

# Statement on Monetary Policy

---

Conditions in the global economy have generally continued to improve. Forecasts for growth have been revised up again recently, with global GDP now expected to grow at trend pace, or a little above, in 2010. While the recovery is most advanced in Asia and in some other emerging economies, there are also signs that the pick-up in North America has become more broad based recently. The main area of weakness continues to be Europe, with concerns about the fiscal situation in a number of countries, particularly Greece, increasing significantly over the past month.

With the recovery at different stages in different parts of the world, the nature of the challenges varies across regions. In the advanced economies, the recovery is still dependent on accommodative fiscal and monetary policies and there are very high levels of excess capacity that will remain for some time. Credit conditions also remain tight and core inflation is still trending lower. While in most countries the data over the past six months have been better than was expected a year ago, significant fiscal challenges lie ahead that are weighing on medium-term growth prospects.

In contrast, Asia has had a V-shaped recovery, with growth in China particularly strong. Unemployment rates in the region are coming down, spare capacity is more limited, housing markets are buoyant and financial systems are not impaired. The process of withdrawing the considerable policy stimulus that was put in place during the depths of the global downturn has now commenced in several countries, and further steps could be expected over

the period ahead to prevent inflationary pressures building further.

The strong recovery in Asia has underpinned substantial rises in the prices of Australia's main commodity exports. In particular, prices for iron ore and coking coal have increased sharply over recent months, reflecting strong growth in steel production in China and elsewhere in Asia. As a result, Australia's terms of trade are likely to increase substantially this year to reach the very high levels of two years ago, providing a significant boost to incomes.

In financial markets, conditions have generally been more settled than was the case last year, although concerns about the Greek Government's public finances have weighed on market sentiment. Yields on Greek debt have increased sharply, and the yields on the debt of several other European governments have also increased markedly. Outside of Europe, the impact has been more limited. Credit spreads in most markets have been little affected, although both equity markets and government bond yields in the major countries have declined recently. More generally, credit markets are working more smoothly than was the case last year, with most central banks having wound back emergency support measures. Notwithstanding this, credit growth remains very weak in the major economies, reflecting a combination of both demand and supply factors. Business investment is at very low levels in most of these economies and many banks remain cautious in their lending decisions. Banking sector profitability has however picked up recently, primarily due to investment banking activities.

Economic conditions in Australia continue to improve from the relatively mild downturn a year or so ago. The recovery has been supported by stimulatory settings of both monetary and fiscal policy, strong growth in Asia, the stability of the financial system and a high rate of population growth. Through the global downturn, Australia's exports held up much better than those from most countries, and investment remained at a high level.

Both consumer and business confidence in Australia are high, although one legacy of the global downturn is a more cautious approach to spending than was previously the case. The household saving rate is higher than it was in earlier years and retail spending has recently been soft, after increasing strongly in late 2008 and early 2009 partly as a result of the Government's payments to households. Outside of the resources sector, businesses' investment plans remain relatively subdued, although they have strengthened a little recently. Over the past year, business credit outstanding has also fallen as many businesses sought to reduce their debt levels. This process of deleveraging, however, looks like it has come to an end, with business credit unchanged over the past three months. Credit conditions have also begun to ease for some borrowers.

Reflecting the high level of commodity prices over recent years, mining investment has been at record levels as a share of GDP and further increases are expected, with very large projects in the LNG, iron ore and coal sectors. This pick-up in investment will support growth in the Australian economy at a time when the boost from the earlier expansionary policy settings is diminishing. It will also expand the supply capacity of the economy, with growth in resource exports likely to pick up further over coming years.

The housing market in Australia also remains buoyant, with auction clearance rates high and nationwide measures of housing prices rising at a double-digit rate over the past year. The housing construction cycle remains in an upswing, although given continuing high rates of population growth, further expansion of the supply side is likely to

be required over the period ahead. In contrast to housing prices, there has been a steady decline in the value and number of housing loan approvals over the past six months, although overall housing credit continues to grow at a solid rate, with households making smaller excess principal repayments than was the case last year when interest rates were lower. While the number of first-time buyers has declined following the earlier rise associated with the temporary boost to the first-home owner grant, demand from investors has picked up, especially in Victoria where the property market has been strongest.

With the Australian economy having performed better than expected, employment has grown strongly over the past six months or so and the unemployment rate has declined by around ½ percentage point from its peak of 5¾ per cent. The recovery in the labour market is evident across a range of industries, although it is most apparent in a number of service industries. Reflecting the weaker demand for labour during the slowdown, wage growth in the private sector slowed significantly over the course of 2009 to its slowest rate in many years, although growth in public-sector wages has remained firm. More recently, despite some tightening of the labour market, business surveys and the Bank's liaison suggest that the rate of wage growth remains below average.

Recent data on prices continue to show a moderation in underlying inflation in year-ended terms, reflecting the earlier weaker demand conditions and the appreciation of the exchange rate. Underlying inflation has now fallen by a little over 1½ percentage points from its peak in September 2008 and for the year to March was around 3 per cent. Inflation as measured by the Consumer Price Index was also around 3 per cent over the year to March.

Although inflation has moderated, the extent of the moderation now looks as though it will not be as large as previously thought. Recently, there have been significant price declines for many imported goods, reflecting the exchange rate appreciation,

tariff cuts and heavy discounting by retailers. But there have also been reasonably widespread price increases for a range of services. Growth in rents remains firm and the prices of utilities have increased significantly, partly to help fund expansions of capacity.

Looking forward, the central forecast is for GDP to grow by around 3¼ per cent over 2010, a similar outcome to that expected three months ago. Growth in public demand is expected to slow as fiscal measures run their course, with this being offset by a pick-up in private-sector demand. Beyond this year, growth is expected to increase to be in the 3¾–4 per cent range, with investment strengthening further. This outlook is underpinned by the positive prospects for the resources sector – including a substantial increase in the terms of trade – with the resources-related parts of the economy expected to record stronger growth than other sectors. This central forecast also assumes that a greater share of the boost to national income arising from the higher commodity prices will be saved than was the case in the boom in the second half of the 2000s.

Some further moderation in the year-ended rate of underlying inflation is still expected in the near term. However, given the relatively limited amount of spare capacity and the current price pressures that exist for services and utilities, the trough in inflation later this year now looks likely to be in the top half of the target band, rather than in the middle of the band as previously forecast. A gradual rise in inflation is then expected, as capacity utilisation gradually increases and the effect of the earlier appreciation on the prices of imported goods diminishes.

As usual, these forecasts are subject to a range of risks. Global growth could continue to surprise on the upside and the expansionary impact of the terms of trade could be greater than currently anticipated, particularly if the prospect of future income gains leads to an upgrading of current

spending plans. On the downside, a marked slowing in the pace of growth in Asia could have a significant impact on the Australian economy, in particular changing the outlook for commodity prices and the resources sector. It is also possible that the fiscal problems in Europe could intensify, prompting a retreat from risk-taking by investors and a sharp slowing in the world economy, although, to date, the impact has been largely confined to Europe.

In October last year, with the risk of serious economic weakness in Australia having passed, the Board began a process of lessening the monetary stimulus that was put in place when the outlook appeared much weaker. At each of its past three meetings, the Board has increased the cash rate by 25 basis points to 4.5 per cent currently, bringing the total increase since October to 1½ percentage points. Although the cash rate remains below its medium-term average, variable lending rates are now around their average levels, as market developments have pushed up most interest rates relative to the cash rate. The Board will continue to assess prospects for demand and inflation and set monetary policy as needed to achieve an average inflation rate of 2–3 per cent over time. ✎

