatively volatile period for foreign exchange markets, reflecting the broadening tensions in the Middle East and North Africa, ongoing concerns regarding the fiscal positions of Portugal and Greece, and the earthquake and nuclear emergency in Japan.

The US dollar has continued to depreciate on a trade-weighted basis over recent months, falling by around 7 per cent since the start of the year and by 14 per cent since mid last year, to reach an historical low (Graph 2.12, Table 2.3). In part, this reflects the divergence in monetary policy between the United States and most other jurisdictions. This is evident in the appreciation of the euro to its highest level against the US dollar since December 2009 following the ECB's policy tightening, and notwithstanding ongoing concerns regarding the fiscal positions of some euro area economies (Graph 2.13).

Table 2.3: Changes in the US Dollar against Selected Currencies
Per cent

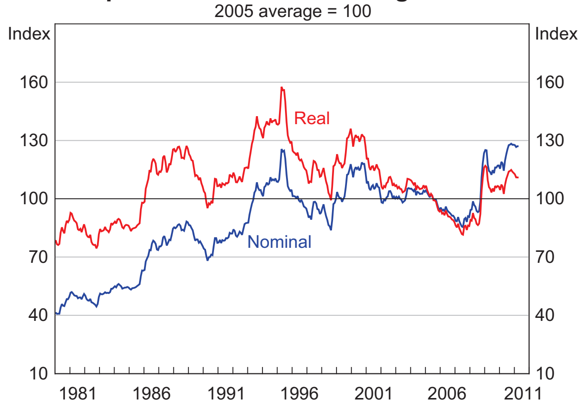
	Past year	Since previous *Statement*
Japanese yen	–15	–1
Chinese renminbi	–5	–1
New Taiwan dollar	–9	–2
UK pound sterling	–8	–2
Malaysian ringgit	–7	–2
New Zealand dollar	–9	–2
South Korean won	–5	–2
Indian rupee	0	–2
Thai baht	–7	–3
Philippine peso	–5	–3
Canadian dollar	–6	–3
Brazilian real	–8	–3
Mexican peso	–7	–3
Singapore dollar	–11	–3
Swedish krona	–18	–5
Indonesian rupiah	–5	–5
Australian dollar	–15	–6
South African rand	–12	–7
European euro	–12	–7
Swiss franc	–22	–8
Majors TWI	**–11**	**–5**
Broad TWI	**–8**	**–3**

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

The earthquake that struck Japan on 11 March and the subsequent nuclear emergency had a significant effect on currency markets. Volatility in yen-crosses increased to their highest levels since mid 2010. The yen initially appreciated in the week following the earthquake on expectations of repatriation flows to fund the rebuilding effort, although these flows have not subsequently materialised. The yen briefly reached an all-time high against the US dollar of 76.59 on 17 March in abnormal trading conditions that caused the yen to appreciate by 4 per cent in a 5 minute period. In response, on 18 March, G7 authorities undertook a coordinated intervention in order to curb the upward pressure on the currency: the Bank of Japan sold approximately US$8.5 billion worth of yen while the other countries sold smaller amounts. The yen has since depreciated but is currently stronger than pre-earthquake levels. While the effective exchange rate for the yen remains just below historical highs in nominal terms, the yen is not at a particularly high level in real terms, reflecting falling prices in Japan over a number of years (Graph 2.14).

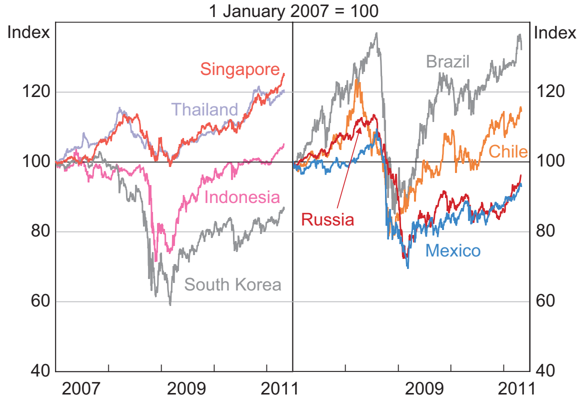
Emerging market currencies have generally appreciated over recent months, despite ongoing intervention, reflecting expectations that policy rates will need to be tightened further, or that exchange rates will be allowed to appreciate, to contain domestic inflation pressures (Graph 2.15).

Graph 2.14
Japanese Effective Exchange Rates*
2005 average = 100



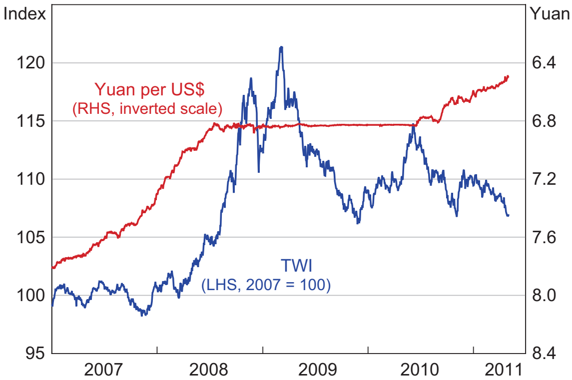
* RBA estimate for April 2011
Sources: BIS; RBA

Graph 2.15
Selected Currencies against the US Dollar
1 January 2007 = 100



Source: Bloomberg

Graph 2.16
Chinese Renminbi



Sources: BIS; Bloomberg; RBA

Among the Asian currencies, the Malaysian ringgit and Indonesian rupiah recently reached their highest levels against the US dollar in 13 and 7 years respectively, while the Singapore dollar reached a record high.

In Latin America, the Brazilian real has appreciated strongly over recent months. The Brazilian authorities intervened in the foreign exchange market in April and increased the tax on foreign borrowing by domestic banks and companies to slow capital inflows. The Russian rouble has also appreciated strongly, supported by higher oil prices, despite Russia's central bank having also intervened in its foreign exchange market during the period.

The appreciation of the Chinese renminbi against the US dollar has slowed in recent months, to 1 per cent since the beginning of the year (Graph 2.16). As this rise against the US dollar has been less than for most other currencies, the renminbi has depreciated by nearly 3 per cent in nominal trade-weighted terms over this period. The premium in the non-deliverable forward market indicates an expected further appreciation of almost 3 per cent against the US dollar over the next 12 months.

China's foreign exchange reserves reached US$3 trillion at the end of March 2011 (Table 2.4). Central banks elsewhere in Asia and Latin America also accumulated foreign exchange reserves at a relatively rapid pace during the first three months of the year, consistent with reported intervention by these countries in foreign exchange markets.

Table 2.4: Foreign Exchange Reserves
As at end March 2011

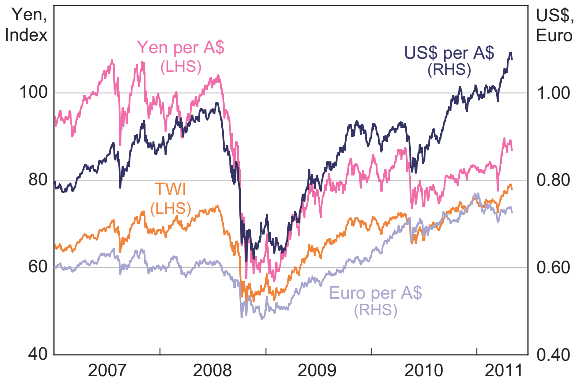
	Three-month-ended change		Level
	US$ billion	Per cent	US$ billion
China	197	7	3 045
Japan	6	1	1 041
Russia	21	5	454
Taiwan	11	3	393
Brazil(a)	28	10	309
South Korea	7	2	294
Thailand	9	5	174
South Africa	5	15	41
Chile(a)	4	13	30

(a) RBA estimates of official reserve assets excluding gold
Sources: Bloomberg; CEIC; RBA

Australian Dollar

The Australian dollar has appreciated strongly over recent months, recording a new post-float high of 79 on a trade-weighted basis and above US$1.10 (Table 2.5, Graph 2.17). The Australian dollar is currently 8 per cent higher against the US dollar than its average level in January when it was trading close to parity. In trade-weighted terms, the appreciation is smaller, around 5 per cent, in part reflecting only a small appreciation of the Australian dollar against the euro over this period. The Australian dollar has been supported by high international prices for Australian commodities.

Graph 2.17
Australian Dollar



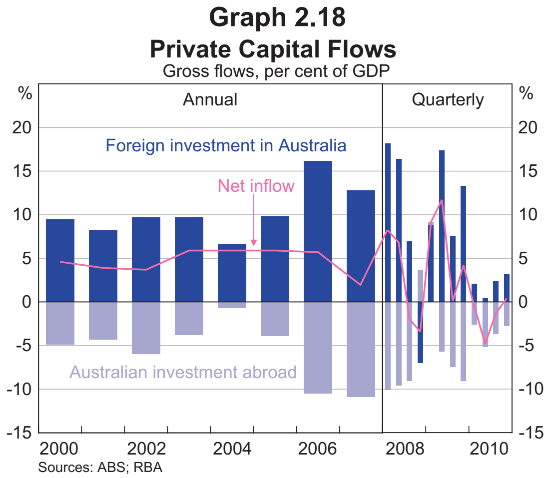
Sources: RBA; Thomson Reuters; WM/Reuters

The Australian dollar fell sharply against the yen in mid March following the Japanese earthquake and ensuing nuclear emergency. Australian assets have been a significant destination for Japanese investment over recent years, which led the Australian dollar to depreciate more than most other currencies when markets expected Japanese investors to repatriate funds after the earthquake; these flows have generally not materialised. However, following the coordinated G7 intervention on 18 March, the Australian dollar appreciated against the yen to its highest level since September 2008.

Table 2.5: Australian Dollar against Selected TWI Currencies
Per cent

	Change over past year	Change since previous *Statement*	Deviation from post-float average
US dollar	19	6	47
Japanese yen	2	5	–8
Chinese renminbi	13	5	48
UK pound sterling	9	4	45
Malaysian ringgit	9	4	42
New Zealand dollar	8	4	10
South Korean won	12	4	66
Indian rupee	17	4	76
Thai baht	10	4	36
Canadian dollar	10	3	10
Singapore dollar	5	3	6
Indonesian rupiah	9	1	138
South African rand	4	–1	58
European euro	3	–1	9
Swiss franc	–9	–3	–13
TWI	**9**	**4**	**31**

Sources: Bloomberg; Thomson Reuters; W/M Reuters



Capital Flows

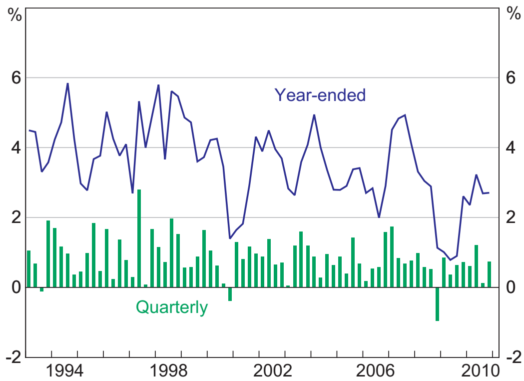
For 2010 as a whole, there was net capital outflow from the private sector (Graph 2.18). With the exception of periods of difficult market conditions in late 2007 and again in late 2008, there has previously been only two quarters of net private capital outflow since at least the late 1980s, when the series began. As discussed elsewhere, this primarily reflects relatively less offshore issuance by Australia's banking sector as it experienced slower asset growth and stronger deposit growth. On the other hand, net foreign investment in government securities was relatively strong in 2010, with net inflows to the public sector equivalent to 4 per cent of GDP over the year.

3. Domestic Economic Conditions

Growth in domestic demand appears to have been solid over recent months, although growth in aggregate production has been significantly affected by the extreme weather conditions in late 2010 and early 2011. The labour market remains strong and recent surveys suggest that business conditions in the overall economy remain positive. The terms of trade are at a record high, which is providing a significant boost to national income at a time when there is a large pipeline of mining investment to be undertaken. Growth in household consumption and borrowing, however, remains relatively subdued, as households continue to save a higher share of income than was the case over the past two decades.

The latest available data for real GDP show growth of 2.7 per cent over the year to December, with nominal income up by 8.8 per cent over the year mainly due to the rise in the terms of trade (Graph 3.1, Table 3.1). More recently, there has been a large decline in output of the mining sector due to the wet weather, which has increased the likelihood of a fall in GDP in the March quarter. Coal production, in particular, has been significantly affected, and the resumption of activity in flooded mines is taking longer than was initially expected (see 'Box B: An Update on the Impact of the Natural Disasters in Queensland'). Production levels should, however, recover over the months ahead, providing a boost to GDP growth in the June and September quarters.

Graph 3.1
GDP Growth



Source: ABS

Table 3.1: Demand and Output Growth
Per cent

	December quarter 2010	Year to December quarter 2010
Domestic final demand	0.3	2.7
– Private demand	0.2	1.6
– Public demand	0.7	6.0
Change in inventories[(a)]	0.8	0.4
GNE	1.1	3.1
Net exports[(a)]	0.0	–0.7
GDP	0.7	2.7
Nominal GDP	1.2	8.8

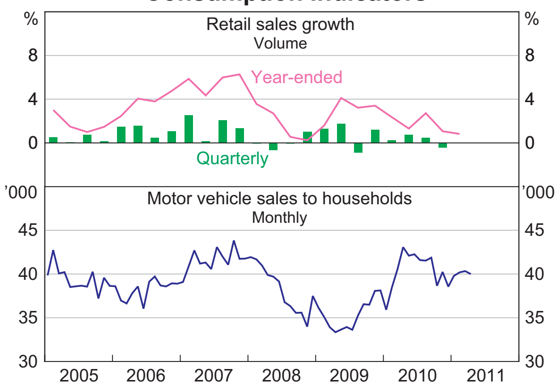
(a) Contribution to GDP growth
Source: ABS

Household Sector

Growth in both household consumption and borrowing remains below the average of the past two decades. The volume of retail sales was flat in the March quarter to be 0.8 per cent higher over the year (Graph 3.2). Retail sales growth in Queensland was stronger than in the rest of the economy in the quarter, driven by sales of household goods, consistent with the replacement of flood-damaged consumer durables. Sales of motor vehicles to households have been somewhat stronger in the first four months of 2011 than in late 2010.

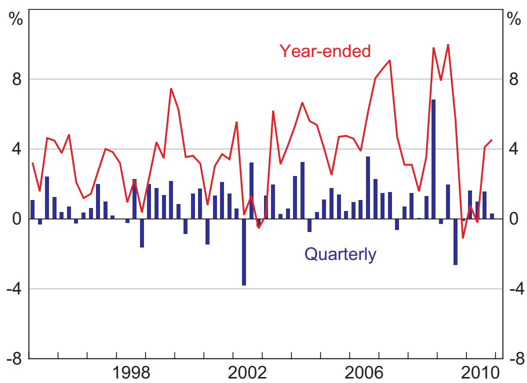
Real household disposable income grew by around 4½ per cent in 2010 – compared with 20-year

Graph 3.2
Consumption Indicators



Sources: ABS; FCAI/VFACTS; RBA

Graph 3.3
Real Household Disposable Income Growth*

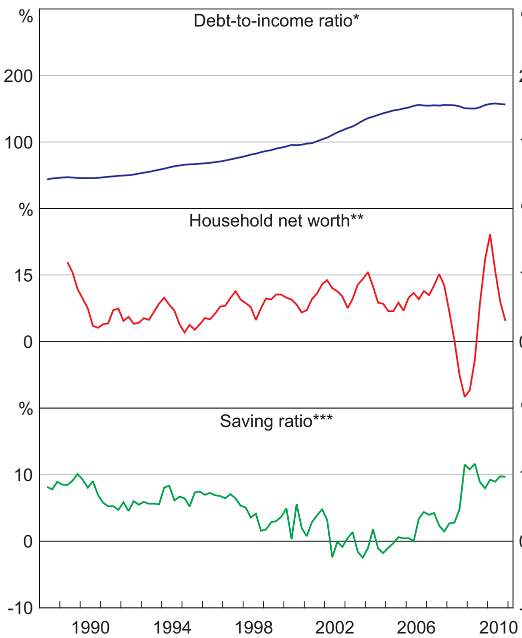


* Household sector includes unincorporated enterprises and is after interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002
Sources: ABS; RBA

average growth of 3¼ per cent – driven by strong labour market outcomes (Graph 3.3). Household net worth increased by 4½ per cent in 2010 and is estimated to have increased by ½ per cent in the March quarter (Graph 3.4). As a ratio to current income, however, household wealth is below the levels of much of the past decade. The household saving ratio remains around 10 per cent, which is its highest level since the late 1980s.

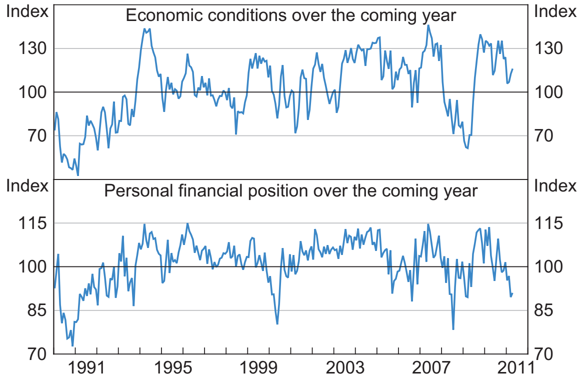
Consumer surveys suggest households continue to be quite optimistic about future economic conditions for Australia as a whole, although they are not as optimistic about their own finances (Graph 3.5). Higher prices for utilities and fuel and higher mortgage interest rates, amongst other things, appear to be weighing on households. In addition, the loss of household wealth during the global financial crisis is likely to have prompted some households to increase their saving to rebuild wealth and consolidate balance sheets. This is being reflected in the marked slowing in the pace of growth

Graph 3.4
Household Debt, Net Worth and Saving



* Debt and income exclude unincorporated enterprises; income is before the deduction of interest payments
** Year-ended percentage change
*** Net of depreciation
Sources: ABS; APM; RBA

Graph 3.5
Consumer Sentiment
Average since 1980 = 100

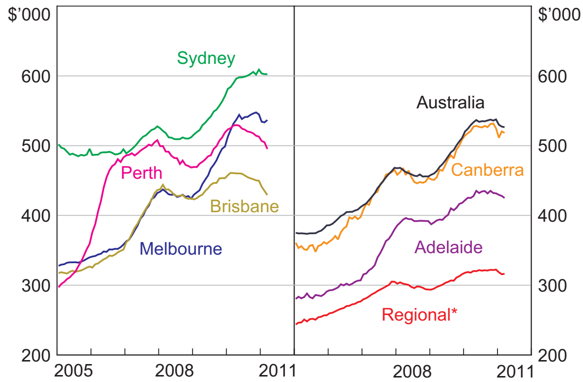


Source: Melbourne Institute and Westpac

in household credit, the stabilisation in the debt-to-income ratio; more households are now well ahead in their mortgage repayments and in paying down credit card debt. The slowing in debt accumulation is consistent with a return of household saving patterns to more traditional norms following the adjustment that took place in the 1990s and early 2000s in response to lower nominal interest rates, and innovation and increased competition in the financial system.

Consistent with the restraint in household spending, the housing market has cooled significantly since early 2010. Nationwide housing prices are estimated to have fallen by around 2 per cent in the March quarter to be slightly lower over the year (Table 3.2). Brisbane and Perth have been the weakest markets, with prices 4–6 per cent lower over the year, while prices in Sydney and Melbourne are broadly unchanged over the year (Graph 3.6). Auction clearance rates, which can provide a timely indicator of housing market conditions, are currently below decade-average levels in Sydney and Melbourne, while the total stock of dwellings listed for sale is relatively high compared with recent years, suggesting that properties are taking longer to sell. Demand for housing finance slowed in the early part of the year, following the increase in mortgage rates in November 2010 and flooding in Queensland and Victoria; loan approvals in February were down by 11 per cent over the year, with investor approvals down a little more than owner-occupier approvals.

Graph 3.6
Dwelling Prices



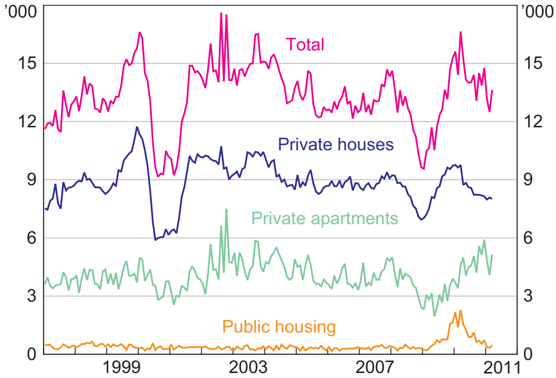
* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia
Sources: RBA; RP Data-Rismark

Table 3.2 National Housing Price Growth
Per cent

	3 months to December 2010	3 months to March 2011	Year to March 2011
Capital cities			
ABS(a) (b)	0.8	–1.7	–0.2
APM	–0.8	–0.2	–0.6
RP Data-Rismark	0.3	–2.1	–0.6
Regional areas			
APM(b)	–1.0	–1.8	–3.1
RP Data-Rismark(a)	0.4	–1.8	–0.5

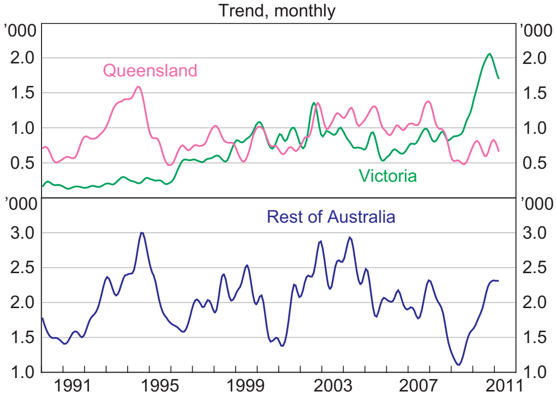
(a) Detached houses only
(b) Quarter-on-quarter growth rate
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 3.7
Residential Building Approvals
Monthly



Source: ABS

Graph 3.8
Private Apartment Approvals
Trend, monthly



Sources: ABS; RBA

Indicators of dwelling investment have softened in early 2011, with disruptions owing to flooding having had some effect on the number of building approvals (Graph 3.7). This was particularly apparent for detached houses, with approvals in Queensland falling by 15 per cent in the March quarter; excluding Queensland, house approvals rose by 1 per cent in the quarter. Apartment approvals fell sharply in the quarter, with a sharp fall in Victoria following a very large run-up through late 2009 and in 2010 (Graph 3.8). Public residential approvals have also fallen further as the impetus from the Social and Defence Housing Initiative has faded. The recent flow of residential approvals implies around 140 000 completions a year, which is below the average level seen over the past two decades.

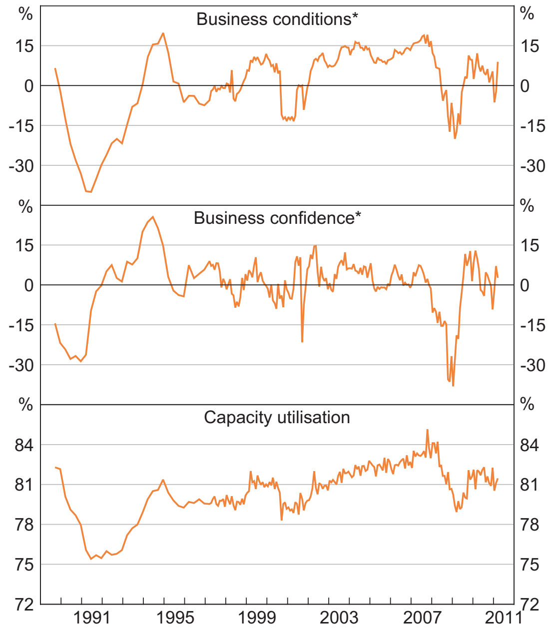
Business Sector

Overall measures of business conditions are around, or modestly above, average levels, although there is significant variation across sectors. Conditions deteriorated sharply in January due to the floods, but have since picked up, and measures of business confidence are at around average levels (Graph 3.9). Not surprisingly, these swings have been largest in Queensland; after the floods disrupted production in January, many businesses are now expecting that the reconstruction activity will boost demand over the months ahead.

Given the various factors currently shaping the Australian economic outlook, business conditions differ significantly across industries. Looking through the weather-related disruptions, the mining sector is growing strongly and the Bank's liaison suggests that engineering construction and service-sector firms exposed to mining and public infrastructure are experiencing strong demand. In contrast, subdued growth in household demand and the unwinding of the construction projects funded by the fiscal stimulus are weighing on firms in retailing and some parts of the building industry. The high Australian dollar also continues to provide a challenging environment for many trade-exposed businesses, including those in the tourism and manufacturing sectors.

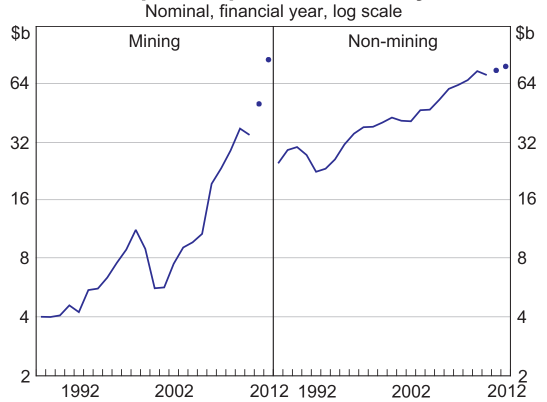
There is a large stock of mining construction in the pipeline, reflecting the high level of commodity prices and the robust outlook for growth in emerging economies in Asia. The ABS capital expenditure survey of firms' spending plans points to large increases in mining sector investment in 2010/11 and 2011/12 (Graph 3.10). A number of

Graph 3.9
NAB Business Survey



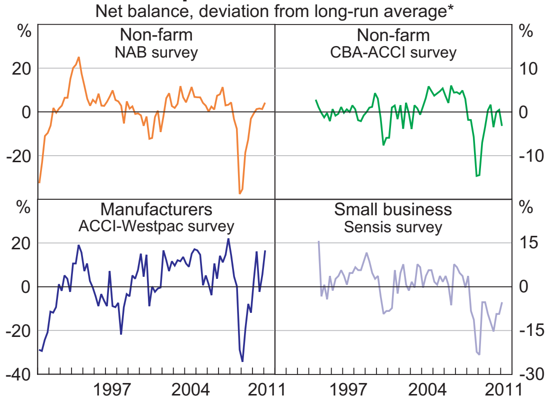
* Net balance; deviation from average since 1989
Sources: NAB; RBA

Graph 3.10
Capital Expenditure Survey*
Nominal, financial year, log scale



* Sample of firms' spending plans; dots represent the survey's most recent estimates for 2010/11 and 2011/12 adjusted for historical realised spend
Sources: ABS; RBA

Graph 3.11
Expected Investment
Net balance, deviation from long-run average*

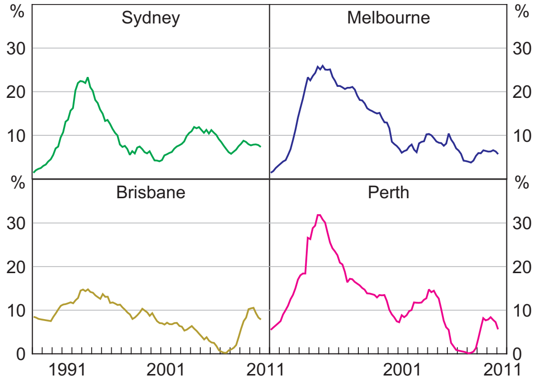


* Deviation from long-run average since 1961 for ACCI-Westpac,1989 for NAB, 1994 for CBA-ACCI and Sensis
Sources: ACCI; CBA; NAB; RBA; Sensis; Westpac

large projects are already underway; the $43 billion Gorgon LNG project is advancing in the construction phase, while construction of the $14 billion Pluto project is now complete with production expected to commence later this year. In recent months, work has begun on two large coal-seam methane to LNG projects in Queensland (Gladstone LNG and Queensland Curtis LNG). Investment plans in the iron ore sector, which accounted for around 17 per cent of the value of exports in 2010, have also progressed significantly over the past year. Over the past six months, Rio Tinto, BHP Billiton and Fortescue Metals have committed to significant expansions in capacity, while other proposed projects, mainly in the Pilbara and Mid West regions of Western Australia are at various stages of planning and design. With this high level of activity in the mining sector, liaison is reporting a pick-up in competition for labour and other inputs, which could delay some projects.

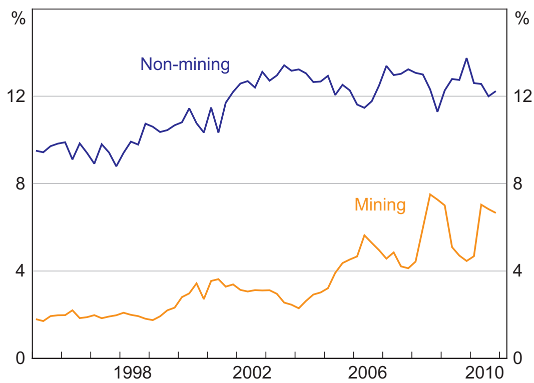
Outside the mining sector, the ABS capital expenditure survey points to modest growth in non-mining investment in 2010/11 and 2011/12. Surveys of investment intentions show a mixed picture, although on balance they suggest around average growth in non-mining investment (Graph 3.11). While the value of non-residential building approvals fell in the March quarter and is significantly lower than pre-downturn levels, the outlook for building appears to have improved. The

Graph 3.12
CBD Office Vacancy Rates



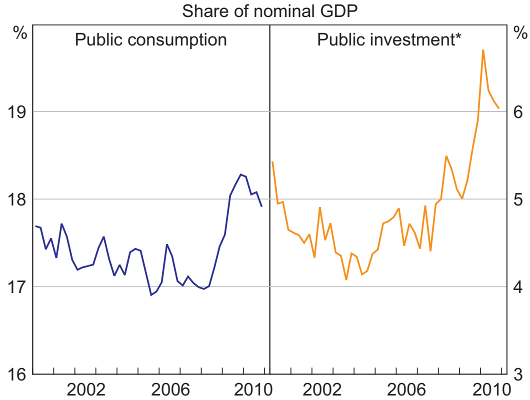
Source: Jones Lang LaSalle

Graph 3.13
Private Non-financial Corporation Profits*
Share of nominal GDP



* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

Graph 3.14
Components of Public Demand
Share of nominal GDP



* Adjusted for second-hand asset transfers between the public and other sectors
Source: ABS

national CBD office vacancy rate has fallen slightly in recent quarters, and more significant falls are expected in Sydney and Melbourne over the next few years, given forecasts of solid increases in office demand and relatively moderate new additions in progress (Graph 3.12).

Company profits rose by around 1 per cent in the December quarter and by 13 per cent over the year. Mining profits fell slightly over the quarter and non-mining profits rose slightly, but in year-ended terms mining profits were up by over 60 per cent while non-mining profits were down by 3 per cent (Graph 3.13). Business balance sheets generally remain in sound shape and many firms are able to use internal sources to fund investment spending; the gearing ratio (the ratio of debt to assets) has continued to decline, to be slightly below its decade average (see also the 'Domestic Financial Markets' chapter).

Government Spending

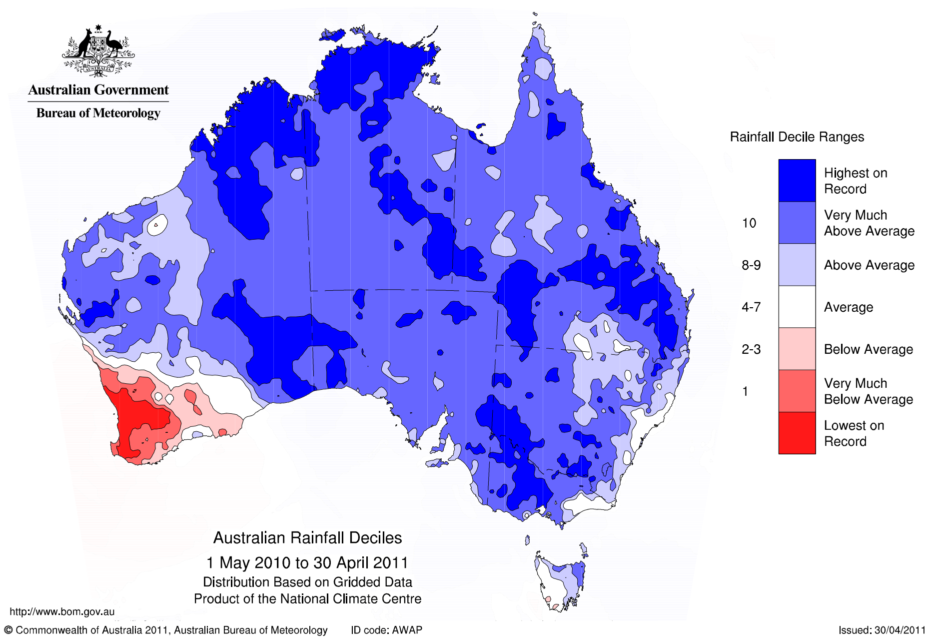
Public demand had been steadily increasing as a share of GDP since around 2005, due to government spending on infrastructure investment and the stimulus-related programs. More recently, however, public investment has been falling as fiscal stimulus projects such as the education-related construction under the Building the Education Revolution program are completed (Graph 3.14). More broadly, with the budget projected to return to surplus over the next few years, the impact of fiscal policy will be contractionary.

Farm Sector

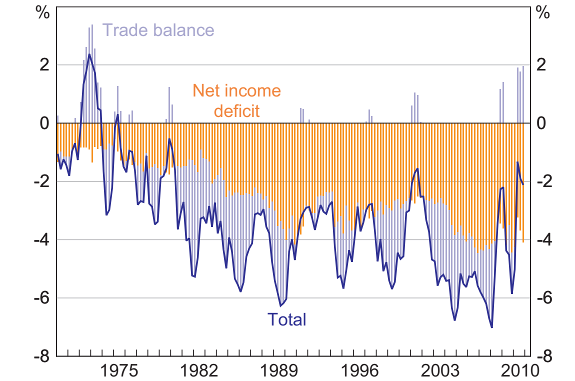
The latest forecasts from rural agencies suggest an increase in farm production of around 8 per cent in 2010/11, including a solid increase in the national wheat harvest to around 26 million tonnes in 2010 from 22 million tonnes in 2009. Offsetting the improvement in the wheat harvest, the flooding in early 2011 across the eastern states has resulted in crop losses in cereals, sugar, fruit and vegetables, cotton and grain sorghum, as well as a significant downgrading in crop quality.

Looking ahead, inflows into the Murray–Darling basin, which contains roughly 40 per cent of the nation's agricultural production, have been at all-time record levels in recent months and non-metropolitan water storages are at their highest levels in a decade. Accordingly, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) suggests that crop production over 2011/12 should benefit from the increased availability of irrigation water and improved subsoil moisture, with farm production expected to increase by 2½ per cent. Given that Australian agricultural exporters are receiving higher prices and anticipating favourable growing conditions, measures of rural confidence have returned to high levels in recent private sector surveys, following a number of years of well-below average readings. However, one notable area of divergence in rural conditions is in the south-west of Western Australia, where drought continues (Graph 3.15).

Graph 3.15
Australian Rainfall
1 May 2010 to 30 April 2011

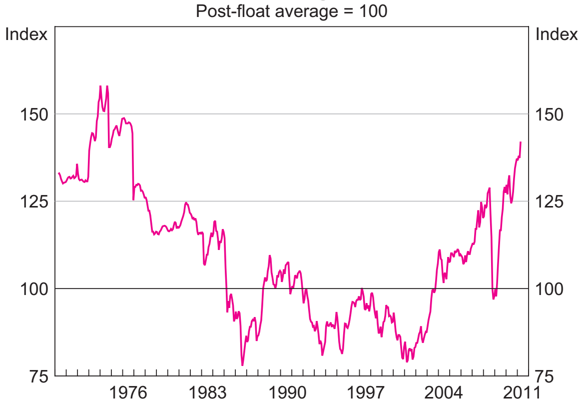


Graph 3.16
Current Account Balance*
Per cent of GDP



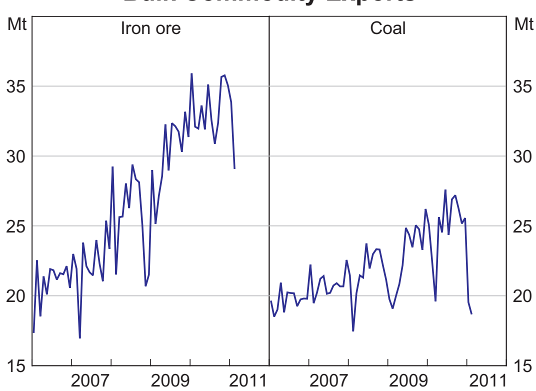
* Excluding RBA gold
Source: ABS

Graph 3.17
Real Exchange Rate*
Post-float average = 100



* Trade-weighted index adjusted for relative price levels
Sources: ABS; RBA; Thomson Reuters

Graph 3.18
Bulk Commodity Exports



Source: ABS

External Sector

The large increases in bulk commodity contract prices have significantly boosted Australia's export revenues, with the trade balance in the December quarter recording its largest surplus as a share of GDP since the early 1970s (Graph 3.16). The current account deficit in the past three quarters averaged 1.8 per cent of GDP, well below the average deficit of 4½ per cent over the preceding decade. The significant increase in contract prices has also contributed to an estimated increase of around 20 per cent in Australia's terms of trade over the year to the March quarter, taking them to around 95 per cent above the average of the 1990s. The large rise in the terms of trade over recent years has led to a significant appreciation of the exchange rate, which in real terms is around the levels of the mid 1970s (Graph 3.17).

Export volumes in early 2011 have been affected by adverse weather events. Coal export volumes fell sharply in January and remained at low levels in February, with exports in the first two months of the quarter around 25 per cent lower than in the December quarter (Graph 3.18). Iron ore exports have been disrupted by a higher-than-usual frequency of cyclones and tropical lows, and were around 11 per cent lower in the first two months of the March quarter. Exports of both commodities are expected to bounce back sharply in coming months, while significant expansions to mine and infrastructure capacity are expected to provide a substantial boost to resource exports in coming years. At the time of writing, there were no data available on the effect of the Japanese earthquake on Australian exports to Japan, although a number of Japanese customers have declared *force majeure*. In 2010, Japan was Australia's second largest merchandise export destination, accounting for nearly one-half of thermal coal exports and one-fifth of iron ore export volumes.

Outside of resources, export growth has been subdued (Graph 3.19). Non-commodity exports fell slightly in the December quarter, with manufacturing and services exports remaining below their pre-crisis peaks. While global demand is strengthening, the relatively high value of the real exchange rate is restraining some non-resource export categories, including tourism. Non-resource export volumes are estimated to be largely flat in the March quarter.

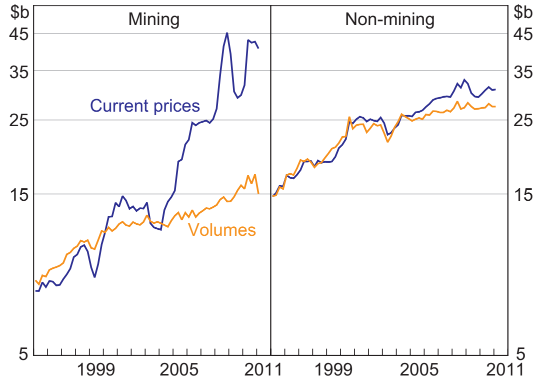
Import volumes are estimated to have grown by ½ per cent in the March quarter to be 7 per cent higher over the year. Imports are expected to grow at a solid pace going forward, due to expected growth in domestic final demand, especially in investment, and as the high exchange rate encourages spending on imports.

Labour Market

Labour market conditions have remained firm over recent months despite some moderation in the pace of headline employment growth from the very strong pace recorded during 2010. Growth in full-time employment has remained strong at around 4 per cent over the year, while part-time employment has been broadly flat after experiencing rapid growth during the initial stage of the recovery from the global slowdown (Graph 3.20). Consistent with the strength in full-time employment, total hours worked have increased more rapidly than employment over the past year, despite a temporary fall in January associated with the Queensland floods.

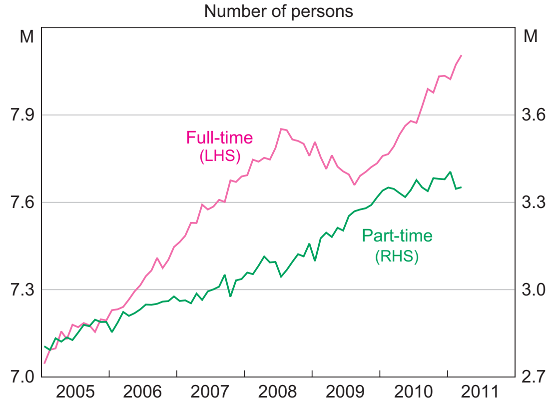
With strong growth in employment, the unemployment rate has drifted lower over the past year, to 4.9 per cent in March, around 1 percentage point below its 2009 peak. The participation rate has remained broadly unchanged over recent months after rising significantly in the June and September quarters of 2010 (Graph 3.21).

Graph 3.19
Exports*
Log scale



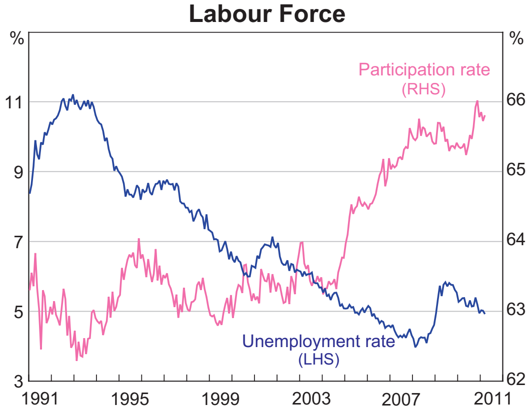
* Volumes data referenced to 2003/04 prices; RBA estimate for the March quarter 2011
Sources: ABS; RBA

Graph 3.20
Employment
Number of persons



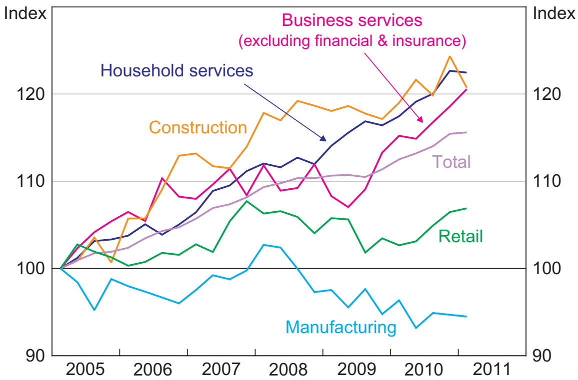
Source: ABS

Graph 3.21
Labour Force



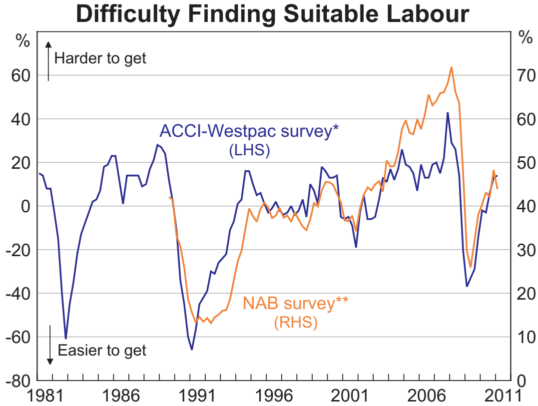
Source: ABS

Graph 3.22
Employment in Selected Industries
February 2005 = 100



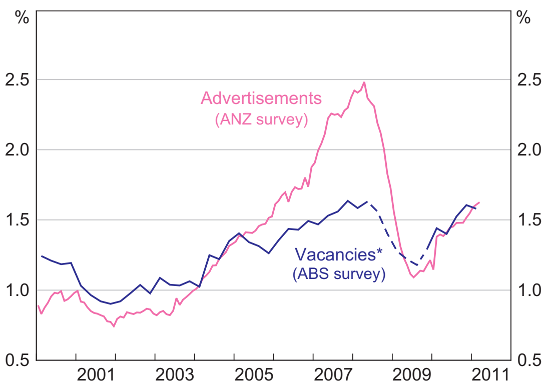
Source: ABS

Graph 3.23
Difficulty Finding Suitable Labour



* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

Graph 3.24
Job Vacancies and Advertisements
Per cent of labour force



* Dashed line represents estimates for August 2008 to August 2009
Sources: ABS; ANZ

Employment growth over the past year has been relatively broad-based across industries, with notable strength in both business and household services (Graph 3.22). Some of the strength in business services employment, particularly in professional, scientific & technical services, is likely related to the expansion of the resources sector. Although construction employment eased in the March quarter, it remains at a relatively high level and is expected to grow strongly in the period ahead given the large pipeline of planned engineering activity in the resources sector. Direct employment in the mining and utilities industries, which account for relatively small shares of total employment (less than 2 per cent each), has grown by around 15 per cent over the past year.

Despite relatively soft retail activity, employment in the retail sector has increased over the past year, although it remains slightly below the peak seen in 2007. Within manufacturing, employment in mining-related firms is receiving a boost from the expansion of the resources sector, while more trade-exposed parts of the sector are contracting under pressure from the high level of the exchange rate.

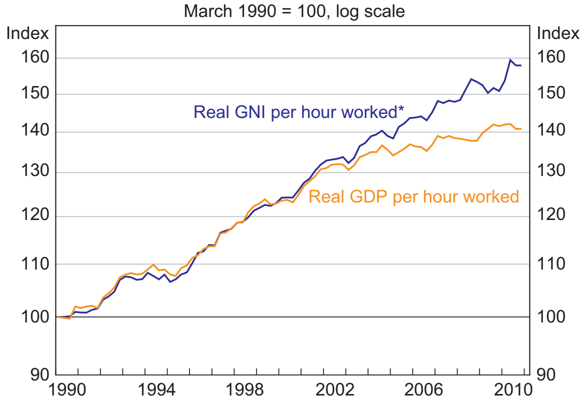
Consistent with the official data, business surveys and liaison indicate that labour market conditions have continued to gradually tighten, but at this stage skill shortages generally remain localised in mining-related industries and some other skilled occupations (Graph 3.23). Leading indicators of labour demand continue to point to solid employment growth, although at a more moderate pace than in the latter part of 2010. The ABS measure of vacancies fell slightly as a share of the labour force in the three months to February, but nevertheless is at a high level (Graph 3.24). More recent data from ANZ indicates that job advertisements increased further in March. At an industry level, the pick-up in vacancies as a proportion of industry employment has been most pronounced for those sectors generally reporting strong employment growth over the past year, particularly mining, construction and business services.

The growth in employment and total hours worked since mid 2010 has been strong relative to the observed increase in output, with the result that estimated growth in labour productivity has been weak. More generally, growth in productivity has been subdued for a number of years, particularly relative to the high productivity period in the 1990s (Graph 3.25). Over the past decade, output per hour worked has grown by an average of 1.2 per cent per year, compared with 2.1 per cent over the preceding decade. However, growth in real incomes over the past decade has been held up by the rise in the terms of trade over this period.

Graph 3.25

Productivity and Income

March 1990 = 100, log scale



* Real GDP adjusted for the purchasing power of changes in the terms of trade and income accruing to foreigners

Source: ABS

Box B

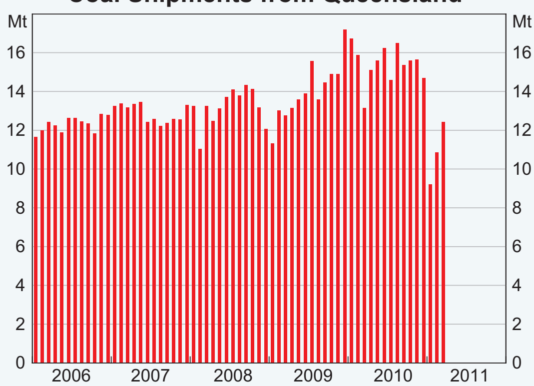
An Update on the Impact of the Natural Disasters in Queensland

Queensland is recovering from the severe rains and flooding across much of the state in late 2010/early 2011 and the damage caused by Cyclone Yasi in early February. While information is still incomplete, this box provides an update on the impact of these events on economic activity and inflation.

Impact on Economic Activity

As foreshadowed in the February *Statement*, the largest impact on activity from the rainfall has been the disruption to coal production in Queensland, which provides almost two-thirds of Australia's coal exports. It now looks likely that the loss to coal production will be somewhat larger than the 25 million tonnes estimated in February. Coal production fell sharply in the month of December and was significantly affected through the March quarter. While exports initially held up in December as inventories were run down, they fell sharply in January. The level of coal shipments recovered somewhat in February and March, although it remains well down on its pre-flood level (Graph B1).

Graph B1
Coal Shipments from Queensland*



* Seasonally adjusted by RBA
Sources: port authorities; RBA

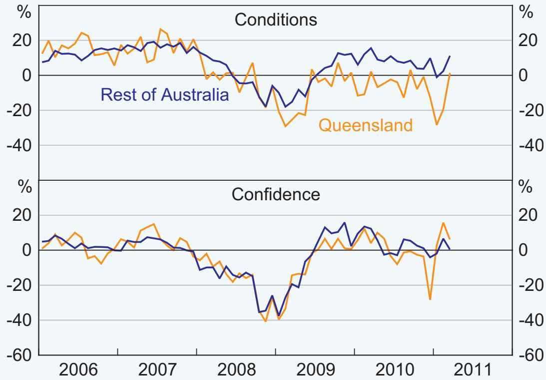
Coal production continues to be constrained by flooded pits, with many of the state's coal mines working below full capacity and a number of miners yet to remove their declarations of *force majeure*. Coal stocks remain depleted and rail and port operators report significant spare capacity. Since December, 68 Transitional Environmental Programs have been issued in Queensland authorising the removal of flood waters from mines (a process known as 'de-watering'), subject to environmental conditions. These conditions have constrained the amount of de-watering that has occurred to date as river stream levels have fallen (high stream levels are required to prevent the build-up of pollutants in the environment). Additional rainfall across the Bowen Basin has also slowed the recovery in the level of coal production. As a result, coal production is now expected to remain below normal levels until well into the June quarter. RBA staff estimates suggest that the fall in coal production subtracted up to ½ percentage point from GDP growth in the December quarter and will have subtracted an additional ¾ to 1 percentage point from growth in the March quarter, a larger impact than had been expected in February. Coal production is, however, expected to add significantly to GDP growth in the June and September quarters as production levels continue to recover.

The agricultural and tourism sectors have also been significantly affected. Losses to agricultural production, as calculated by rural agencies, are in the order of $2 billion. Losses have been particularly concentrated in the sugar cane, cotton and banana industries. In regard to the tourism sector, Australian Government estimates suggest that the recent natural disasters will result in a loss of around $400 million in activity.

The weather events resulted in disruptions to other economic activity as well, although much of this was temporary. Housing loans – both for new and existing dwellings – fell sharply in Queensland in January and remained low in February. There was also a sharp fall in building approvals for new houses in Queensland in the March quarter. In contrast, retail sales in Queensland rose by 0.7 per cent in the March quarter while sales in the rest of Australia were broadly flat. Queensland sales of household goods – which include furniture, floor coverings, homewares and electronic goods – rose particularly strongly in the quarter, consistent with the replacement of consumer durables damaged by flooding. Such replacement spending would have been supported by payments to households from a number of sources that have already been disbursed, including $745 million in the 646 000 Australian Government Disaster Recovery Payments made so far, $825 million paid on 118 000 insurance claims to date (including payments to businesses), and disbursements of $58 million from the Premier's Disaster Relief Appeal that has raised $252 million.

The temporary nature of much of the interruptions to business activity in Queensland is also apparent in the NAB business survey, which showed an initial sharp fall in business conditions in early January but a subsequent bounce-back in business conditions and especially in confidence (Graph B2). These results suggest that many businesses anticipate a pick-up in activity associated with repair and rebuilding. A supplementary question in the survey taken in late January indicated that business activity had returned to pre-flood levels for more than half of the affected firms, while more than three-quarters of firms expected that their activity would have fully recovered within three months of the survey's date.

Graph B2
NAB Business Survey*



* Net balance; deviation from average since 1989
Sources: NAB; RBA

The extent of the damage to the stock of private dwellings and public infrastructure from the natural disasters has become clearer over time. According to the Queensland Reconstruction Authority report released in late April, around 7 600 residential properties were severely affected, with at least 3 300 homes needing to be completely rebuilt and an additional 1 700 needing to be vacated in order to be repaired. Much public infrastructure in Queensland was also damaged and rebuilding and repair spending is under way. The restoration of essential services has largely been completed: virtually all affected homes and businesses have had power restored, and the affected water supply schemes and sewerage treatment plants have now mostly returned to operation. Of the 411 schools affected across Queensland, only one continues to operate from a temporary location. The state's main rail systems have reopened following the restoration of the Western Rail Line (three months earlier than scheduled), and all the state's ports are operating following the resumption of shipping in March at the Port of Bundaberg. Much of the total public repair spending is expected to be on the road network.

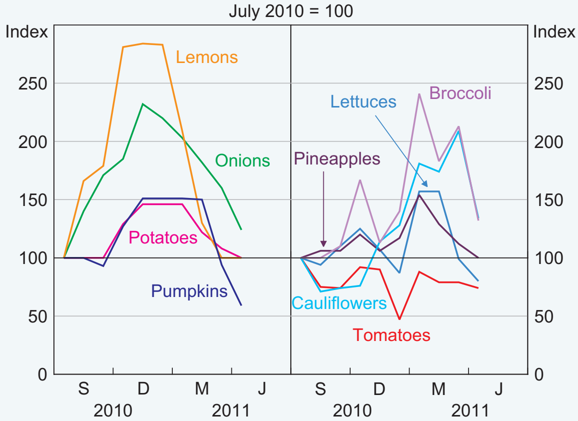
According to the Reconstruction Authority, around one-quarter of the state road network was damaged and, while work in this area is also underway, around one-third of the affected roads are yet to be restored to former speeds and legal load limits.

Looking ahead, the remaining rebuilding of damaged private and public assets is expected to provide a modest boost to activity. The Queensland Government expects the overall public reconstruction effort associated with the floods will eventually reach \$5 billion, with damage to public infrastructure associated with Cyclone Yasi estimated at an additional \$0.8 billion. Under the Natural Disaster Relief and Recovery Arrangements, the Federal Government will fund around \$4.4 billion of this total damage cost. Both the Federal and State Governments have indicated that they will review spending priorities and reduce other planned infrastructure spending to fund part of this work. Taking all these factors into account, net additional private and public spending – with quite a high share of the latter likely to be offset by delays to other planned spending – will provide a mild boost to overall activity in the next couple of years. Liaison suggests much of the housing reconstruction task can be accommodated by the Queensland construction industry, given existing spare capacity.

Impact on the Consumer Price Index

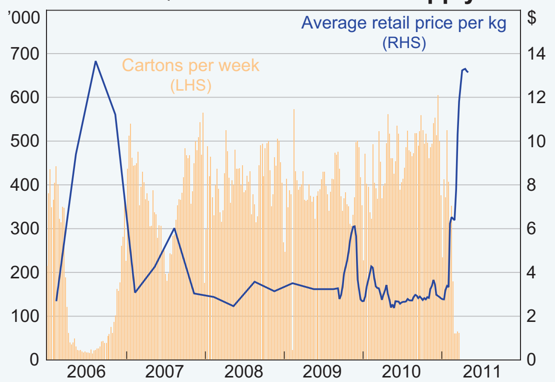
As had been expected, the Queensland floods and Cyclone Yasi have led to a temporary increase in food prices, primarily due to their effect on some fruit and vegetable crops. Prior to these events, wet weather had put upward pressure on fruit and vegetable prices in the December quarter. The floods had an additional effect on the prices of a range of vegetables in the March quarter, with Cyclone Yasi also raising the price of bananas in the quarter.

Graph B3
Wholesale Fruit and Vegetable Prices*
July 2010 = 100



* Prices are for Melbourne Wholesale Markets
Sources: Datafresh; RBA

Graph B4
North Queensland Banana Supply*



* Selected areas
Sources: ABS; Australian Banana Growers' Council Inc; RBA

More timely wholesale fruit and vegetable price data indicate that supply pressures for many fruit and vegetables affected by the poor weather conditions have since eased, with the notable exception of bananas (Graphs B3 and B4). Wholesale prices for a range of fruit and vegetables (including potatoes, pumpkins, lettuce and pineapples), which spiked during the December and March quarters, had returned by April to around or below pre-flood levels. For many of these crops, the ready availability of alternative sources or short production cycles has meant that the price impact of the adverse weather events has been relatively short.

In contrast, since bananas have a comparatively long production cycle and cannot be imported, the supply impact will be more prolonged. The supply of bananas from areas in North Queensland has fallen sharply as a result of Cyclone Yasi, to around 15 per cent of normal levels; the fall is, however, expected to be slightly smaller than that following Cyclone Larry in 2006. Supply is not expected to start to recover until the second half of this year, and prices have risen sharply from February. While banana prices appear to have stabilised in recent weeks, in quarterly average terms they are likely to add further to food price inflation in the June quarter, before returning to their pre-cyclone level by around the end of this year.

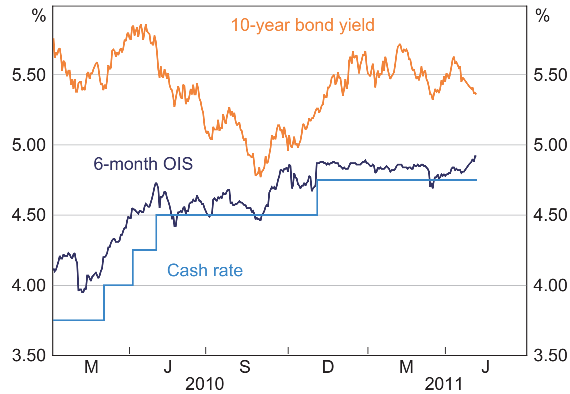
4. Domestic Financial Markets

Money and Bond Markets

The Reserve Bank has maintained the target for the overnight cash rate at 4.75 per cent since November last year (Graph 4.1). Money market yields declined in March reflecting concerns about nuclear security in Japan, but subsequently increased as the concerns were allayed and following the publication of the March quarter inflation data. Market yields currently indicate an expectation of a higher cash rate towards the end of the year. In addition, credit spreads have narrowed: the spread between 3-month bank bills and the overnight indexed swap (OIS) rate has fallen to around 10 basis points, close to its pre-crisis level and well below its peak of just over 100 basis points in late 2008.

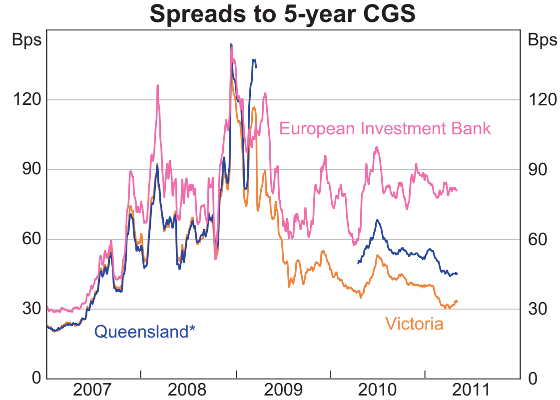
Long-term bond yields are currently towards the bottom half of a 50 basis point range that has existed for the past six months. Daily movements in yields since the previous *Statement* have largely been influenced by offshore developments, and the spread to US Treasuries has remained a little over 200 basis points over the past few months. The spreads of highly rated domestic debt securities have narrowed, with some semi-government debt now trading around the narrowest spreads to Commonwealth Government Securities (CGS) since the financial crisis began (Graph 4.2). In contrast, spreads on supranational debt remain wider, particularly for debt issued by European-based institutions.

Graph 4.1
Interest Rates



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

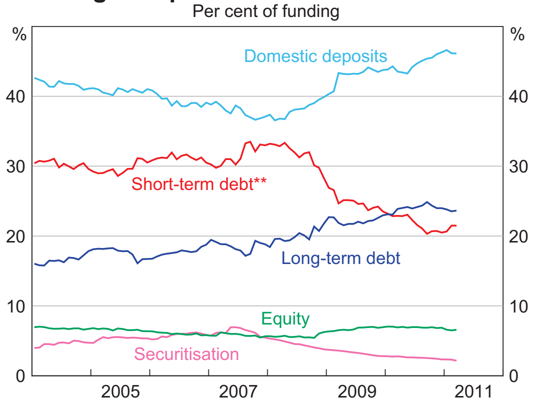
Graph 4.2
Spreads to 5-year CGS



* From March 2009 to April 2010 all debt of this maturity was guaranteed by the Australian Government.

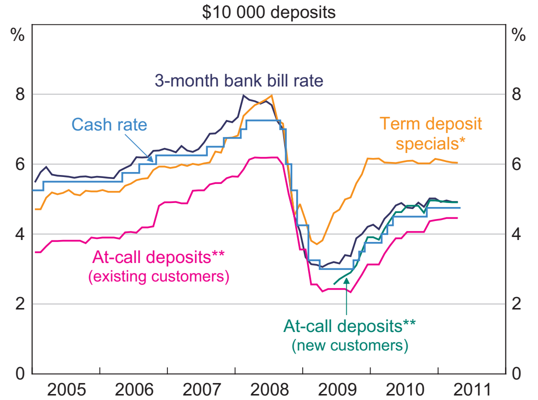
Sources: RBA; Yieldbroker

Graph 4.3
Funding Composition of Banks in Australia*
Per cent of funding



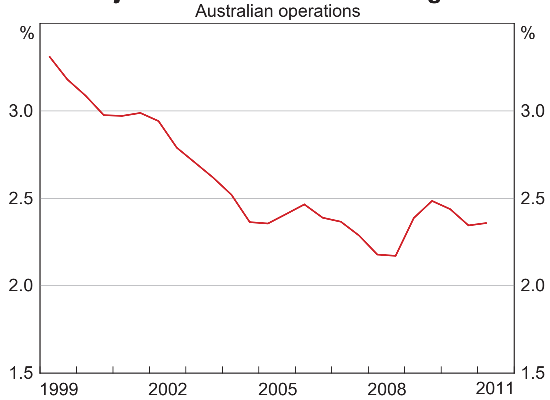
* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.4
Deposit Rates
$10 000 deposits



* Average of 1–12, 24-, 36- and 60-month terms at the major banks
** Average of online, bonus and cash management accounts at the major banks
Source: RBA

Graph 4.5
Major Banks' Net Interest Margin*
Australian operations



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis; data exclude St. George Bank and Bankwest prior to 2009
Sources: RBA; banks' financial reports

Financial Intermediaries

After a significant shift in the composition of bank liabilities over the past two years, funding shares have stabilised over recent months (Graph 4.3). Short-term debt continues to account for a significantly smaller share of funding than it did previously, with deposits and longer-term wholesale funding accounting for a larger share.

There has been little movement in interest rates on deposits over recent months as the intense competition for deposits has abated somewhat. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) is currently about 4½ per cent (Graph 4.4). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, is just over 6 per cent, having stabilised at just under 100 basis points above equivalent duration market rates. On average, the smaller Australian-owned banks' 'special' term deposit rates are at similar levels to those offered by the major banks.

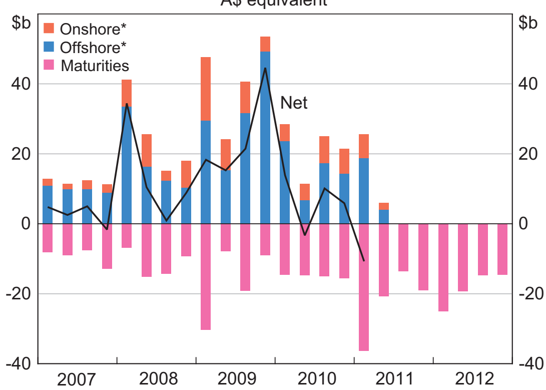
While the average cost of major banks' variable-rate bond funding continues to gradually rise, as bonds issued pre-crisis are rolled over at higher spreads, this process has mostly run its course. As there was also a rise in average interest rates on loans following the November cash rate increase, the major banks reported, on average, little change in their net interest margins in the first half of their 2011 financial years (Graph 4.5). Overall, margins have fluctuated in a relatively narrow range since 2004.

Australian major banks have issued around $20 billion worth of bonds since the previous *Statement*, with much of the proceeds being used to roll over maturities in the March quarter of around $36 billion (Graph 4.6). Over the remainder of 2011, maturities are expected to average around $18 billion per quarter. Over two-thirds of Australian major bank issuance was offshore, predominantly in the US dollar and euro markets. The banks tapped a range of maturities spanning one to seven year terms, reflecting ongoing efforts to lengthen the maturity of their funding. The recent declines in cross-currency basis swap spreads, due in part to the large volume of Kangaroo bond issuance in the March quarter (see below), have increased the attractiveness of issuing offshore for Australian banks (Graph 4.7).

In the domestic market, the cost of bank bond issuance, as measured by the spread of domestically issued bank bonds to swap, has been steady since the previous *Statement* (Graph 4.8). The announcement by Moody's in February that it had placed Australia's four major banks on review for a possible downgrade, reflecting ongoing changes to its ratings methodology, had no effect on the market.

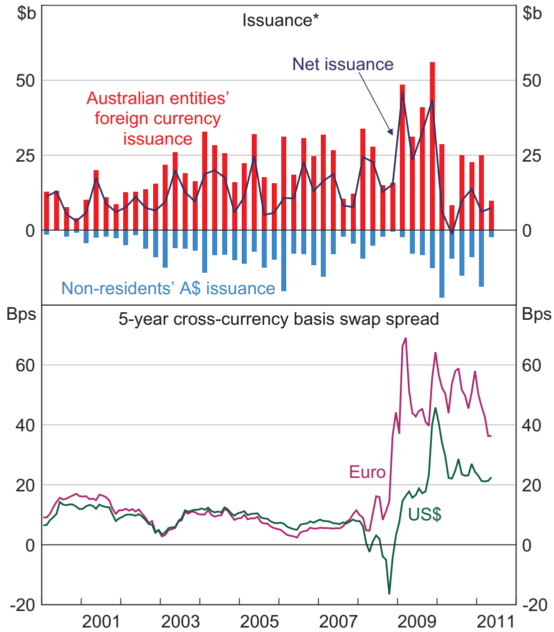
Activity in the securitisation market has picked up in recent months. Since the February *Statement*, issuance of Australian residential mortgage-backed securities (RMBS) has totalled around $8 billion, representing eight transactions from seven issuers comprising major and smaller banks, a non-ADI

Graph 4.6
Major Banks' Bond Issuance
A$ equivalent



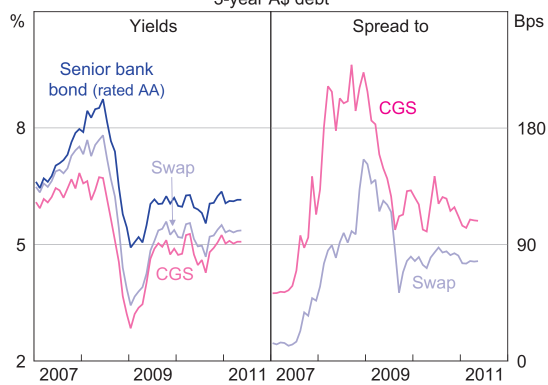
* Latest quarter issuance to date
Source: RBA

Graph 4.7
Bond Issuance and the Cross-currency Basis Swap Spread



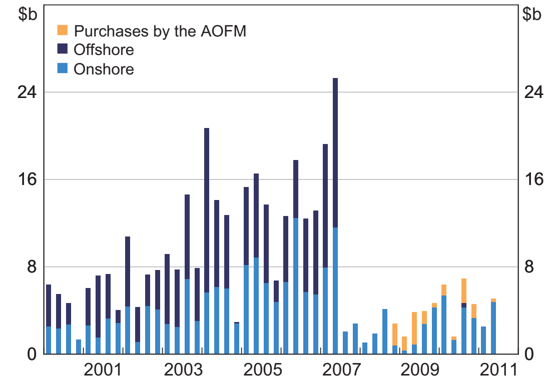
* Latest quarter issuance to date
Sources: Bloomberg; RBA

Graph 4.8
Major Banks' Bond Pricing
3-year A$ debt



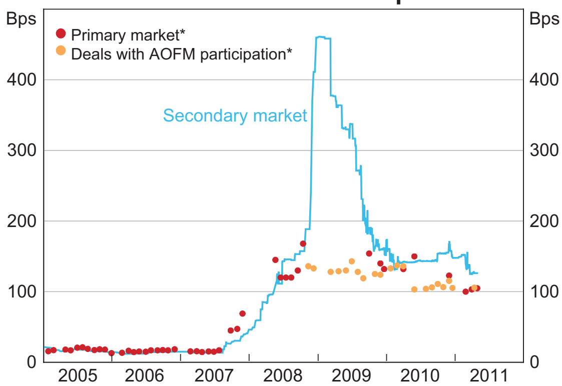
Sources: RBA; UBS AG, Australia Branch

Graph 4.9
Australian RMBS Issuance*
A$ equivalent



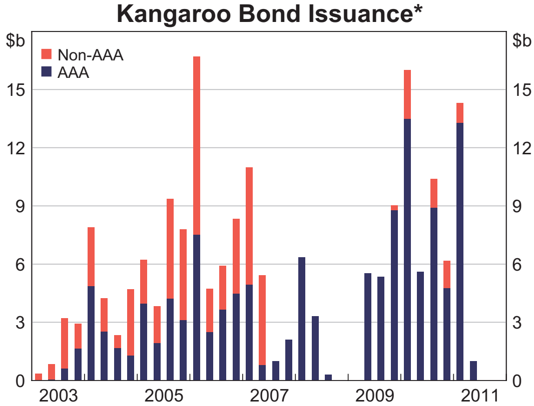
* Latest quarter issuance to date
Source: RBA

Graph 4.10
AAA-rated Prime RMBS Spreads



* Primary market spreads are face-value weighted monthly averages of AAA-rated RMBS with conservative average LVRs and low-doc loans.
Sources: RBA; Royal Bank of Scotland

Graph 4.11
Kangaroo Bond Issuance*



* Latest quarter issuance to date
Source: RBA

issuer and a credit union (Graph 4.9). A $3 billion issue by the Commonwealth Bank was the largest securitisation since 2007. It was issued at the lowest average weighted spread in over two years; the most senior tranche was issued with a spread of 95 basis points. The increase in demand for newly issued prime RMBS reflects a significant reduction in supply in the secondary market and more generally in the stock of outstanding RMBS. Secondary market RMBS spreads have declined to a post financial crisis low of around 125 basis points (Graph 4.10).

Private investor demand has been strong for longer-dated RMBS tranches, allowing the Australian Office of Financial Management (AOFM) to scale back its involvement to zero in some issues. The Treasurer recently announced that the AOFM will have a further $4 billion to invest in AAA-rated Australian RMBS, taking the total amount the AOFM is permitted to invest in Australian RMBS from non-major banks to $20 billion. To date, the AOFM has invested $12.8 billion across 45 transactions, supporting 19 issuers.

The Australian Government has also released draft legislation that will enable Australian ADIs to issue covered bonds. After a period of consultation with industry, the legislation will be introduced to Parliament later this year. The proposed legislation sets a limit on the value of the cover pool of assets of 8 per cent of an ADI's Australian assets and modifies the depositor preference provisions of the *Banking Act 1959*.

In April, Moody's placed 56 tranches of 25 Australian RMBS transactions totalling around $6.5 billion on review for a possible downgrade of their credit ratings. Following recent adjustments to its methodology, Moody's judged that the liquidity support in these transactions could be insufficient to mitigate the risks of payment disruptions to RMBS investors. The review, which is expected to take three months, will take into account any strengthening of liquidity support arrangements that the issuers of the RMBS put in place during that time.

Kangaroo bond issuance was particularly strong in the March quarter, totalling $14 billion (Graph 4.11).

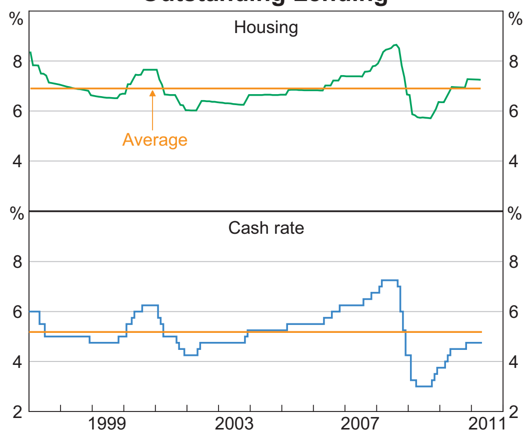
A significant share of this was issued by sovereign and supranational agencies from Europe, which tend to be most active at the start of the year to fund their balance sheets. Two new AAA-rated issuers have entered the market since the start of 2011.

Household Financing

Most lenders have left their indicator rates on standard variable-rate housing loans unchanged in recent months. Fixed rates were also little changed. However, competition in the mortgage market has picked up this year. In particular, the major banks have increased the discounts available on some mortgage products by as much as 20 basis points, and have waived some fees or offered new mortgage products with no fees (Table 4.1). Furthermore, some of the major banks have temporarily offered to pay the costs incurred by other institutions' customers in switching to one of their mortgage products. There has also been an increase in the maximum loan-to-valuation ratios lenders are willing to offer on loans to new customers, although this follows reductions in 2008 and 2009.

Overall, the average interest rate on all outstanding housing loans (fixed and variable) remains a little above its post-1996 average, having risen by around 155 basis points since its trough in 2009 (Graph 4.12).

Graph 4.12
Average Interest Rates on Outstanding Lending



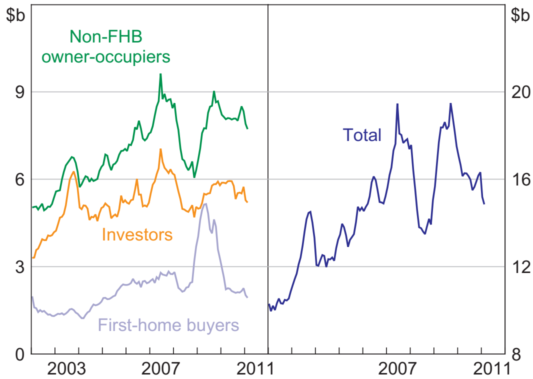
Sources: ABS; APRA; Perpetual; RBA

Table 4.1: Intermediaries' Lending Rates[(a)]
Per cent

	Level at end April 2011	Change since: February *Statement*	End April 2010
Cash rate	4.75	0.00	0.50
Housing loans[(b)]	7.09	–0.06	0.59
Personal loans	12.89	–0.01	0.65
Small business			
Residentially secured			
– Term loans	8.99	0.00	0.65
– Overdraft	9.86	0.00	0.65
Average actual rate	8.82	0.00	0.48
Large business			
Average actual rate (variable and bill funding)	6.97	–0.10	0.63

(a) Variable interest rates unless otherwise indicated
(b) Average of the major banks' discounted package rates on $250 000 full-doc loans
Sources: ABS; APRA; Perpetual; RBA

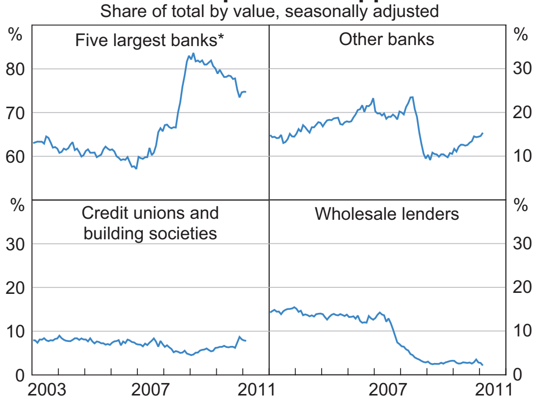
Graph 4.13
Value of Housing Loan Approvals*



* Excludes owner-occupier refinancing, alterations and additions, investor approvals for new construction and by 'other' investors

Sources: ABS; RBA

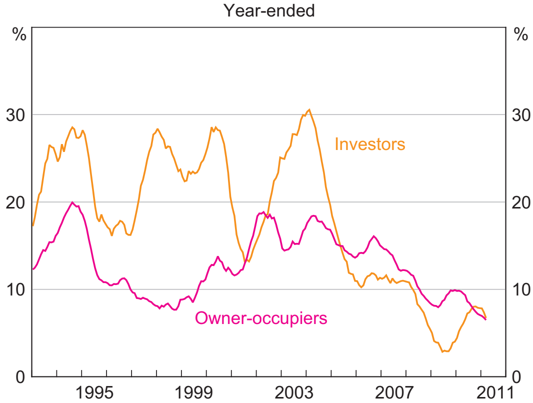
Graph 4.14
Owner-occupier Loan Approvals
Share of total by value, seasonally adjusted



* Includes Bankwest from December 2008

Sources: ABS; APRA; RBA

Graph 4.15
Housing Credit Growth
Year-ended



Source: RBA

The total value of housing loan approvals declined over the first two months of the year, with a reduction in approvals to both owner-occupiers and investors (Graph 4.13); the level of total approvals is now similar to that seen in late 2008. Bank liaison suggests that approvals may have fallen further in March. Some of the recent weakness in loan approvals appears to be due to the effects of flooding in the eastern states.

The recent decline in owner-occupier lending activity has been fairly broad-based across types of lenders. Over a longer period, the share of new lending by the major banks has fallen by 9 percentage points from its peak in early 2009, while the share of the regional and foreign banks has increased by 6 percentage points (Graph 4.14).

Housing credit growth has continued at a monthly average pace of 0.5 per cent in the March quarter with a similar pace of lending to investors and owner-occupiers (Graph 4.15). The level of loan approvals implies a continuation of credit growth for housing at around its current pace.

Most interest rates on variable personal loans – including credit cards, home equity loans and margin loans – have remained unchanged since the end of January. Personal credit, which is a small component of household credit, rose at a monthly average rate of 0.3 per cent over the March quarter. The modest growth in recent months was largely due to increased credit card lending, while other personal lending has been broadly unchanged. The value of margin lending outstanding remains around 10½ per cent lower over the year. Margin calls remain low (at less than one call per day per 1 000 clients), reflecting low gearing levels.

Business Financing

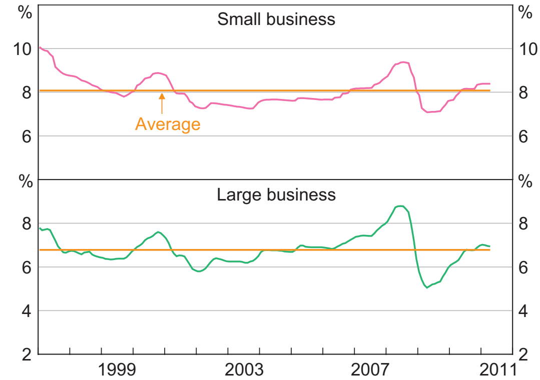
Indicator rates on most small business loans are little changed since the previous *Statement*. The average rate on outstanding small business loans remains about 30 basis points above its post-1996 average (Graph 4.16). The average interest rate on banks' outstanding variable-rate lending to large business (bill and term facilities of $2 million or more) is estimated to have decreased by 10 basis points since the end of January. These loans are repriced at regular intervals off money market benchmark rates (such as the 3-month bank bill rate), which have decreased slightly in recent months. The average risk margin that banks charge above these benchmark rates appears to have stabilised, as margins on new loans have moved closer to the average margin on existing loans.

In recent months, corporate bond activity has picked up considerably (Graph 4.17), as conditions have become more favourable for corporate debt funding in a range of markets, especially the US dollar market where the bulk of recent Australian corporate issuance has taken place. A broad range of Australian companies have issued bonds for terms of between 5 and 10 years in the US dollar market, providing them with access to long-term funding, which is more difficult to obtain in the domestic corporate bond market. In the domestic market, there has also been a pick-up in investor demand for corporate debt with bonds being issued with terms of up to 5½ years and priced at narrower spreads than was the case last year.

Business net external funding rose as a share of GDP in the March quarter, largely reflecting a recovery in business credit, which grew at an annualised rate of around 7 per cent over the quarter (Graph 4.18). On the other hand, equity issuance was more subdued, with corporates raising around $5 billion of net equity in the first quarter, compared with around $9 billion in the previous quarter.

Graph 4.16

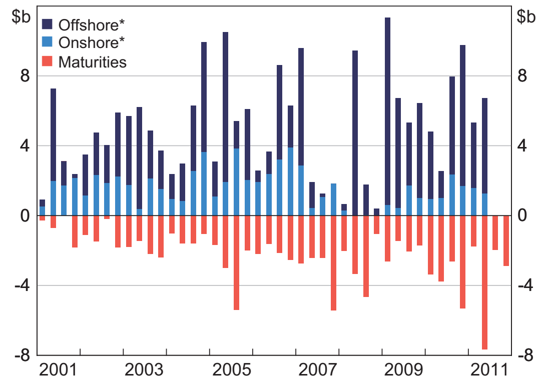
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

Graph 4.17

Australian Corporates' Bond Issuance



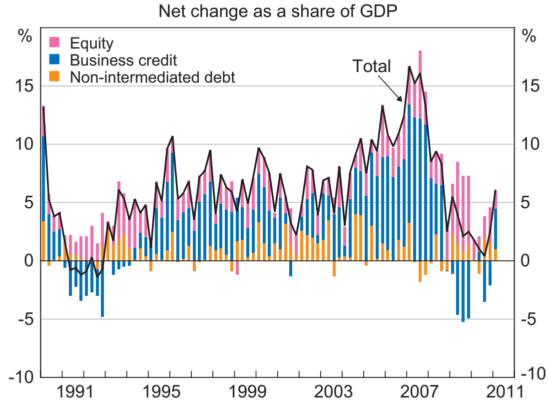
* Latest quarter issuance to date

Source: RBA

Graph 4.18

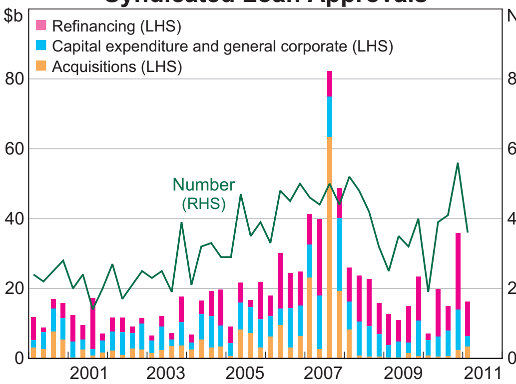
Business External Funding

Net change as a share of GDP



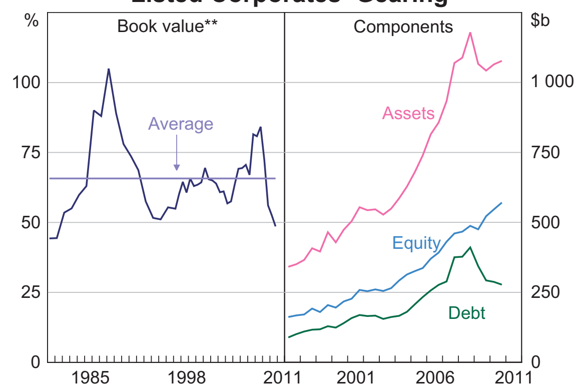
Sources: ABS; ASX; Austraclear Limited; RBA

Graph 4.19
Syndicated Loan Approvals



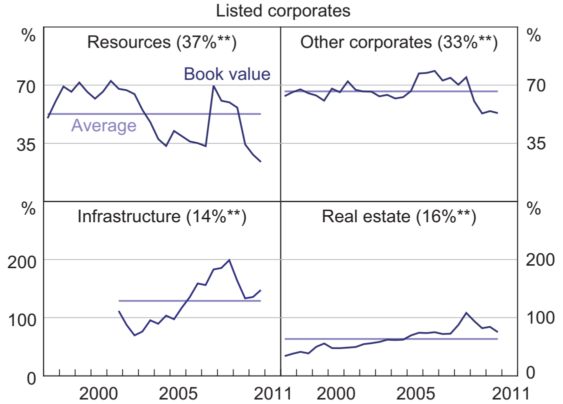
Sources: RBA; Thomson Reuters

Graph 4.20
Listed Corporates' Gearing*



* Excludes foreign-domiciled companies
** Data from 1997 includes real estate companies
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

Graph 4.21
Gearing Ratios by Sector*
Listed corporates



* Excludes foreign-domiciled companies
** Sectoral share of listed corporates' total assets
Sources: Bloomberg; Morningstar; RBA

There were 36 syndicated loan deals worth around $16 billion approved in the March quarter (Graph 4.19). While this is a significant fall from the December quarter 2010, the March quarter is traditionally the slowest of the year, and approvals were more than double their level in the March quarter 2010.

Reflecting the recent subdued pace of borrowing, there was only a marginal expansion of listed corporates' balance sheets in the second half of 2010 and gearing ratios reached cyclical lows (Graph 4.20). Book value gearing – the ratio of debt to the book value of shareholders' equity – declined to 49 per cent, the lowest level since the early 1980s. Repeating the pattern seen in the first half of 2010, the decline in gearing in the second half of the year was driven by both higher retained profits and lower debt.

Resource companies, which continue to enjoy significant increases in both profits and retained earnings, experienced the sharpest reduction in gearing and were influential in driving down the aggregate level of gearing (Graph 4.21). Real estate companies also continued to reduce their gearing, which is around 30 percentage points lower than the peak of 108 per cent in December 2008.

Aggregate Credit

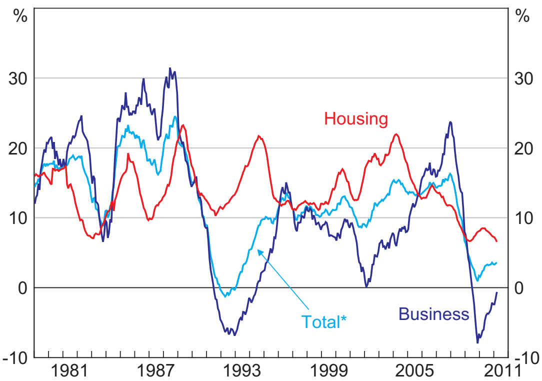
Total outstanding credit grew at an annualised rate of around 6 per cent over the March quarter, reflecting moderate growth in household credit and a solid increase in lending to businesses. The recent growth in business credit follows falls throughout the latter half of 2010 (Table 4.2; Graph 4.22). Broad money has grown at about the same pace as the nominal economy over the year, partly reflecting a preference to hold assets in the form of deposits.

Table 4.2: Financial Aggregates
Percentage change

	Average monthly growth		Year to March 2011
	December quarter 2010	March quarter 2011	
Total credit	0.2	0.5	3.6
– Owner-occupier housing	0.6	0.5	6.5
– Investor housing	0.5	0.4	6.7
– Personal	0.0	0.3	1.0
– Business	–0.4	0.6	–0.6
Broad money	0.7	0.6	7.6

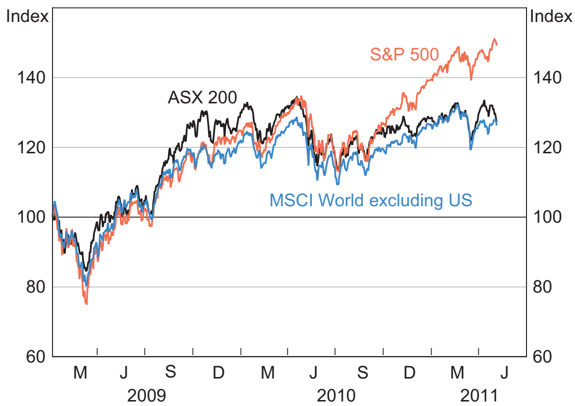
Source: RBA

Graph 4.22
Credit Growth
Year-ended



* Includes housing, personal and business credit
Source: RBA

Graph 4.23
Share Price Indices
End December 2008 = 100



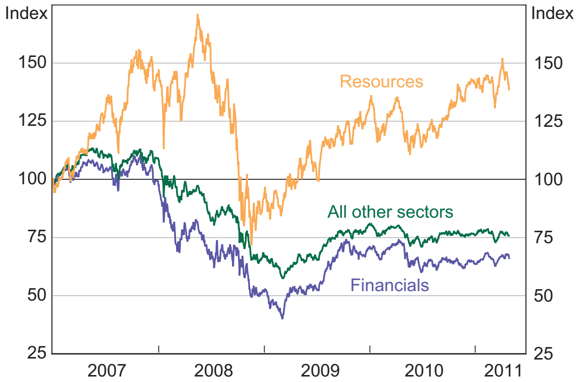
Sources: Bloomberg; Thomson Reuters

Equity Markets

Both the local and offshore equity markets fell sharply in response to the natural catastrophes in Japan (Graph 4.23). After recovering all of its decline, the Australian equity market has trended downwards, in part due to the appreciation of the Australian dollar and notwithstanding the fact that profits announced by Australian listed companies during the recent reporting season were, on average, close to market expectations. Underlying profits – which exclude asset revaluations and other significant items – rose 34 per cent compared with the corresponding period in 2009, to $52 billion.

Resource stocks outperformed other sectors to reach levels last seen in mid 2008, although they have subsequently retreated owing to concerns about the impact of extreme weather on production in the Australian mining sector (Graph 4.24). Earnings for resource companies increased by 39 per cent from

Graph 4.24
Australian Share Price Indices
End December 2006 = 100



Sources: Bloomberg; RBA

the first half of 2010 and contributed the most to the aggregate increase in profits, representing around 50 per cent of total market earnings. This increase was mainly driven by higher commodity prices.

The non-bank financial sector reported a 47 per cent increase in profits, driven mainly by the real estate investment trust and insurance sectors. Apart from resource and financial companies, other companies reported a 36 per cent rise in profits, although this partly reflects seasonal factors. Compared with earnings in the second half of 2009, other companies' profits rose just 2 per cent.

For the first half of the 2011 financial year, the major banks reported that underlying, after-tax profits were 9 per cent higher than the first half of the 2010 financial year at $11 billion. The banks' underlying, after-tax return on equity rose by 0.3 percentage points to 15 per cent, reflecting a further reduction in bad and doubtful debt expenses. Profits were also supported by modest balance sheet growth.

Shareholder distributions for the market as a whole rose sharply in the most recent half compared with the previous period, largely owing to share buybacks by BHP and Rio Tinto.

Since the previous *Statement*, just over $13 billion worth of merger and acquisition deals were announced. AMP's $13 billion acquisition of AXA Asia Pacific proceeded in early April. Other large deals announced include a $4 billion tie up between West Australian Newspapers and Seven Media Group, and BHP's purchase of Chesapeake Energy's gas-producing assets in Arkansas, United States, for $5 billion. Around $27 billion of deals are pending. However, Singapore Stock Exchange's $8.3 billion proposed merger with the ASX was formally rejected by the Federal Treasurer on the recommendation from the Foreign Investment Review Board that the proposal was not in the national interest.

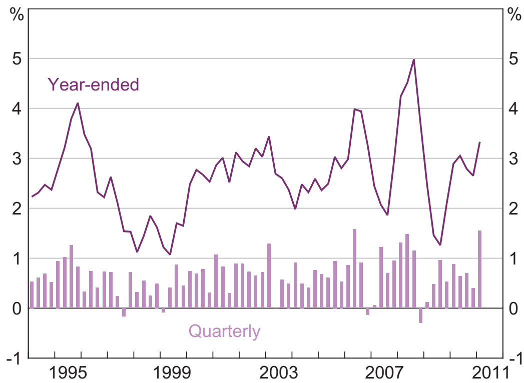
5. Price and Wage Developments

Recent Developments in Inflation

Headline consumer price inflation picked up significantly in the March quarter. The quarterly increase was quite high relative to outcomes over the inflation-targeting period, with significant increases in the prices of fruit, vegetables and fuel.

The consumer price index (CPI) increased by 1.6 per cent in the March quarter, to be 3.3 per cent higher over the year (Graph 5.1, Table 5.1). Prices for fruit and vegetables rose by 15 per cent in the quarter, a consequence of the earlier extreme weather conditions. Automotive fuel prices rose by 9 per cent due to higher global oil prices, partly as a result of geopolitical developments in North Africa and the

Graph 5.1
Consumer Price Inflation*



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

Table 5.1: Measures of Consumer Price Inflation
Per cent

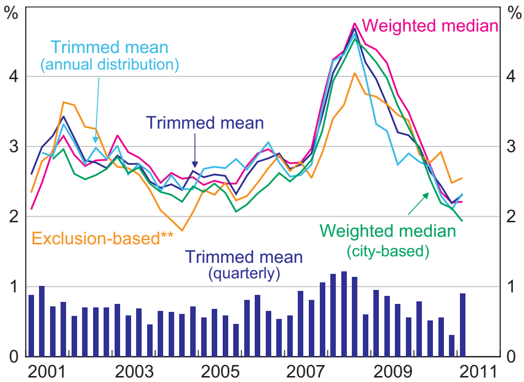
	Quarterly		Year-ended	
	December quarter 2010	March quarter 2011	December quarter 2010	March quarter 2011
CPI	0.4	1.6	2.7	3.3
– Tradables	0.3	1.8	1.6	3.3
– Tradables (excl food, fuel and tobacco)	–1.2	–0.6	–2.0	–1.6
– Non-tradables (excl deposit & loan facilities)	0.6	1.1	3.5	3.3
Selected underlying measures				
Trimmed mean	0.3	0.9	2.2	2.3
Weighted median	0.5	0.8	2.2	2.2
CPI excl volatile items[(a)] and deposit & loan facilities	0.1	0.7	2.5	2.6

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

Middle East. There was also a 4½ per cent increase in the estimated price of deposit & loan facilities, a 5 per cent increase in electricity prices, and large seasonal increases in the prices of education and health services. Offsetting these rises, the prices of many imported retail goods continued to decline, although generally by less than in the previous quarter.

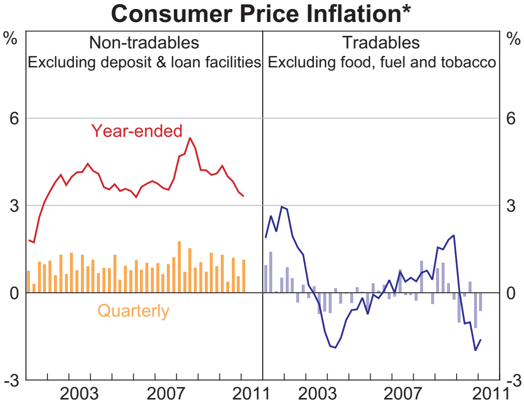
Based on a range of measures, year-ended underlying inflation is estimated to have been around 2¼ per cent, well below the headline rate of inflation (Graph 5.2). Underlying inflation now appears to have troughed in the lower half of the

Graph 5.2
Consumer Price Inflation*



* Adjusted for the tax changes of 1999–2000
** Excludes fruit, vegetables, automotive fuel and deposit & loan facilities
Sources: ABS; RBA

Graph 5.3
Consumer Price Inflation*



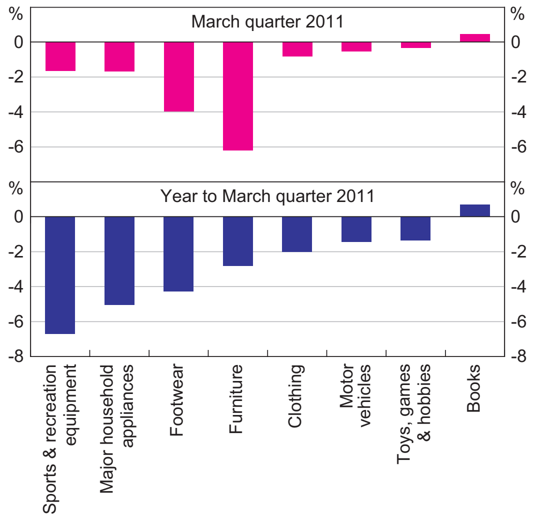
* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

target range, a significant fall from the peak of a little over 4½ per cent in 2008. Quarterly underlying inflation is estimated to have been around 0.8 per cent in the March quarter. While this was a little higher than expected, it followed an unexpectedly low outcome in the December quarter.

Inflation in non-tradable items (excluding deposit & loan facilities) was 1.1 per cent in the March quarter, partly reflecting seasonal increases in education and some health services prices (Graph 5.3). There were significant increases in housing costs including rents, electricity and house purchase costs in the quarter. These increases were partly offset by falls in domestic tourism prices, where the high exchange rate is resulting in some discounting, and by falls in milk prices due to competition amongst major retailers. The year-ended rate of non-tradables inflation eased further to 3.3 per cent, which is 2 percentage points below its peak in 2008. Looking ahead, recent regulatory announcements on electricity pricing indicate that inflation in utilities prices will remain relatively high over the next year. In addition, there are some early signs of upstream pressures in construction costs which may add to house purchase costs, and rents can be expected to pick up further given the tightness of the rental market. More generally, the gradual tightening in the labour market is expected to contribute to a pick-up in inflation in the prices of various household services.

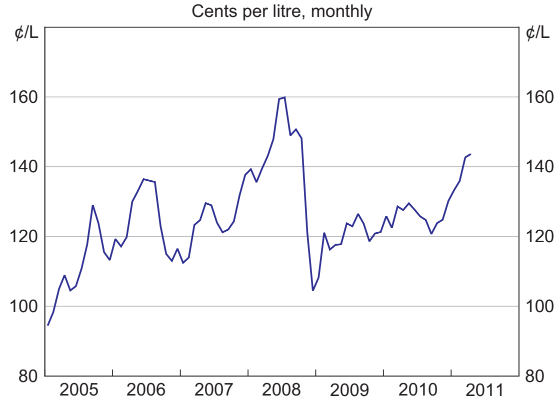
The prices of many tradable items continued to decline in the March quarter, albeit by somewhat less than in the previous quarter. In aggregate, excluding food, fuel and tobacco, tradables prices fell by 0.6 per cent in the quarter and by 1.6 per cent over the year. There were broad-based price declines across a range of items over the year, especially in audio, visual & computing equipment (–19½ per cent), footwear (–4¼ per cent), major household appliances (–5 per cent) and furniture (–2¾ per cent), as well as clothing and motor vehicles (Graph 5.4). These falls reflect the ongoing pass-through of the exchange rate appreciation and discounting by retailers. While the further appreciation of the

Graph 5.4
Inflation in Consumer Durables



Source: ABS

Graph 5.5
Retail Petrol Prices
Cents per litre, monthly



Sources: Australian Institute of Petroleum; FUELtrac; RBA

exchange rate in recent weeks is likely to continue to exert downward pressure on tradables prices in coming quarters, this will be somewhat offset by rising inflation in global manufactures prices.

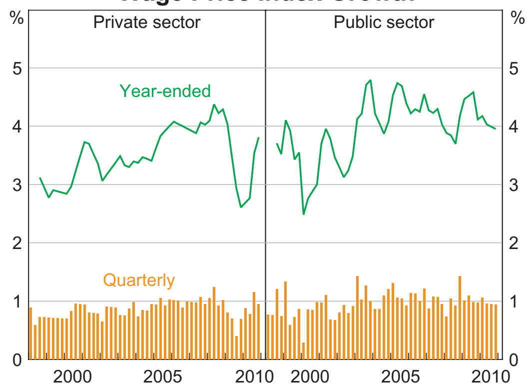
Food prices rose by 2.9 per cent in the March quarter and by 4.3 per cent over the year. The pick-up in food price inflation, from less than 1 per cent a year ago, mostly reflects large increases in the prices of fruit and vegetables: excluding the latter, year-ended food price inflation was 1.5 per cent, with falls in the prices of some general grocery items, including milk. The pick-up in fruit and vegetable prices, which rose by 15 per cent in the March quarter, following an increase of 13 per cent in the December quarter, is the result of the Queensland and Victorian floods and Cyclone Yasi. Bananas were particularly affected, with prices doubling in the quarter and likely to have increased further in the June quarter. However, the increases in fruit and vegetable prices are likely to be temporary and are expected to be largely unwound as supply returns to normal over coming quarters. There is some evidence in wholesale price data that the prices of some crops affected by the floods, such as potatoes and broccoli, have already declined significantly (see 'Box B: An Update on the Impact of the Natural Disasters in Queensland').

Automotive fuel prices rose by nearly 9 per cent in the quarter – the largest quarterly increase since June 2007 – and contributed 0.3 percentage points to headline inflation (Graph 5.5). As noted in 'Box A: Commodity Prices and Global Inflation', fuel prices in Australia have risen by less than in many other countries, with the appreciation of the exchange rate partly offsetting the significant increase in world oil prices.

Costs

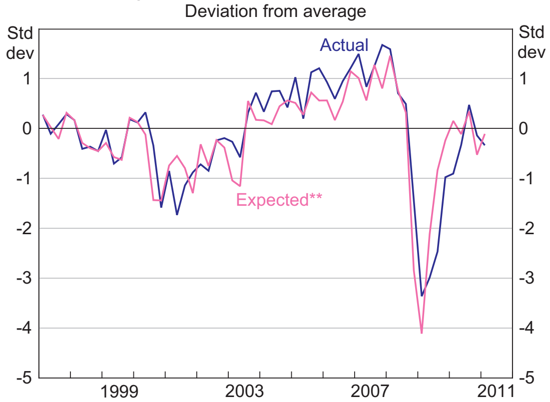
Growth in average labour costs has picked up from the low outcomes seen in 2009, in line with the tightening in the labour market. The wage price index rose by 1 per cent in the December quarter, to be 3.9 per cent higher over 2010; this was a little above the average rate since the series began in 1997. The rise in wage growth reflects a pick-up in private-sector wage growth, with public-sector wage growth – which was relatively unaffected by the economic slowdown – moderating slightly over

Graph 5.6
Wage Price Index Growth



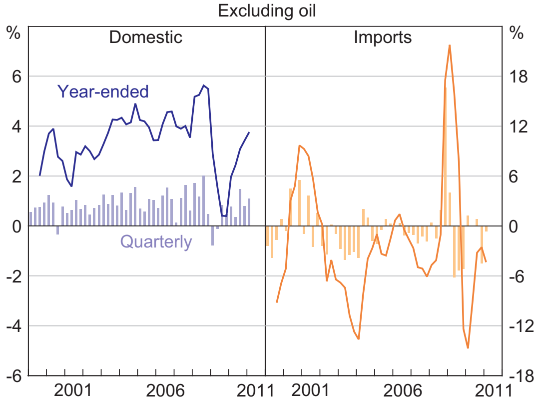
Source: ABS

Graph 5.7
Surveys of Business Labour Costs*
Deviation from average



* Weighted average of data from various business surveys since 1994, with weights calculated by the RBA using the principal component method
** Expectation for following quarter
Sources: CBA-ACCI; NAB; RBA; Sensis

Graph 5.8
Final Stage Producer Price Inflation
Excluding oil



Sources: ABS; RBA

2010 (Graph 5.6). Growth over 2010 was strongest in Queensland and Western Australia. The highest outcomes were recorded in the utilities industry, followed by the mining and professional, scientific & technical services industries, with the strength in these industries partly related to the growth of the resources sector. More broadly, liaison points to variation in wage outcomes, with quite large increases in specialised occupations in some industries and reasonably subdued growth for lower-skilled employees in other industries.

As discussed in the 'Domestic Economic Conditions' chapter, there has been a gradual tightening in the labour market, with half of the 2008–2009 increase in the unemployment rate having been unwound and the ABS measure of the vacancy rate back to high levels. In general, however, most firms are not reporting significant difficulties finding suitable labour, with the exception of a few skilled professions and occupations, typically linked to the mining sector. Business surveys and the Bank's liaison suggest that labour cost pressures remained around average in the March quarter (Graph 5.7).

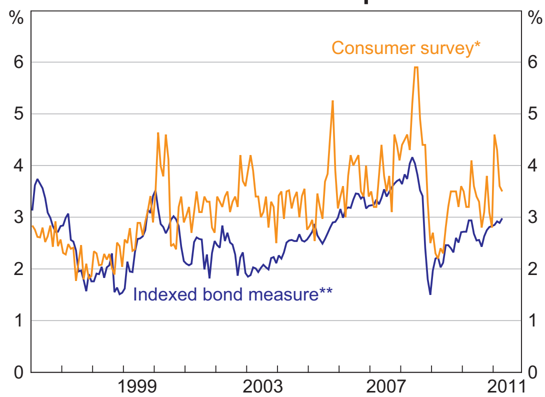
Estimated labour productivity growth was weak over 2010, following fairly strong growth over 2009. In combination with rising wage growth, this weakness in productivity implies that growth in labour costs per unit of output was relatively high over 2010, following low growth over 2009.

Producer price data suggest some strengthening in upstream price pressures in the March quarter, particularly in the earlier stages of production. Final-stage producer prices (excluding oil) rose by 2.7 per cent over the year to March, while preliminary prices (excluding oil) rose by 4.4 per cent over the year (Graph 5.8). The pick-up in producer price inflation was driven by solid rises in domestically produced goods and services, most notably food and utilities. Import prices continued to subtract from final stage producer price inflation.

Inflation Expectations

Developments in inflation expectations over recent months have been influenced by the anticipated effects of the floods and Cyclone Yasi. The Melbourne Institute's measure of consumer inflation expectations, which rose sharply in January following the floods, has eased in the past couple of months to be a little above its inflation-targeting period average (Graph 5.9). Financial market indicators of longer-term inflation expectations have risen modestly over recent months, with the indexed bond measure also slightly above the average for the inflation-targeting period. The inflation expectations of market economists and union officials for 2011 and 2012 are broadly unchanged from three months ago at around the top of the target range, with a slight moderation expected in 2012 (Table 5.2). Somewhat in contrast, business survey measures of expected selling prices in the near term remain around or below average levels; this may partly reflect the deflationary influence of the high exchange rate on many manufactured goods prices. ✠

Graph 5.9
Indicators of Inflation Expectations



* Median expectation of average annual inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
Sources: Melbourne Institute of Applied Economic and Social Research; RBA

Table 5.2: Median Inflation Expectations
Per cent

	Year to December 2011			Year to December 2012	
	November 2010	February 2011	May 2011	February 2011	May 2011
Market economists(a)	3.2	3.3	3.3	3.1	3.1
Union officials(b)	3.0	3.2	3.3	3.2	3.1

(a) RBA survey
(b) Workplace Research Centre

6. Economic Outlook

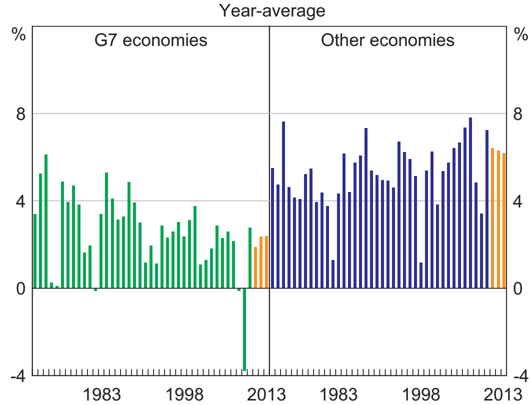
The International Economy

The global economy is expected to grow at an above-average pace over the next few years, albeit somewhat slower than the pace seen earlier in the recovery. The central scenario is for world output to expand by around 4½ per cent in 2011, 2012 and 2013, consistent with forecasts from the International Monetary Fund. The aggregate forecast for 2011 is unchanged from the February *Statement*, with a downward revision to the outlook for Japan following the earthquake and tsunami offset by upward revisions to other countries in Asia and Latin America (Graph 6.1). With above-average growth forecast for the next few years and commodity prices already elevated, one key risk to growth relates to a possible acceleration of global inflation and the subsequent monetary policy responses.

Graph 6.1

Global GDP Growth*

Year-average



* Australia's major trading partners; weighted using output shares at market exchange rates

Sources: CEIC; IMF; RBA; Thomson Reuters

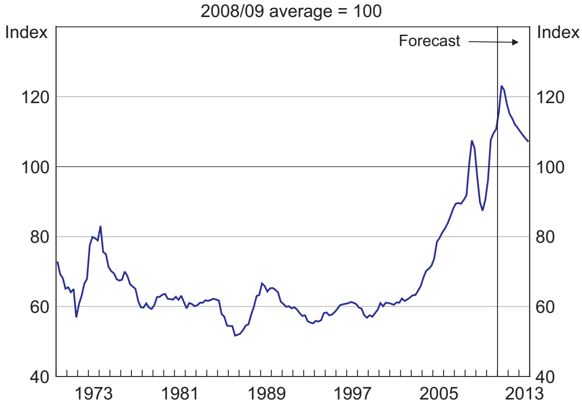
Global commodity prices have increased sharply since mid 2010, reflecting strong demand, particularly from the emerging economies of Asia, as well as some supply disruptions. Global food prices are now back around the peak levels they were at in mid 2008, reflecting the ongoing increase in per capita incomes in developing countries and the resulting changes in food consumption patterns, as well as weather-related disturbances that have affected production of some agricultural commodities. Industrial production in China and other emerging markets continues to grow at a rapid pace, while production in advanced economies, except for Japan, is also expanding. This is contributing to upward pressure on the prices of raw materials such as base metals, coal and iron ore. Oil prices have also increased sharply in recent months, and the price of gold has recently reached a record high in nominal terms. While the strength in commodity prices primarily reflects strong global demand, for some economies it can be viewed as an adverse supply shock and is having a negative impact on real household incomes.

The increases in commodity prices, including the effect of the Queensland floods on coking coal production, are being reflected in a further increase in Australia's terms of trade, which are expected to rise to a new peak in the June quarter (Graph 6.2). The terms of trade are forecast to then gradually

Graph 6.2

Terms of Trade

2008/09 average = 100



Sources: ABS; RBA

decline as the effects of weather-related disruptions to rural and coal production fade and more global capacity in iron ore and coal comes on line. Overall, there has been an upward revision to the forecast of the terms of trade, with the terms of trade expected to remain at historically high levels over the next few years: the forecasts imply that the terms of trade in 2011/12 will be at their highest level since at least 1870 (when the data begin).

Domestic Activity

The medium-term outlook for the economy continues to be dominated by the expected build-up in mining investment and the boost to incomes from the high terms of trade. Providing a partial offset to these factors, monetary policy is mildly restrictive, the exchange rate has appreciated substantially and fiscal policy will be contractionary over the next couple of years. Nevertheless, inflationary pressures are expected to build gradually over the forecast period as spare capacity is absorbed and the labour market continues to tighten. The risks around the forecasts are discussed below.

Extreme-weather events are likely to have resulted in a decline in GDP in the March quarter. This effect is larger than had been expected at the time of the February *Statement*, mainly reflecting a larger-than-expected loss of coal production in the March quarter due to problems in removing water from flooded coal pits. Iron ore exports are also estimated to have declined in the March quarter as adverse weather (a greater than usual number of cyclones and tropical lows) disrupted port activity. However, these effects are expected to be temporary, with the anticipated recovery in production providing a boost to GDP growth over the rest of 2011.

As usual, the domestic forecasts have been prepared under the technical assumption that the cash rate moves broadly in line with market pricing; this implies an increase in the cash rate of ¼ percentage point by early 2012 and a further ¼ percentage point increase by mid 2013, a slower rise than suggested by the forecasts of market economists. The exchange rate is assumed to remain at its current level over the forecast horizon (TWI at 78, A$ at US$1.07, which is an appreciation of around 5 per cent and 7 per cent respectively since the February *Statement*). The assumption for the Tapis oil price – which is the most relevant for Australian fuel prices – is 22 per cent higher than in February at US$126.

The updated central forecasts are summarised in Table 6.1. Taking into account the expected decline in GDP in the March quarter and the subsequent expected rebound as production of coal and iron ore recovers, growth over 2011 is forecast at 4¼ per cent. The forecasts for 2012 and 2013 have been revised down slightly, mostly reflecting the effects outside the mining sector of the appreciation of the exchange rate, although growth is expected to remain at an above-average pace over this period. In year-average terms, GDP is expected to grow by 2½ per cent in 2010/11, 4½ per cent in 2011/12 (reflecting the base effect of the impact of floods in 2011) and 3¾ per cent in 2012/13.

Mining investment is expected to rise from around 4 per cent of GDP in 2009/10 to over 6 per cent in 2012/13, with a number of large projects already underway. Non-mining investment is expected to expand more moderately over the forecast period,

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended						
	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013
GDP growth	2.7	2½	4¼	4¼	3¾	3¾	3¾
Non-farm GDP growth	2.1	2½	4½	4	3¾	3¾	3¾
CPI inflation	2.7	3½	3¼	2½	3	3	3¼
Underlying inflation	2¼	2½	3	3	3	3	3¼
	Year-average						
	2010	2010/11	2011	2011/12	2012	2012/13	2013
GDP growth	2.7	2½	3¼	4½	4¼	3¾	3¾

(a) Technical assumptions include A$ at US$1.07, TWI at 78 and Tapis crude oil price at US$126 per barrel
Sources: ABS; RBA

remaining largely constant as a share of GDP. While private-sector surveys point to an increase in investment intentions in some sectors and the ABS capital expenditure survey suggests building activity should pick up in 2011/12, the high exchange rate, tight credit conditions for some borrowers and subdued consumer spending are weighing on conditions.

Households remain cautious in their spending behaviour, despite strong labour income growth and consumer sentiment being modestly above average levels. While income growth is expected to be solid over the next few years, the central forecast assumes that the household saving ratio remains at around its current level, reflecting above-average interest rates, some residual uncertainty stemming from the global financial crisis, and a desire for some further consolidation of balance sheets. Growth in dwelling investment is expected to be weak in the near term, and then to pick up modestly over the forecast period in line with solid population growth.

Resource exports are expected to grow strongly over the next few years, as significant new capacity, particularly in iron ore, comes on line. Rural exports are also expected to grow solidly, given the improved outlook for farm production. The high exchange rate is likely to weigh on growth in non-resource exports, offsetting the support from above-average major trading partner growth. Import growth is expected to be very strong, reflecting the large pipeline of mining investment and the appreciation of the exchange rate.

The medium-term outlook for the labour market is little changed from that in February. Employment growth is expected to remain solid over the forecast period, consistent with the outlook for GDP growth. The forecasts incorporate a number of developments that are expected to contribute to labour supply growth, including a modest pick-up in population growth, a continuation of the trend increase in participation rates (particularly among older workers), and a stabilisation in average hours worked after a decline over the past decade. The labour market is expected to gradually tighten over the forecast period, with the unemployment rate forecast to reach 4¼ per cent by the end of the forecast period in December 2013.

Inflation

At present, a number of volatile items are simultaneously adding to headline inflation. The effect of the severe weather events on fruit and vegetable prices contributed significantly to inflation in the December and March quarters. Along with higher fuel prices, this is expected to see headline inflation above the medium-term target over the year to June, but the pace of headline inflation is likely to slow by early next year following the unwinding of the recent spike in fruit and vegetable prices.

Abstracting from these volatile items, underlying inflation appears to have troughed at around 2¼ per cent in the December and March quarters, down from just over 4½ per cent in mid 2008. The appreciation of the exchange rate has led to significant declines in the prices of many traded manufactured goods, and inflation for non-traded items has also declined somewhat over the past year. Nevertheless, underlying inflation in the March quarter was slightly higher than anticipated at the time of the February *Statement*. Looking ahead, given the outlooks for both the world and domestic economies, year-ended underlying inflation is expected to pick up over the course of 2011.

In 2012, underlying inflation is expected to be around 3 per cent and, on the stated assumptions, to increase to 3¼ per cent by the end of 2013. This reflects a combination of factors, including a gradual further strengthening in labour costs as capacity utilisation and the labour market tighten, and the waning of the disinflationary effect of the recent appreciation. It is likely that inflation rates for a range of non-tradable items, including utilities (particularly electricity) and rents, will contribute significantly to overall inflation. Furthermore, global factors are likely to contribute more to inflation than over the past couple of years, given the recent strength in commodity prices and an expected modest acceleration in global manufactures prices.

Risks to the Forecasts

As always, there are risks and uncertainties around the central forecasts.

One set of risks on the international front concerns the effects of strong economic growth and accommodative global monetary policy on commodity prices. With global growth forecast to remain somewhat above trend, commodity markets are likely to remain quite tight with implications for global inflation. In Asia, where economies are already operating close to capacity, both headline and core measures of inflation are increasing. Although some tightening of policy has occurred, including through exchange rate appreciation, real interest rates remain low. In the advanced economies where monetary policy is in most cases still at very accommodative settings, rising commodity prices are reducing purchasing power and dampening economic activity while also contributing to higher inflation expectations. Central banks in both groups of countries will face challenges in calibrating the appropriate response. If policy is too slow to respond, the result could be further pressure on commodity prices in the near term, further increases in inflation expectations, and then a sharp slowing in growth as policy is belatedly adjusted. This would be a scenario where growth in demand in the Australian economy would be stronger in the near term but weaker in the medium term if commodity prices subsequently fell significantly.

An additional ongoing downside risk stems from the fiscal challenges in some of the advanced economies. To date, this has mostly concerned some of the smaller economies in the euro area and the risk has been that any heightening or broadening of problems could be disruptive to markets and potentially also result in a retreat from cross-border risk-taking in international financial markets. More recently, there has also been greater attention on the fiscal challenges of the US economy. The risk here is of a flight from US dollar assets and a spike in bond yields. While it is hard to be sure how this would play out, it is likely that such a scenario would see weaker global and domestic growth.

The main uncertainty surrounding domestic demand concerns the behaviour of Australian households. The central forecast envisages that the saving ratio remains at around its current level over the forecast period, which is well above the average of the past two decades.

On the one hand, it is possible that households could continue to show significant restraint in their spending and the household saving ratio could rise further. Alternatively, with the labour market continuing to tighten and the unemployment rate expected to decline further, households may become more confident and consumption growth could pick up faster than envisaged in the central forecast.

A second important domestic uncertainty concerns the outlook for investment in the resources sector. One possibility is that the considerable complexity of some of the large planned projects results in the pick-up in resources investment occurring more slowly than is envisaged in the central forecasts. If so – or if the terms of trade were to weaken more rapidly than in the central forecast – domestic demand growth would be weaker and the tightening of the labour market and the pick-up in wage and inflation pressures would be slower than in the central forecast.

The greater risk, however, is that the significant pick-up in mining investment continues and that companies compete aggressively for labour and other inputs, leading to more pressure on wages and other costs than is envisaged in the central forecast. The experience of the first stage of the resources boom in 2006–2008 was that labour market pressures in the affected sectors appeared to be relatively contained in terms of their spillover to the broader labour market. Nevertheless, in that episode with high levels of economy-wide capacity utilisation and strong growth in global commodity prices, domestic inflation picked up significantly.

A final uncertainty concerns prospects for the exchange rate and its effect on the economy. The significant appreciation of the exchange rate since February reflects both an improved outlook for Australia's exports and a range of financial factors. The forecasts incorporate the effect of the higher exchange rate on the economy, in terms of restraining growth in exchange rate sensitive sectors and holding down near-term inflation, although there is inevitably uncertainty as to how large these effects will be.