Statement on Monetary Policy

AUGUST 2010

Contents

The material in this *Statement on Monetary Policy* was finalised on 5 August 2010. The next *Statement* is due for release on 5 November 2010.

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

Statement on Monetary Policy Enquiries

Information Department
Tel: (612) 9551 9830
Facsimile: (612) 9551 8033
E-mail: rbainfo@rba.gov.au

ISSN 1448–5133 (Print)
ISSN 1448–5141 (Online)

Statement on Monetary Policy

The global economy has continued to recover, with growth over the past year generally exceeding earlier expectations. There are, however, signs that global growth is now moderating from its above-trend pace over the past year, and the extent of the recovery varies significantly across regions. It has been strongest in Asia, with a number of countries in the region again approaching capacity constraints. In contrast, growth in the major North Atlantic economies has been more subdued, with these economies likely to continue operating with high levels of excess capacity for some years to come.

Overall, the Bank expects global growth to be around trend over the coming year, although uncertainty about the outlook remains elevated. In May and June, risk aversion rose globally as investors' concerns about the outlook for public finances in Europe and the health of the European banking system increased. Since then, risk aversion has abated somewhat reflecting a number of factors, including the establishment of new financial stability arrangements in Europe; the announcement of fiscal consolidation programs by most European governments; and the publication of the results of the stress test of the banking system. The recent economic data in Europe have also been more positive, although the outlook remains subdued. In the United States, the economy is also continuing to recover, although growth over the second half of the year is likely to be slower.

Importantly for Australia, growth in Asia has been very strong since mid 2009, with a number of countries, including China and India, recording double-digit increases in output. There are, however, signs that growth in the region is now moderating to a more sustainable pace. This is a welcome development, as a continuation of recent growth rates risked a build-up of inflationary pressures. Most countries in the region have also started to move interest rates back towards more normal levels, reducing the risk of imbalances developing, including in asset markets. A number of central banks in other parts of the world have also commenced tightening policy, although markets do not expect any change in official interest rates in the United States, Japan and the euro area until well into 2011 at the earliest.

The strong growth in Asia over the past year has led to large rises in the contract prices of iron ore and coal, which are Australia's two largest exports. As a result, Australia's terms of trade are back around the historically very high levels that they reached in 2008. While the spot prices for many commodities have fallen over the past few months – reflecting the concerns in Europe and signs of growth moderating in China – Australia's terms of trade seem likely to remain very high over the next couple of years.

The period since the previous *Statement* has been a turbulent one in financial markets. In May and June, equity prices declined sharply and bond yields in the larger economies fell to historically low levels as investors became more cautious, largely reflecting the problems in Europe. The elevated degree of uncertainty also meant that global issuance of bonds slowed significantly for a couple of months and there were large movements in exchange rates. More recently, there has been some recovery in equity markets and a reversal of much of the earlier movement in exchange rates, although volatility in financial markets remains high.

The Australian financial system remains in sound shape and loan losses appear to have peaked. During May and June, there was a notable decline in bank bond issuance, consistent with developments in global markets, although more recently, as conditions have improved, issuance has again picked up with the banks retaining ready access to both domestic and foreign markets. Over the past month or so the securitisation market has also shown further signs of improvement. While there has been a rise in credit spreads on banks' longer-term debt, the effect of this on overall funding costs is modest.

The recent data suggest that the Australian economy has been growing at around its average pace due, in part, to a strong contribution from public investment. Over the period ahead, public investment is set to decline as the various stimulus projects are completed, but a strengthening in private demand, particularly business investment, is expected.

The positive outlook for investment is underpinned by Australia's high terms of trade and the expected strong growth in Asia's demand for energy and resources over coming years. Reflecting this, investment in the mining sector, which is already at high levels, is expected to increase further, particularly in the LNG and iron ore sectors. Survey-based measures of capacity utilisation and business conditions are at, or slightly above, average levels and corporate balance sheets are generally in sound shape. In contrast, business credit growth remains subdued and credit conditions are still difficult for some firms, particularly small businesses and those in the property industry, with commercial construction at quite low levels.

Consumption expenditure has recorded modest growth over the past year. Many households are continuing to take a more cautious approach to their finances, and the household saving rate is higher than it has been over much of the past decade. This caution is particularly evident in retail spending, which has been relatively subdued since mid 2009 after the earlier boost from the stimulus payments. Other forms of household spending – most notably on motor vehicles and a range of services – have been stronger over the first half of the year. Measures of consumer sentiment also remain above average and household wealth has risen by around 20 per cent over the past year, although it was flat in the June quarter.

Conditions in the established housing market look to have stabilised recently. Most nationwide measures of housing prices have levelled out over the past few months after the earlier strong increases, and auction clearance rates have declined significantly to around average levels. Loan approvals to owner-occupiers have also trended lower, although investor approvals have increased, and housing credit growth has slowed recently. This moderation in the established housing market is a welcome development and partly reflects the return of mortgage rates to around average levels. In terms of new dwellings, the rate of growth in the dwelling stock remains low relative to the growth in the population.

The labour market has continued to firm, with the unemployment rate standing at 5.1 per cent in June, down by ¾ percentage point from its level in mid 2009. Average hours worked also appear to be picking up although they remain significantly below the levels recorded in 2008, when the labour market was very strong. Over the past year, most industries have recorded an increase in employment, with growth fastest in the mining and business services industries. Reflecting the strength in employment, measures of private-sector wage growth have also picked up somewhat recently after the marked slowing last year. The various forward-looking indicators continue to suggest solid growth in employment over the period ahead.

Year-ended underlying inflation has moderated in line with the Bank's expectations, and at 2¾ per cent is now back in the 2–3 per cent range for the first time since September 2007. Consumer Price Index (CPI) inflation, however, was just above 3 per cent over the latest four quarters, largely due to the effect of the higher tobacco excise. The decline in underlying inflation reflects the weaker demand growth in 2008 and the first half of 2009, the lower wage increases in 2009 and the appreciation of the exchange rate. Recently, there has also been significant discounting by many retailers in response to subdued sales growth. Working in the other direction, there have been large increases in the prices of a range of utilities over the past year.

The Bank's central forecasts for output and inflation in the period ahead are largely unchanged from those published in May. The central forecast is for GDP growth of around 3¼ per cent over 2010 and 3¾–4 per cent over 2011 and 2012. This forecast is underpinned by the positive prospects for investment, particularly in the resources sector. Over the period ahead, strong growth in resource exports and a gradual pick-up in business investment is expected to offset the scaling back in public demand as stimulus-related projects are completed. In this central scenario, the economy is likely to be pushing up against supply-side constraints over time, although conditions are expected to vary across industries, with the resource-related sectors stronger than other parts of the economy. This central scenario also assumes that the household saving rate increases a little further, and that more of the boost to national income from the rise in the terms of trade is saved than was the case in the boom a few years ago.

The central forecast for underlying inflation is around 2¾ per cent over the next year or so, similar to its current rate. CPI inflation is, however, likely to be above 3 per cent for the next year due to the increase in the tobacco excise and large increases in the prices of utilities. Beyond the next year, underlying inflation is expected to gradually increase to around 3 per cent in 2012, reflecting capacity pressures in parts of the economy.

As always, these central forecasts are subject to a range of risks. On the downside, the main domestic risk is that the forecast pick-up in private demand does not occur as quickly as expected at a time when public investment is contracting. Internationally, there is some risk that the recent measures by the Chinese authorities to cool the property market will slow the Chinese economy by more than currently expected, causing commodity prices to fall and investment in Australia to be delayed. A significant retreat from risk taking around the world as a result of renewed concerns about the financial position of European banks and governments also remains a possibility, although the probability of this looks lower than was the case a couple of months ago.

On the upside, it is possible that private domestic demand could be stronger than currently expected, with firms in the mining sector attempting to push ahead with investment more rapidly than assumed. In addition, it is possible that the current cautiousness in spending by households may not persist, particularly if the unemployment rate continues to decline. There is also a risk that growth in the global economy surprises on the upside, as it has done over much of the past year.

As it became evident in the latter part of last year that the Australian economy had weathered the global downturn in better shape than many other countries, the Board moved gradually to remove the considerable monetary stimulus that was put in place when the outlook seemed much weaker and downside risks were significant. Reflecting this, the cash rate was increased by a cumulative 1½ percentage points between October 2009 and May this year to 4.5 per cent. As a result of these increases, most lending rates in the economy have returned to around average levels.

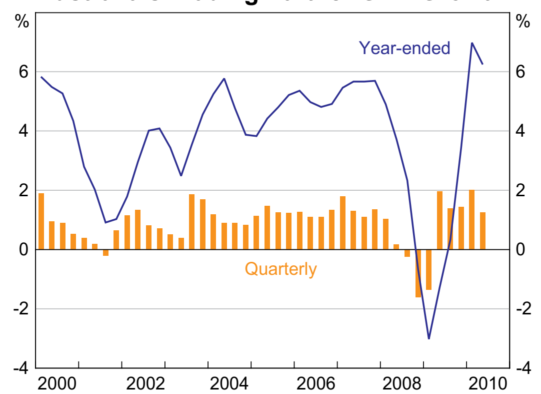
Since May, the Board has kept the cash rate unchanged. Available information over this period suggests that the Australian economy has performed broadly in line with the Bank's expectations, although uncertainty about the global economy has risen. Given these developments, and with growth in the Australian economy likely to be close to trend over the year ahead, underlying inflation having declined into the 2–3 per cent range, and lending rates around average, the Board views the current setting of the cash rate as appropriate at this stage. Over the period ahead, the Board will continue to assess developments in both the Australian and global economies and set monetary policy to achieve an average rate of inflation of between 2 and 3 per cent. ✠

International Economic Developments

The recovery in the world economy continued in the June quarter, including in Europe where available data suggest activity accelerated after a half year of little growth. GDP growth in Australia's major trading partners is estimated to have been around 1¼ per cent in the June quarter and a robust 6 per cent over the year, a stronger outcome than had been expected earlier (Graph 1). However, uncertainty about the future pace of global expansion has increased since the May *Statement*, due chiefly to increasing concern about the fiscal positions of a range of advanced economies, and the associated decisions by various governments to commence or accelerate fiscal consolidation. In addition, growth is moderating in east Asia to more sustainable rates following the V-shaped recovery over the preceding year. Global industrial production has continued to expand at a robust rate (Graph 2).

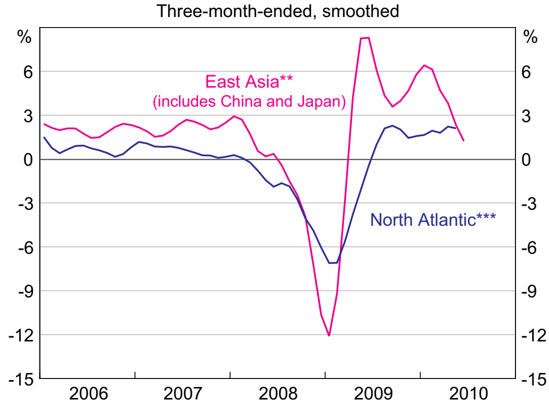
While the recent economic data in Europe have been better than earlier in the year, concerns about medium-term fiscal sustainability increased significantly over recent months. In an effort to address these concerns, a large number of European governments have recently announced fiscal consolidation programs of varying degrees of austerity, as discussed further in 'Box A: Public Finances in Europe'. This represents a marked shift in attitude from earlier this year, when most of these governments were indicating a preference to wait until the recovery was more firmly entrenched before commencing discretionary tightening. The announced programs are expected to exert downward pressure on aggregate demand in the euro area, through weaker public spending and

Graph 1
Australia's Trading Partner GDP Growth*



* Weighted using merchandise export shares at market exchange rates; RBA estimates for June quarter 2010
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2
Industrial Production Growth*
Three-month-ended, smoothed



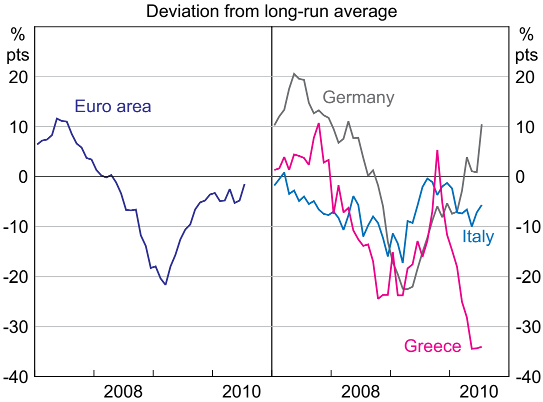
* Aggregated using shares of world output at market exchange rates
** RBA estimates for June 2010
*** Canada, euro area, the UK and US
Sources: CEIC; RBA; Thomson Reuters

reduced transfers. Given the timing of the announced measures, and the ongoing impact of some previously enacted stimulus measures, the direct effect of discretionary fiscal changes on demand and output growth is expected to be modest in 2010 for the euro area as a whole (although substantial for some countries), but to build in 2011 and 2012. This dampening influence should be partly offset by a boost to external demand from the depreciation of the euro over the past year.

In moving to a tighter fiscal policy than previously planned, European governments are seeking to strike a delicate balance. On the one hand, in a number of cases failure to begin consolidation risked a further loss of market confidence, with potentially large downside consequences. On the other hand, with household spending in Europe still weak, overly rapid fiscal retrenchment could be counterproductive if it were to depress demand and weaken growth significantly.

At this stage it is too early to tell what the impact of the recent market uncertainty and policy announcements will be on the euro area economy. However, euro area sentiment measures have thus far held up well, even though there has been some deterioration in the more forward-looking components relating to the general economic situation. Consumer confidence is at an extremely low level in Greece, and has fallen somewhat in France, Italy and Spain since the start of the year, but the declines in these countries have been limited and confidence has picked up strongly in Germany (Graph 3). As a result, aggregate consumer sentiment for the region has risen slightly since the start of the year, while industrial sentiment has continued to improve to above-average levels.

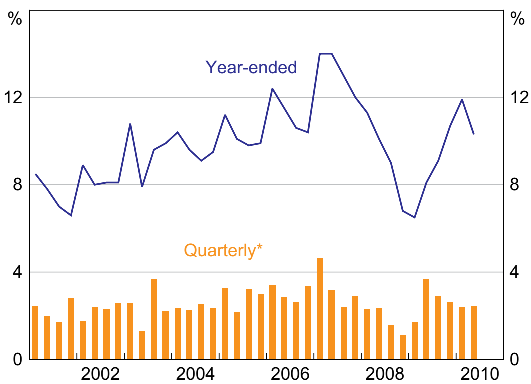
Graph 3
Euro Area – Consumer Sentiment
Deviation from long-run average



Source: Thomson Reuters

The recent resilience of consumer and business sentiment in the euro area partly reflects the momentum in activity that was beginning to build in some countries in the region prior to the heightening of concerns over the fiscal situation and associated response by governments. Available indicators suggest that output growth was firm in the June quarter, especially in Germany. Both industrial production and exports appear to have risen strongly in the quarter, while indicators of equipment investment increased solidly. Likewise, in the United Kingdom, GDP rose by 1.1 per cent in the quarter, a marked step-up from the pace of expansion seen in the December and March quarters.

Graph 4
China – GDP Growth



* RBA estimates
Sources: CEIC; RBA

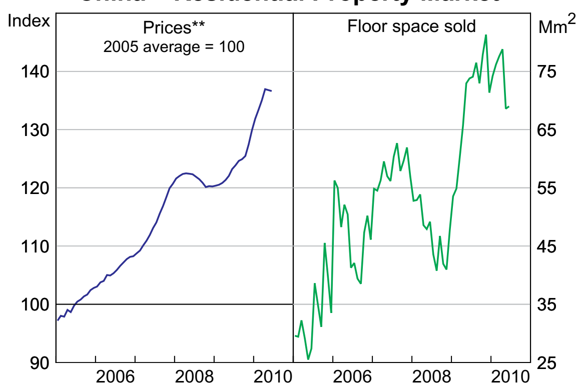
Activity in China has been very strong, although there are signs that growth is now slowing to a more sustainable rate. GDP is estimated to have expanded by around 2½ per cent in the June quarter and by 10¼ per cent over the year (Graph 4). The rapid expansion in the economy through 2009 and early 2010 was the result of very stimulatory fiscal and monetary policies, which the Chinese government implemented to counter the effects of the global financial crisis. Over the coming year, fiscal policy is expected to be less expansionary as the stimulus measures wind down, including the increase in the sales tax rate on certain vehicles back to its pre-stimulus level and the expiry of the car scrappage scheme. Monetary policy remains mildly accommodative, with the People's Bank of China maintaining benchmark interest rates at low levels, although the authorities have increased the required reserve ratio by 150 basis points so far this year and credit conditions have been tightened.

The recent moderation in growth appears to have been broadly based although activity in secondary industry (mostly manufacturing and construction) has decelerated noticeably. Data for industrial production show a marked slowing since the surge in March, consistent with the slowing in manufacturing investment. The PMI data for China, which earlier this year were at very strong levels, also suggest some moderation in growth.

The policy measures adopted by the authorities in China to address developments in the property market look to be having the desired effect of cooling the high end of the property market. Monthly growth in residential property prices, as measured by the National Bureau of Statistics, has slowed since April, with average nationwide prices estimated to have fallen slightly in June (Graph 5). There has also been a noticeable decline in turnover in the residential property market, with monthly sales of residential floor space having fallen by 12 per cent since April when the most recent set of measures was introduced. In cities such as Beijing, where local governments have implemented additional measures to cool their local property markets, turnover has fallen by around 40 per cent. New construction activity looks to be slowing, although the government has taken steps to boost construction of housing for lower-income households.

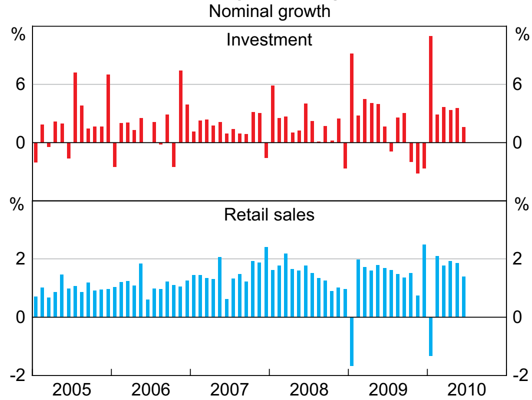
In contrast to some slowing in the production indicators, growth in household consumption and infrastructure spending has been strong (Graph 6). Real retail sales grew by 15 per cent over the year to June, with continued growth expected to be underpinned by rising wages. Recent months have seen large increases in minimum and other wages in many parts of China. While this partly represents compensation for wage freezes through 2009, it is also consistent with some structural adjustment towards higher real wages and higher household consumption as a share of GDP. Investment in infrastructure also remains strong, despite growth

Graph 5
China – Residential Property Market*



* RBA estimates
** Average of new and existing residential property prices
Sources: CEIC; RBA

Graph 6
China – Monthly Activity Indicators*
Nominal growth



* RBA estimates
Sources: CEIC; RBA

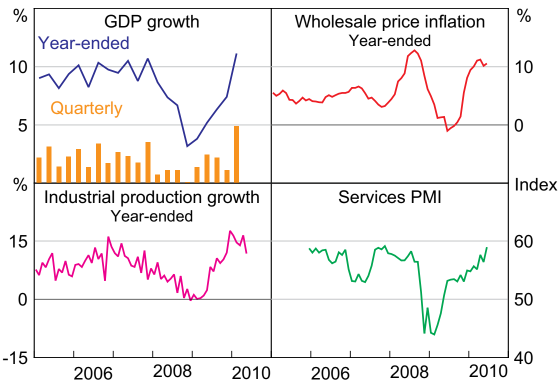
slowing from its extraordinary pace through 2009, with a sizeable pipeline of work still outstanding.

China's export growth has also been robust, with volumes increasing by around 10 per cent over the six months to June. Growth has been broad-based, with exports to the European Union and the United States surprisingly strong. Nevertheless, the subdued outlook for activity in the major advanced economies may see some slowing in export growth over the period ahead.

Economic conditions in India remain robust, although they look to have softened in some sectors. GDP at market prices grew very strongly in the March quarter to be 11 per cent higher over the year (Graph 7). Much of the growth in the quarter was due to private investment, associated with strength in construction activity. In contrast, conditions in the manufacturing sector have softened over the first half of 2010, with industrial production having fallen since the beginning of the year. This is consistent with softer merchandise exports, which were also broadly unchanged over the first half of the year after growing strongly in late 2009. The services PMI for June, however, suggests that conditions in the services sector – the largest sector of the Indian economy – remain firm.

Graph 7

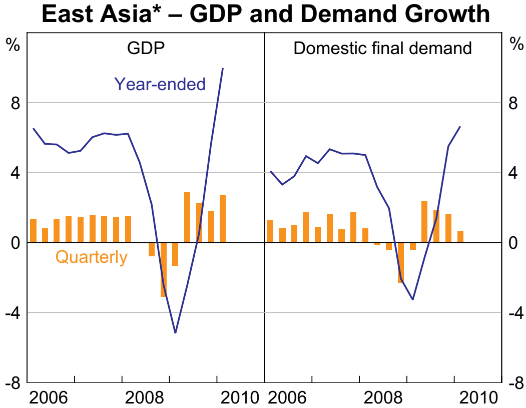
India – Economic Indicators



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

Graph 8

East Asia* – GDP and Demand Growth



* Excludes China and Japan

Source: CEIC

The strong growth in India has been associated with a pick-up in the inflation rate, with year-ended wholesale price inflation hovering around 10 per cent since the beginning of the year. Although food prices have contributed to higher inflation, price pressures have been widespread, with year-ended growth in non-food manufactured prices rising to around 7 per cent. Citing inflation concerns, the Reserve Bank of India has increased its policy rates by 75-100 basis points and its cash reserve ratio by 100 basis points since January.

In east Asia (excluding China and Japan) growth appears to be moderating to more sustainable quarterly rates, after a year of very rapid expansion. Output growth was strong in the March quarter – exceeding 1¼ per cent in all of the ASEAN-4 and higher-income economies, and double that pace in four economies (the Philippines, Singapore, Taiwan and Thailand). However, the proportion of this strong growth attributable to inventory rebuilding was unusually large for this stage of the cycle. Quarterly domestic final demand growth, by contrast, continued its moderation since mid 2009 in the March quarter, with growth of around ¾ per cent for the region as a whole (Graph 8).

In recent months, overall growth in industrial production and exports has been solid, although outcomes have been mixed across countries. Excluding Singapore, industrial production in the region was little changed over April and May – partly due to a notable fall in production in Thailand associated with unrest in the country during this period – but available data suggest a firm increase in June. In Singapore, industrial output soared by 16 per cent in the June quarter – contributing to a second consecutive quarter of exceptionally rapid GDP growth according to the advance estimate. In Korea, GDP growth eased somewhat but remained robust in the June quarter, with the quarterly rise of 1½ per cent driven by strength in the manufacturing and services sectors.

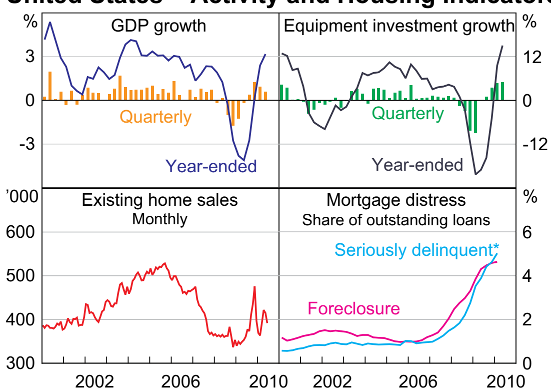
Japanese output also appears to have increased in the June quarter but at a more moderate pace than in the preceding half year, when quarterly expansions in excess of 1 per cent were recorded. Export growth was robust in the quarter, consumer confidence has continued to rise, and business surveys remain modestly positive (although the latest Tankan survey suggests conditions for non-manufacturing firms are still subdued). Indicators of labour market conditions, however, have become more mixed in recent months after earlier improvement. Housing starts also remain depressed, and the Cabinet Office's monthly consumption indicator points to more moderate household spending growth after several quarters of solid increases in purchases (especially of large durable goods).

In the United States, the recovery continued in the June quarter at a solid pace. Output rose by 0.6 per cent, to be 3¼ per cent higher over the year, but the level of GDP was still around 1 per cent below its previous peak recorded in late 2007 (Graph 9). Equipment investment again contributed strongly to growth, driven by the continuing need for firms to renew or replace equipment following the period of very weak investment in 2008 and early 2009. Robust growth in spending by firms also reflects positive business conditions, as measured by the manufacturing and non-manufacturing ISMs, and strong profitability in the first half of the year. For a number of sectors, however, the current environment remains difficult. Non-residential construction is still weak despite a modest rise in the June quarter, and builders report ongoing difficulties in obtaining credit. Small businesses, which account for 60 per cent of gross job creation in the United States, also report that they continue to face weak demand and restrictive credit conditions.

Household consumption grew at a moderate pace in the June quarter, but downward revisions have noticeably weakened the profile of consumption over the past three years, so that it is still some way below its late-2007 quarterly peak. The household saving rate has been revised up substantially, to stand above 6 per cent in the quarter, its highest level since the early 1990s (abstracting from the spike in the June quarter 2009 associated with the one-off payments and tax cuts put in place as part of the 2009 stimulus package). Retail sales values fell in May and June, and renewed weakness in the housing market may also weigh on household demand over coming months through confidence and wealth effects. Following the expiry of the federal government's home-buyer tax credit at the end of April, monthly existing home sales fell in May and June. The proportion of home loans in foreclosure also continues to rise, despite evidence of greater forbearance by lenders before foreclosing on seriously delinquent borrowers.

Graph 9

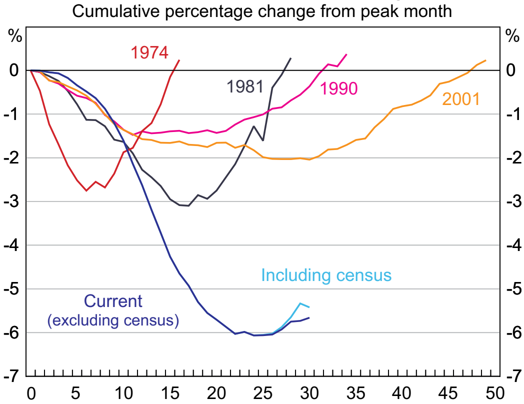
United States – Activity and Housing Indicators



* 90 days or more past due
Source: Thomson Reuters

While conditions in the labour market have improved from those prevailing last year, firm growth in output is yet to translate to a significant bounce-back in employment. Private payrolls rose by less than 100 000 jobs per month in the first half of the year, with only 60 000 jobs added on average in May and June. Total payrolls were boosted in the three months to May by government hiring associated with the running of the ten-yearly census, which generated over half a million short-term jobs, but the bulk of these jobs have now come to an end (Graph 10). Near-term indicators of labour market conditions are mixed. The employment component of the manufacturing ISM continues to be strong, but weekly initial jobless claims remain elevated and the median duration of unemployment is very high.

Graph 10
United States – Non-farm Payrolls
Cumulative percentage change from peak month



Sources: Bureau of Labor Statistics; Thomson Reuters

Overall, despite signs of some moderation in the outlook for global growth in the near term, official forecasts for growth in 2010 have been revised upwards since the May *Statement* – reflecting both the exceptionally strong GDP outcomes recorded in many Asian economies in the March quarter and the signs of generally solid expansion in most regions in the June quarter. The IMF now expects global output to increase by just over 4½ per cent in 2010 (with countries weighted by GDP at purchasing power parities), 0.4 percentage points stronger than it anticipated in April (Table 1). Year-average growth is then forecast to ease slightly in 2011 to around 4¼ per cent, unchanged from April. These forecasts are broadly consistent with those of the Bank for 2010, but somewhat stronger than the Bank's forecast for 2011, as discussed further in the 'Economic Outlook' chapter.

Table 1: World GDP Growth
Year-average, per cent[(a)]

	2008	2009	2010	2011
			IMF forecasts[(b)]	
United States	0.0	–2.6	3.3	2.9
Euro area	0.6	–4.1	1.0	1.3
Japan	–1.2	–5.2	2.4	1.8
China	9.6	9.1	10.5	9.6
Other east Asia[(c)]	2.8	0.0	6.5	5.0
India	7.4	6.7	9.4	8.4
World	**3.0**	**–0.6**	**4.6**	**4.3**
Australia's trading partners[(d)]	2.7	0.1	5.5	4.7

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

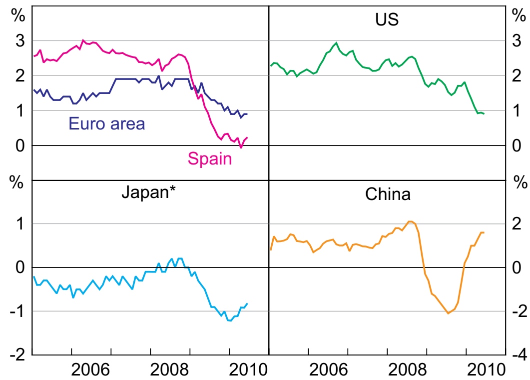
Inflation pressures appear to have eased slightly in east Asia since the May *Statement*, while remaining muted in the large advanced economies. Weak household demand and high levels of spare capacity have seen year-ended core consumer price inflation trend lower in the euro area since late 2008, to be below 1 per cent currently, with noticeably lower outcomes in a number of countries including Spain (Graph 11). To the extent that fiscal consolidation weighs on household confidence and spending, this may place further downward pressure on inflation across the region. Year-ended core consumer price inflation has also fallen below 1 per cent in the United States in recent months.

In Japan, deflation persists although its pace has moderated slightly (after abstracting from the 18 per cent one-time fall in education prices in April associated with the reduction of high school fees by the government). In China, by contrast, year-ended core inflation rose through the second half of 2009 and early 2010. However, inflation has stabilised over the past few months, with core inflation remaining around 1½ per cent over the year to June, which is roughly its average for the years prior to the global downturn. Year-ended headline inflation also appears to have steadied for the present at around 3 per cent, with food prices falling in each of the four months to June.

Commodity Prices

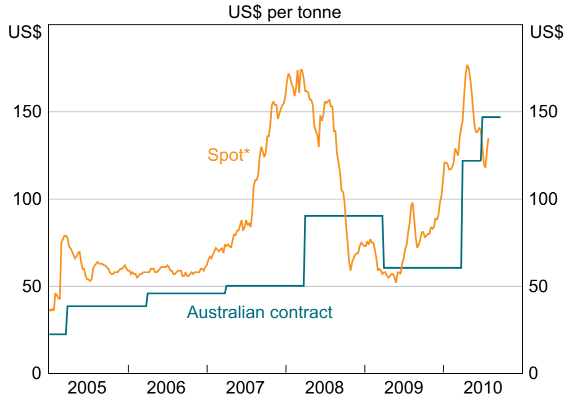
The commodity prices that Australian producers receive have continued to rise in recent months, with large contract price increases in the June quarter for iron ore and coal (Graph 12). Further increases in contract prices are estimated for the September quarter, with iron ore contract prices reaching historically high levels. These increases mean that the contract prices that Australian iron ore and coal producers receive have risen by around 140 and 75 per cent over the past year, reflecting the strong growth in demand from Asia.

Graph 11
Core Consumer Price Inflation
Year-ended



* Excludes impact of policy-induced reduction in school fees in April 2010
Sources: CEIC; RBA; Thomson Reuters

Graph 12
Iron Ore Prices
US$ per tonne



* China landed import price less spot freight rate from Australia to China
Sources: ABARE; Bloomberg; RBA

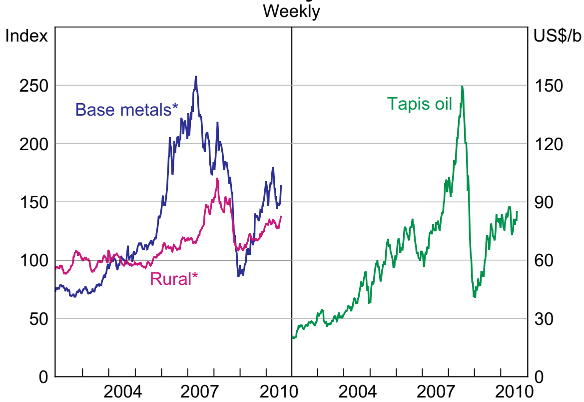
Table 2: Commodity Price Growth
SDR terms, per cent

	Since end April 2010	Since end July 2009
RBA index	11	54
– Coal and iron ore[(a)]	19	81
– Excluding coal and iron ore	1	28
Rural	3	16
– Wheat	22	5
– Other	–2	20
Base metals	–3	24
Gold	0	27
Tapis crude oil	–3	20

(a) Export prices; RBA estimates for recent months
Sources: Bloomberg; RBA

The sharp rise in bulk commodity contract prices has driven an increase in the RBA's index of commodity prices since the May *Statement* of around 10 per cent, with the index now around 50 per cent above its trough in mid 2009 (Table 2). These increases in commodity prices are feeding through into a significant increase in the terms of trade to a historically high level. The increase in the terms of trade is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.

Graph 13
Commodity Prices
Weekly



* 2004 average = 100, SDR terms
Sources: Bloomberg; RBA

Spot prices for bulk commodities, which affect contract prices with a lag, have fallen since May, driven by the moderation in growth in China, albeit from a very fast pace. The estimated September quarter contract prices stand at a premium of around 10 per cent relative to recent spot prices for iron ore and coking coal. While spot iron ore and coking coal prices have fallen by around 20 per cent since the May *Statement*, they remain at high levels.

The prices of exchange-traded commodities including crude oil and base metals have also fallen since the May *Statement*, amid greater uncertainty over the global outlook and the broader weakening in financial markets, though they have stabilised more recently (Graph 13). The price of gold has been the exception, being broadly unchanged over the period, underpinned by 'safe haven' demand.

Among the rural commodities, wheat and canola prices have risen strongly as adverse weather conditions in several key northern hemisphere countries have lowered the supply outlook for 2010/11. Sugar prices also increased strongly reflecting some rebuilding of sugar stocks, after weather-related supply disruptions earlier this year.

Box A

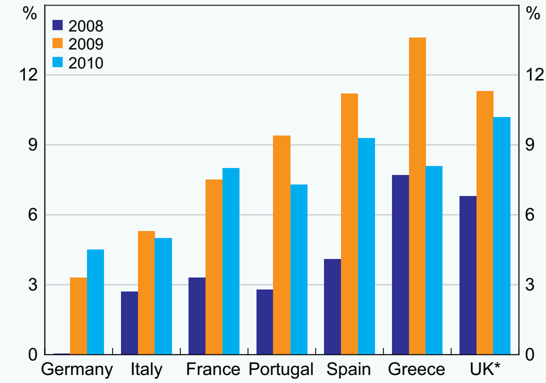
Public Finances in Europe

The global economic downturn triggered a sharp deterioration in public finances across Europe. Budget deficits widened significantly, reflecting a combination of falling tax receipts, discretionary stimulus measures aimed at reducing the severity of the downturn, and the costs of providing support to the banking sector (Graph A1). For the euro area as a whole, the aggregate budget deficit exceeded 6 per cent of GDP in 2009 – with a number of countries recording double-digit outcomes – and is projected to be of a similar magnitude in 2010. As a result of these deficits, and of the falls in output that have occurred, general government gross debt as a share of GDP is forecast by the European Commission to exceed 80 per cent in a large number of euro area countries (and in the United Kingdom) by 2011 – an increase of 30 percentage points or more in many cases since the onset of the financial crisis (Graph A2).[1]

These sharp increases in public debt have come on top of already-high debt levels in many European countries prior to the global recession. From the mid 1990s, gross public debt regularly exceeded 60 per cent of GDP in a number of major euro area economies, and in Italy, Greece and Belgium stood persistently at around 100 per cent of GDP. There was also a tendency, even in countries with generally lower public debt levels such as France and Germany, for debt to gradually trend upwards as a share of GDP over the preceding few decades. Under the Stability and Growth Pact, euro area countries were meant to keep their budget deficits below 3 per cent of GDP except in 'exceptional circumstances'. However, this limit was regularly

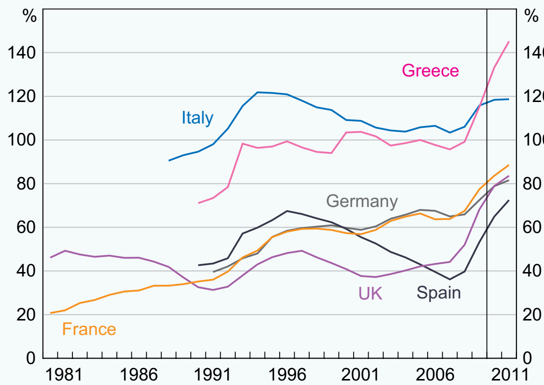
1 For most European countries, the difference between gross and net debt is relatively small.

Graph A1
Europe – General Government Budget Deficits
Per cent of GDP



* Fiscal years
Sources: European Commission; Eurostat; national authorities

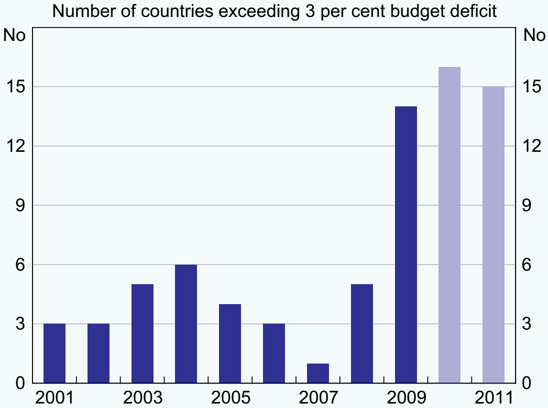
Graph A2
Europe – Gross Public Debt
Per cent of GDP



Sources: European Commission; IMF; Thomson Reuters exceeded even during the previous cyclical upswing, and the penalties for breaches agreed as part of the Pact were never imposed (Graph A3).

The recent deterioration in the fiscal positions of European governments has seen investors become concerned about the state of public finances in the region. In response, the European Union and member governments have taken action along two lines. First, in May the Council of the European Union, in conjunction with the IMF, announced the creation of the European Financial Stability Facility (EFSF). The EFSF is a lending facility with funding of up to €440 billion from European governments, together with provision for a substantial additional contribution from the IMF, intended to provide support to euro area countries facing financing difficulties. Access to the EFSF is to be under similar conditions to the separate three-year €110 billion emergency support package for Greece established earlier in May, which required Greece to implement a stringent and closely monitored fiscal consolidation program designed to reduce its budget deficit to below 3 per cent of GDP by 2014.

Graph A3
Euro Area – Stability and Growth Pact



Sources: European Commission; Eurostat

Second, numerous European governments have announced new or supplementary fiscal consolidation packages, intended to reassure financial markets that their public finances will be restored to a sustainable footing over the medium term (Table A1). In some countries – most notably Greece, Ireland, Portugal and Spain – substantial front-loaded cut-backs are in train, reflecting the more limited fiscal room for manoeuvre in these economies and consequent need to take earlier action to establish credibility with investors. In other

Table A1: Discretionary Fiscal Tightening in Europe

	Share of EU GDP[(a)]	Tightening announced since late 2009[(b)]	
	Per cent	Per cent of GDP	
		For 2010	For 2011
Germany	19	0	½
France	14¼	0	½
Italy	11¾	½	1
Spain	9¼	2½	2½
Greece	2¼	8	4
Ireland	1¼	2½	2
Portugal	1½	2	2½
United Kingdom	14½	½	1½

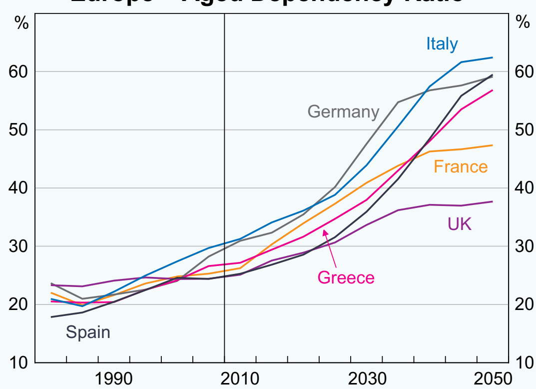
(a) Shares in 2009 at purchasing power parity exchange rates
(b) RBA estimates, to nearest ½ per cent of GDP
Sources: European Commission; Eurostat; IMF; RBA; national authorities

countries, including the four largest economies (France, Germany, Italy and the United Kingdom), the announced tightenings are smaller in scale or build more gradually over 2011 and subsequent years. In Germany, the impact of recently announced cut-backs also needs to be set against previously enacted stimulus measures still coming into effect in 2010, which provide an expansionary offset. Overall, the aggregate fiscal consolidation in 2010 for both the euro area and the United Kingdom is modest, at around ½ per cent of GDP, before becoming more substantial in 2011 and 2012. While this is expected to have some dampening effect on demand and growth across Europe over the next few years, failure to begin reducing deficits risked a noticeable decline in confidence among market participants, with flow-on effects for banks and the supply of credit.

The announced fiscal consolidation programs entail a combination of expenditure and revenue measures. On the outlays side, Greece, Ireland, Portugal and Spain have all flagged or enacted significant cuts in public-sector wages, especially for those on higher salaries, where the reductions typically range from 5 to 15 per cent. These countries have also instituted hiring freezes or labour shedding rules for the public sector, as well as cuts or freezes in pensions and in public investment. Revenue measures include value-added tax rate increases of between 1 and 4 percentage points in a number of countries, as well as increases in corporate and personal income tax rates and in excise duties on fuel, cigarettes, alcohol and luxury items. Overall, the announced discretionary tightening is heavily weighted towards expenditure reductions in Spain, and spending cuts also make up the bulk of the planned consolidation in the United Kingdom. In Greece, the mix between spending and revenue measures is approximately equal, and the fiscal tightening is complemented by an extensive privatisation program involving outright sales and the introduction of strategic private-sector partnerships, intended to improve efficiency in the affected sectors.

In the majority of countries implementing fiscal consolidation packages, discretionary cuts are also complemented by other economic and financial reforms aimed at bolstering the long-term sustainability of public finances. In particular, increases in the eligible pension age for both men and women are planned or have been enacted in various euro area countries, including France, Germany, Greece, Italy and Spain, while various countries are also limiting early retirement options for public-sector workers. More broadly, the substantial projected increases in aged dependency ratios across Europe – the ratio of people aged 65 years and over to those aged 15 to 64 years – suggest that pension and healthcare reforms will be important for restraining the long-run growth of public expenditure in many European countries (Graph A4).

Graph A4
Europe – Aged Dependency Ratio*



* Population aged 65 years and over as a percentage of the working-age population (15–64 years)
Source: United Nations

International and Foreign Exchange Markets

Developments in European sovereign debt markets have been the main influence on financial markets in recent months. Concerns about fiscal sustainability in peripheral euro area countries intensified in early May as markets focussed on the Greek Government's large near-term funding requirement. The announcement by euro area countries and the IMF that they would provide €110 billion in financial assistance to Greece (of which €20 billion has since been allocated) failed to calm markets.

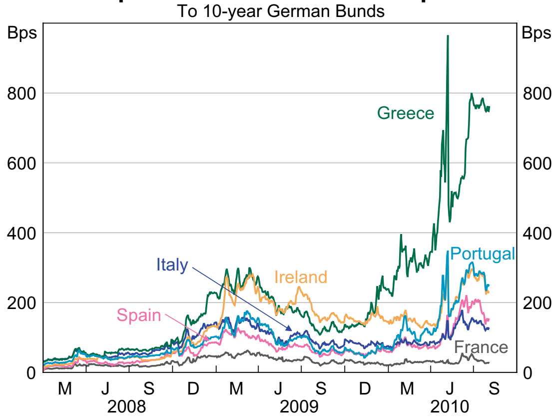
In the following week, the European Union (EU) announced a stabilisation mechanism that would provide support of up to €500 billion to euro area governments if needed. Of this amount, €440 billion would be provided via a special purpose vehicle – the European Financial Stability Facility (EFSF) – that would issue bonds guaranteed by participating EU countries. This facility became operational towards end July and may be extended beyond its three-year lifespan. The IMF would provide additional financial assistance should the stabilisation mechanism be utilised.

In addition to these stabilisation measures, at the same time the European Central Bank (ECB):

- announced that it would purchase euro area government bonds in order to improve the functioning of these markets;
- announced that it would provide further unlimited fixed-rate funds at three- and six-month maturities to support market liquidity; and
- together with the Bank of Canada, Bank of England, Bank of Japan and the Swiss National Bank, re-established temporary US dollar swap lines with the US Federal Reserve to help address emerging strains in US dollar short-term funding markets. Use of these swap facilities has been low, partly reflecting that the US dollars are provided above the market rate payable by most financial institutions.

Financial market conditions stabilised somewhat following the announcement of the EFSF and the various central bank initiatives. Spreads between yields on peripheral euro area sovereign bonds and German Bunds narrowed, although the market for some of these bonds has been highly illiquid and pricing is indicative only (Graph 14).

Graph 14
European Government Bond Spreads
To 10-year German Bunds

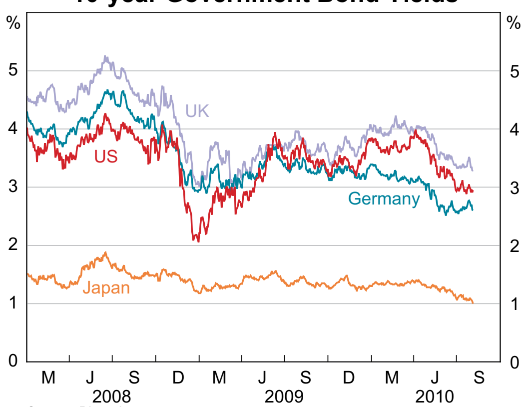


Source: Bloomberg

However, tensions in financial markets persisted, exacerbated at times by sovereign ratings downgrades. Following earlier downgrades by other rating agencies, over the past three months Moody's downgraded Greece's credit rating to sub-investment grade, Portugal's credit rating to the equivalent of A+ from AA, and Ireland's credit rating by one notch to the equivalent of AA; Fitch also downgraded Spain's credit rating to AA+ from AAA.

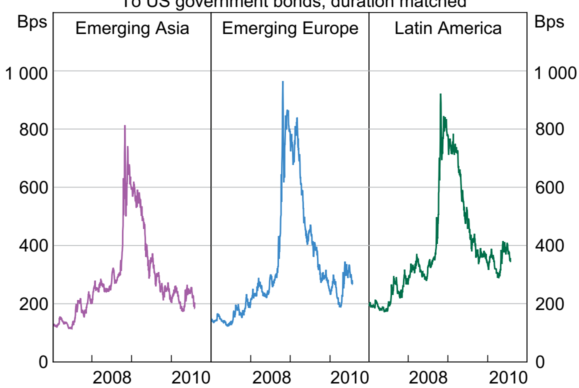
In response to the continuing concerns over fiscal sustainability, a number of government austerity measures were announced, including in Spain, Portugal and Italy (see Chapter on 'International Economic Developments'). Although these announcements generally supported market sentiment, they also raised concerns about the implications for economic growth.

Graph 15
10-year Government Bond Yields



Source: Bloomberg

Graph 16
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

In late July, the European authorities released the results of stress tests of 91 European banks, representing 65 per cent of EU banking sector assets, to adverse macroeconomic and financial market conditions and sovereign risks. The results of these stress tests suggest that most large European banks are sufficiently capitalised relative to a benchmark of a Tier 1 capital ratio of 6 per cent. Seven banks (one German, one Greek and five Spanish) did not pass the tests, with a combined capital shortfall of €3.5 billion under the stress scenario. Aggregate losses across all banks under the stress scenario were estimated to be €566 billion, most of which reflected loan-loss provisions.

Sovereign Debt Markets

Longer-term government bond yields in the major advanced economies have fallen to low levels, reflecting safe-haven demand as risk aversion and concerns about the outlook for global growth have increased (Graph 15). Yields on German 10-year bonds fell to their lowest level since at least the 1920s and 10-year US Treasury yields fell below 3 per cent for the first time since April 2009. Shorter-term government bond yields remain around their historically low levels, reflecting expectations that policy rates will remain low for some time. In the United States, the 2-year bond yield declined to its lowest rate in over 70 years.

Spreads of emerging market US dollar-denominated debt have narrowed slightly from those prevailing prior to the announcement of the EFSF but remain above the lows in April (Graph 16). The absolute levels of emerging market yields are around the lowest since at least the early 1990s. Fitch raised Argentina's local- and foreign-currency credit ratings to B with a stable outlook, citing the country's restructuring of over 90 per cent of its defaulted debt and solid economic performance in recent years.

Central Bank Policy

Financial markets have pushed back the expected timing of initial monetary policy tightening in the euro area, Japan, the United Kingdom and the United States: no change in policy interest rates is expected until at least some time in 2011. However, a number of other central banks have started to increase policy rates, including those in Brazil, Canada, India, Malaysia, New Zealand, South Korea and Sweden (Table 3). The first five of these have raised rates on more than one occasion. In contrast, several central banks in Europe, including the Czech Republic and Russia, have continued to ease monetary policy.

The ECB's balance sheet continued to expand until the maturity of a large one-year liquidity providing operation on 1 July. Of the €442 billion in one-year loans that matured, €132 billion was rolled into three-month fixed-rate loans. With the decline in liquidity, money market rates in the euro area have risen by around 25 basis points (Graph 17).

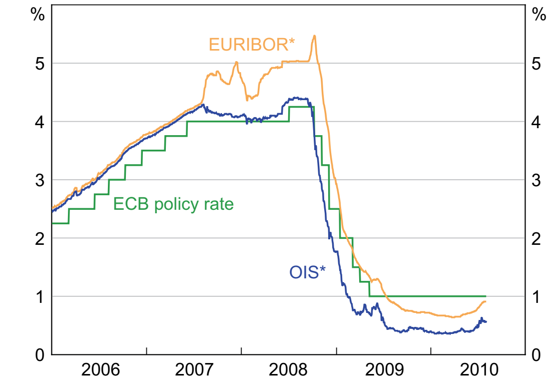
As noted above, the ECB began purchasing euro area sovereign bonds in May. The purchases have been generally modest and have declined steadily to be very small amounts in recent weeks. The ECB also completed its purchases of €60 billion of covered bonds at the end of June. These bond purchases have not offset the fall in liquidity provided by the ECB and, as a result, the ECB's balance sheet has started to contract (Graph 18). In contrast, the balance sheets of the Fed and Bank of England have been relatively stable since early 2010.

Table 3: Policy Rates

	Current level Per cent		**Most recent change**	**Cumulative increase** Basis points
Euro area	1.00	↓	May 09	–
Japan	0.10	↓	Dec 08	–
United States	0.125	↓	Dec 08	–
Brazil	10.75	↑	Jul 10	200
Canada	0.75	↑	Jul 10	50
China	5.31	↓	Dec 08	–
India	5.75	↑	Jul 10	100
Indonesia	6.50	↓	Aug 09	–
Israel	1.75	↑	Aug 10	125
Malaysia	2.75	↑	Jul 10	75
Mexico	4.50	↓	Jul 09	–
New Zealand	3.00	↑	Jul 10	50
Norway	2.00	↑	May 10	75
Russia	7.75	↓	Jun 10	–
South Africa	6.50	↓	Mar 10	–
South Korea	2.25	↑	Jul 10	25
Sweden	0.50	↑	Jul 10	25
Switzerland	0.25	↓	Mar 09	–
Taiwan	1.38	↑	Jun 10	13
Thailand	1.50	↑	Jul 10	25
Turkey	7.00	↓	Nov 09	–
United Kingdom	0.50	↓	Mar 09	–

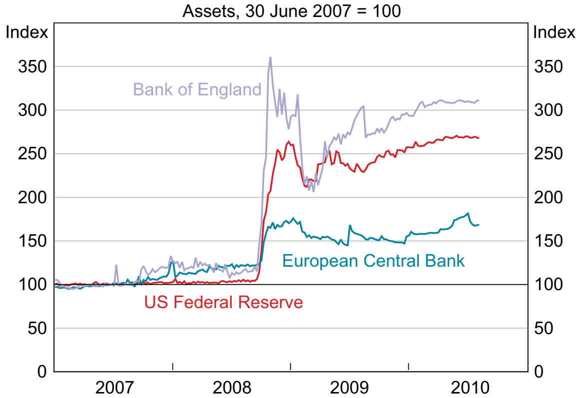
Sources: central banks

Graph 17
Euro Area Interest Rates



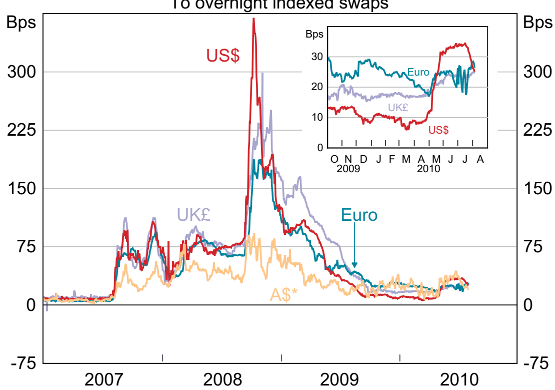
* 3-month annualised
Sources: Bloomberg; European Central Bank

Graph 18
Central Bank Balance Sheets
Assets, 30 June 2007 = 100



Source: Thomson Reuters

Graph 19
3-month LIBOR Spreads
To overnight indexed swaps



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

In the United States, the Fed has tested its Term Deposit Facility, which allows financial institutions to deposit funds at the Fed for up to 84 days at competitively-determined interest rates. This facility, and large-scale reverse repo operations, will allow the Fed to reduce the substantial reserves held by depository institutions when required.

The Bank of Japan announced a new loan facility for financial institutions to fund loans to industries with potential for growth. The facility will start around the end of August and disbursements could continue until mid 2012. Under the facility a maximum of ¥3 trillion (US$35 billion) in loans will be offered.

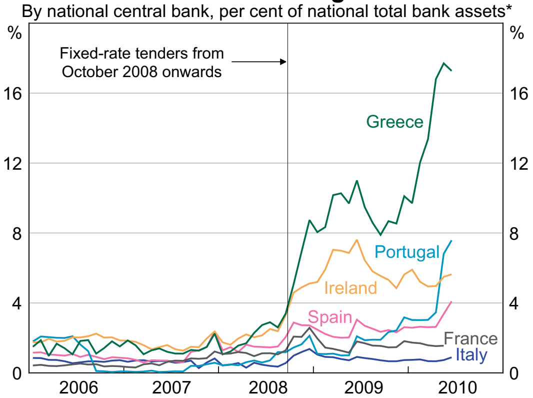
Credit Markets

In money markets, spreads between LIBOR and the expected cash rate (a measure of perceived bank risk) widened as European sovereign debt and banking sector concerns escalated in early May (Graph 19). This was most pronounced for US dollar LIBOR spreads as the relative cost of US dollar funds increased for European banks, although these spreads are well below those prevailing during the height of the financial crisis.

There are indications of tiering in the interbank market in Europe, with some banks having to pay a sizeable premium to obtain funding. Reflecting this, borrowing from the ECB by banks in several peripheral euro area economies has risen (Graph 20). Relative to the size of banks' balance sheets, this increase in borrowing has been most pronounced for Greek and Portuguese banks, while Spanish banks have relied a little more on ECB lending than in the past.

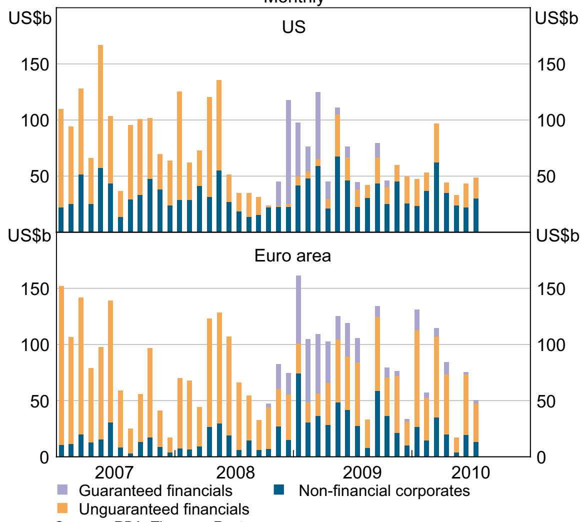
Spreads on bonds issued by US and euro area corporates also widened in response to heightened sovereign debt concerns but have since narrowed slightly. In part reflecting the deterioration in credit market conditions, corporate bond issuance in both regions has been low in recent months (Graph 21). Much of the issuance by financial institutions in Europe has been in the form of covered

Graph 20
ECB Lending
By national central bank, per cent of national total bank assets*



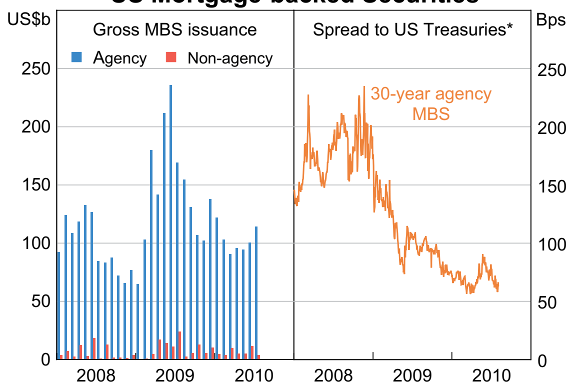
* Monetary financial institutions used as a proxy for total bank assets
Sources: central banks

Graph 21
Corporate Bond Issuance
Monthly



Sources: RBA; Thomson Reuters

Graph 22
US Mortgage-backed Securities



* Spread to 10-year US Treasury yields to approximate the duration of 30-year MBS
Sources: Bloomberg; agency monthly summary reports

bonds. Several EU countries recently extended the expiry date for their government guarantees on bank-issued bonds from end June to end December 2010 but increased the cost of the guarantees. Government-guaranteed issuance, however, has been minimal.

Issuance of agency mortgage-backed securities (MBS) in the United States has increased a little in recent months despite the completion of the Fed's purchase program in March (Graph 22). Nearly all of the issuance continues to be by the agencies, with minimal non-agency issuance. Agency debt and MBS spreads to US Treasuries remain at relatively low levels.

Government Financial Policy

In the United States, financial reform legislation was signed into law in July. Key points in the Act include:

- banking entities will be prohibited from proprietary trading (the 'Volcker rule'). Banks can, however, invest up to 3 per cent of Tier 1 capital in hedge funds and private equity if they are involved in organising or offering the funds. Non-bank financial corporations that conduct proprietary trading will be subject to additional capital requirements;
- banks will be required to spin-off to affiliates derivatives trading operations other than hedging activities using foreign exchange swaps, interest rate swaps, credit default swap contracts and gold/silver derivatives. Most derivatives will be required to be traded on exchanges and cleared through central counterparties;

- issuers of MBS will be required to retain at least 5 per cent of the credit risk, unless the underlying loans meet certain criteria for being low risk;
- an orderly liquidation procedure will be created that will allow regulators to liquidate financial firms that pose a risk to financial stability. No taxpayer funds are to be put at risk in this process and the Federal Reserve is prohibited from bailing out individual institutions in default or in danger or default;
- leverage restrictions and increased capital requirements will be imposed to prevent firms becoming 'too big to fail';
- a Financial Stability Oversight Council will be set up to identify and respond to emerging risks throughout the financial system; and
- a Consumer Financial Protection Bureau will be set up within the Federal Reserve to regulate the offering and provision of consumer financial products and services under federal laws.

The Act also makes rating agencies liable for the quality of their rating decisions if the ratings are included in the registration documents associated with securities issues. As a result, the three major rating agencies have refused permission for their ratings to be included in the registration documents for new debt issues. In response, the Securities and Exchange Commission (SEC) has suspended until January 2011 the requirement that publicly issued asset-backed bonds include ratings in the associated documentation.

The costs of implementing the Act will be recouped by ending the Troubled Asset Relief Program (TARP) earlier than planned and by increasing the fees that banks pay to the Federal Deposit Insurance Corporation for insuring deposits. The US Treasury revised lower its projection of the lifetime cost of the TARP to around US$105 billion in net present value terms from an estimate of US$117 billion made earlier in the year. These costs mainly derive from losses from assisting insurer AIG and the automakers as well as housing-related assistance. The US Treasury expects to earn a profit on the assistance to banks using TARP funds. Repayments of funds provided under the TARP have reached US$201 billion; US$185 billion of funds remain outstanding. The US Treasury has also received US$23 billion in revenue (e.g. dividends) associated with TARP funding.

The UK Government announced that it will introduce a levy on the balance sheets of banks and building societies with relevant liabilities of £20 billion or more in January 2011. The levy will initially be 0.04 per cent and increase to 0.07 per cent in 2012, except for funding with a maturity of more than one year, which will incur half the standard rate. The proceeds from the levy will go to consolidated revenue rather than be used to establish a rescue fund. The French and German Governments as well as the EU Council and European Commission are in the process of drafting proposals for bank levies.

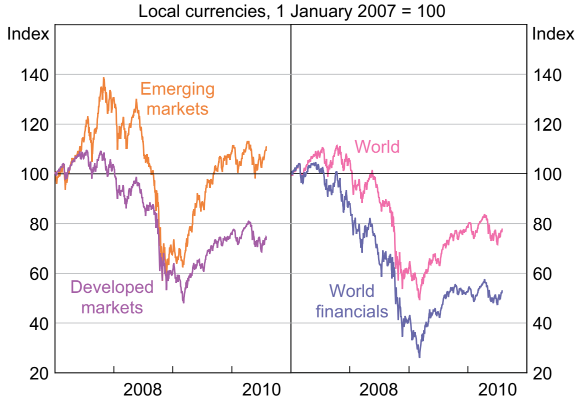
The UK Government also announced significant changes to financial regulation infrastructure. Under the proposal, the Financial Services Authority (FSA) will cease to exist in its current form. A new Prudential Regulatory Authority will be established as a subsidiary of the Bank of England with sole responsibility for the day-to-day prudential supervision of financial institutions. A new Financial Policy Committee, to be chaired by the Governor of the Bank of England, will assess macroeconomic and financial risks to financial stability. The remaining functions of the FSA, which include monitoring the conduct of both retail and wholesale financial services firms, will be performed by a new Consumer Protection and Markets Authority. An independent commission on banking is also looking at how to reduce systemic risk in the banking sector, mitigate moral hazard, and promote competition in both retail and investment banking.

In a similar effort to improve oversight, the European Commission proposed creating a new single supervisor of credit rating agencies in the European Union. Moreover, the Commission aims to make the derivatives market safer and more efficient by enhancing reporting and clearing requirements for over-the-counter derivatives.

Germany introduced a ban on naked short-sales of euro area government bonds, credit default swaps based on such bonds, and shares. In addition, the German regulator has been given authority to ban euro currency derivatives for up to one year if required.

The Irish Government's 'bad bank', the National Asset Management Agency (NAMA), has purchased loans at around 50 per cent of their nominal book value of €20.5 billion from a number of Irish banks. NAMA expects to return a profit of €1 billion in net present value terms but there is considerable uncertainty around this estimate.

Graph 23
MSCI Global Share Price Indices
Local currencies, 1 January 2007 = 100



Source: Bloomberg

Equities

Global equity markets declined by 15 per cent from their recent peak in mid April as European tensions increased, and by early July had fallen to around the level of September 2009 (Graph 23). Most major equity markets have since retraced some of these falls but remain well below their mid-April highs (Table 4).

Table 4: Changes in International Share Prices
Per cent

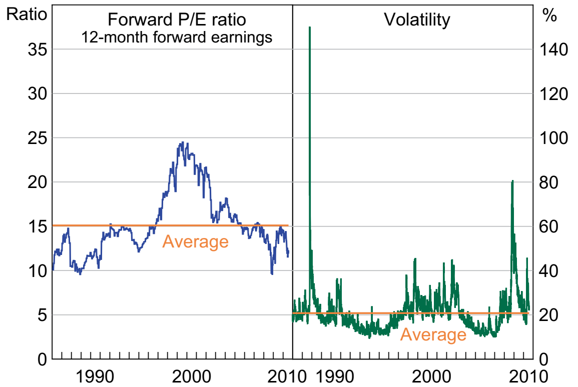
	Since 08/09 trough	April peak to current
United States		
– Dow Jones	63	–5
– S&P 500	67	–7
– NASDAQ	82	–9
Euro area		
– STOXX	59	–6
United Kingdom		
– FTSE	53	–8
Japan		
– Nikkei	35	–16
Canada		
– TSE 300	57	–4
China		
– China A	54	–17
Australia		
– ASX 200	44	–9
MSCI indices		
– Emerging Asia	101	–1
– Latin America	101	–4
– Emerging Europe	107	–7
– World	**58**	**–7**

Source: Bloomberg

Equity markets have recently been supported by US corporate earnings results, with around 80 per cent of earnings reports for the June quarter better than expected. The US forward price-to-earnings ratio has fallen to be well below average (Graph 24).

Most large US banks' earnings beat analysts' expectations due to lower loan-loss provisions but revealed relatively subdued revenue growth. Goldman Sachs' earnings were affected by its agreement to pay US$550 million to settle the SEC charge that Goldman Sachs had made materially misleading statements and omissions in connection with a collateralised debt obligation (CDO) issued in 2007. This penalty is the largest assessed by the SEC against a financial firm but is less than the estimated US$1 billion investors lost on the CDO. US$250 million of the penalty will be returned to the CDO investors and US$300 million will be paid to the US Treasury.

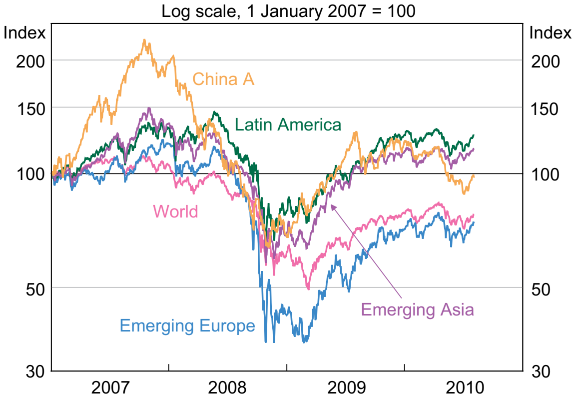
Graph 24
S&P 500



Sources: Bloomberg; Thomson Reuters

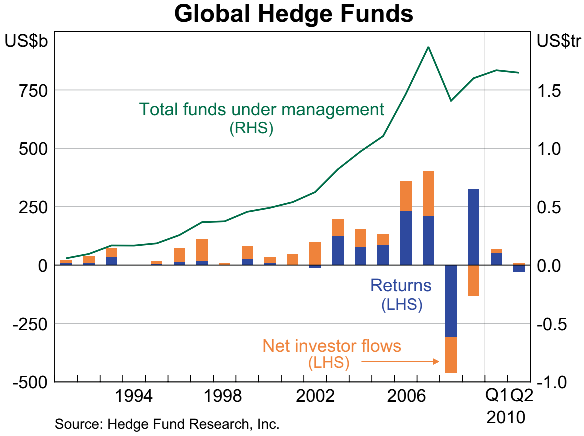
Graph 25
MSCI Share Price Indices

Log scale, 1 January 2007 = 100



Source: Bloomberg

Graph 26
Global Hedge Funds



Source: Hedge Fund Research, Inc.

Volatility in US equity prices has been above average since early May. In response to the unusually large price movements in US equity markets on 6 May, the SEC commenced a six-month pilot program in June that requires each US national exchange to pause trading in any S&P 500 stock that experiences a price change of more than 10 per cent in a five minute period. In addition, the national exchanges have proposed rules to clarify processes for cancelling erroneous trades.

Japanese equity market prices have underperformed other major advanced equity markets, in part reflecting the effect of the appreciation of the yen on Japanese export earnings. European equity markets have slightly outperformed other major equity markets since early May, with European banks' share prices increasing particularly sharply.

Equity price movements in most emerging economies have broadly reflected those in major advanced economies in recent months (Graph 25). An exception is Chinese equity prices which reached a 15-month low in July and have fallen by around 17 per cent since mid April. This has reflected concerns over the pace of policy tightening in China and the related uncertainty regarding China's economic outlook.

Hedge Funds

The decline in equity markets was reflected in an average 3 per cent loss for the global hedge fund industry in the June quarter 2010 (Graph 26). The fall followed five quarters of positive returns. A small injection of investor capital partly offset the loss so that funds under management declined by just 1 per cent. Despite funds largely recovering losses incurred during the financial crisis, funds under management in the industry remain around 15 per cent below their peak prior to the crisis owing to the large redemptions in 2008 and 2009.

Foreign Exchange

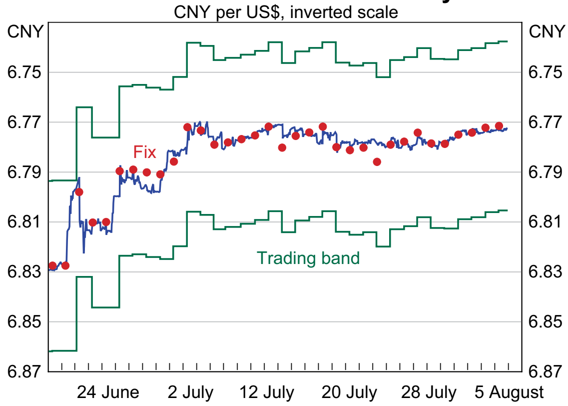
In mid June the People's Bank of China (PBC) announced that it would increase the flexibility of the renminbi exchange rate, signalling an end to the peg with the US dollar that had been in place since July 2008. Daily moves in the exchange rate will continue to be limited to a 0.5 per cent band around the fix set by the central bank each day. There was a number of relatively large daily moves in the renminbi in the two weeks following the announcement – with the renminbi appreciating against the US dollar by around 1 per cent – but since then it has traded in a tight range (Graph 27).

The PBC's statement emphasised the official view that the renminbi is close to its equilibrium value and that there is no basis for a large scale appreciation. In trade-weighted terms, the Chinese exchange rate has appreciated modestly since the start of 2010, but remains below its peak in March 2009 (Graph 28).

In trade-weighted terms the US dollar and the euro have depreciated slightly since the previous *Statement*, although there have been sizeable swings over the period (Graph 29). The US dollar is 5 per cent above its lows in late 2009, while the euro is around 10 per cent lower than its peak of around the same time.

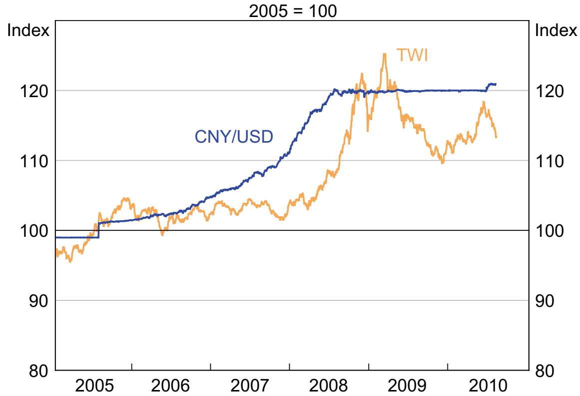
Concerns over the fiscal position of a number of euro area countries saw the euro depreciate against the US dollar in May (Graph 30; Table 5). However, the euro has appreciated against the US dollar since its low point in early June, reflecting relatively strong economic data, in contrast with the somewhat weaker-than-expected US data, and moderating concerns regarding the European fiscal situation following the positive outcome from the bank stress tests. The Japanese yen has also appreciated against the US dollar to be close to its record highs.

Graph 27
Chinese Renminbi – Intraday
CNY per US$, inverted scale



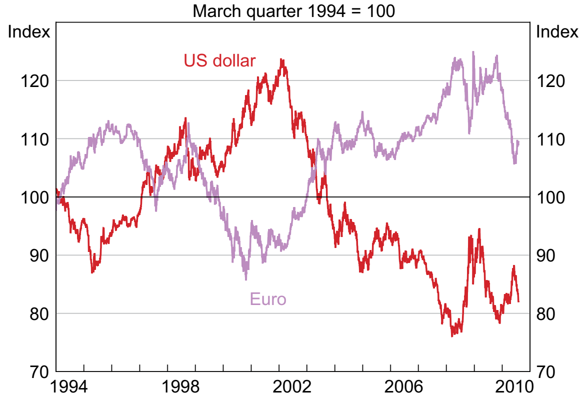
Source: Bloomberg

Graph 28
Chinese Renminbi
2005 = 100



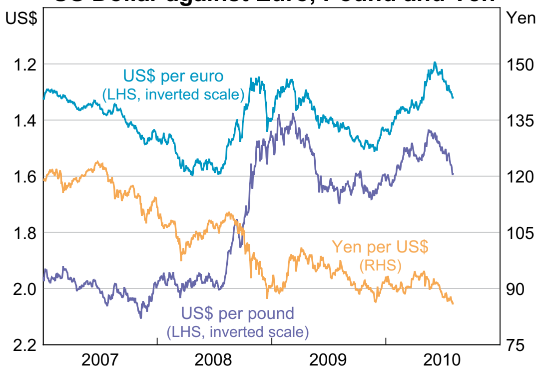
Source: Bloomberg

Graph 29
US Dollar TWI and Euro TWI
March quarter 1994 = 100



Sources: Board of Governors of the Federal Reserve System; European Central Bank

Graph 30
US Dollar against Euro, Pound and Yen



Source: Bloomberg

Table 5: US Dollar against Other Currencies
Percentage change

	Past year	Since previous *Statement*
European euro	9	0
UK pound sterling	7	–4
Swedish krona	0	–2
Swiss franc	–1	–3
Chinese renminbi	–1	–1
New Taiwan dollar	–3	–1
Brazilian real	–4	0
Indian rupee	–4	3
South Korean won	–4	5
Mexican peso	–5	1
Canadian dollar	–5	1
Philippine peso	–5	1
Thai baht	–5	–1
Singapore dollar	–6	–2
South African rand	–7	–2
Australian dollar	–8	1
New Zealand dollar	–8	–2
Indonesian rupiah	–9	–1
Malaysian ringgit	–9	–1
Japanese yen	–9	–8
Majors TWI	**0**	**–2**
Broad TWI	**–1**	**–1**

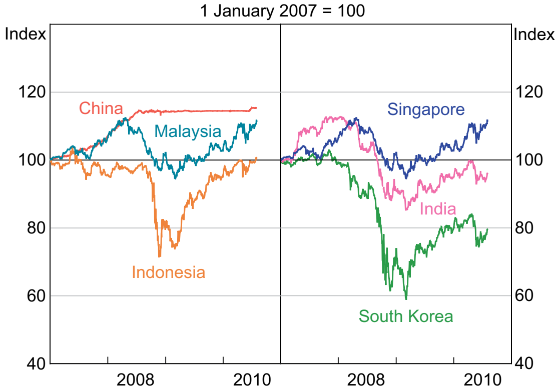
Sources: Bloomberg; Board of Governors of the Federal Reserve System

The Swiss franc appreciated against the US dollar and reached a record high of nearly 76 euro cents on 30 June. The Swiss National Bank intervened heavily in the market, rapidly accumulating foreign exchange reserves until mid June, when it indicated in a statement that the receding risk of deflation would allow it to moderate its intervention activity. The franc has since depreciated slightly against the euro.

Emerging Asian currencies have been mixed against the US dollar, despite the strength of the recovery in the region, due to lingering concerns about sovereign debt in some euro area countries and evidence that China's growth may be slowing (Graph 31). The South Korean won and the Indian rupee have depreciated significantly in recent months, by 5 per cent and 3 per cent respectively, while most other currencies have appreciated modestly.

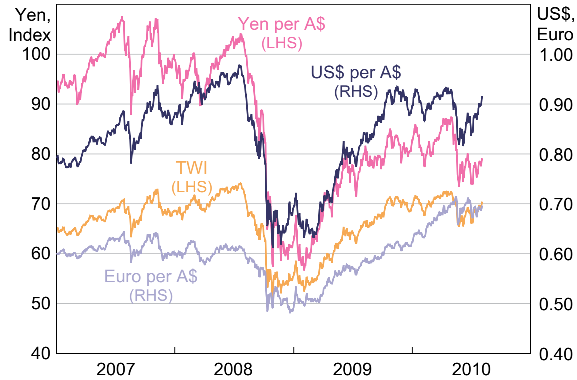
South Korea introduced capital controls in June, citing a need to reduce the volatility in their capital flows. The Bank of Korea announced that it was placing new limits on banks' currency forward positions and reinforcing restrictions on foreign-currency lending for domestic operations. Indonesia also introduced measures designed to reduce the short-term volatility of their capital flows. Bank Indonesia introduced longer maturity central bank bills, restrictions on the resale of bills within a month of purchase, and reduced the interest rate on deposits at the central bank. These measures apply to both foreign and domestic investors, but are designed primarily to slow potentially volatile short-term capital inflows. Both announcements were perceived by the market as relatively benign, with the negative effect on the respective currencies relatively muted.

Graph 31
Selected Asian Currencies against US Dollar



Source: Bloomberg

Graph 32
Australian Dollar



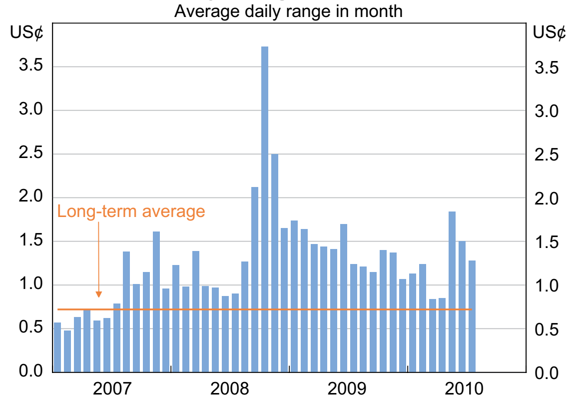
Sources: RBA; Thomson Reuters; WM/Reuters

Australian Dollar

The Australian dollar depreciated sharply from early May as risk appetite fell in response to concerns about the fiscal situation in some European economies and lower commodity prices, reaching a low of 81 US cents in early June (Graph 32). As concerns about the European situation have moderated and domestic data releases have signalled that the Australian economy is performing relatively well, the currency has reversed most of the decline (Table 6). On a trade-weighted basis, the Australian dollar remains around 35 per cent above its trough in February 2009.

After rising in May to its highest level since the most intense period of the financial crisis, volatility in the Australian dollar has declined, but remains high relative to its long-term average (Graph 33).

Graph 33
Intraday Range in AUD/USD



Source: Bloomberg

Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

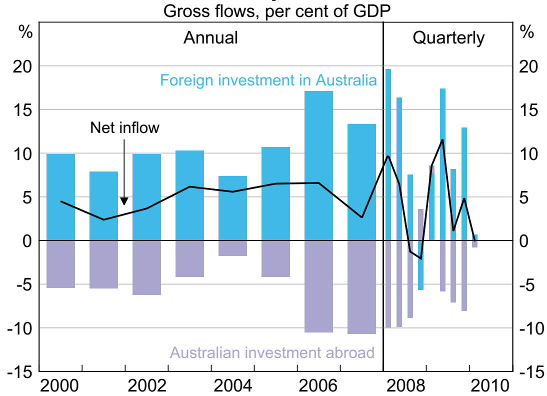
	Past year	Since previous *Statement*	Deviation from post-float average
European euro	19	0	5
UK pound sterling	17	–5	29
US dollar	9	–1	26
Swiss franc	8	–4	–9
Chinese renminbi	8	–2	33
Indian rupee	6	2	58
South Korean won	4	4	55
Canadian dollar	4	0	0
Thai baht	3	–1	24
Singapore dollar	3	–2	–1
South African rand	0	–3	49
New Zealand dollar	0	–3	1
Japanese yen	–1	–9	–16
Malaysian ringgit	–1	–2	30
Indonesian rupiah	–1	–2	119
TWI	**6**	**–3**	**19**

Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

Capital Flows

Net private capital inflow was relatively modest in the March quarter as strong issuance of long-term debt by Australian banks was offset by a decline in their short-term foreign liabilities, a trend evident over the past year (Graph 34). Some of the decline in private inflows was accommodated by stronger inflows into government debt, in line with the pick-up in issuance of Commonwealth government debt. ✠

Graph 34
Private Capital Flows
Gross flows, per cent of GDP



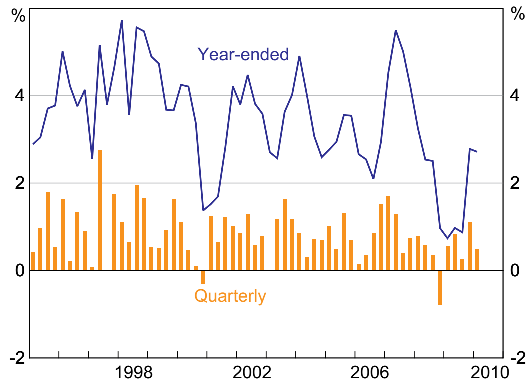
Sources: ABS; RBA

Domestic Economic Conditions

The Australian economy continued to expand at a solid pace over the first half of 2010. The economy is benefiting from elevated commodity prices and high levels of public investment. Employment growth has been strong and confidence remains generally positive. Over the period ahead, some rebalancing of growth is expected, with public investment likely to decline as stimulus projects are completed, while private demand is expected to strengthen. The outlook for investment in the resources sector remains especially positive and the high level of the terms of trade is boosting incomes and demand.

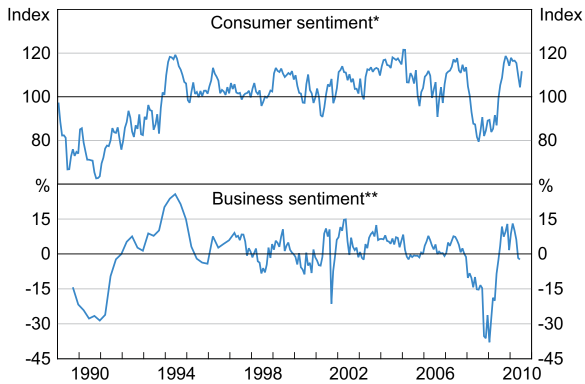
The latest available GDP data show that real GDP increased by 0.5 per cent in the March quarter, to be 2.7 per cent higher over the year (Graph 35, Table 7). The level of output in Australia is now 2.5 per cent above that in the September quarter of 2008, whereas for most other advanced economies, the level of output remains around or below its earlier peak. As discussed in previous *Statements,* the share of investment in GDP in Australia remains much higher than in other advanced economies and Australia's exports have performed relatively well. Looking forward, timely indicators of economic activity, including measures of consumer and business confidence and information from the Bank's liaison program, are consistent with continued growth in economic activity (Graph 36).

Graph 35
GDP Growth



Source: ABS

Graph 36
Sentiment Indicators



* Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index; average since 1980 = 100
** Net balance; deviation from average since 1989
Sources: Melbourne Institute and Westpac; NAB; RBA; Roy Morgan Research

Table 7: Demand and Output Growth
Per cent

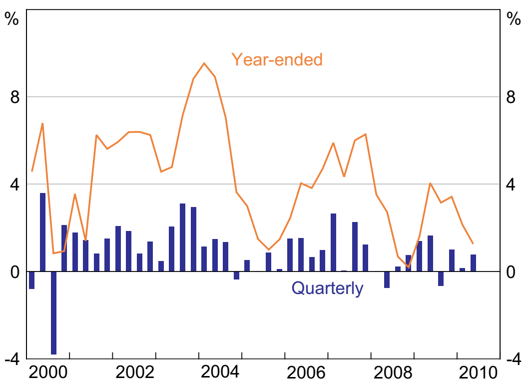
	March quarter 2010	Year to March quarter 2010
Domestic final demand	0.6	4.4
– Private demand	–0.4	2.0
– Public demand	3.8	12.9
GNE	0.8	5.7
Net exports[a]	–0.5	–2.7
Statistical discrepancy[a]	0.2	–0.4
GDP	0.5	2.7

(a) Contribution to GDP growth
Source: ABS

Household Sector

Household spending appears to have grown at a moderate pace through the first half of 2010. While this partly reflects the unwinding of the boost to spending that occurred in late 2008 and early 2009 as a result of the stimulus payments, it also appears that many households are taking a more cautious approach to their finances than was the case over much of the past decade and a half. In the June quarter this year, the volume of retail sales increased by 0.8 per cent, after rising by just 0.1 per cent in the March quarter (Graph 37). Other components of household consumption – particularly motor vehicles and services – have been stronger than retail sales. Total consumption rose by 0.6 per cent in the March quarter, to be 3.1 per cent higher over the year, while motor vehicle sales to households rose by more than 10 per cent in the June quarter, although they eased in July. The level of motor vehicles sales has recovered the 20 per cent fall that occurred in 2008 and the first half of 2009.

Graph 37
Real Retail Sales Growth



Source: ABS

Household income and confidence have been supported by the improvement in labour market conditions and the recovery in household wealth. Household net worth is estimated to be more than 20 per cent higher than the trough in early 2009, although it was little changed in the June quarter, reflecting softer growth in housing prices and a decline in equity prices. Measures of consumer sentiment continue to be above long-run average levels, with consumers appearing to be optimistic about future economic conditions. Despite this, the increased cautiousness of the household sector means that the household saving rate remains above its decade average (Graph 38). The increase in mortgage rates to around average levels has also resulted in households using more of their income to service debt; the ratio of household interest payments to disposable income has increased by around 2½ percentage points over the past year, although it remains well below its peak in September

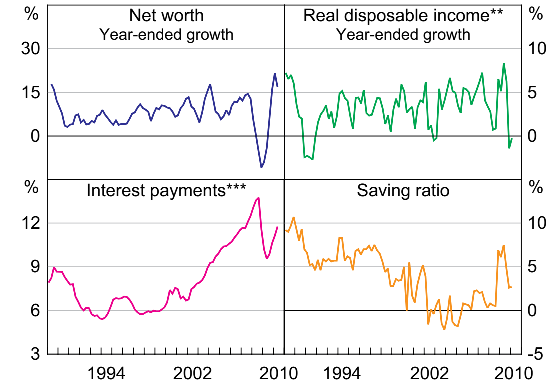
2008. However, this is likely to overstate somewhat the increase in overall payments on mortgages, given that some households left their payments unchanged as interest rates fell in late 2008 and early 2009 and will not have been as affected by the subsequent rise in interest rates.

The housing construction sector has been in a modest upswing since mid 2009, although recent data for building approvals indicate a slowing in momentum (Graph 39). Private building approvals rose by close to 50 per cent over 2009, boosted by the higher federal and state government grants to first-home buyers and the very low level of interest rates. However, with those factors being largely unwound more recently, private building approvals have fallen by 9 per cent over the first half of 2010, although a significant fall in approvals for houses has been partly offset by a gradual recovery in approvals for apartments. Overall, despite strong demand for housing from a rapidly growing population and a boost to activity from the construction of new homes under the Federal Government's Social Housing Initiative, the pick-up in homebuilding has been moderate by historical standards, with the number of building approvals currently below peaks seen in the late 1980s, mid 1990s and early 2000s when both the level and rate of growth of the population were lower than is now the case.

In the established housing market, conditions have eased in the June quarter. Data from RP Data-Rismark suggest that monthly growth in housing prices slowed in April and May and that prices fell in June (Graph 40). The cooling in the housing market is also apparent in a slowing in quarterly average price growth (Table 8). Auction clearance rates, which are timely indicators of housing market conditions, have also fallen over recent months from near historic highs to around average levels (Graph 41). The moderation in housing price growth has been relatively broad-based across capital cities and regional

Graph 38

Household Financial Indicators*

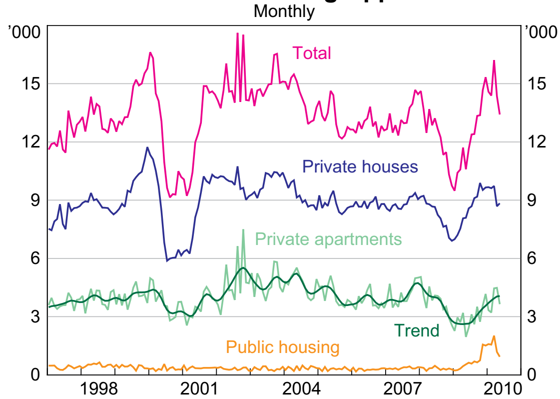


* Net worth and saving ratio include unincorporated enterprises; RBA estimate of net worth for June quarter 2010
** Income is after interest payments and smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002
*** Per cent of household disposable income before the deduction of interest payments; RBA estimate for June quarter 2010
Sources: ABS; RBA

Graph 39

Residential Building Approvals

Monthly

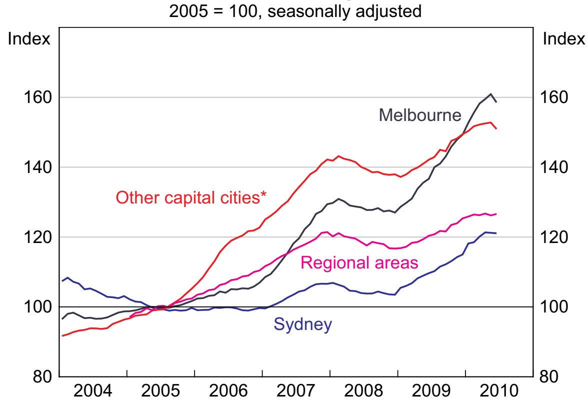


Source: ABS

Graph 40

National Housing Prices

2005 = 100, seasonally adjusted



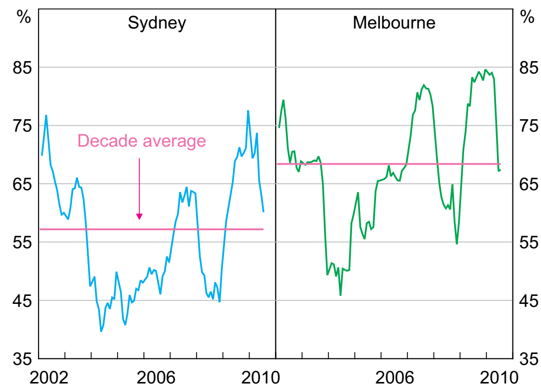
* Includes Adelaide, Brisbane, Canberra and Perth
Sources: RBA; RP Data-Rismark

Table 8: National Housing Price Growth
Per cent

	March quarter 2010	June quarter 2010	Year to June quarter 2010	Trough-to-latest
Capital cities				
ABS[(a)]	4.2	3.1	18.4	23.4
APM	3.7	2.5	15.2	19.2
RP Data-Rismark	4.5	1.4	12.2	17.3
Regional areas				
APM	0.7	0.5	9.4	11.9
RP Data-Rismark[(a)]	1.6	0.3	5.9	8.5

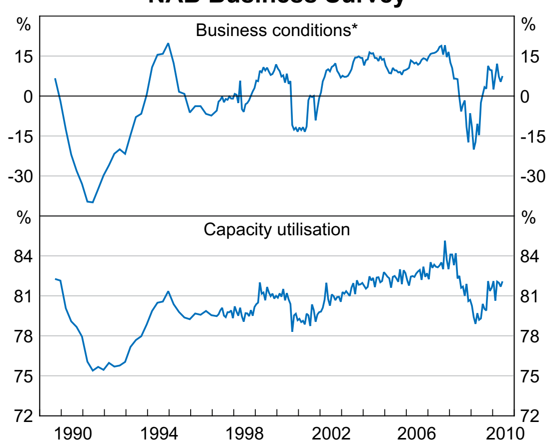
(a) Detached houses only
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 41
Auction Clearance Rates*



* Seasonally adjusted; RBA estimate for Sydney for July 2010
Sources: APM; RBA; REIV; RP Data-Rismark

Graph 42
NAB Business Survey



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

areas, with signs that the previous strong growth in Melbourne house prices has eased (Graph 40).

The slowing in housing price growth is broadly consistent with recent developments in housing finance, with housing loan approvals having fallen by around 15 per cent from their September 2009 peak. The decline has been driven by a fall in owner-occupier loan approvals likely reflecting higher mortgage rates and a fall in turnover in lower-priced suburbs following the expiration of the boost to federal grants to first-home buyers. In contrast, investor loan approvals have been trending steadily higher over the past year, although as a share of total approvals they remain well below the peaks reached over 2002–03, when very strong investor demand was contributing to overheating in some property markets. Loan approvals have been strongest in Victoria, consistent with the stronger housing market conditions in that state.

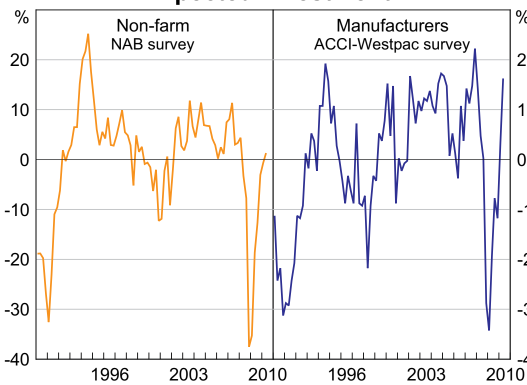
Business Sector

Conditions in the business sector remain reasonably favourable, although there is considerable variation across industries. Business surveys generally report that through to the middle of the year, conditions and capacity utilisation have remained at, or above, average levels (Graph 42). While the pattern of recent data on business investment has been affected by the timing of tax incentives in 2009, there are signs that private investment, outside of that related to the fiscal stimulus building program, is now starting to pick up. Investment is being underpinned by solid internal funding for businesses; survey measures of business profits remain at above-average levels, with the large increases in bulk commodity contract prices likely to have provided a boost to mining profits in the June quarter. Consistent with this, the value of capital imports has risen recently to be 4 per cent higher in the June quarter.

Measures of investment intentions are positive (Graph 43), particularly for the resources sector. The capital expenditure (Capex) survey's second estimate of firms' spending plans in 2010/11 points to a significant rise in buildings and structures investment, led by the mining sector. In particular, with work on the $43 billion Gorgon LNG project having commenced in late 2009, there is a significant pipeline of engineering work yet to be done (Graph 44). Further out, there are a number of significant projects in the advanced stages of planning, including additional LNG projects on the North-West Shelf off the coast of Western Australia and coal-seam methane projects in Queensland. More generally, the positive medium-term outlook for China and other trading partners in Asia suggests that strong demand for a number of Australia's commodities will continue to support a high level of engineering investment activity in the period ahead. Mining investment is underpinning total business investment, which, notwithstanding a modest fall recently, is currently at 16 per cent of GDP – a very high level compared both with history and other advanced countries (Graph 45).

In contrast to the mining sector, private non-residential building activity remains weak (Graph 46). Outside of public spending on private schools, the value of non-residential building approvals has remained at a low level since early 2009. While in recent quarters there have been further declines in approvals for industrial, retail & wholesale sector developments, there appears to be a tentative recovery in approvals for office

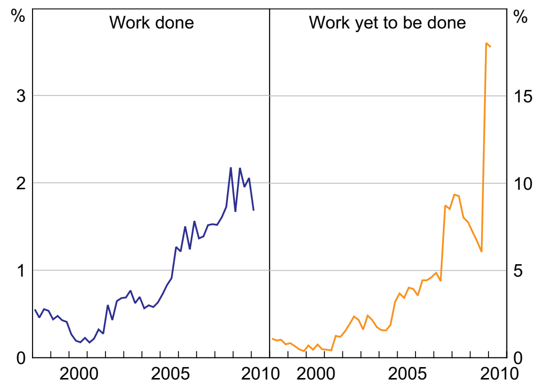
Graph 43
Expected Investment*



* Net balance; deviation from long-run average since: 1989 for NAB, 1961 for ACCI-Westpac

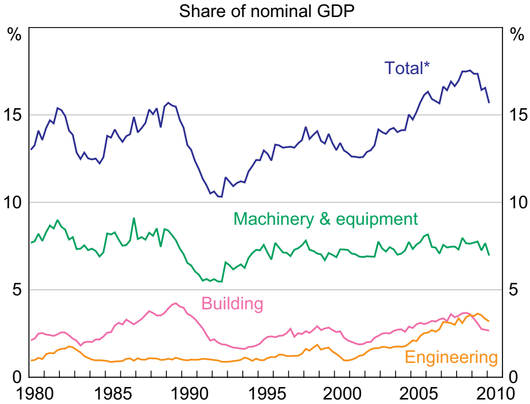
Sources: ACCI-Westpac; NAB

Graph 44
Mining Sector – Engineering Construction
Per cent of nominal GDP



Source: ABS

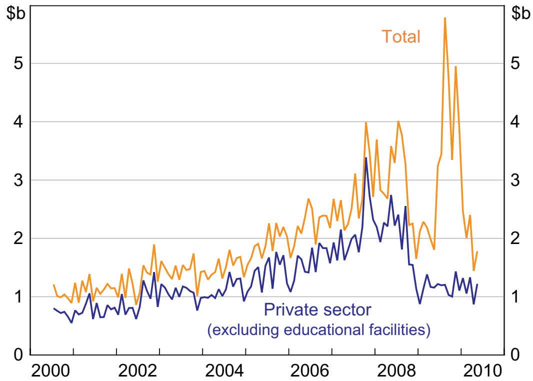
Graph 45
Business Investment
Share of nominal GDP



* Adjusted for second-hand asset transfers between the private and other sectors

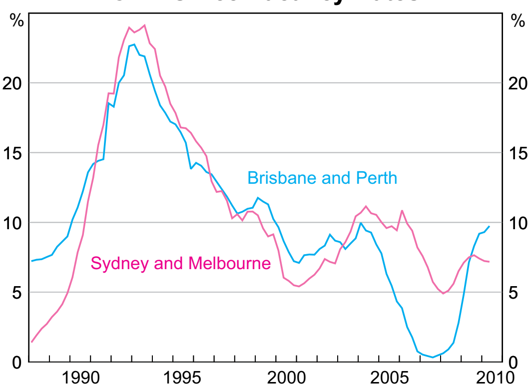
Source: ABS

Graph 46
Non-residential Building Approvals
Current prices, monthly



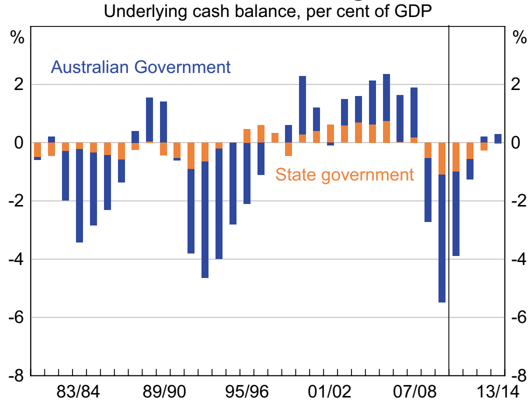
Source: ABS

Graph 47
CBD Office Vacancy Rates



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

Graph 48
General Government Budget Balance
Underlying cash balance, per cent of GDP



Sources: ABS; Australian Treasury; state Treasuries

developments. Demand for office space looks to have picked up in most CBD markets, although conditions in Brisbane and Perth remain soft (Graph 47). Over the next few years, office markets in some capital cities are likely to tighten, due to strong tenant demand and expected modest additions to office space. Liaison suggests that access to funding for most commercial property developer firms remains relatively tight.

Government Budgets

Australian Government and state budgets released since the start of May indicate a gradual reduction in deficits after the significant stimulus that occurred in 2008/09 and 2009/10. In total, the general government (federal plus states) deficit is budgeted to narrow from 5.5 per cent of GDP in 2009/10 to 3.9 per cent in 2010/11, before moving to a small surplus in 2013/14 (Graph 48). The narrowing of the deficit reflects the phasing out of fiscal stimulus and rising government receipts as growth picks up. Total capital expenditure by the state public sector (including both public trading enterprises and the general government sector) is expected to remain high in 2010/11 after rising strongly in 2009/10.

Farm Sector

Farm production is estimated to have increased slightly in 2009/10, with a modest increase in crop production partly offset by a small fall in livestock production. The outlook for the farm sector in 2010/11 appears largely favourable, with an improvement in seasonal conditions. Most cropping regions in the eastern states received average or above-average rainfall in the first half of 2010, and have enjoyed a good start to the season. The Southern Oscillation Index has been positive since April, consistent with the early stages of a La Niña weather pattern, which would normally suggest higher-than-average rainfall in most parts of eastern Australia in the remainder of 2010. However, cropping regions in Western Australia have tended to receive significantly below-average rainfall in the first half of 2010, and the outlook there is weaker. Overall, ABARE estimates that the area planted to wheat has fallen by 2 per cent this year to 13.5 million hectares, but that higher yields will see production increase by 2 per cent to 22.1 million tonnes.

Water inflows to the Murray-Darling basin returned to long-run average levels in the first half of 2010. Water storage levels have picked up in the eastern states since the beginning of the year, most notably in New South Wales and Queensland, and remain at high levels in Western Australia.

External Sector

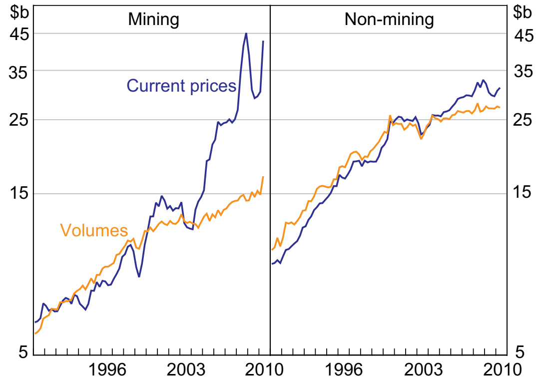
The large increases in bulk commodity contract prices have provided a significant boost to export revenue (Graph 49). As a consequence, the trade balance is estimated to have moved from a deficit of 1.0 per cent of GDP in the March quarter to a surplus of around 2 per cent of GDP in the June quarter, and the current account deficit to have narrowed. The significant increases in contract prices are also estimated to have led to a sharp rise in the terms of trade in the June quarter, back to around their peak in late 2008 (Graph 50).

Export volumes are estimated to have recorded very strong growth in the June quarter, to be around 6 per cent higher over the year, largely reflecting growth in resource exports. Coal exports recovered from weather-related supply disruptions (rising by around 16 per cent in the June quarter), while iron ore export volumes rose more modestly (up 3 per cent), with growth constrained by available port capacity. Gold exports increased sharply in the quarter to be 20 per cent higher, reflecting both an increase in domestic production capacity and higher re-exports. Strong demand for Australia's resource commodities in recent years has supported significant investment in resource projects by mining companies to boost capacity. Further investment in the resources sector – particularly for iron ore, coal and LNG – is expected to underpin strong growth in export volumes as capacity expands further.

Graph 49

Exports*

Log scale



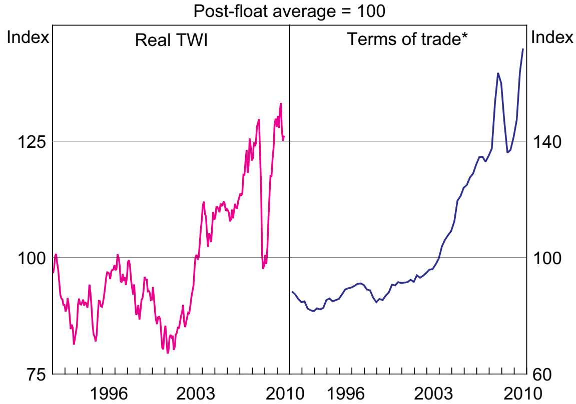
* Volumes data re-referenced to 2003/04 prices; RBA estimate for the June quarter 2010

Sources: ABS; RBA

Graph 50

Real Exchange Rate and Terms of Trade

Post-float average = 100



* RBA estimates for June and September quarters 2010

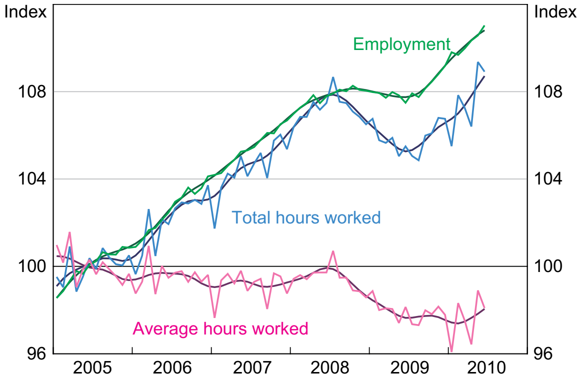
Sources: ABS; RBA; Thomson Reuters

Outside of resources, exports have been more subdued. Non-commodity exports fell slightly in the June quarter, with manufactures and services exports remaining below their pre-crisis peak. Weakness in manufactures exports has been broad-based. Travel-related service exports appear to have fallen in the June quarter, which has contributed to recent weakness in service exports. While global demand is improving, the relatively high value of the Australian dollar (currently around 25 per cent above its post-float average in real terms) may dampen growth for these other export categories (Graph 50).

Graph 51

Employment and Hours Worked

2005 = 100*

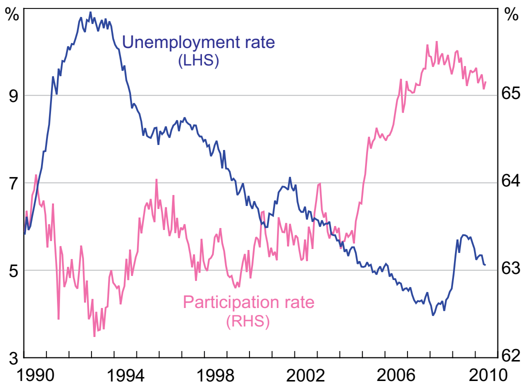


* Smoothed line is a 13-period Henderson trend

Sources: ABS; RBA

Graph 52

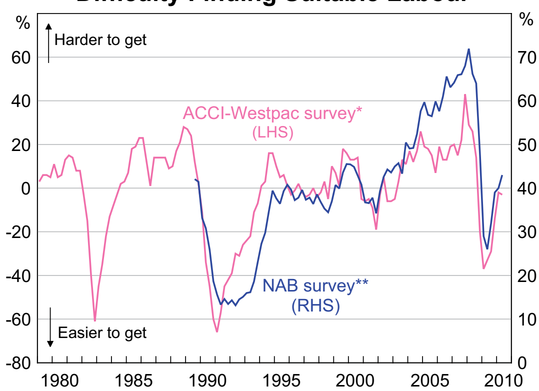
Labour Force



Source: ABS

Graph 53

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

Import volumes are estimated to have increased by around 3½ per cent in the June quarter, with strong growth across the major components. Imports have now recovered the 15 per cent decline that occurred in late 2008 and early 2009, and are expected to grow at a solid pace going forward, underpinned by growth in domestic demand.

Labour Market

Conditions in the labour market have continued to improve. Employment increased by 0.7 per cent in the June quarter, to be 3¼ per cent above its trough in mid 2009 (Graph 51). Most of the growth in recent months has been in full-time employment, which has surpassed its previous peak in 2008. Employment growth has become more broad-based recently, with particularly strong growth in Western Australia and Queensland, following the earlier strength in Victoria. Growth has also broadened across industries, with solid employment gains in services industries, as well as in mining and construction.

The strong employment growth has seen the unemployment rate continue to edge lower, reaching 5.1 per cent in June, around ¾ percentage point below the peak in the recent downturn (Graph 52). Most states have recorded a decline in the unemployment rate over the past year, with the unemployment rate lowest in Western Australia. There are also signs that average hours worked have started to pick up, after declining during the recent labour market downturn.

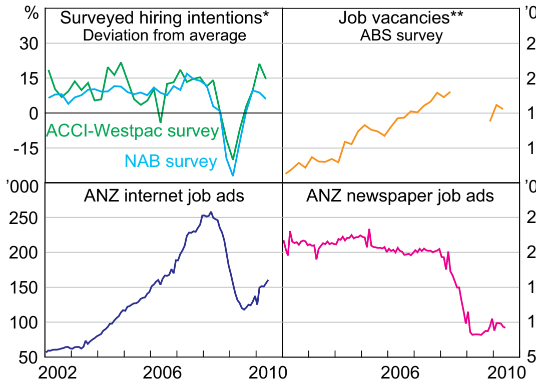
Notwithstanding this improvement in the labour market, business surveys and the Bank's liaison suggest that most firms are not encountering significant difficulty in sourcing suitable labour, except in mining-related industries where there have been reports of emerging skills shortages (Graph 53). While the decline in the participation rate during 2009 was modest relative to previous labour market downturns, it remains ¼–½ percentage point below its recent peak. Further, the decline in the participation rate was associated with a pick-up in the number of 'discouraged job seekers', which includes those who wanted to work but gave up looking due to labour market conditions. This group tends to have a relatively high probability of re-entering the labour force as the labour market improves. More generally, the supply of labour continues to grow robustly, driven by strong growth in the working-age population.

Forward-looking indicators of labour demand suggest that demand is likely to remain solid in coming months, despite some measures easing a little recently (Graph 54). Business survey measures of hiring intentions are at above-average levels. While job vacancies declined slightly over the three months to May according to the ABS survey, this followed a large increase over the previous three months. The ANZ measure of job advertisements has continued to grow, albeit at a slower pace in recent months; aggregate job advertisements in June were more than 30 per cent higher than a year earlier.

The growth in employment and total hours worked since mid 2009 has been strong relative to that in output, with the result that estimated growth in labour productivity has been relatively weak. One partial explanation for the relatively strong employment growth over this period is the subdued growth in real wages in 2009, which is likely to have contributed to hiring. Another possibility is that firms in some sectors may have recommenced hiring at an earlier-than-normal stage in the recovery, prompted by the widespread shortages of skilled labour experienced prior to the recent downturn. More generally, growth in productivity has been subdued for a number of years, particularly relative to the high-productivity period in the 1990s. This slowdown is difficult to explain fully, although lags between investment in the resources sector and new production coming on line may be part of the answer, as is the mining of more input-intensive resources that has become profitable due to elevated commodity prices. Another factor is the higher level of investment in the utilities sector to replace ageing infrastructure and improve the reliability of service. Given the current historically strong growth rates in both capital and labour, a return to average growth rates of productivity would lift estimates of potential output growth (Graph 55). ✠

Graph 54

Labour Market Indicators

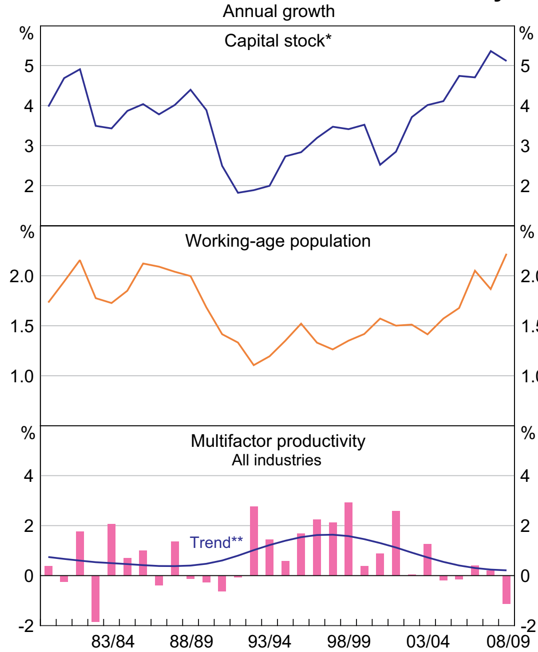


* Expectations for following quarter, net balance
** This series was discontinued by the ABS after May 2008 and subsequently reinstated for the November 2009 reference period
Sources: ABS; ACCI-Westpac; ANZ; NAB; RBA

Graph 55

Factors of Production and Productivity

Annual growth



* Excluding livestock & orchards and private dwelling investment
** Estimated using a Hodrick-Prescott filter, $\lambda = 50$
Sources: ABS; RBA

Domestic Financial Markets

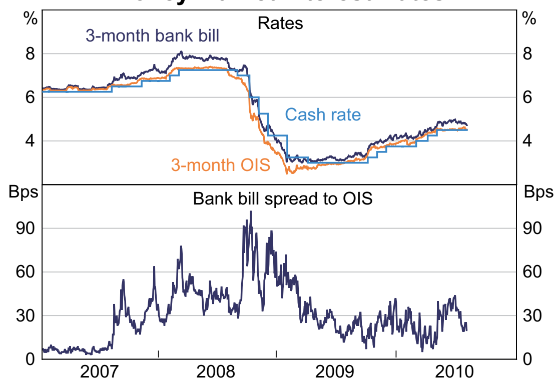
Money Markets and Bond Yields

Since the *Statement* in May, the Reserve Bank Board has maintained its target for the overnight cash rate at 4.50 per cent. An intensification in pressures in global financial markets over recent months saw domestic yields move to price in some probability that the cash rate target could be reduced later in 2010. More recently, as global conditions have stabilised and domestic indicators have pointed to a reasonably buoyant domestic outlook, money market yields have shifted to imply a small chance that monetary policy may be tightened in the year ahead.

Bank bill rates are little changed from the time of the last *Statement*. However, as global financial tensions increased from early May, there was upward pressure on bank bill rates, and relative to overnight indexed swaps (OIS), bill spreads temporarily rose to their highest level since the first quarter of 2009 (Graph 56). As the global tensions have eased, the spread has fallen back towards the centre of its recent range. Throughout this time, conditions within the domestic money markets have remained liquid and orderly. In its market operations, the Bank has generally maintained aggregate Exchange Settlement (ES) balances within a $1½–2 billion range, having allowed balances to rise temporarily over the financial year-end.

Bond yields fell sharply during May and June in line with global developments (Graph 57). The yield on 10-year Commonwealth Government Securities (CGS) declined by around 50 basis points to reach

Graph 56
Money Market Interest Rates

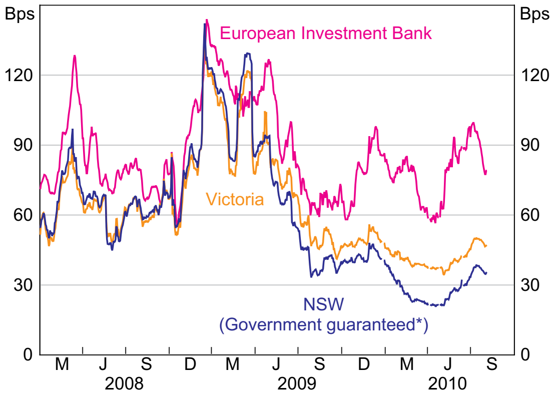


Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

Graph 57
Australian Government Bond Yields

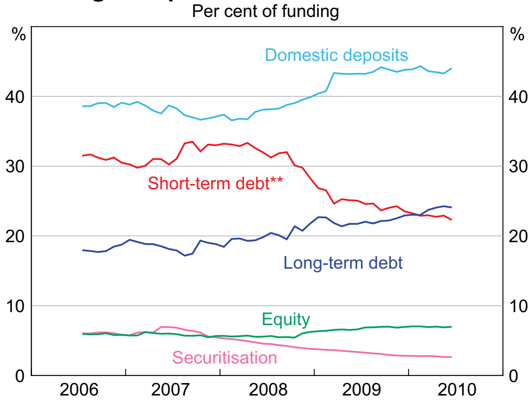
Source: RBA

Graph 58
Spreads to 5-year CGS



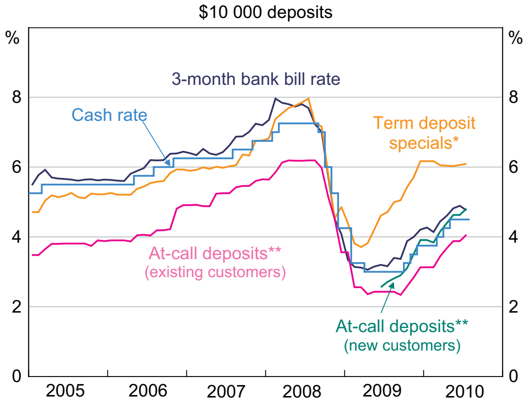
* Guaranteed since September 2009
Sources: RBA; Yieldbroker

Graph 59
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

Graph 60
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

5 per cent at the start of July, with the decline in shorter-dated bond yields more pronounced. In recent weeks as market pessimism has abated, yields have rebounded from their lows. Spreads between CGS and other highly-rated paper – including state government and supranational bonds – widened during the most recent episode of financial turbulence but have since stabilised (Graph 58).

Financial Intermediaries

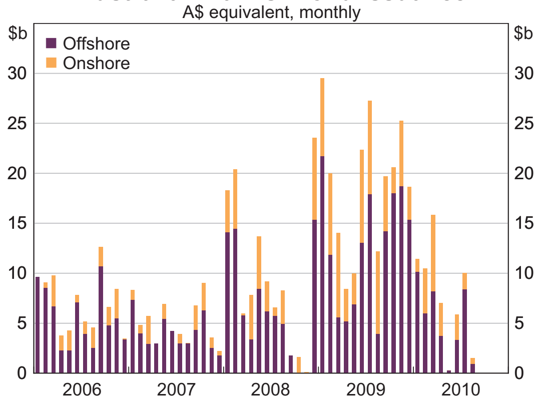
The composition of banks' funding has remained relatively stable in recent months (Graph 59). Competition in deposit markets has eased somewhat from its heightened levels earlier in the year, although pressures for retaining deposit funding at a high level remain strong. The average interest rate on the major banks' new and existing at-call deposits (including online savings, bonus saver and cash management accounts) increased slightly less than the cash rate in May. At-call rates have, however, subsequently increased a little more.

The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has been little changed since end April, at just over 6 per cent (Graph 60). It remains about 240 basis points higher than it was in early 2009, and around 110 basis points above market rates of equivalent duration. The major banks continue to offer higher interest rates on 'special' term deposits than on wholesale funds of equivalent maturity (both for short and long maturities). On average, the smaller Australian-owned banks' 'special' term deposit rates are also little changed since end April, and are at similar levels to those offered by the major banks.

Australian bank bond issuance was subdued in May and June, reflecting the heightened uncertainty in global markets and the fact that the banks were well ahead on their funding requirements. Issuance rebounded in July as market conditions have improved. Since the previous *Statement*, domestic banks have issued bonds totalling $17.8 billion, with around one-quarter of the issuance in the domestic market (Graph 61). The cost of the recent issuance has increased a little, broadly in line with the rise in spreads in secondary markets. Since the previous *Statement*, secondary market yields on the major banks' bonds have not fallen as much as those on CGS, with the spread widening by a little over 20 basis points (Graph 62). Nevertheless, spreads remain well below their peaks in early 2009. The recent increase in bank bond spreads has had only a small effect on banks' funding costs, as discussed in 'Box B: Developments in Bank Funding costs'.

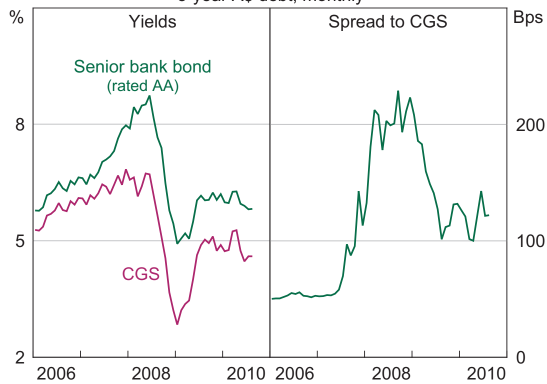
Cross-currency basis swap spreads – which represent an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – have increased slightly since the previous *Statement* but remain below their levels early this year (Graph 63). The elevated cross currency basis swap generally

Graph 61
Australian Banks' Bond Issuance
A$ equivalent, monthly



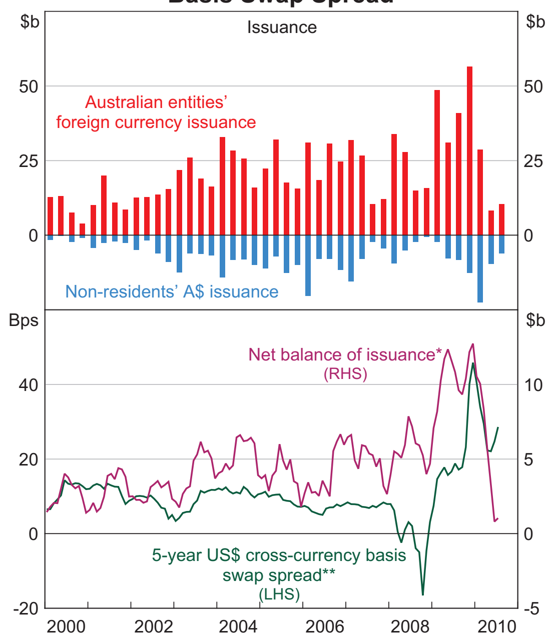
Source: RBA

Graph 62
Major Banks' Bond Pricing
3-year A$ debt, monthly



Sources: RBA; UBS AG, Australia Branch

Graph 63
Bond Issuance and the Cross-currency Basis Swap Spread



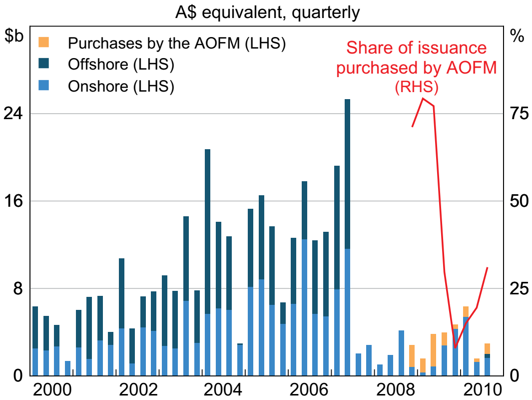
* Australian entities' foreign currency issuance less non-residents' domestic and offshore Australian dollar issuance; 6-month moving average

** Monthly average

Sources: Bloomberg; RBA

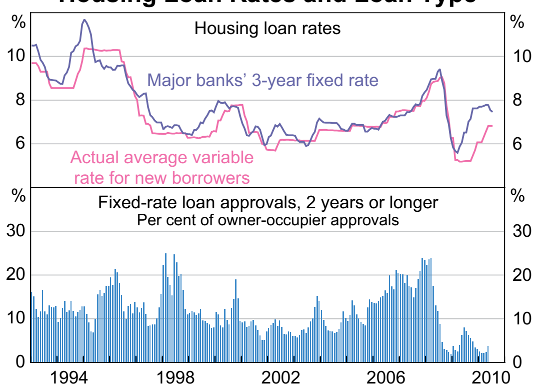
encourages non-resident bond issuers – including those of Kangaroo bonds – to issue in Australian dollars and hedge into foreign currency. Kangaroo issuance, which was very strong early this year when the cross-currency basis swap was more elevated, has moderated while Australian entities' foreign-currency issuance has also been moderate over the period as a whole. This has resulted in less liquidity in cross-currency swaps.

Graph 64
Australian RMBS Issuance
A$ equivalent, quarterly



Source: RBA

Graph 65
Housing Loan Rates and Loan Type



Sources: ABS; APRA; Perpetual; RBA

Activity in the Australian securitisation markets was subdued in the June quarter, with just $2.3 billion of issuance. It has picked up in July with issuance amounting to around $4.2 billion. The Australian Office of Financial Management (AOFM) has increased its participation in the residential mortgage backed securities (RMBS) market, purchasing around one-quarter of the securities issued since the previous *Statement* (Graph 64). The AOFM announced in late May that it intended to tighten pricing in the primary RMBS market by investing at lower spreads. The AOFM's initiative reduced average spreads on primary issuance but secondary market spreads have remained broadly stable in the last few months, at around 145 basis points above the bank bill swap rate (BBSW).

In July, two securitisation transactions by Australian entities were launched in US dollars, one involving RMBS and another issue backed by auto loans. This was the first US dollar-denominated securitisation by Australian entities since May 2007, and the first offshore securitisation since the Euro market was tapped in July 2008.

Household Financing

Financial intermediaries largely passed on the May increase in the cash rate to variable housing loan rates (Table 9). With the cash rate unchanged since then, most lenders have also left their variable rates unchanged. Consequently, the average variable interest rate on prime full-doc loans (including discounts) has risen by 25 basis points since end April. Interest rates on low-doc loans have risen by a little more than the cash rate over this period.

The major banks' interest rates on new 3-year fixed-rate housing loans have declined by around 30 basis points in recent months (Graph 65). This is less than the decline in corresponding swap rates, a common pricing benchmark. The decline in fixed rates over recent months has resulted in a narrowing of the spread between fixed rates and variable rates on housing loans. Nevertheless, with fixed rates still around 60 basis points above variable rates, the share

Table 9: Intermediaries' Variable Lending Rates

Per cent

	Level at end July 2010	Change since: End April 2010	End April 2009
Cash rate	4.50	0.25	1.50
Housing loans			
Prime full-doc	6.82	0.25	1.63
Prime low-doc	7.48	0.31	1.68
Personal loans	12.64	0.25	1.69
Small business			
Residentially secured			
Term loans	8.59	0.25	1.51
Overdraft	9.45	0.25	1.56
Average actual rate[a]	8.52	0.25	1.42
Large business			
Average actual rate, variable and bill funding[a]	6.80	0.57	1.79

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

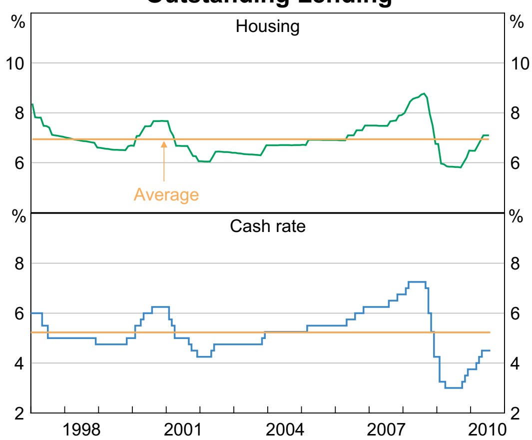
of owner-occupier loans approved at fixed rates has remained relatively low at around 4 per cent.

The average rate on all housing loans (both fixed and variable) has increased by around 130 basis points from its low in 2009, and is broadly in line with its post-1996 average (Graph 66).

After declining from late 2009, the value of housing loan approvals has been little changed in recent months (Graph 67). Owner-occupier loan approvals are well below the peak late last year, reflecting the fall in first home buyers and the rise in mortgage rates. Housing loan approvals to investors have continued to rise modestly over recent months.

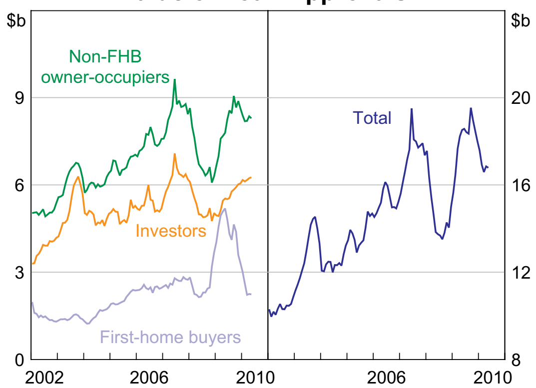
The five largest banks' share of gross owner-occupier loan approvals has declined in recent months, but remains well above its pre-crisis level. At 77 per cent, the market share of the major banks is around 6 percentage points below its peak in early 2009.

Graph 66
Average Interest Rates on Outstanding Lending



Sources: ABS; APRA; Perpetual; RBA

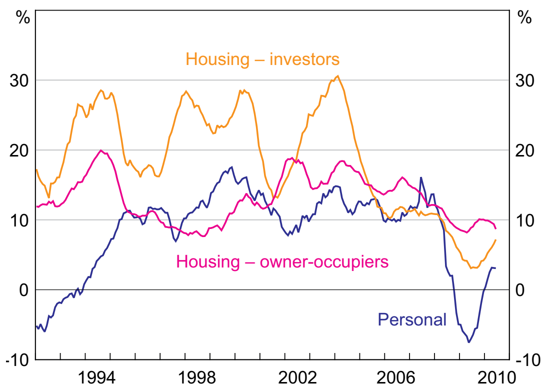
Graph 67
Value of Loan Approvals*



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

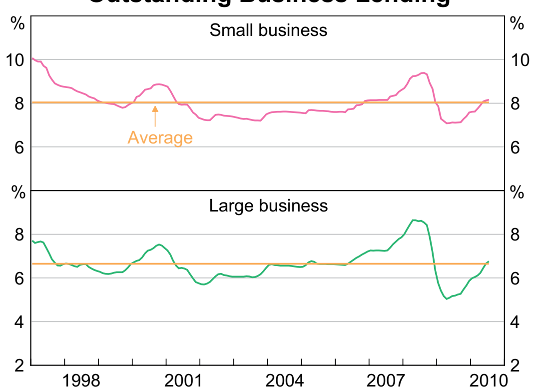
Sources: ABS; RBA

Graph 68
Household Credit Growth
Year-ended



Source: RBA

Graph 69
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

Broadly consistent with recent trends in loan approvals, housing credit growth eased to an average 0.5 per cent per month in the June quarter (Graph 68). While owner-occupier housing credit has been the main driver of growth over the past year, growth in lending to investors has picked up in recent months.

Financial institutions' rates on most variable personal loans have increased by an average of 25 basis points in the three months to end July, with similar increases across most products, including unsecured personal loans, home equity loans, credit cards and margin loans.

Personal credit, which is a small component of household credit, decreased in the June quarter following three quarters of growth. The fall in recent months was largely due to a fall in margin lending. Despite the fall in lending, gearing levels still picked up a little due to weakness in the value of collateral (mainly equities). Nevertheless, the low level of gearing has meant that the number of margin calls also remained low (at less than one margin call per day per 1 000 clients).

Business Financing

Since the beginning of the tightening phase in October 2009, the major banks have increased their variable indicator rates on small business lending in line with increases in the cash rate. Since end April, the indicator rate has increased by 25 basis points, while indicator rates on 1-5 year fixed-rate facilities have generally decreased by around 40 basis points, broadly in line with corresponding swap rates. At 8.16 per cent, the average rate on small business loans outstanding is now around its post-1996 average (Graph 69). However, small businesses report that lending conditions remain tight, with long and involved approval processes for establishing new facilities.

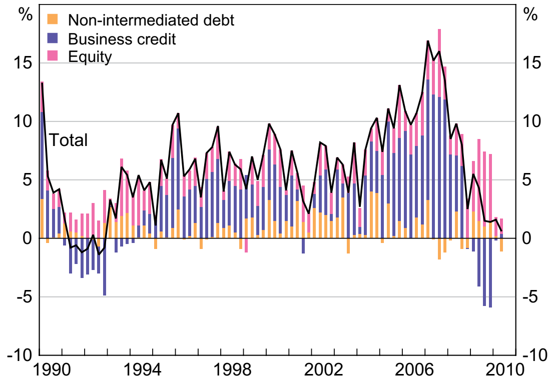
The average interest rate on banks' outstanding variable-rate lending to large business (i.e. variable-rate facilities of $2 million or more, including bill funding) is estimated to have increased by almost 60 basis points since end April, to 6.80 per cent. These loans are repriced at regular intervals off a money market benchmark (such as the 3-month bank bill yield) with the rise in line with higher market rates and some increases in average risk margins as spreads on new loans are higher than those on existing loans. While the average spread on outstanding lending has continued to rise slowly, there are signs that credit conditions have eased somewhat over the past year for some business borrowers, with a decline in the average spread on new lending.

Net corporate external funding was little changed as a share of GDP in the June quarter, with a decline in the stock of non-intermediated debt offset by equity raisings and a small rise in business credit (Graph 70). After record equity issuance of over $70 billion in 2009, so far this year listed corporates' have raised around $10 billion. Commercial loan approvals have been trending higher in recent months. Following a weak start to the year, syndicated loan approvals picked up in the June quarter, with deals worth just over $20 billion. The majority of approvals were for refinancing of existing debt, with loans for general corporate and capital expenditure purposes remaining at low levels.

Aggregate Credit

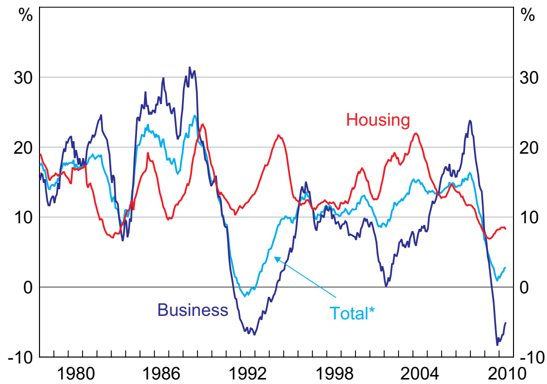
Total outstanding credit grew at an annualised rate of just under 4 per cent over the June quarter, reflecting moderate growth in household credit. Business credit was little changed over the six months to June following falls throughout 2009. Growth in broad money partly reflects banks' competition for term deposits (Table 10; Graph 71).

Graph 70
Business External Funding
Net change as a share of GDP, quarterly



Sources: ABS; ASX; Austraclear Limited; RBA

Graph 71
Credit Growth
Year-ended



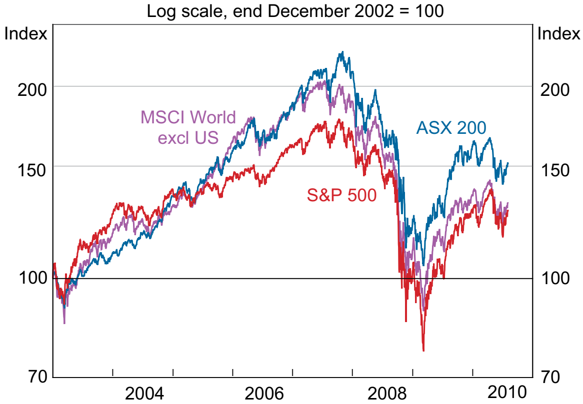
* Includes housing, personal and business credit
Source: RBA

Table 10: Financial Aggregates
Percentage change

	Average monthly growth		Year to June 2010
	March quarter 2010	June quarter 2010	
Total credit	0.4	0.3	2.8
– Owner-occupier housing	0.7	0.5	8.7
– Investor housing	0.7	0.7	7.2
– Personal	0.5	–0.2	3.1
– Business	0.0	0.1	–5.0
Broad Money	0.8	0.5	2.9

Source: RBA

Graph 72
Share Price Indices
Log scale, end December 2002 = 100



Sources: Bloomberg; Thomson Reuters

Equity Markets

Since the previous *Statement,* there has been a significant increase in volatility in the Australian share market. After sharp falls in equity prices throughout May, volatility spiked in early June to levels last seen at the start of 2009. However, as Australian share prices rebounded from recent lows, volatility has declined, though it remains above its long-run average.

In net terms, the ASX 200 is little changed since the previous *Statement,* broadly in line with overseas markets (Graph 72). It remains around 33 per cent below its 2007 peak (Table 11). On a forward earnings basis – which incorporates earnings forecasts for the next 12 months – domestic equities are trading on a P/E ratio of around 12. This is its lowest level since early 2009, and compares with a long-run average of about 14.

Table 11: Sectoral Movements in the ASX 200

	Per cent change since:		
	May *Statement*	Trough (March 2009)	Peak (November 2007)
Resources	5.7	44	–21
Financials	–4.3	61	–41
Other	–1.7	29	–34
ASX 200	**–0.7**	**44**	**–33**

Sources: Bloomberg; RBA

Box B

Developments in Bank Funding Costs*

After a period in which spreads had been relatively steady, a pick-up in uncertainty in global financial markets and general investor risk aversion in recent months has seen renewed upward pressure on spreads in wholesale debt markets globally. Reflecting this, spreads on the major banks' bonds were around 25–50 basis points higher than the recent low in April, although they remain well below the peak levels in late 2008 and early 2009 (see Graph 62). There has also been some increase in costs associated with hedging the foreign exchange risk on new foreign-currency denominated bonds.

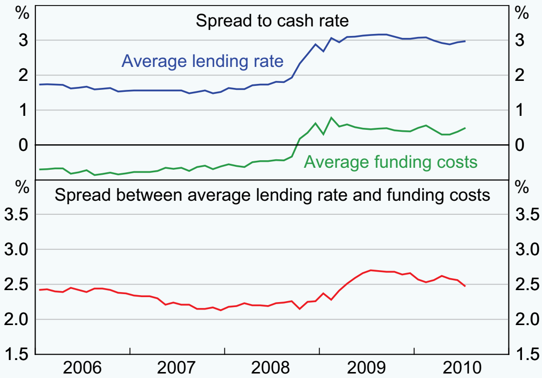
Nevertheless, these recent increases in bond spreads are estimated to have had only a small effect on the major banks' overall funding costs to date. While long-term wholesale debt funding accounts for around one-quarter of the major banks' debt funding liabilities, due to the long life of this type of funding only a small share has actually been issued in the past few months. The major banks have issued $15 billion in bonds (domestically and offshore) in the three months to end July compared with around $425 billion of outstanding long-term debt capital market liabilities (see Graph 61).

In contrast to bond market spreads, the cost of deposits relative to the cash rate has been little changed since the beginning of the year. Given deposits (excluding CDs) account for about one-half of the major banks' overall debt funding liabilities, the cost of this funding source is particularly important in driving movements in overall funding costs. While banks continue to offer attractive rates on deposits (particularly term deposits) in an effort to attract this source of funding, the intensity of competition in the deposit market seems to have eased somewhat over the past few months. In particular, the average spread of new term deposit rates relative to wholesale market interest rates has fallen by around 30–40 basis points from its peak in February.

Banks source the remainder of their funding largely from the wholesale short-term money markets. While spreads in these markets rose during the turbulence in May and June, they have since fallen back and remain around the average seen over the past year.

* This is an update of previous Reserve Bank research on banks' funding costs published as Brown A, M Davies, D Fabbro and T Hanrick (2010), 'Recent Developments in Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 34–44.

Graph B1
Major Banks' Interest Spreads



Source: RBA

Taking into account the various costs for new debt and deposit raisings in recent months, as well as the average cost of outstanding funding, banks' overall funding costs, relative to the cash rate, are estimated to have risen slightly since the beginning of the year (Graph B1). Looking ahead, if bond spreads and hedging costs were to remain around their current levels, then as maturing bonds and hedges are rolled over, the average spread on banks' outstanding bonds is estimated to increase by around 20–25 basis points by the end of 2011. Together with spreads on deposit and short-term wholesale funding staying around current levels, this would imply a rise in banks' overall funding costs of around 5 basis points over the next 18 months or so.

These pressures on funding costs, however, are partially offset by banks continuing to reprice their business loans as facilities are rolled over. Average risk margins have been gradually increasing over the past couple of years. Overall, taking into account movements in average lending rates relative to the movements in the funding costs, the major banks' interest spread has declined from its peak in the middle of 2009 but remains higher than prior to the onset of the global financial turmoil.[1]

1 The interest spread estimated here differs from the net interest margin published by the major banks. Their published margins include interest received on total financial assets (loans, liquid assets and other debt securities), while the calculations used here focus on interest earned on loans.

Price and Wage Developments

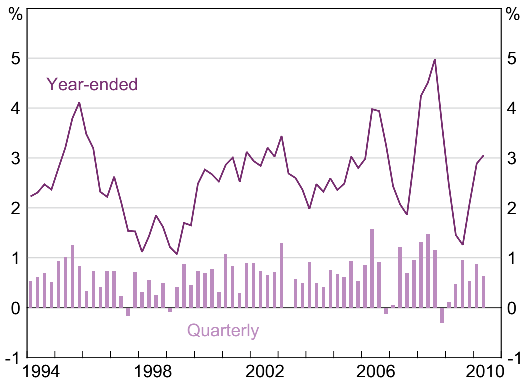
Recent Developments in Inflation

Inflationary pressures have moderated substantially since late 2008, broadly in line with the Bank's expectations. This moderation reflects the significant easing in demand and capacity pressures through 2008 and the first half of 2009, as well as the slowing in wage growth and more recently the effects of the exchange rate appreciation, all of which act over time to dampen inflation. The gradual easing in inflation due to these factors is likely to have largely run its course, with underlying inflation not expected to fall much further over the next year or so.

The consumer price index (CPI) increased by 0.6 per cent in the June quarter, to be 3.1 per cent higher over the year (Table 12, Graph 73). A large rise in tobacco prices contributed 0.4 percentage points

Graph 73

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 12: Measures of Consumer Price Inflation

Per cent

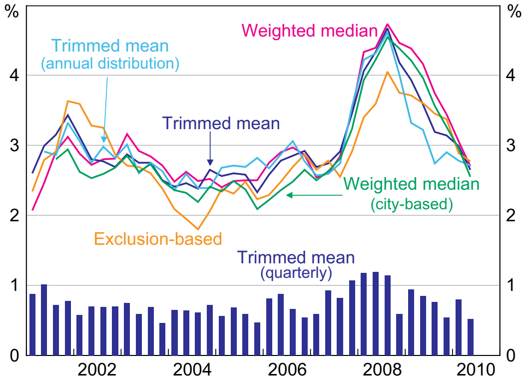
	Quarterly		Year-ended	
	March quarter 2010	June quarter 2010	March quarter 2010	June quarter 2010
CPI	0.9	0.6	2.9	3.1
– Tradables	0.2	1.0	1.1	1.4
– Tradables (excl food, fuel and tobacco)	–1.0	–0.1	0.1	–1.1
– Non-tradables	1.5	0.3	4.2	4.2
Selected underlying measures				
Trimmed mean	0.8	0.5	3.0	2.7
Weighted median	0.8	0.5	3.1	2.7
CPI excl volatile items[(a)] and deposit & loan facilities	0.7	0.7	2.9	2.8

(a) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

Graph 74

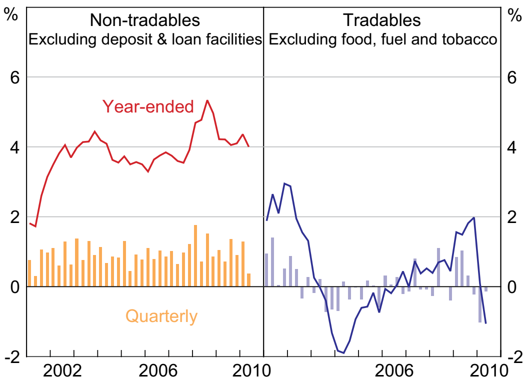
Consumer Price Inflation*



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

Graph 75

Consumer Price Inflation*

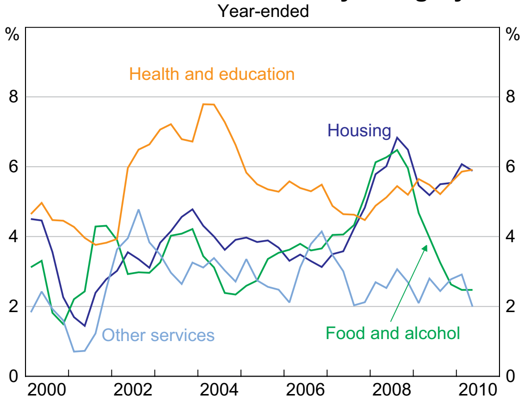


* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

Graph 76

Non-tradables Inflation by Category*

Year-ended



* Adjusted for the tax changes of 1999–2000; excluding deposit & loan facilities
Sources: ABS; RBA

to the quarterly increase, mostly due to the 25 per cent increase in the tobacco excise in late April. Hospital & medical services prices also recorded a solid quarterly rise following the annual resetting of health insurance premiums, as did automotive fuel prices. These were partly offset by significant price falls for holiday travel & accommodation and fruit & vegetables, and subdued outcomes for a number of tradable items.

Based on a range of measures, underlying inflation is estimated to have moderated to around 0.5 per cent in the June quarter and 2¾ per cent over the year (Graph 74). This is well down from the peak of a little over 4½ per cent in September 2008, and it is the first time underlying inflation has been below 3 per cent since September 2007. Consistent with the moderation in underlying inflation, price pressures were less broad-based in the quarter. The proportion of expenditure classes with prices rising in the quarter at an annualised rate of more than 2.5 per cent (seasonally adjusted) fell to around 40 per cent, which is low relative to outcomes over the past decade.

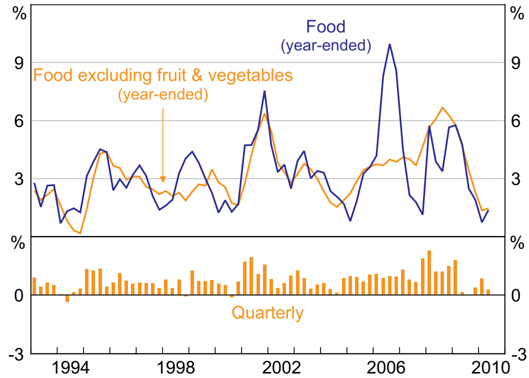
Inflation for non-tradable items has been consistently stronger than inflation for tradable items over a long period (Graph 75). Over the year to the June quarter, non-tradables inflation (excluding deposit & loan facilities) remained firm at 4 per cent, driven by strong price rises for housing, health and education (Graph 76). In the quarter, however, non-tradables inflation slowed to less than ½ per cent, following solid outcomes in previous quarters. This easing was partly due to a 6 per cent fall in the price of domestic holiday travel & accommodation, the largest quarterly decline in a decade, reflecting significant discounting. A slowing in housing-related inflation also contributed to the quarterly easing in non-tradables inflation, although this moderation is likely to be temporary. Inflation in the housing group – which includes house purchase costs, utilities prices and rents – has been strong in recent years and is expected to remain so in the period ahead. While house purchase cost inflation eased in the June quarter, producer price data suggest that the cost of building materials rose solidly in the quarter, which may exert upward pressure on house purchase cost inflation in future. Utilities prices were flat in the quarter, but remained 15 per cent higher over the year, partly reflecting the implementation of large price increases related to ongoing investment in infrastructure. Further significant increases are expected in the September quarter, although some moderation in the year-ended rate of utilities price inflation is expected in the period ahead. Rent inflation remained firm in the June quarter, at a little over 1 per cent, and is expected to pick up over the year ahead, consistent with the tight rental market.

In contrast, inflation for tradable items was subdued over the past year, reflecting the pass-through of the exchange rate appreciation during 2009 and, more recently, the tariff reductions that came into effect in early 2010 and heavy discounting in the retail sector. Excluding tobacco prices – which rose by 15 per cent, mostly due to the excise increase – tradables prices were broadly flat in the quarter. While the prices of some tradable items continued to fall – audio, visual & computing equipment prices declined by more than 6 per cent in the June quarter – there is evidence to suggest that the effects of the exchange rate appreciation may be starting to wane, with producer price data showing that import price inflation has picked up at the earlier stages of production.

Inflation in food prices has also been relatively subdued, with inflation over the past year low relative to outcomes over the past decade (Graph 77). The moderation in food price inflation since early 2009 reflects a number of factors, including an easing in the global prices of some food commodities, the appreciation of the exchange rate, and the broader easing in demand pressures. The Bank's liaison also suggests that there has been significant competition amongst retailers.

Graph 77

Food Price Inflation*



* Adjusted for the tax changes of 1999–2000

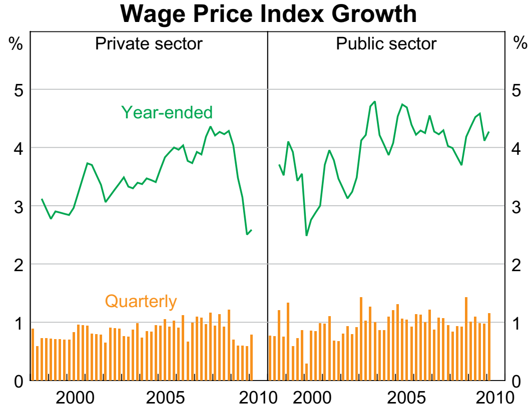
Sources: ABS; RBA

Costs

Labour cost growth has been picking up this year, after a period of unusually low outcomes in 2009, particularly in the private sector. The wage price index (WPI) increased by 0.9 per cent in the March quarter, which is around the average quarterly growth rate since the series began in 1997, with the pick-up fairly broad-based across the states. Over the year, the WPI increased by 3.0 per cent, more than ½ percentage point below its decade average, reflecting subdued quarterly outcomes during 2009. Private-sector wages grew at a below-average pace, to be 2.6 per cent higher over the year, while public-sector wage growth remained solid at 4.3 per cent over the year (Graph 78). Wage growth was stronger

Graph 78

Wage Price Index Growth



Source: ABS

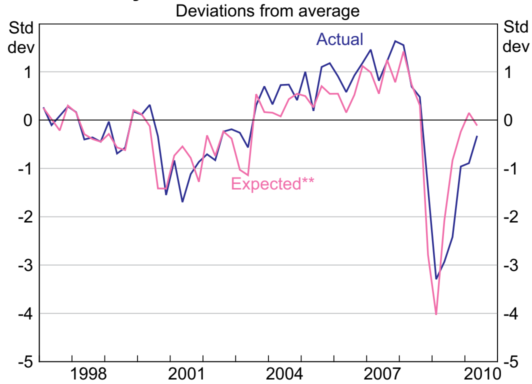
in utilities and public-related industries over the past year, while subdued growth was recorded in manufacturing, wholesale trade and a range of service industries.

Business surveys and the Bank's liaison in recent months also suggest that labour cost growth is picking up (Graph 79), although both indicate that, in general, firms are continuing to have relatively little difficulty finding suitable labour, despite reports of emerging skills shortages by firms exposed to the mining industry.

Graph 79

Surveys of Business Labour Costs*

Deviations from average



* Weighted average of data from various business surveys since 1994, with weights calculated by the RBA using the principal component method

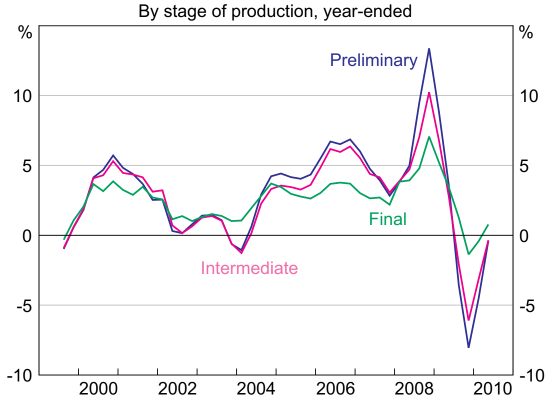
** Expectation for following quarter

Sources: CBA-ACCI; NAB; RBA; Sensis

Graph 80

Producer Price Inflation*

By stage of production, year-ended



* Excluding oil

Sources: ABS; RBA

Fair Work Australia (FWA) handed down its first minimum wage decision in June, increasing the federal minimum wage by around $26 per week, or 4.8 per cent, to $569.90. This was the first increase since late 2008 and followed the Australian Fair Pay Commission's decision to leave the federal minimum wage and basic award rates unchanged in 2009. The increase was towards the upper end of submissions by major stakeholders, which ranged from 2 per cent to 5 per cent, with FWA noting that better-than-expected economic conditions warranted a significant increase in the minimum wage. The $26 increase applies to all federal award wages and came into effect in July. This implies an estimated average increase of around 3½ per cent for award-reliant workers, who account for a little less than a fifth of all employees.

Estimated labour productivity growth appears to have been relatively weak in recent quarters, following strong outcomes over the first half of 2009 (see the 'Domestic Economic Conditions' chapter). The combination of weaker productivity growth and the pick-up in wage growth implies that growth in labour costs per unit of output has increased recently, following significant weakness over 2009.

Producer price data showed that inflation at the final stage of production was quite soft in the June quarter. Final-stage producer prices (excluding oil) rose by 0.3 per cent in the quarter, to be 0.8 per cent higher over the year (Graph 80). At the sectoral level, construction and manufacturing output price inflation eased in the quarter, despite a pick-up in input cost inflation. The data point to emerging price pressures at the early stages of production, following significant declines over 2009. At the preliminary stage, domestic inflation remained firm in the quarter and the disinflationary effects of the exchange rate appreciation in 2009 on import prices appear to have mostly passed. Preliminary prices have risen at an annualised pace of around 5 per cent over the first half of 2010 after declining by 8 per cent over 2009.

Table 13: Median Inflation Expectations
Per cent

	Year to December 2010			Year to December 2011		
	February 2010	May 2010	August 2010	February 2010	May 2010	August 2010
Market economists[(a)]	2.3	3.1	3.2	2.9	3.0	3.0
Union officials[(b)]	3.0	3.1	3.1	3.0	3.0	3.2

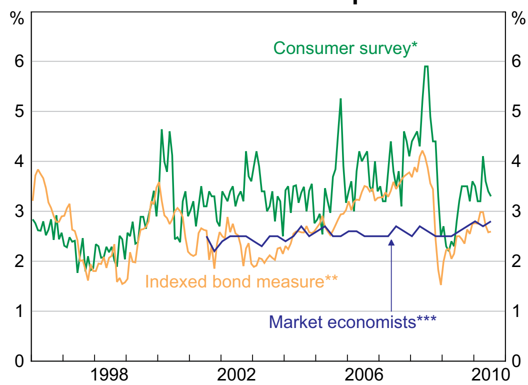
(a) RBA survey
(b) Workplace Research Centre

Inflation Expectations

Measures of inflation expectations have provided mixed signals in recent months. Market economists' inflation forecasts are little changed from three months ago, with inflation expected to be slightly above 3 per cent over 2010, before declining to around 2¾ per cent in 2012 (Graph 81, Table 13). Union officials' inflation forecasts remain slightly below the average of the past decade. The Melbourne Institute's survey measure of consumer inflation expectations has eased in recent months to be slightly above its inflation-targeting average, while financial market indicators of longer-term inflation expectations have also moderated; the indexed bond measure is a little below the average for the inflation-targeting period. Business surveys suggest that expected selling price growth in the near term has picked up to around average levels. ✠

Graph 81

Indicators of Inflation Expectations



* Median expectation of average annual inflation over the next year
** Break-even 10-year inflation rate on indexed bonds
*** Median expectation of annual inflation 2 years ahead
Sources: Melbourne Institute of Applied Economic and Social Research; RBA

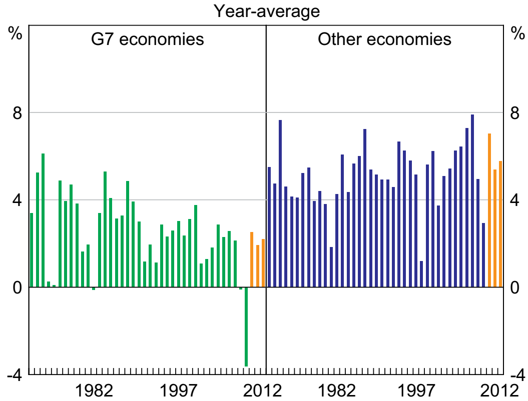
Economic Outlook

The International Economy

The world economy has continued to expand over the period since the May *Statement*. With many Asian economies having experienced strong V-shaped recoveries, growth in Asia has been especially robust over the past year. However, growth is now slowing towards more sustainable rates, with a gradual withdrawal of the earlier exceptional monetary and fiscal stimulus underway in a number of countries, including China. In the advanced economies, where the degree of economic slack remains greater, growth is estimated to have been relatively firm in the June quarter, but is also forecast to moderate in the latter part of this year and in 2011. This reflects expected headwinds from ongoing banking sector repair and fiscal consolidation to reduce budget deficits and stabilise public debt ratios.

Graph 82

Global GDP Growth*



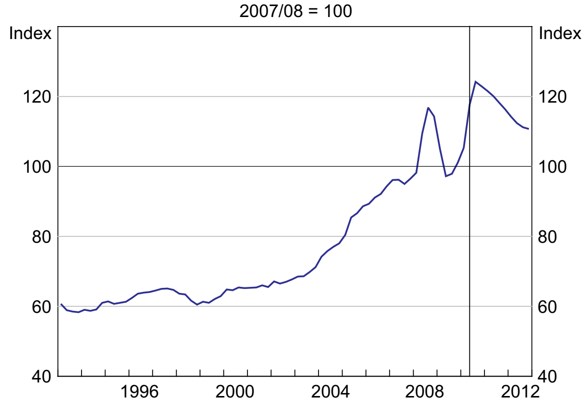
* Australia's major trading partners, weighted using output shares at market exchange rates

Sources: CEIC; IMF; RBA; Thomson Reuters

Consistent with this outlook, the domestic forecasts are based on the expectation that global output will grow by a little over 4½ per cent in year-average terms in 2010. Such an outcome would be above the average rate of global growth recorded during the decade prior to the recent global downturn (Graph 82). World output is then projected to expand by a little under 4 per cent in 2011, and by around 4 per cent in 2012.

Graph 83

Terms of Trade



Sources: ABS; RBA

While the May forecasts envisaged a gradual easing in prices for iron ore and coking coal over the forecast period, developments in commodity markets over the past three months have prompted a revision, with contract prices now forecast to decline a little more quickly, but to around the same end-point as in the previous forecasts. This implies a slightly lower level of the terms of trade over most of the forecast period. Nonetheless, the terms of trade are expected to remain at a historically high level and to continue to support domestic incomes over the forecast period (Graph 83).

Domestic Activity

As discussed in earlier chapters, the Australian economy continued to expand over the first half of 2010, supported by elevated commodity prices, high levels of public investment and ongoing strong growth in the population. Employment growth has been strong, underpinning household income. Measures of business and consumer confidence have remained generally positive, though some caution is evident in behaviour. Over the period ahead, a rebalancing of growth is expected, with public investment set to decline as fiscal stimulus projects are completed, while private demand is expected to become a more important driver of growth. The outlook for investment in the resources sector remains favourable and the high level of the terms of trade is boosting incomes and demand.

The central forecasts are summarised in Table 14 and are based on the technical assumption that the cash rate moves broadly in line with market expectations. As noted in previous *Statements,* this technical assumption does not represent a commitment by the Board to any particular path for policy.

The central forecast for the domestic economy is similar to that at the time of the May *Statement*. In year-ended terms, GDP growth is forecast to be around 3¼ per cent over 2010 and to strengthen to 3¾ per cent over 2011 and 4 per cent over 2012, with growth in the mining sector stronger than in other sectors reflecting the reallocation of resources within the economy. In year-average terms, GDP is estimated to have grown by 2¼ per cent in 2009/10, and is forecast to grow by 3½ per cent in 2010/11 and 3¾ per cent in 2011/12. The forecast of robust GDP growth in 2011 and 2012 is partly driven by forecasts of above-average growth in the capital stock, especially in the resources sector, and the labour force. The latter assumes both continued above-average growth in the working-age population and a modest increase in the participation rate. Nevertheless, from 2011 through to the end of the forecast period, some tightening of capacity is expected following the period of below-average growth in 2008 and 2009. The labour market is expected to tighten gradually over the forecast period.

The outlook for overall demand is driven less by consumption than has been the case over much of the past couple of decades. While consumer confidence is buoyant and the labour market is strong, growth in household consumption is expected to be a little weaker than that in income. As a result, the saving rate is expected to rise modestly, with households being more cautious about their finances than in the past. Business investment is forecast to grow strongly over the forecast period, driving growth in domestic demand. The outlook for the business sector is positive, with signs that investment is picking up following temporary weakness in the wake of the tax incentives for equipment spending. Investment is also being underpinned by strong internal

Table 14: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012
GDP growth	2.8	3	3¼	3¾	3¾	3¾	4
Non-farm GDP growth	2.8	3	3¼	3½	3¾	3¾	4
CPI inflation	2.1	3.1	3¼	3¼	2¾	3	3
Underlying inflation	3¼	2¾	2¾	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$0.92, TWI at 70, WTI crude oil price at US$84 per barrel and Tapis crude oil price at US$87 per barrel.
Sources: ABS; RBA

funding for businesses; survey measures of business profits remain at above-average levels, with the recent increases in bulk commodity contract prices providing a boost to mining profits. Engineering investment is expected to grow strongly over the period, reflecting the $43 billion Gorgon LNG project and a number of other significant resources projects in iron ore, coal and LNG. Resource exports are expected to grow strongly as a result of the earlier and ongoing significant expansions in capacity.

Inflation

Underlying inflation eased to around 2¾ per cent over the year to the June quarter, down from a peak of just over 4½ per cent in the September quarter 2008, and in line with expectations at the time of the May *Statement*. This easing reflects the significant moderation in capacity utilisation, demand pressures and some non-labour input costs through 2008 and 2009, and the slowing in wage growth. These factors, together with some contribution from the substantial appreciation of the exchange rate since early 2009, are expected to result in underlying inflation remaining at around 2¾ per cent over the next year or so.

Underlying inflation is then expected to gradually move higher, to be around 3 per cent in 2012. This reflects the effects of higher levels of capacity utilisation in the economy and a forecast pick-up in wage growth from recent relatively low levels as the labour market tightens. Inflation in non-tradable items is expected to remain firm, with significant contributions from rent, utilities and other housing costs. However, tradables inflation is likely to be moderate in the near term, due to recent softness in the retail sector and some ongoing effect from the exchange rate appreciation in 2009 on imported consumer prices. Overall, the outlook for inflation is little changed from that in May.

Headline CPI inflation was 3.1 per cent over the year to the June quarter and modestly higher than underlying inflation, as had been anticipated. Year-ended CPI inflation is expected to remain a little above 3 per cent over the next year, largely due to the recent tobacco excise increase and strong utilities price inflation.

Risks

As always, there are risks in both directions around the forecasts, although overall, these risks are viewed as evenly balanced.

On the upside, global growth has been stronger than expected in recent quarters and it is possible that the forecast moderation in the pace of world growth over the next year or so will not eventuate. It is also possible that domestic private demand could be stronger than forecast, particularly if firms in the mining sector attempt to push ahead with investment more rapidly than assumed in the central forecast. This would result in capacity pressures in the construction sector and the broader economy. In addition, the current cautiousness in spending by households may not persist and the forecast modest increase in the saving rate may not occur, particularly if the unemployment rate continues to trend lower and consumer confidence remains at elevated levels. If these risks were to eventuate, inflationary pressures could build more quickly than expected under the central forecast.

The main downside risk on the domestic front is that the forecast pick-up in private demand occurs more slowly than expected and does not fully offset the contraction in public investment that will be occurring over the next few quarters. The maximum effect of all the fiscal measures (including the cash payments) on the growth rate of output is estimated to have occurred around mid 2009 with the maximum effect on the level of output in early 2010, so fiscal policy will be subtracting from growth in the period ahead. Given the uncertainty about the timing of a number of planned large investment projects in the resources sector, it is possible that overall growth over the next few quarters could be a little weaker than in the central forecast.

On the international front, there is some risk that the recent policy measures by the Chinese authorities result in a larger than intended slowing in growth. A material slowdown in steel-making and the construction sector could lead to a significant fall in commodity prices and potentially a delay in investment by resources companies in Australia. In addition, there is a possibility of a renewal of concerns about the financial position of European banks and governments, although the likelihood of this appears to have fallen somewhat over the past month or so. The direct trade effects on Australia of problems in Europe would probably be relatively limited, but there could be more significant effects if they resulted in a renewed retreat from risk taking and a slowing in the broader global economy. Under either of these scenarios, inflation would, in time, be lower than in the central forecast.