Statement on Monetary Policy

Prospects for the global economy have evolved in two quite distinct phases during 2002, broadly corresponding with the two halves of the year. The first half of the year was a period of emerging optimism, with most observers expecting a gradual recovery in the global economy after last year's downturn, and the momentum of growth expected to build steadily in all the major economic regions. These perceptions were encouraged by clear signs of stronger growth in a number of countries, particularly in the United States but also in parts of east Asia and, to a lesser extent, in the euro area. In the second half of the year, however, considerable uncertainty has emerged as to whether the momentum of growth will be sustained.

The changing mood about the global economic outlook has been most clearly reflected in financial markets. The major changes have been the fall in share prices in all major countries since early in the second quarter of 2002, the fall in long-term government bond yields to 50-year lows, and the widening in spreads on corporate debt.

Broader economic data in a number of the major countries have also taken on a softer tone in recent months, suggesting that the modest global recovery underway since the start of this year has weakened. In the US, which has been the strongest of the major economies this year, the expansion to date has been driven mainly by consumer spending, and there is little sign yet of a pick-up in business investment, which would be an essential element of a more durable recovery. Elsewhere, the picture has been very mixed. Growth in the euro area has turned out to be disappointing, after some reasonably promising signs earlier in the year. In Japan, there are some signs of a pick-up in activity, but the economy remains fragile and heavily dependent on export markets. Non-Japan Asia has been the best performing of the major regions, with the Chinese and Korean economies growing strongly, though some of the smaller economies in the region appear to have weakened recently. Overall, the global recovery has remained tentative and has fallen short of the relatively optimistic expectations that were held around the middle of the year.

Whether or not the global economy gains greater momentum will depend importantly on the resolution of imbalances still weighing on growth in the major countries. Of particular importance will be the ongoing effects of the cumulative falls in equity prices. These will affect the major economies in a number of ways, including not just through their impact on wealth and confidence but also through their effects on corporate and financial-sector balance sheets. Some of these effects are already being seen, with businesses in the US for example now finding it more

difficult or more expensive to raise capital, reflecting perceptions of increased risk. This has been associated with disappointing corporate profits in the US, a result, in part, of an overhang of capacity in some capital-intensive industries. In some respects, financial stresses in the European economies may be more severe than those in the US, given that the falls in equity markets in Europe have generally been larger. Share prices in financial firms in Europe, particularly insurance companies, have shown pronounced falls in recent months. Japan, of course, has its own longstanding imbalances that continue to hamper growth.

The overall effect of these forces on the global economy is highly uncertain. In an optimistic scenario, cyclical growth spurred by consumer demand and expansionary policy may be sufficient to wind back the various balance-sheet stresses, but a more pessimistic scenario involving disappointing profits, heightened pressure on balance sheets and weak investment spending in the major economies is also a real possibility.

It is not surprising that in this environment there has been a marked reassessment about the outlook for official interest rates in all major countries. In the US, expectations of monetary tightening largely evaporated in the third quarter, and were replaced by expectations of easing, which the Fed delivered in November. Similarly, in Europe, expectations of tightening have been replaced by expectations of easing, though official rates have continued steady to date. The group of mid-sized economies that were raising interest rates in the first half of the year, which includes Australia, have all kept rates steady since at least July; markets do not expect any near-term moves and in some cases expectations of easing are emerging even among these countries.

Australian financial markets have not been immune from developments overseas. Share prices in Australia have fallen over the past six months and domestic interest rates, both long term and short term, have adjusted down. Overall, however, domestic financial markets continue to show a good deal more stability than markets overseas, reflecting the steadier path of the domestic economy.

In contrast to the tentative nature of the global expansion, the Australian economy has so far continued to grow at a good pace. This performance has been driven by strong growth in domestic demand which, to date, has broadly counterbalanced the dampening effects of the weak external sector. The growth of domestic demand over the past year has been spread across all main components, with consumer spending, housing construction and business investment all contributing strongly. These developments have been associated with above-trend growth in employment, and a declining unemployment rate. Prospects in the period ahead will of course depend importantly on global developments, but will also depend on a range of rather disparate domestic factors, most notably conditions in the business sector, the dynamics of the housing market, and the impact of the drought.

Business investment has been an important contributor to growth over the past year. In contrast to the major economies abroad, Australia's business sector is in good shape, with a relatively high level of profits and generally sound balance sheets. In addition the direct effects of declining equity prices in Australia are likely to be more muted than those in other countries, given that Australia's share market has remained relatively resilient. In these circumstances, prospects for further growth in investment are still good, particularly given that the level of investment is coming off a quite low base. A number of large resource and infrastructure projects have commenced recently, and data on building approvals and commencements indicate that further strong growth in non-residential building work is in prospect. Of course, recent financial market developments and weaker global economic prospects might yet affect business spending plans, but the most recent business surveys, in the main, suggest a generally positive outlook.

The large rise in housing construction has also made an important contribution to the strength of the economy over the past year.

As well, the rise in house prices over much of the recent period has added to household wealth and boosted the capacity of households to borrow and spend. Investors have played a large part in the buoyancy of the housing market, accounting for virtually all of the growth in new finance approvals in the sector over the past year, presumably in expectation of strong growth in prices. It has been apparent, however, that this process would not be sustainable indefinitely, with emerging oversupply being bound at some point to limit the scope for further price increases.

While most measures of housing prices rose strongly in the September quarter, there are some signs that price appreciation in particular sectors of the market is starting to abate. Prices of apartments have lagged behind house prices recently, and there are indications that apartment prices in parts of Melbourne and Sydney showed little, if any, increase in the September quarter. Recent anecdotal reports point to a more general waning of buyer interest, and there has been a noticeable decline in auction clearance rates in the past month or so.

With regard to housing construction activity, the latest indicators have remained quite strong, with building approvals, and approvals for housing finance, generally moving higher in the September quarter. Hence, in the short term, housing construction activity is set to continue expanding. But given the emerging oversupply in the sector, housing activity now appears likely to begin declining in the first half of 2003.

The rural sector is continuing to experience a severe drought, which will sharply cut rural production and incomes. It is now estimated that the decline in farm production could directly reduce GDP growth by around 1 percentage point over the current financial year. Despite higher prices for some rural commodities, notably wheat and wool, net farm incomes this financial year are expected to be down by more than half from the high levels seen last year.

Drawing all these influences together, a modest slowing in domestic demand and output appears likely in the period ahead, principally reflecting the expected maturing of the housing cycle and the impact of the drought. While these factors have been evident for some time, they were initially expected to lead mainly to a rebalancing of growth, with the slowing in domestic demand being more or less offset by the impact of gradually improving external conditions. But with global economic prospects less assured, this expectation is unlikely to be met, and hence the economy overall can be expected to slow from its recent strong pace over the coming year.

Recent data on inflation have been consistent with the near-term outlook described in previous *Statements*. The CPI increased by 3.2 per cent over the past year, while measures of underlying inflation, designed to remove the effects of extreme price movements, are currently in a range between 2½ and 3¼ per cent in year-ended terms. The Bank's assessment based on the range of available measures is that underlying inflation is currently around 2¾ per cent.

With evidence that wages and upstream price pressures are subdued, and no sign of global inflationary pressures, underlying inflation is likely to remain close to its recent level of around 2¾ per cent during 2003. This represents a slightly lower forecast than was presented in previous *Statements*, reflecting the noticeably weaker outlook for the global economy and, consequently, the less favourable environment for growth in Australia. CPI inflation could remain a bit higher than the underlying rate in the short term, reflecting the influence of the drought on food prices. But looking further ahead, the prospect is that CPI inflation will converge towards the underlying rate and hence will be within the target range. The risks around this forecast appear evenly balanced. If a reasonably favourable international growth outlook were to eventuate, the domestic economy could continue to expand at close to its recent pace, and in that scenario

inflationary pressures may be expected to build gradually. On the other hand, an extended period of weaker growth in Australia and abroad might see inflation pressures easing further.

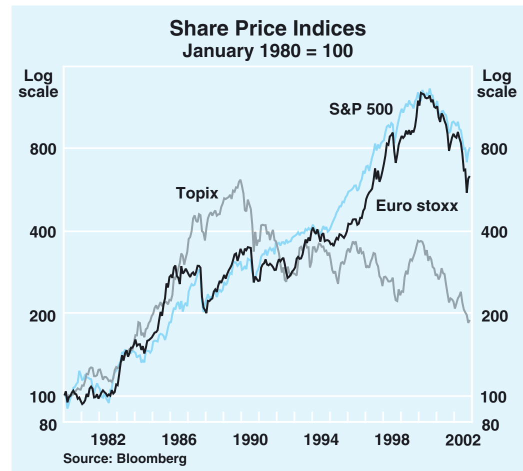
In its deliberations on monetary policy over recent months, the Board has taken into account the shifting prospects for the global economy as well as the range of important domestic influences on the economic outlook. These factors have been working in divergent directions, with the drought and the weak international environment subtracting from growth, while the stance of monetary policy and the dynamics of the housing market have been providing a stimulatory influence. The balance of these forces has shifted quite noticeably since mid-year. While initially it appeared that their net effect on the Australian economy in the medium term would most likely be in the direction of generating greater inflationary pressures, this became less clear as events unfolded during the second half of the year, as prospects for the global economy weakened. Some of this shift was already apparent at the time of the previous *Statement* in August, though subsequent events have suggested a further weakening in global prospects since that time. In view of these developments the Board at its recent meetings has judged that the most prudent course was to retain the current policy setting for the present time, while continuing to assess how the international and domestic economies evolve.

International and Foreign Exchange Markets

Equity markets

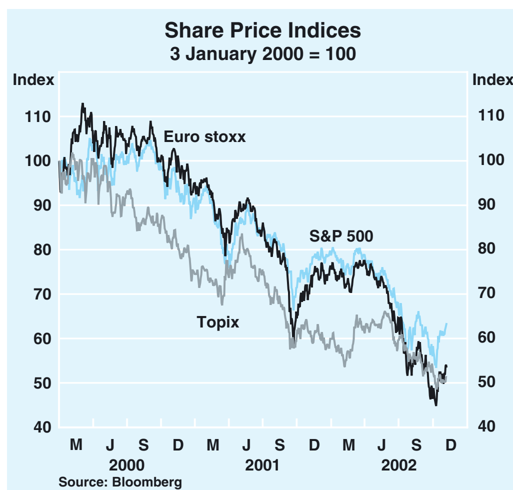
Equity markets have remained at centre stage over recent months, with ongoing weakness in the major global indices accompanied by extreme volatility. The recovery from the post-September 11 lows started to peter out early in the June quarter, with broad measures of stock prices in the major economies having fallen sharply since. A rebound in late July and early August proved short-lived, with all of the major equity indices falling to new multi-year lows in early October (Graph 1). In the US and Europe the broad-based indices fell to levels last seen in 1997, while in Japan the Topix fell to its lowest level since 1984 (Graph 2). Although there was a modest recovery in equity prices in mid October, the US S&P 500 index remains down by 20 per cent since the start of the year, and the Euro STOXX and the Japanese Topix are down 29 per cent and 14 per cent, respectively. The S&P 500 and the Euro STOXX are now down 40 per cent and 52 per cent respectively from their March 2000 peaks, while the Topix is down 50 per cent since February 2000 and 69 per cent since its peak at the end of 1989 (Table 1).

Graph 2



The falls on major equity markets have been accompanied by extreme volatility, with the median daily percentage change in benchmark US indices over the past few months higher than at any time since the 1930s (Graph 3). Within the sharp downward trend over the past half year, there have been two significant

Graph 1



Graph 3

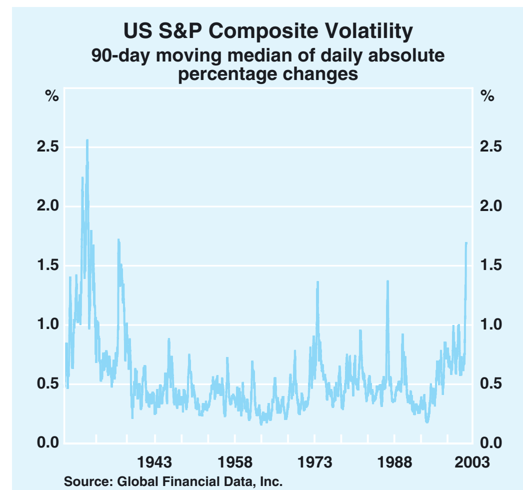


Table 1: Changes in Major Country Share Prices
Per cent

	Change since 2000 peak	Change over 2001	Change in 2002
United States			
– Wilshire	–44	–12	–19
– Dow Jones	–26	–7	–13
– S&P 500	–42	–13	–20
– NASDAQ	–74	–21	–28
Euro area			
– STOXX	–54	–20	–29
United Kingdom			
– FTSE	–44	–16	–21
Japan			
– Topix	–43	–20	–14
Canada			
– TSE 300	–46	–14	–17

Source: Bloomberg

rallies. The S&P 500 increased by 21 per cent in a 4½ week period in July and August, and by 16 per cent in a 1½ week period in mid October. While these were significant movements, similar short-lived retracements have occurred in the past after large falls, without necessarily signalling the end to a bear market.

While the falls in broad measures of US equity prices over the past two years are significant, they remain well within the historical experience. The most comprehensive way of comparing the current equity weakness to previous bear markets is in terms of the real total return on equities over different periods. This measure includes both the price change and dividends received by shareholders, and then adjusts for changes in consumer prices. There have been 12 periods when this measure showed negative returns greater than 20 per cent in the US since 1870 (the period for which reliable data exist) (Table 2). The loss suffered by investors in real total returns in the current episode has been around 40 per cent, slightly larger than the average for earlier bear markets, and the biggest fall since 1974. Since the S&P 500 peaked in March 2000, the current bear market has reversed around 5½ years of gains in real wealth, which is similar to the average for earlier declines.

The global equity market weakness since early 2000 has been driven primarily by the recognition that earnings of companies have been too low to justify the high valuations reached. Concerns about the strength of the global economic recovery, particularly the possibility that the recovery may be stalling, are adding to the nervousness about share valuations since, in that event, the expected increases in profits may not eventuate. In the US the outlook has led to significant downward revisions to market earnings expectations over the past few months, with Standard and Poor's 'top-down' forecasts for 'as reported' earnings growth in the US for 2002 cut from 44 per cent to 24 per cent within a three-month period.

Continuing doubts about the accuracy of corporate accounts in the light of recent accounting scandals have added to the uncertainty. There remain divergences between different measures of corporate earnings, with many market participants now focusing on the National Accounts measure of earnings which shows corporate profits to have fallen marginally over the first half of 2002, with earnings now having been

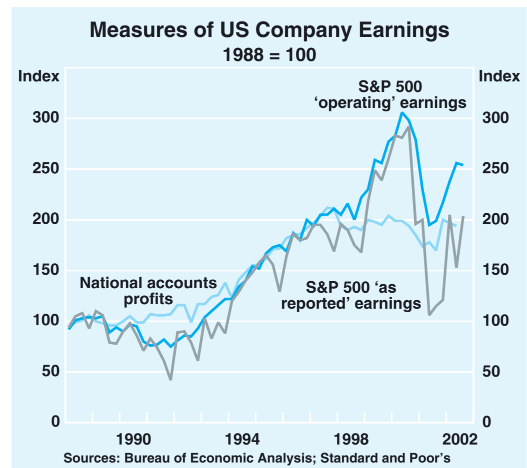
Table 2: Real Cumulative US Equity Returns

Bear market period	Negative return from peak to trough Per cent	Years of wealth gains reversed	Time taken to regain peak
Jun 1876 to Jun 1877	–29	3 years 7 months	1 year 9 months
May 1892 to July 1893	–23	2 years	3 year 2 months
Aug 1902 to Oct 1903	–26	2 years 11 months	2 years 5 months
Sep 1906 to Nov 1907	–37	3 years 5 months	2 years 8 months
Nov 1916 to Dec 1920	–47	13 years 1 month	7 years 9 months
Sep 1929 to Jun 1932	–77	7 years 11 months	7 years 2 months
Feb 1937 to Apr 1942	–48	6 years 11 months	8 years 2 months
Apr 1946 to Feb 1948	–35	3 years 9 months	4 years 6 months
Dec 1961 to Jun 1962	–22	1 year 6 months	1 year 5 months
Dec 1968 to Jun 1970	–32	6 years 7 months	3 years 11 months
Jan 1973 to Dec 1974	–50	12 years 2 months	12 years 0 months
Aug 1987 to Nov 1987	–30	1 year 9 months	1 year 11 months
Average	**–38**	**5 years 6 months**	**4 years 9 months**
Mar 2000 to date	–40	5 years 6 months	na

Sources: http://aida.econ.yale.edu/~shiller/data.htm; Standard and Poor's; RBA

essentially flat since the beginning of 1997 (Graph 4).

Graph 4

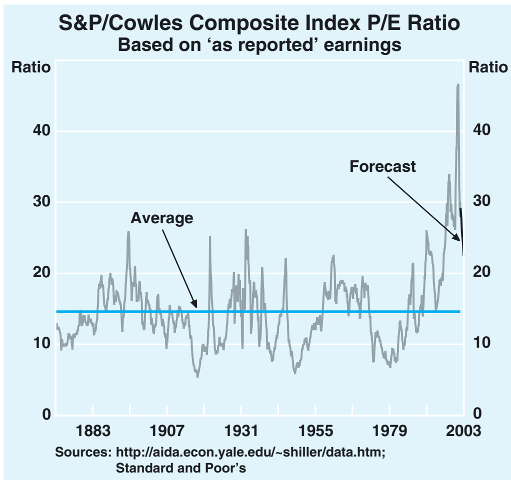


Concerns about the traditional measures of earnings were highlighted by the release in October of Standard and Poor's new 'core earnings' measure, which attempts to focus on the ongoing operations of companies. Standard and Poor's estimate that there are two significant costs that are not fully accounted for under standard measures of earnings, including under Generally Accepted Accounting Principles, namely stock options and the cost of funding pension liabilities when pension funds have failed to cover these liabilities on an ongoing basis. They estimate that if stock options had been accounted for when issued they would have reduced 'as reported' earnings for the aggregate of the S&P 500 companies by around 20 per cent over the year to the June quarter 2002. The cost of topping up defined benefit pension schemes in the face of falling asset values would separately have reduced earnings by 25 per cent.

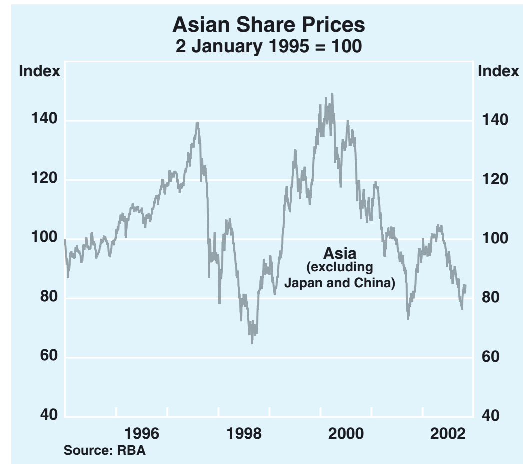
While the price/earnings ratio based on trailing earnings for the S&P 500 has fallen to around 30, down from a peak of 47 earlier in the year, it remains well above the historical average of 15 and even the strong market expectations about earnings for the next 12 months imply a forward-looking ratio that is well above historical norms (Graph 5).

Equity markets in Europe, Japan and elsewhere have been subject to many of the same pressures affecting the US market. In fact, European markets have fallen by more than those in the US. One factor that has

Graph 5



Graph 6



contributed to the weakness has been concerns about the health of financial institutions, especially insurance companies. While the Euro STOXX had fallen 60 per cent from its peak by early October, the fall in insurance stock prices reached 70 per cent. Although on average bank stock prices have fallen about the same as the Euro STOXX, some of the major European banks had fallen by more than 80 per cent to their most recent trough in early October. In Japan, domestic factors have also contributed to weakness, with the possible impact of a more aggressive policy stance in dealing with problems in the financial sector contributing to falls in banking sector stocks. The broader market was also affected by this news on expectations that large numbers of companies could be affected by tightened credit standards in the banking sector.

Asian emerging equity markets have generally followed the same pattern as markets in the major industrial economies over recent months, albeit with a smaller fall and more muted recovery (Graph 6). The Indonesian market was hit hard by the news of the Bali bombings, with share prices falling 10 per cent in the first day of trading following the attacks. Latin American markets have also generally moved with the major markets.

Short-term interest rates

In the US, the Federal Open Market Committee (FOMC) kept the policy rate unchanged at 1.75 per cent from December 2001 to November 2002, when it cut rates by a further 50 basis points (Graph 7, Table 3). As an indication of how views about the economy and markets have changed in recent months, market participants throughout the first half of 2002 were expecting the Fed to be increasing rates by the end of the year (Graph 8). These expectations started to recede in the third

Graph 7

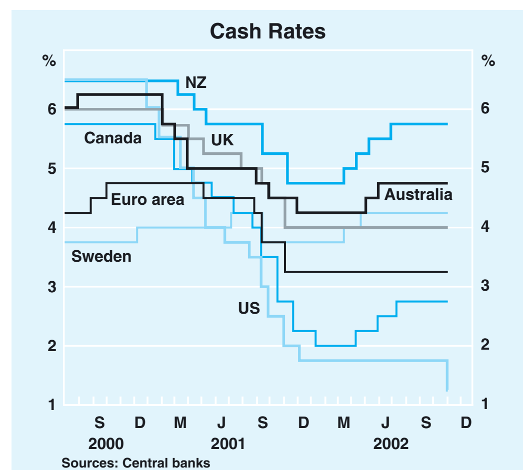
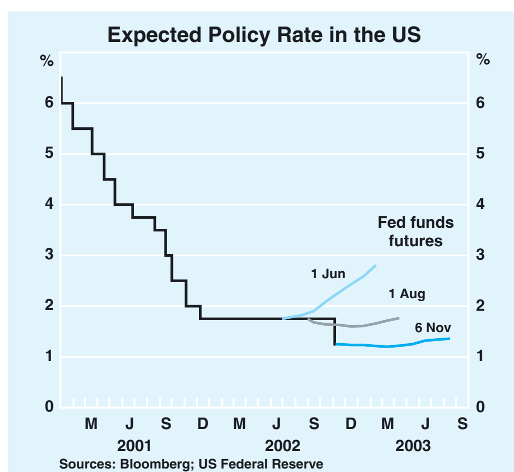


Table 3: Policy Interest Rate Changes
Basis points

	Current level Per cent	Cumulative changes in down cycle	Changes in policy rates	
			Jan–June 2002	Since July 2002
US	1.25	–525	–	–50
Canada	2.75	–375	25	25 [(a)]
Switzerland	0.75	–275	–50	–50
UK	4.00	–200	–	–
Australia	4.75	–200	50	–
NZ	5.75	–175	75	25 [(a)]
Euro area	3.25	–150	–	–
Sweden	4.25	–50	50	–
Japan	0.00	–25	–	–

(a) Increase was in early July
Sources: Central banks

Graph 8



Sources: Bloomberg; US Federal Reserve

quarter, and were eventually replaced by expectations of easing; these were fulfilled in November.

Policy interest rates in the euro area have remained unchanged for the past year. However, as in the US, financial market expectations for future policy changes have moved significantly over recent months. Whereas earlier expectations were that the next move would be an increase, the current expectation is that the ECB will cut its policy rate by 25 basis points, to 3.00 per cent, by December. In the UK the futures market is also signalling a cut of 25 basis points (to 3.75 per cent) in the policy rate by the end of the year, an expectation which was heightened by the release of the minutes of the October Monetary Policy Committee meeting which showed that three of the nine committee members voted for a 25 basis point cut.

The Bank of Japan (BoJ) increased its reserves target from ¥10–15 trillion to ¥15–20 trillion in late October and increased its monthly purchases of Japanese Government bonds by ¥0.2 trillion per month to ¥1.2 trillion. It also made initial moves to address weakness in the financial sector by announcing a plan to purchase stocks from banks to reduce their exposure to equity market volatility.

The tightening cycles in several of the smaller industrial economies that began over the first half of 2002 have paused over the past three months as the outlook for the global recovery has been downgraded. In addition to Australia's moves earlier this year (see chapter on 'Domestic Financial Markets'), there were also increases in policy rates in Canada (a cumulative 75 basis points to

2.75 per cent), New Zealand (100 basis points to 5.75 per cent), Norway (50 basis points to 7 per cent) and Sweden (50 basis points to 4.25 per cent). Unlike in the larger economies, where expectations have been for monetary easing, market expectations in most of these mid-sized economies are for generally steady official rates in the months ahead, reflecting their relative economic strength. In New Zealand, the new Reserve Bank Governor and the Finance Minister signed a new policy targets agreement, which raises the lower range of the inflation target band to 1 per cent from zero and extends the time horizon for the target to the medium term.

Official interest rates in most emerging economies have remained relatively steady over recent months. One exception was Brazil, where the central bank raised interest rates in October by 3 percentage points to 21 per cent, in a move aimed at stemming the slide of the real on the foreign exchange market.

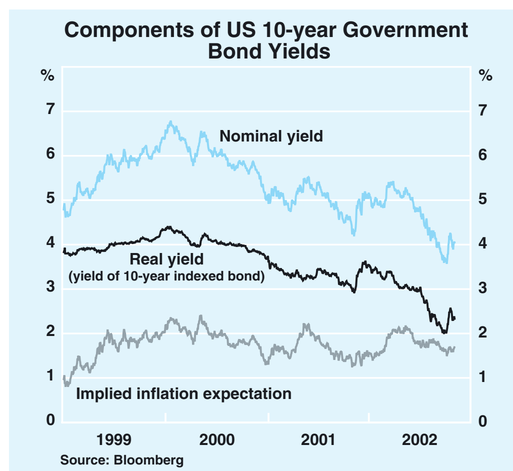
Long-term interest rates

Bond markets in the major economies have largely taken their lead from equity markets over recent months. Government bond yields fell to very low levels, and spreads on corporate debt continued to widen, as investors sought the relative security of government debt. While these movements have reversed somewhat since mid October as the equity market has recovered, corporate debt spreads remain unusually elevated, reflecting ongoing concerns about financial fragility in the corporate sector.

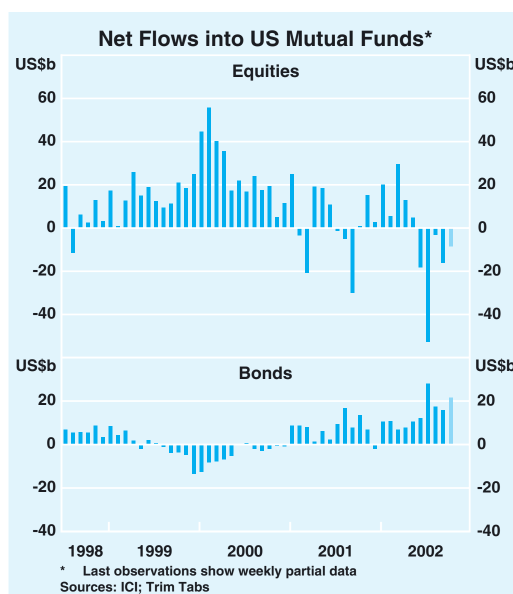
Yields on 10-year US government debt fell by around 90 basis points over August and September, to a 44-year low of 3.6 per cent. They rebounded sharply in mid October as equity markets recovered, but this proved temporary, and yields have since fallen back to 4.1 per cent (Graph 9). Using yields in the market for inflation-indexed securities, it is possible to decompose these movements in nominal yields into the change in inflationary expectations and the change in real yields on bonds. The data suggest that most of the fall in nominal yields in August and September was attributable to lower real yields, although reduced inflation expectations also played a role. This fall in real bond yields is consistent with both a flight to quality and security in the wake of large falls in equity prices over this period, and a lowering of real growth expectations for the US economy. US investors have been shifting money out of equity mutual funds into bond funds in recent months (Graph 10).

Yields on European government bonds have moved in a similar fashion to US yields, although movements have been more subdued. Yields on German government

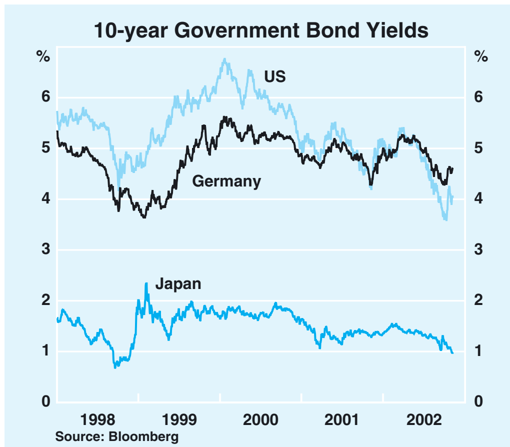
Graph 9



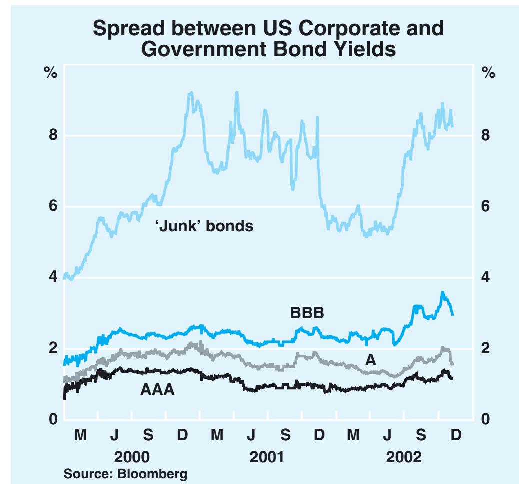
Graph 10



Graph 11



Graph 12



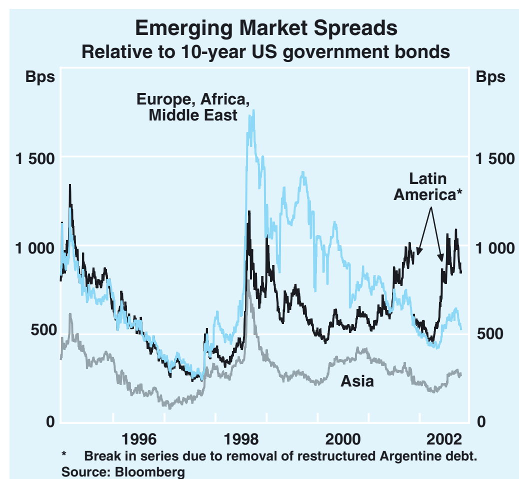
bonds fell by around 40 basis points during August and September as equity markets weakened, the outlook for the European economic growth deteriorated, and market expectations of lower short-term rates increased (Graph 11). Yields reached a low of 4.3 per cent in late September, before rebounding in October on the turnaround in global equity markets.

Yields on Japanese Government bonds have also fallen since August, declining by 35 basis points to around 1 per cent. Yields initially approached this level in mid September, but rebounded to 1.3 per cent after the Bank of Japan announced its initiative to buy equities from banks, a measure which was perceived as likely to reduce future BoJ bond purchases. Yields have since moved back to their lows as market participants have scaled back their perceptions about the likely size of BoJ stock purchases. The move lower was also assisted by the BoJ announcement that it will increase its monthly purchases of Government bonds, and indications from the Government that changes in the stance on resolving banking sector problems will not be accompanied by any major increase in debt issuance.

In the US, corporate spreads to Treasuries have generally remained high over recent months, reflecting continued risk aversion and concerns over US corporate health (Graph 12). These concerns have been most notable for medium-grade credits; the spread between BBB-rated corporate bonds and 10-year Treasuries at one point in October reached 3.6 per cent, the highest level since the early 1980s. There seems to be a fear that companies in this grouping in particular are at risk of downgrades to 'junk' status. A prominent example is the very large rise in the spread for Ford Motor Co. debt, from 200 basis points mid year to around 600 basis points now.

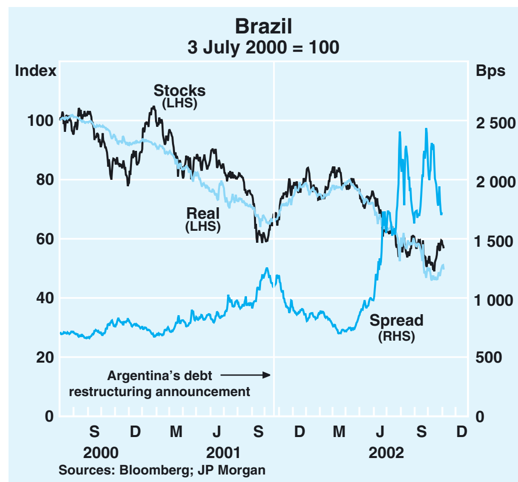
Emerging market sovereign spreads have narrowed over the past few months (Graph 13). Spreads on Brazilian debt rose to more than 2000 basis points ahead of the October elections, but have since moderated, although at 1700 basis points they remain at

Graph 13



unsustainable levels (Graph 14). Spreads remain at default levels in Argentina, but have fallen slightly in other Latin American countries. Yields spreads on Asian sovereign bonds have also narrowed modestly since the time of the last *Statement*.

Graph 14



Exchange rates

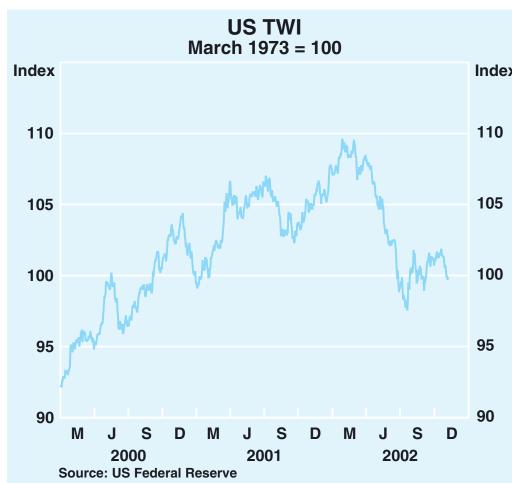
In contrast to the extreme volatility seen in equity and bond markets, currency markets have been relatively stable over the past three months (Graphs 15 and 16). In trade-weighted terms the US dollar has fallen by around 1 per cent, with a 2 per cent appreciation against the yen, offset by an equivalent depreciation against the euro.

Asian and Latin American currencies that float were generally weaker against the US dollar over the quarter. The Brazilian real weakened significantly through September on electoral uncertainty, and despite a recovery since then remains down 35 per cent for the year to date.

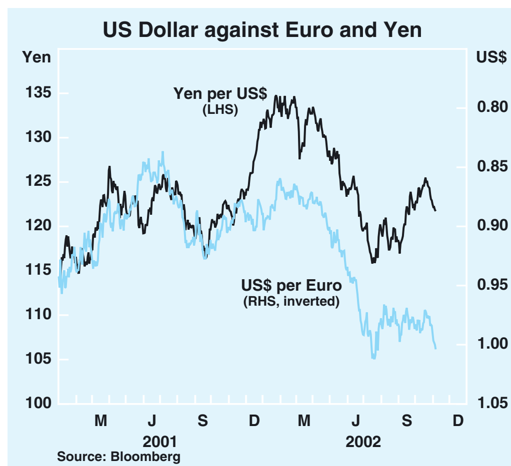
Australian dollar

Initially, as sentiment about the global economy began to deteriorate around mid year, the Australian dollar fell quite sharply, from around US57 cents to around US54 cents (Graph 17). This reversed about half the rise that had taken place during the

Graph 15

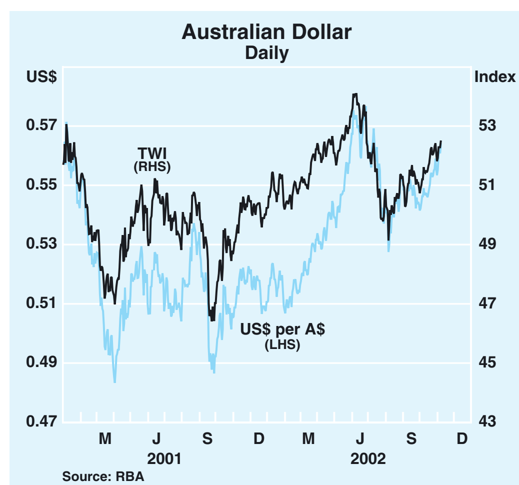


Graph 16



phase of bullish sentiment about the global economy in the first half of the year. Since then, however, even though sentiment about the global economy has deteriorated further, the Australian dollar has not followed. In fact, it has appreciated by around 3 per cent against the US dollar over the past three months. The initial sharp reaction to the change in global sentiment may have reflected a view that the global slowing would flow through quickly to the local economy. The fact that many market participants had built up quite long positions in the Australian dollar during the first half of the year, in anticipation of global economic recovery, may have accentuated the move as these positions were adjusted.

Graph 17



The relative resilience of the Australian economy to date has no doubt helped support the currency recently. One mechanism through which this is happening is the widening interest spread in the Australian dollar's favour, as interest rates around the world have fallen to exceptionally low levels. This is leading to strong demand for Australian dollar securities in overseas markets. One area where this has been particularly noticeable is among Japanese retail investors. For the year to date, issuance of A$ Uridashi bonds amounted to $10.4 billion, with most of the issuance occurring over the past four months. The recent period has been the strongest for Uridashi issuance on record.

Also lending support to the currency was the upgrade in October by Moody's of Australia's foreign currency credit rating and country credit ceiling from Aa2 to Aaa (Table 4). Moody's had reduced Australia's rating from Aaa to Aa1 in 1986, with a further reduction to Aa2 in 1989. Standard and Poor's and Fitch also lowered Australia's rating over this period, though subsequently Standard and Poor's raised its rating from AA to AA+ (equivalent to a change from Aa2 to Aa1).

On a trade-weighted basis the Australian dollar has appreciated by around 3 per cent over the past three months, with strongest gains against the Japanese yen and some other Asia-Pacific currencies (Table 5). The current level of the trade-weighted index is around 6 per cent below its 1990s average.

Table 4: Changes in Australia's Foreign Currency Long-term Debt Rating

Date	Moody's	S&P
Prior to 1986	Aaa	AAA
September 1986	Aa1	AAA
December 1986	Aa1	AA+
August 1989	Aa2	AA+
October 1989	Aa2	AA
May 1999	Aa2	AA+
October 2002	Aaa	AA+

Source: Bloomberg

The RBA has continued to purchase foreign reserves in the market over recent months. In net terms its outright transactions (and interest earnings) have lifted holdings of net reserves. At the end of October, net reserves were $11.1 billion, up from $7.0 billion at the start of 2002. Total reserve holdings have not changed much as there has been some reduction in foreign exchange held under swaps, from $29.5 billion in December 2001 to $26.2 billion.

Table 5: Australian Dollar against Selected TWI Currencies since 31 July 2002
Percentage change

Philippines	6.6
Thailand	6.5
South Korea	5.8
Taiwan	5.6
Japan	5.0
Indonesia	4.5
UK	3.6
Singapore	3.1
US	3.0
Canada	1.6
Switzerland	1.4
Euro	1.0
Sweden	–0.4
NZ	–2.6
TWI	**3.2**

Source: RBA

International Economic Developments

The global economy continues to recover at a modest pace, although sentiment in international financial markets remains fragile and the downside risks to the recovery appear to have increased recently. This is clearly affecting business and household confidence, and is evident in some recent economic indicators. Domestic demand continues to drive growth in the US, while exports have formed the basis of the very weak recoveries in both Europe and Japan. Exports have also played an important role in the pick-up in non-Japan Asia, though in contrast to earlier recoveries, domestic demand (and intra-regional trade) is making a sizable contribution to growth.

Forecasts for world growth have been revised down in recent months. In its latest assessment of the international outlook, released in September, the IMF lowered its forecast for growth in the G7 countries in 2003 by 1/2 percentage point, to 2 1/4 per cent on a year-average basis (Table 6). The latest private-sector Consensus forecasts present a similar view in aggregate for 2003.

United States

The recovery has continued in the US, though the growth has been uneven. After a weak outcome in the June quarter, GDP increased by 0.8 per cent in the September quarter to be 3.0 per cent higher over the year (Table 7). However, the pace of growth slowed through the quarter. Nearly all of the growth in the September quarter was accounted for by consumption, which was boosted by a surge in purchases of motor vehicles.

Household spending remains firm, supported by low interest rates and continued growth in household disposable income. The fall in long-term interest rates, in particular, has encouraged borrowers to refinance existing home loans at a lower cost. House prices have also risen, allowing home owners to use the increased equity to finance consumption. Marketing incentives, such as zero-interest financing for motor vehicles, have also boosted spending. Notwithstanding these positive factors, the fall in equity prices has reduced household wealth over the past couple of years, particularly for higher income households. Consumer sentiment has also fallen to well below average levels.

Table 6: World Growth
Year-average, percentage change

	2001	2002 (f)	2003 (f)	
		September 2002	April 2002	September 2002
United States	0.3	2.2	3.4	2.6
Euro area[a]	1.5	0.9	2.9	2.3
G7[b]	0.6	1.4	2.8	2.3
Japan	–0.3	–0.5	0.8	1.1
China	7.3	7.5	7.4	7.2
Other Asia[a]	1.1	4.2	4.7	4.6
World[b]	**2.2**	**2.8**	**4.0**	**3.7**

(a) GDP weights
(b) PPP weights
Source: IMF *World Economic Outlook*

Table 7: United States – National Accounts
Percentage change, seasonally adjusted

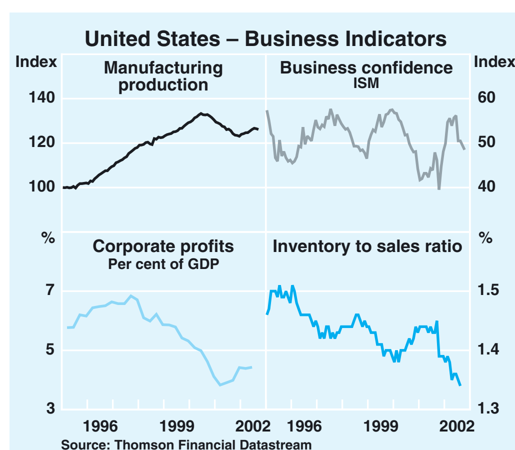
	June quarter 2002	September quarter 2002	Year to September 2002
Private consumption	0.4	1.0	3.8
Residential investment	0.7	–0.2	3.0
Business investment	–0.6	0.1	–4.7
Public demand	0.4	0.5	4.8
Change in inventories(a)	0.4	0.0	0.7
Domestic demand	0.6	0.8	3.6
Net exports(a)	–0.4	0.0	-0.8
– Exports	3.4	0.5	2.2
– Imports	5.1	0.6	6.5
GDP	**0.3**	**0.8**	**3.0**

(a) Contribution to GDP growth
Source: Thomson Financial Datastream

After shedding jobs through much of 2001 and into the early part of this year, the US labour market recovered for a time, but employment flattened out again in September and October. Manufacturing employment has continued to fall, while employment in the public and services sectors has grown moderately.

In contrast to the resilience of household spending, conditions in the business sector remain subdued. Industrial production has fallen in recent months, reversing some of the rise that had occurred over the previous six months (Graph 18). The most recent fall was largely associated with a decline in the production of motor vehicles, which had been boosted around the middle of the year when large sales incentives were re-introduced. There has also been a deterioration in manufacturing sentiment, with the ISM measure returning to levels associated with stable output, after rising strongly around the turn of the year. Orders for non-defence capital goods declined marginally in the September quarter. Notwithstanding these developments, with the current level of inventories relative to sales remaining at a low level, any growth in demand should be quickly reflected in production in the period ahead.

Graph 18



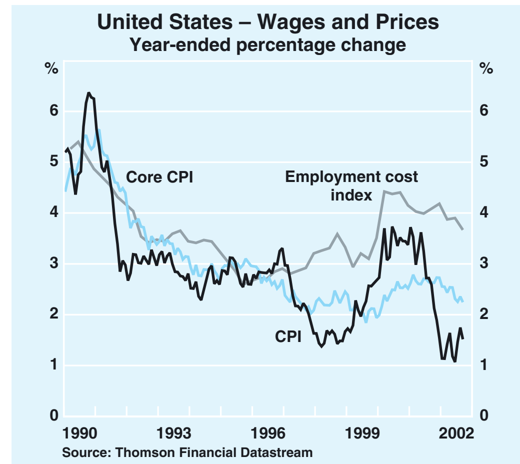
Corporate profits, as measured in the national accounts, have begun to increase after falling quite markedly over the past five years. However, the ability of the larger corporations to raise funds is being adversely affected by market perceptions of corporate balance sheet fragility, owing in part to the shortfall in defined benefit superannuation schemes. The ratio of business investment to GDP has now reached quite low levels, which implies some unwinding of the investment overhang built up in earlier years, but significant excess

capacity remains in a number of capital intensive sectors.

US fiscal policy over the past year has been strongly supportive of growth, with the turnaround in the budget balance the largest since 1975. The more expansionary state of fiscal policy this year owes mainly to the effect of automatic stabilisers, as well as tax cuts and increased government expenditure, particularly for defence. Monetary policy also remains accommodative, with the Fed easing by a further 50 basis points in November.

Consumer price inflation has fluctuated with movements in energy prices, but has remained below 2 per cent in year-ended terms (Graph 19). The core measure of inflation has edged lower and was $2^1/_4$ per cent in September. The large gap between services and goods inflation remains. Services inflation slowed to a little over $3^1/_2$ per cent in the year to September, while core goods prices fell by around 1 per cent. Growth in labour compensation has eased with the employment cost index rising at a year-ended rate of 3.7 per cent in the September quarter; growth in the wages component has slowed a little from earlier in the year, while benefits have continued to grow strongly.

Graph 19



Asia-Pacific

Japan

Having recorded declines in output in the four previous quarters, the Japanese economy returned to growth in the June quarter, with GDP rising by 0.6 per cent (Table 8). Sizable revisions to the national accounts data eliminated the strong growth that was originally reported for the March quarter, while also indicating that the contraction in 2001 was deeper than previously thought (Graph 20). Exports have been a significant driver of growth, and while there have been modest increases in private consumption, both business and residential investment have continued to fall.

There are some positive signs, with industrial production increasing in recent months, although the pace of growth has been somewhat slower than earlier in the year. This pattern is evident in the Tankan survey, with business sentiment and investment intentions having recovered from their lows towards the end of 2001, but with the rate of improvement slowing more recently. Exports have declined over the past couple of months, though they remain at high levels. Machinery orders, after falling through much of 2001, appear to have stabilised, albeit at a low level. Outside of the manufacturing sector, the tertiary activity index has been broadly flat over the past year.

Conditions for the household sector remain poor. While employment has risen in recent months, with employment in September

Graph 20

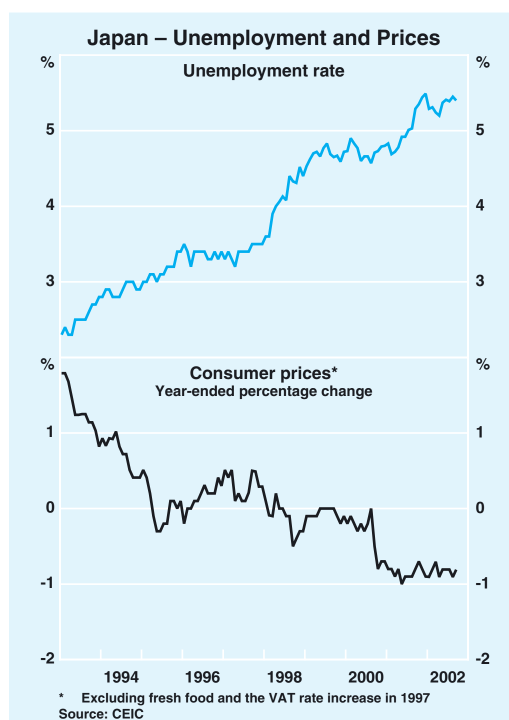
Table 8: Japan – National Accounts
Percentage change

	March quarter 2002	June quarter 2002	Year to June 2002
Private consumption	0.5	0.3	0.8
Residential investment	–2.0	–0.8	–2.3
Business investment	–1.9	–0.4	–8.7
Public demand	0.0	–0.1	1.1
Change in inventories[(a)]	–0.4	0.2	–0.7
Domestic demand	–0.5	0.3	–1.6
Net exports[(a)]	0.5	0.4	0.8
– Exports	4.8	5.7	5.5
– Imports	0.0	2.6	–2.8
GDP	**0.0**	**0.6**	**–0.7**

(a) Contribution to GDP growth
Source: Thomson Financial Datastream

$^1/_2$ per cent higher than the trough in May, the unemployment rate has remained around its historical high of $5^1/_2$ per cent (Graph 21). The decline in compensation has accelerated, owing mainly to a reduction around the middle of the year in bonus payments, which are typically linked to corporate profitability. Deflation continues, with consumer prices declining by 0.7 per cent over the year to September. Over the past five years the price level, as measured by the consumer price index, has fallen by nearly 3 per cent.

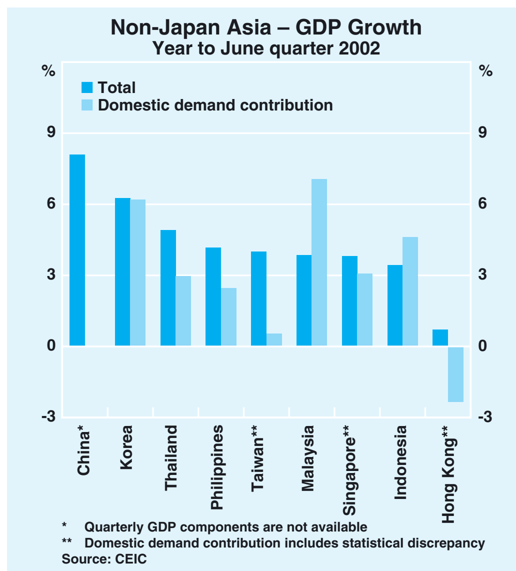
Graph 21



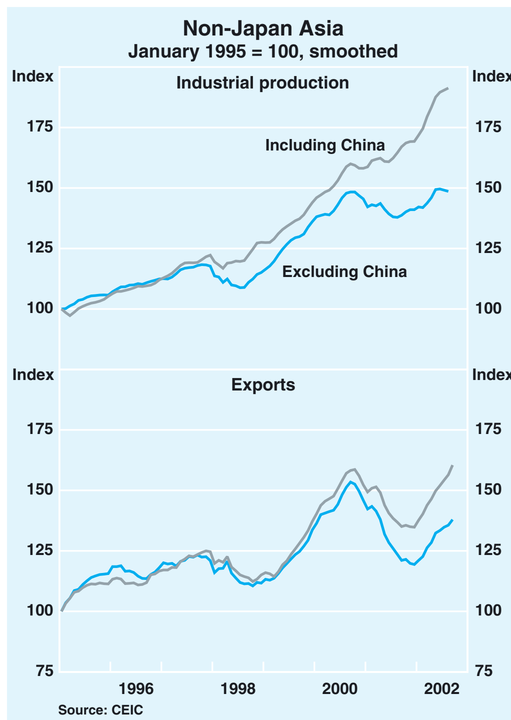
Non-Japan Asia

Non-Japan Asia has been an area of relative economic strength so far in 2002. The Chinese economy is continuing to grow at around 8 per cent per annum, according to official data. Excluding China, output in the region increased for a fourth consecutive quarter in June, to be $4^1/_2$ per cent higher over the year. While some of this growth has been sourced from the external sector, a sizable proportion is due to rising domestic demand (Graph 22). Consumption was a major contributor to growth in most countries over the year to June, with business investment also rising strongly in the first half of this year. Growth in Korea has been particularly robust, owing mainly to rapid growth in consumption, which has been supported by a strong pick-up in household borrowing and low unemployment. In contrast, Hong Kong remains weak with domestic demand falling significantly over the year to June. Growth in Singapore also faltered in the September quarter.

Graph 22



Graph 23



Manufacturing production in non-Japan Asia has expanded rapidly over the past year (Graph 23). While China accounted for much of the strength, output in the rest of non-Japan Asia has exceeded its previous peak in the middle of 2000. Reflecting increased domestic demand, manufacturing production has generally grown faster than exports over the past couple of years. Services sector output has also increased, while, in contrast, the construction industry has continued to weaken.

Labour markets in most countries in the region continue to improve, with unemployment rates generally declining. China, Hong Kong, Singapore and Taiwan are experiencing mild deflation on a year-ended basis.

New Zealand

In New Zealand output rose by 1.7 per cent in the June quarter to be 4.0 per cent higher over the year. Growth in both domestic demand and exports has been robust over the past year. Inflation, at 2.6 per cent over the year to the September quarter, has been steady for most of this year. A change to the Reserve Bank of New Zealand policy objective was announced in September, with the focus moving to a more medium-term approach to achieving price stability. The bottom of the inflation target was also raised from 0 to 1 per cent, with the 3 per cent upper limit retained.

Europe

Europe has yet to show signs of a significant recovery. GDP in the euro area increased only modestly in the first half of the year, to be 0.7 per cent higher than a year earlier (Table 9). For the first time in nearly a year household consumption contributed to growth in the quarter, though investment fell for the sixth consecutive quarter and is nearly 3 per cent lower over the year. Exports remain the main source of growth. Across the major economies, growth remains weaker in Germany and Italy, while more robust consumption growth has driven stronger outcomes in France and Spain.

More recent data have been disappointing. Growth in industrial production appears to have stalled, following a moderate pick-up in the early part of the year. With financial stresses of the type hampering the US recovery

Table 9: Europe GDP and Unemployment Rates
Per cent

	GDP growth		Unemployment rate
	June quarter	Year to June quarter	Latest
Euro area	0.4	0.7	8.3
– Germany	0.3	0.1	8.3
– France	0.4	1.0	8.8
– Italy	0.2	0.2	9.0
– Spain	0.4	2.0	11.2
– Netherlands	0.1	–0.1	2.9
United Kingdom	0.6	1.3	5.2

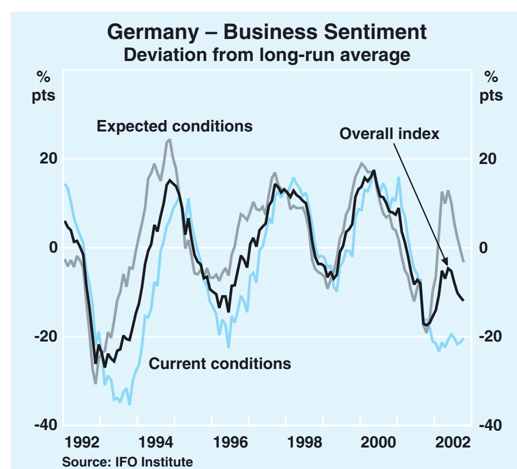
Source: Thomson Financial Datastream

at least as severe in Europe, measures of business sentiment have retraced some of their earlier gains. Current business conditions, as measured in the German IFO survey, have remained weak, while some of the optimism evident in the expectations component of the survey earlier in the year, has been wound back (Graph 24). A similar pattern is evident in the other major euro area economies. The export sector remains an exception, with exports rising over much of this year.

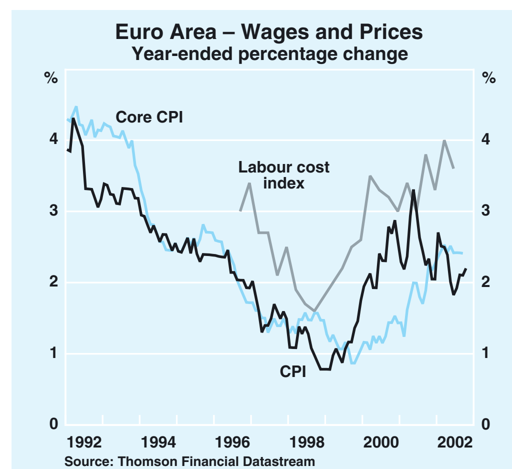
The labour market has remained relatively resilient despite the slow pace of growth, with the unemployment rate for the euro area in the September quarter only 0.3 percentage points above the cyclical trough last year. However, the aggregate numbers mask differing developments amongst the major economies. In Germany, unemployment has risen by 0.7 percentage points from its low in 2001, while unemployment in Italy has continued to fall. Consumer sentiment has also unwound most of the gains from earlier in the year to be marginally above its trough late last year.

Year-ended consumer price inflation has picked up slightly in the past few months to be a little over 2 per cent, after falling in the early part of the year (Graph 25). This mostly reflects the impact of higher oil prices, as core inflation (which excludes food and energy) has remained steady at just under 2½ per cent. In Germany, year-ended inflation is currently around 1 per cent, the lowest rate in the euro

Graph 24



Graph 25



area, while it is around 1³/₄ per cent in France and 2³/₄ per cent in Italy. Annual wages growth in the euro area has remained a little under 4 per cent, after accelerating over the past few years.

The European Commission has indicated that some requirements of the Stability and Growth Pact are likely to be modified, as weak economic conditions have made the 2004 deadline for countries to balance their budgets unrealistic. A relaxation of the deadline would give the French and Italian governments some scope to proceed with promised tax cuts.

In the United Kingdom GDP grew by 0.7 per cent in the September quarter, to be 1.7 per cent higher over the year. Growth in the services sector in the quarter continued at a robust pace and the manufacturing sector expanded for the first time since 2000. Growth in household consumption remained firm, supported by rapid growth in house prices, which are over 20 per cent higher than a year ago. Rises in house prices have also boosted dwelling investment in recent quarters. The labour market has been resilient, with unemployment just above historical lows in the September quarter, as jobs have continued to be created in the services sector. Year-ended inflation (excluding mortgage payments) was around 2 per cent in recent months, as falling goods prices have offset increasing services prices.

Domestic Economic Activity

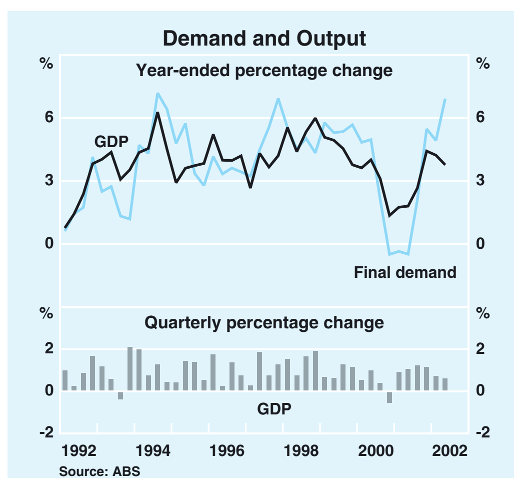
According to the latest national accounts, real output rose by 0.6 per cent in the June quarter, to be 3¾ per cent higher than a year earlier (Graph 26). While this represents a somewhat slower pace of growth than was recorded in recent quarters, the aggregate figure masks sharply contrasting trends in domestic demand and exports. Domestic final demand has expanded by 6.9 per cent over the past year, close to its strongest annual pace of growth over the past decade. The recent strength in domestic demand has reflected the combination of continued rapid growth in consumer spending, the upswing in housing activity and a pick-up in business investment. In line with the strength in domestic demand, import volumes grew by 12 per cent over the year while exports declined by more than 1 per cent, owing to the weak global economy. Consequently, net exports subtracted 3 percentage points from GDP growth over the year to June (Table 10).

Table 10: National Accounts
Percentage change

	June quarter 2002	Year to June quarter 2002
Private final demand[a]	2.3	7.7
Consumption	1.5	4.5
Dwelling investment	4.8	29.6
Business investment[a]	6.3	14.7
Public final demand[a]	1.5	4.2
Domestic final demand	2.1	6.9
Change in inventories[b]	–0.4	–0.1
Exports	0.4	–1.5
Imports	6.0	11.9
Net exports[b]	–1.3	–3.0
Gross domestic product	**0.6**	**3.8**

(a) Excluding the effect of transfers between the private and other sectors
(b) Contribution to GDP growth
Source: ABS

Graph 26



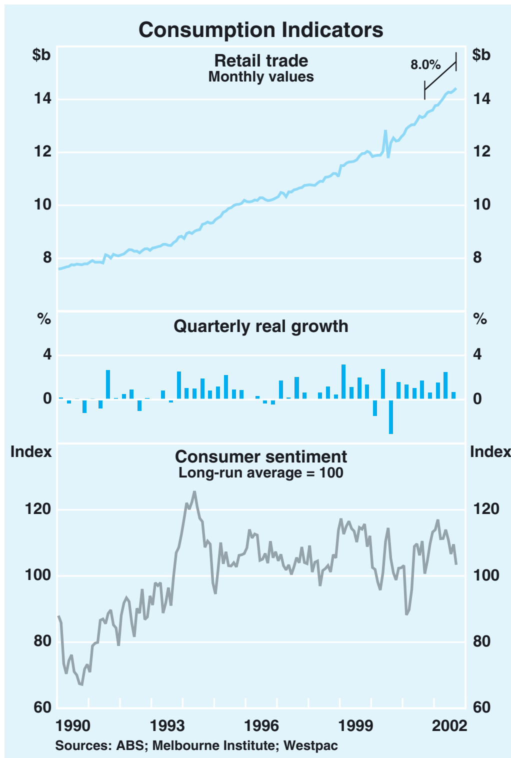
The outlook for the Australian economy remains quite favourable, although growth will be reduced by the impact of the drought on the farm sector. In addition there is likely to be some rebalancing of growth, with domestic demand slowing while net exports continue to reduce growth, but by a lesser amount than they did over the past year.

Household consumption

Household consumption spending continued to grow robustly in the June quarter, rising by 1½ per cent to be 4½ per cent higher than a year earlier. Spending on household goods was especially strong, in line with buoyant house-building activity. Recent indicators suggest that consumption has continued to rise at a good pace, with the volume of retail sales up by 0.7 per cent in the September quarter (Graph 27). Motor vehicle sales to households fell slightly in the September quarter but remain at a high level.

Consumer spending has been supported by rising household incomes and house prices.

Graph 27



Consumer sentiment has eased back in recent months, but is still slightly above its long-run average. The value of household assets rose by 12¼ per cent over the year to June and has averaged more than 10 per cent per annum over the past five years (Table 11). In recent quarters the large increases in house prices have more than offset the effect on aggregate household wealth of the falls in the value of equity holdings, which account for a smaller share of the total. This pattern continued in the September quarter, with indicators suggesting a further strong rise in house prices, while equity prices fell by 7½ per cent.

Rises in the value of household assets and low financing costs have encouraged households to finance consumption through borrowing. Over the year to September, household borrowing rose by around 17¾ per cent. While the bulk of this borrowing is to finance dwelling acquisition, some part of that recorded as borrowing for housing is likely to have been used to fund consumption. Products and financial services such as home-equity loans and redraw facilities have improved the ability of households to borrow against their equity in property. Overall, growth in household debt outpaced that of household assets over the year to the June quarter, and as a result the ratio of debt to assets increased to 15 per cent from 14½ per cent in the previous year. However, debt service payments have

Table 11: Household Assets(a)
June 2002

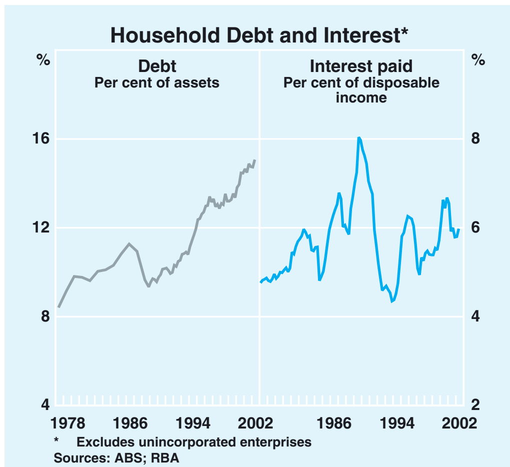
	Level	Share of total	Growth Per cent	
	$billion	Per cent	**Year to June 2002**	**Average June 1996 – June 2001**
Housing	1 939	59.9	19.2	10.6
Consumer durables	186	5.7	14.0	5.0
Financial assets	1 113	34.4	1.6	11.9
– Superannuation and life offices	524	16.2	–0.7	13.2
– Equities and unit trusts	250	7.7	–3.9	21.6
– Currency and deposits	299	9.2	13.3	5.7
– Other	39	1.2	–7.9	0.2
Total	**3 237**	**100.0**	**12.2**	**10.7**

(a) Includes unincorporated sector but excludes unfunded superannuation and prepayment of insurance

Sources: ABS; RBA

remained relatively stable at around 6 per cent of household disposable income in recent quarters (Graph 28).

Graph 28

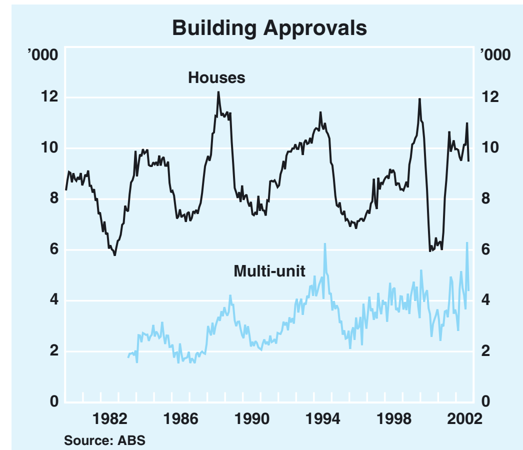


Housing

Activity in the housing sector has expanded strongly over the past year with dwelling investment rising by 4¾ per cent in the June quarter, to be 30 per cent higher over the year. Leading indicators for housing suggest that this high level of activity is likely to be sustained until the March quarter of 2003.

However, the indicators suggest somewhat divergent trends in the period ahead for the detached housing market, which is predominantly owner-occupied, compared with the multi-unit sector, which tends to have a greater share of investors. Activity in the detached housing sector appears to be close to its peak. Building approvals for the construction of new houses have stabilised at a high level over the past year, notwithstanding a temporary surge in August (Graph 29). The number of new loan approvals for the construction of housing for owner-occupation has declined over the course of 2002. In part this reflects the cessation at the end of June of the Commonwealth Additional Grant to first-home buyers building a home – the share of first-home buyers obtaining a loan approval has fallen noticeably over the past year. But it is also consistent with the pattern observed in previous housing cycles that the owner-occupied market tends to peak prior to the investor segment of the market.

Graph 29

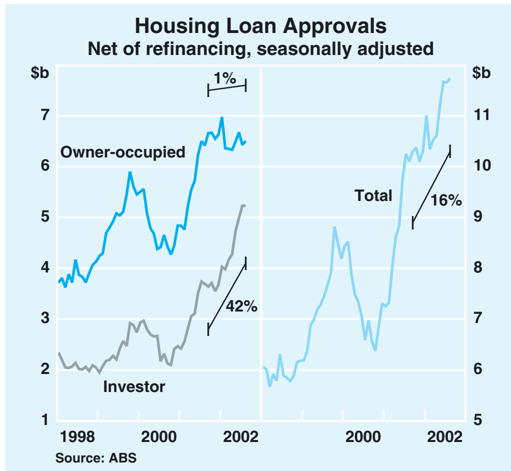


In contrast, leading indicators of activity in the multi-unit sector have picked up again recently. Approvals for the construction of multi-unit housing in the September quarter were nearly 18 per cent higher than a year earlier. The recent increase in approvals was spread across most of the capital cities. Loan approvals to investors for new construction have also risen sharply in recent months, increasing by 15 per cent over the three months to August.

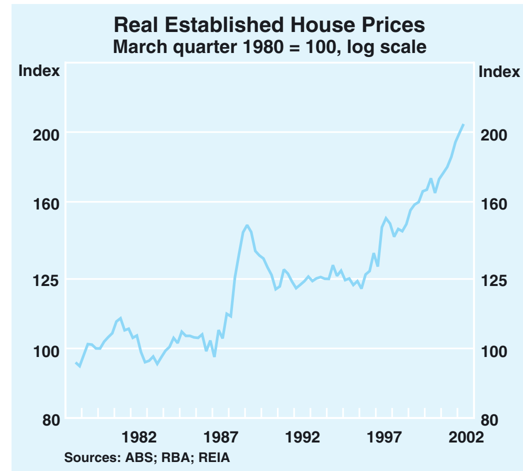
Lending for housing is still being pushed along by historically high activity in the investor market. Over the past year, loan approvals to investors have risen by 42 per cent compared with 1 per cent for owner-occupiers over the same period (Graph 30). Thus virtually all the increase in approvals over the past year is attributable to investors.

A number of factors seem to be contributing to the surge in lending to investors. Low interest rates and eager mortgage lenders have made finance readily available. The relatively poor performance of equity markets over the past couple of years has also increased the attractiveness of investing in property and made it easier for those organisations aggressively marketing property as a tax-effective investment. Finally, the large increases in property prices in the past have led investors to assume that these will continue

Graph 30



Graph 31



in the future, notwithstanding the increasing signs of oversupply in the investor property market.

These developments share a number of similarities with those in the late 1980s (Graph 31). In both episodes, there was an increase in the appeal of housing as an investment option in the wake of a downturn in equity markets. Consequently, there was a marked increase in lending to investors in both periods, although investor participation has been greater in the current episode.

Most indicators of house prices show strong rises in the September quarter following on from the large rises over recent years (Table 12). In Sydney, Melbourne and Brisbane – the cities for which there are the most complete data – there is a clear tendency for house prices to have risen further than unit prices. There is also evidence that, in some cases, unit prices have been flat or have fallen. The real estate consultants Residex collect a series for prices based on repeat sales; that is, they follow the prices of individual properties that have changed hands at least twice in recent years. This suggests that although house prices rose in the September quarter, the prices of units were flat in Sydney and fell in Melbourne. Thus the part of the property market to which most of the investor borrowing is being directed is the part where prices are rising least, if at all.

Table 12: House Prices
September quarter, percentage change

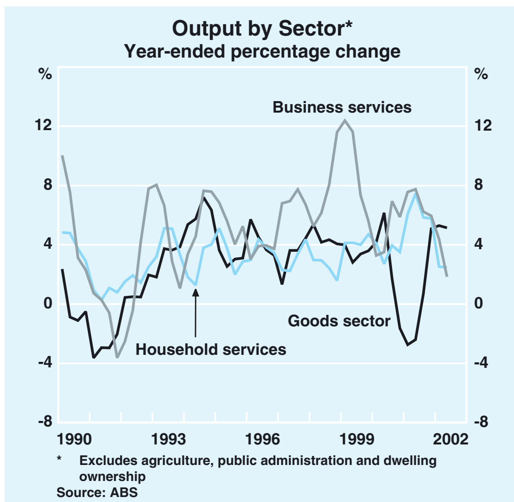
	CBA		Residex	
	Houses	Units	Houses	Units
Sydney	7.7	4.3	2.8	0.7
Melbourne	8.5	5.1	3.3	–4.4
Brisbane	6.6	–1.2	3.7	4.0
Adelaide	2.1	7.7		
Perth	1.3	3.9		
Canberra	12.0			
Hobart	12.9			
Australia	**7.1**	**4.3**		

Sources: CBA; Residex

The business sector

In line with strong growth in domestic demand, businesses have generally experienced favourable conditions through the past year, though conditions have varied significantly between sectors. Growth in the goods-producing sector has been robust, with strength in the construction, manufacturing and retail sectors, while the service sectors have continued to slow (Graph 32). This is particularly so for the property and business services sector, which has been affected by reduced spending by firms on, inter alia, consulting, marketing and technical services.

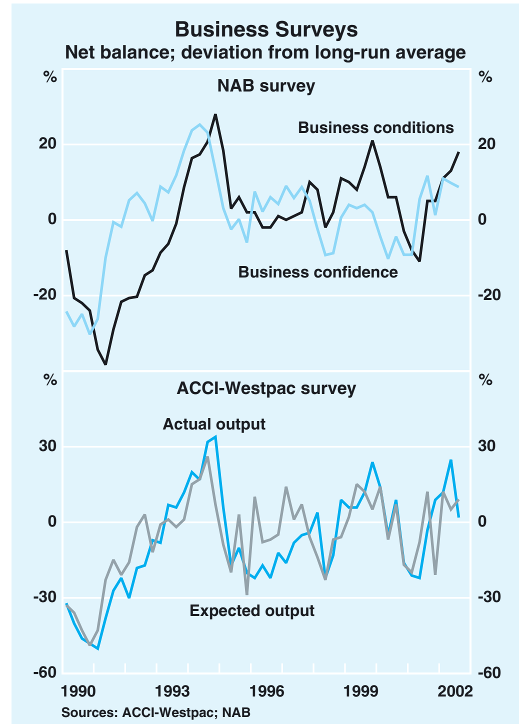
Graph 32



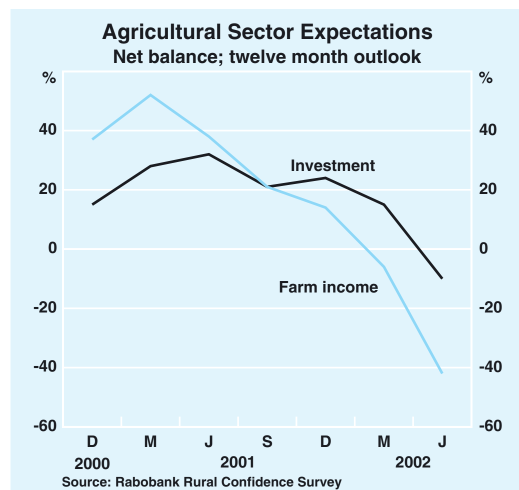
Most measures of business conditions remain at levels consistent with trend growth in the non-farm sector (Graph 33). The broadly based NAB survey suggests that business conditions continued to improve in the September quarter, particularly in sectors such as construction, retail and wholesale trade. In the manufacturing sector, the ACCI-Westpac and AIG surveys report conditions being slightly above average despite easing recently. Consistent with the recovery in business investment, capital spending intentions remain high. While measures of business confidence have fallen in recent months, they generally remain at or above long-run average levels.

The farm sector remains a notable exception and conditions have deteriorated further in recent months as the drought has persisted. The June quarter Rabobank Rural Confidence Survey recorded a large increase in the number of respondents expecting investment in the agricultural economy and farm incomes to weaken over the next 12 months (Graph 34). Confidence has fallen

Graph 33



Graph 34



across all parts of the country, with the sharpest falls in New South Wales owing to the severity of drought in that state. The dry conditions curtailing farm output will limit rural exports (see the chapter on 'Balance of Payments') and farm incomes and those of businesses connected to the rural economy, with adverse consequences for overall economic growth (see 'Box A: Economic Effects of the Drought' for further details).

Reflecting the strong conditions in the non-farm sector, corporate profits as measured by gross operating surplus (GOS) were around 12 per cent higher over the year to June, despite falling slightly in the June quarter. Profits of domestically oriented industries continued to rise in the June quarter, benefiting from the strength in domestic demand. However, this was more than offset by a decline in mining profits, reflecting lower export volumes, lower US dollar prices for some resources and the higher Australian dollar prevailing in the first half of the year. Nonetheless, the level of mining profits remains high by historical standards. Small-business profits also declined slightly in the June quarter, with a decline in rural incomes more than offsetting continued strength in the retail and residential construction sectors, but have grown by about 12 per cent over the year. Business surveys show that firms generally remain confident about the profit outlook.

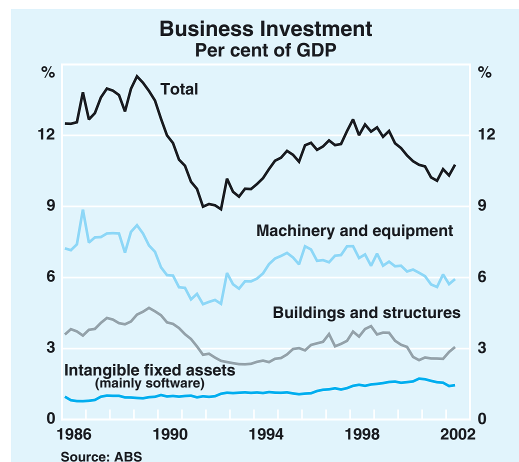
In addition to the internal funding provided by the rise in profits over the past year, businesses have also increased their capital raisings from external sources. Business borrowing from intermediaries grew at an annualised rate of 8 per cent over the six months to September, after being broadly flat over the preceding six-month period. Direct capital raisings through both non-intermediated debt and equity issuance increased more modestly over this period, possibly reflecting the decline in equity markets and a widening in corporate bond spreads.

The overall financial position of the business sector remains in good shape. Debt levels relative to gross operating surplus have been broadly constant in recent years, following significant reductions in leverage in the early 1990s, and they remain low by historical standards. Interest payments expressed as a share of profits remain at low levels.

The combination of ready access to funding at a relatively low cost and strong domestic economic growth has been conducive to a solid recovery in investment spending. Business investment rose by nearly 15 per cent over the year to the June quarter, led by strong increases in spending on both machinery and equipment and buildings and structures; growth in computer software investment picked up only modestly through this period.

Despite this growth over the past year, investment as a share of GDP still remains at a relatively low level (Graph 35). Indicators of investment intentions point to further strong growth in business investment in 2002/03. The June quarter ABS capital expenditure (Capex) survey suggests that investment in machinery and equipment is expected to grow by around 13 per cent in nominal terms this financial year, assuming a five-year average realisation ratio; private-sector surveys also report robust investment intentions. The pick-up in equipment investment spending is expected to be particularly strong in the mining, manufacturing, and transport and storage industries. However, weaker spending on agricultural equipment, owing to drought

Graph 35



conditions and an expected fall in agricultural income, is likely to provide a restraining influence on overall investment in machinery and equipment in the current financial year.

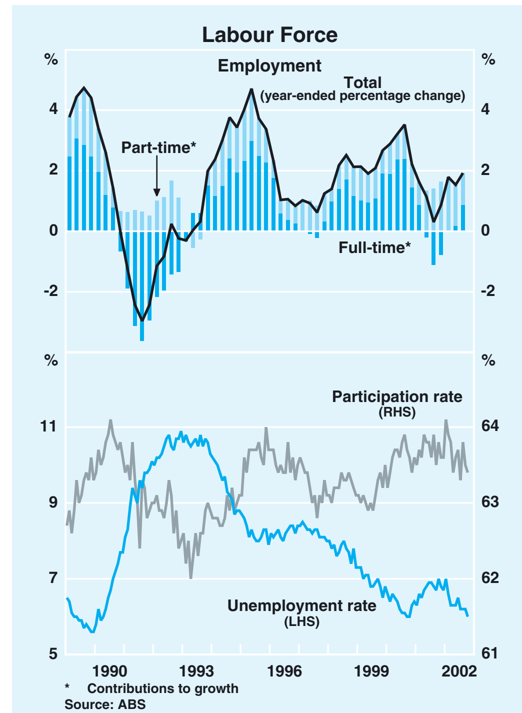
Investment in buildings and structures has also risen strongly over the first half of 2002. Favourable forward-looking indicators and a large build-up of work in the early stages of construction imply that growth in buildings and structures investment should continue over the coming quarters. Furthermore, state governments have recently announced a suite of major projects, some with private-sector involvement and largely concentrated in the transport and utilities industries, which will result in a significant increase in investment. The Access Economics *Investment Monitor* confirms the favourable outlook for buildings and structures investment, with work about to begin or recently having commenced on a large number of resource-related projects, many public infrastructure projects, and on office construction. Looking further ahead, a number of large-scale engineering projects are in prospect as a result of Australia LNG securing a contract to supply LNG to China for 25 years, beginning in about the middle of the decade.

The labour market

After a period of slower growth around the middle of the year, employment increased by 0.6 per cent in the three months to October, and is now 2.0 per cent higher than the same period last year (Graph 36). Full-time employment rose by 0.6 per cent in the three months to October to be 1.1 per cent higher than a year ago, while part-time employment has remained strong, rising by 0.7 per cent in the three months to October, to stand 4.5 per cent higher over the year. These gains in employment have been reflected in the unemployment rate, which has fallen by 1 percentage point since the beginning of the year.

Improved labour market conditions have been evident in most states. Queensland recorded the fastest employment growth in the year to the three months to October, rising by 3.1 per cent, and, consistent with this,

Graph 36



recorded the largest unemployment rate fall across all states (Table 13). Employment growth in South Australia and Western Australia has also been strong, at 2.6 and 2.4 per cent in the year to the three months to October. While employment growth has been slower in Victoria and NSW, these states have recorded the lowest unemployment rates. Tasmania continues to record a higher unemployment rate than the rest of the country.

The decomposition of employment growth by industry reveals trends generally in line with the pattern of output (Table 14). Employment in the retail and wholesale trade sectors, which increased by 0.8 per cent in the September quarter, continues to be supported by strength in consumer spending. There has also been a recovery in manufacturing employment, with a 2 per cent rise in the quarter, following two previous consecutive quarters of growth. However, employment remains weak in industries that have been most exposed to the downturn in tourism, such as accommodation, cafes and restaurants and

Table 13: Labour Market by State
Per cent

	Employment growth		Unemployment rate	
	Three months to October	Year to three months to October	Three months to October	Year to three months to October[(a)]
NSW	0.3	1.4	5.6	–0.6
Victoria	0.6	1.9	5.9	–0.6
Queensland	1.2	3.1	7.1	–1.1
WA	0.6	2.4	6.3	–0.6
SA	0.3	2.6	6.5	–0.7
Tasmania	0.5	0.1	8.4	–0.7
Australia	**0.6**	**2.0**	**6.1**	**–0.7**

(a) Percentage point change
Source: ABS

transport and storage, which includes airline travel. Furthermore, employment in the rural sector fell sharply in the quarter, to be well down on levels of a year ago, with much of the fall concentrated in NSW and Western Australia, reflecting the initial effects of drought conditions.

Labour productivity growth measured on an output per person employed basis has slowed somewhat from the rapid pace recorded in the second half of last year. In the June quarter this measure of productivity increased by 0.4 per cent, to be 2.2 per cent higher over the year. Productivity measured on an hours-worked basis also increased by

Table 14: Employment
Per cent

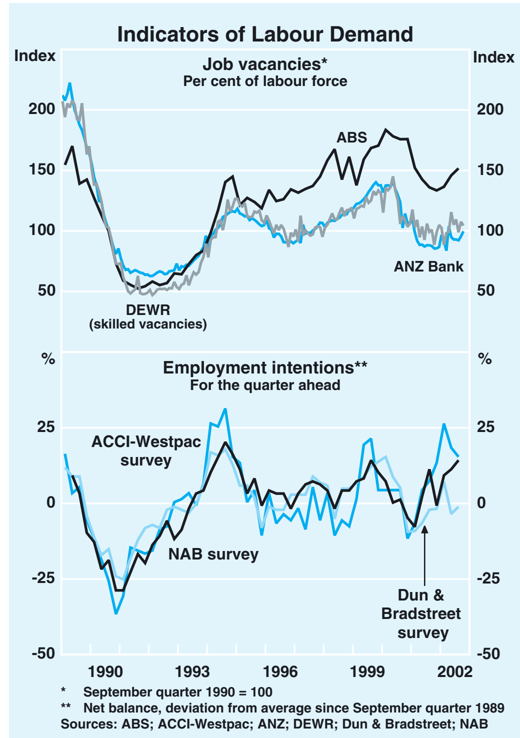
		Growth	
Industry	**Share of total 2001**	**September quarter 2002**	**Year to September quarter 2002**
Retail and wholesale trade	20	0.8	3.0
Manufacturing	12	2.0	3.3
Property and business services	12	2.4	5.0
Health and community services	10	4.3	5.8
Construction	7	–4.1	2.2
Education	7	3.7	3.4
Accommodation, cafes and restaurants	5	–4.8	–3.3
Agriculture	5	–9.2	–12.5
Transport and storage	5	–0.5	–5.3
Finance and insurance services	4	0.5	–2.9
Personal and other services	4	2.6	2.0
Cultural and recreational services	2	6.2	17.7
Communication services	2	4.8	–1.4
Total[(a)]	**100**	**0.8**	**2.0**

(a) Includes public administration and defence, mining and utilities
Source: ABS

0.4 per cent in the quarter, and by 3.2 per cent in year-ended terms.

Forward-looking indicators of labour demand have generally improved over the past few months, and remain supportive of a continued expansion in employment in the near term (Graph 37). The ABS employer-based measure of vacancies picked up in the September quarter to reach levels considerably higher than a year earlier. After patches of weakness in the middle of 2002, measures of print-based vacancies have also reported more positive outcomes, restoring the upward trend evident in these series since the beginning of the year. The ANZ newspaper-based series posted a 4.4 per cent increase in October, to be 17.8 per cent higher than the same time last year. In contrast, skilled vacancies data compiled by the Department of Employment and Workplace Relations (DEWR) fell slightly in October, but are almost 20 per cent higher than a year ago. Employment intentions for the December quarter reported in the NAB and ACCI-Westpac surveys are well above long-run levels, while intentions reported in other surveys, such as Dun & Bradstreet, remain around long-run levels.

Graph 37



Box A: Economic Effects of the Drought

Over the course of this year, conditions have been extremely dry across a wide stretch of the country. The drought has severely reduced winter-crop production and brought forward livestock slaughtering, and will significantly curtail farm output and incomes.

The direct effects of the drought will be most evident in a decline in agricultural production and an associated reduction in rural exports (around two-thirds of agricultural production is exported). However, fluctuations in rural exports tend not to be as pronounced as those of agricultural production as rural exports include output of the forestry and fishing industries, as well as processed agricultural products. In addition, agricultural inventories tend to be run down during periods of drought. The reduction in farm incomes will translate into lower farm consumption and investment (farm equipment is, on average, around 8 per cent of total machinery and equipment investment spending). Although difficult to quantify, the drought will also have indirect effects on the economy, most particularly in those industries that supply and service agriculture, such as the wholesale and transport sectors, as well as retail operations in rural areas.[1]

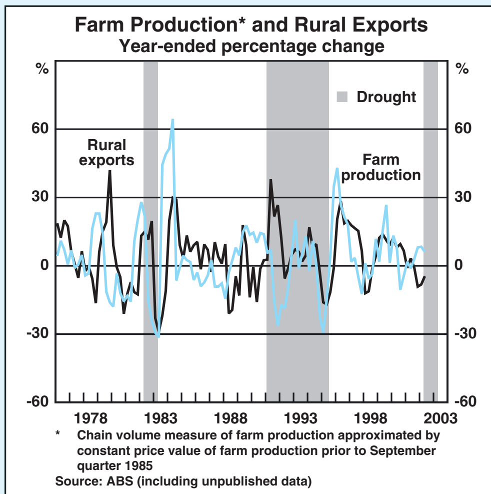
The adverse effect of a drought on production varies across the different parts of the farm sector. Drought conditions lead to an immediate reduction in grain production, whereas a downturn in meat production tends to occur with some delay as farmers initially increase slaughter rates in response to the rising cost of feed. Conversely, crop production recovers faster than meat production following the breaking of a drought, with meat production delayed by the need to rebuild stock numbers. Similarly, there are differing effects on rural commodity prices, with wheat and other grain prices initially rising, reflecting the reduced supply, and meat prices initially falling; the reverse price movements typically occur following the cessation of the drought.

To provide some guidance as to the likely effects of the current drought on the economy, it is useful to examine the effect of earlier droughts. Although changing weather conditions are an ever-present source of volatility in agricultural production, two particularly severe droughts are identifiable in the past 20 years: the first in 1982–1983, which affected eastern and southern Australia; and the second, a series of low-rainfall years from 1991 to 1995, during which several regions across Australia experienced varying degrees of drought conditions at different times. In both episodes, agricultural production and rural exports declined significantly and then recovered strongly following the breaking of the drought (Graph A1). The sharp fall and subsequent rise in agricultural production during the 1982–1983 drought first subtracted, and subsequently added, around 1–1½ percentage points to GDP growth (Graph A2). In the 1991–1995 drought, GDP was reduced by around ½–¾ percentage point in both 1991/92 and 1994/95, and was subsequently boosted by around ¾ percentage point in 1995/96.

Based on the latest Australian Bureau of Agricultural and Resource Economics (ABARE) estimates of crop and livestock production, agricultural production could fall by close to 15 per cent in 2002/03, more than half the fall experienced in 1982/83 and

1. See Aspden C (1996), ‘Impact of the 1995-96 farm season on Australian production’, Australian National Accounts: National Income, Expenditure and Product, ABS Cat No 5206.0, September quarter, pp 123–131, for examples of how these indirect effects might be estimated.

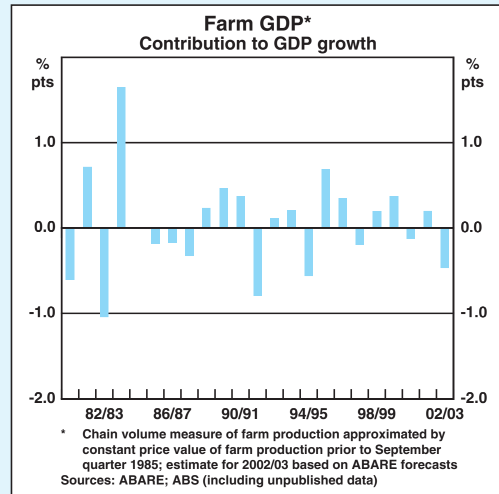
Graph A1



* Chain volume measure of farm production approximated by constant price value of farm production prior to September quarter 1985

Source: ABS (including unpublished data)

Graph A2



* Chain volume measure of farm production approximated by constant price value of farm production prior to September quarter 1985; estimate for 2002/03 based on ABARE forecasts

Sources: ABARE; ABS (including unpublished data)

close to the falls in 1991/92 and 1994/95. The smaller expected fall in production in the current episode in part reflects improvements in cropping techniques since the 1980s, which have enabled farmers to cope more effectively with adverse weather conditions.[2] Another factor reducing the impact on the aggregate economy is that the share of agricultural production in GDP has fallen from around 6 per cent in the early 1980s to just over 3 per cent in recent years. Nevertheless, the forecast decline in production would still directly subtract around 1/2 a percentage point from aggregate economic growth in 2002/03 and as much as 1 percentage point from growth over the year to June 2003.

Fluctuations in farm incomes – that is, the proceeds of sales net of operating costs – tend to be of considerably larger magnitude than the fluctuations in production. In September, ABARE estimated that farm incomes will be around 60 per cent lower in 2002/03 than the relatively high levels in the previous year. To some extent, the increased use of Farm Management Deposits (FMD) in recent years has provided scope for farmers to smooth their income and expenditures. The recent high levels of farm income have facilitated a large build-up of FMDs, which should help insulate farmers from some of the effects of the expected fall in earnings. Nonetheless, a significant decline in expenditure by rural producers can be expected as a consequence of the drought.

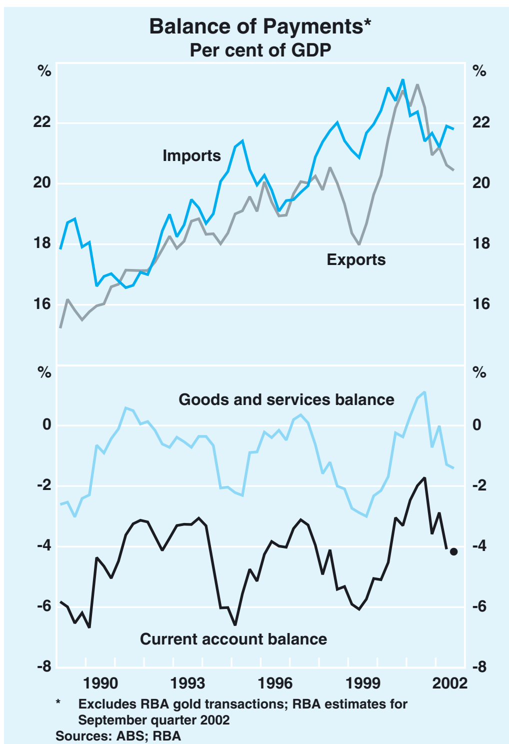
While the drought is a serious negative shock to the economy, past experience suggests that there will subsequently be a significant boost to growth when the drought breaks, as crop production typically rebounds strongly following drought years. In the past, El Niño episodes have tended to start towards the middle of the calendar year and last a little less than 12 months. At this stage, the Bureau of Meteorology expects drier-than-average conditions to persist in much of the country for at least the next several months.

2. Ha A and L Chapman (2000), 'Productivity growth trends across Australian broadacre industries', *Australian Commodities: Forecasts and Issues*, 7(2), pp 334–340.

Balance of Payments

With the Australian economy continuing to grow faster than a number of its major trading partners, the trade deficit has widened over the past year, to be around 1½ per cent of GDP in the September quarter. Assuming that the net income deficit as a proportion of GDP remained constant, this would suggest a current account deficit of around 4¼ per cent of GDP in the September quarter (Graph 38). Unlike the experience in previous international downturns, Australia's terms of trade have remained relatively stable during the recent period at around their highest level for over 10 years. This largely reflects the high prices received for a number of commodity exports, as well as declining import prices, particularly for electronic equipment. The strength of Australia's terms of trade has helped to limit the cyclical widening in the current account deficit.

Graph 38



Reflecting the weak world economy, the value of exports has fallen by about 3¾ per cent over the year to the September quarter. Much of this decline was concentrated towards the end of last year, when merchandise exports to most markets fell. Since then, growth in merchandise exports has varied across markets (Table 15). Strength in domestic demand has supported rapid growth in exports to Korea and China, while exports to New Zealand have picked up strongly. A recovery is also evident in merchandise exports to Japan. In contrast, exports to the US remain weak, owing to sizable falls in exports of motor vehicles, pharmaceuticals and meat. There have been large declines in exports to India and the Middle East, though this followed very strong rises in previous years.

After declining sharply in the second half of 2001, the value of resource exports has subsequently recovered, increasing by about 7½ per cent over the past three quarters (Graph 39). A large rise in the value of exports of oil and LNG accounted for around half of the increase, mainly reflecting increases in oil prices. In contrast, receipts from coal exports have fallen as subdued growth in world industrial production and an unusually mild northern hemisphere winter have pushed thermal coal prices lower. The value of base metals exports also fell over the three quarters to September, owing partly to softer prices for a number of base metals. In the period ahead, the Australian Bureau of Agricultural and Resource Economics (ABARE) expects nickel and zinc production to be boosted by the introduction of new capacity.

In August, the Australia LNG consortium won the right to supply LNG to China. The contract to supply over 3 million tonnes of LNG annually to China's Guangdong province over 25 years, beginning in 2005/06, is reported to be worth between $20 billion and $25 billion. According to ABARE, LNG

Table 15: Merchandise Exports by Destination[(a)]

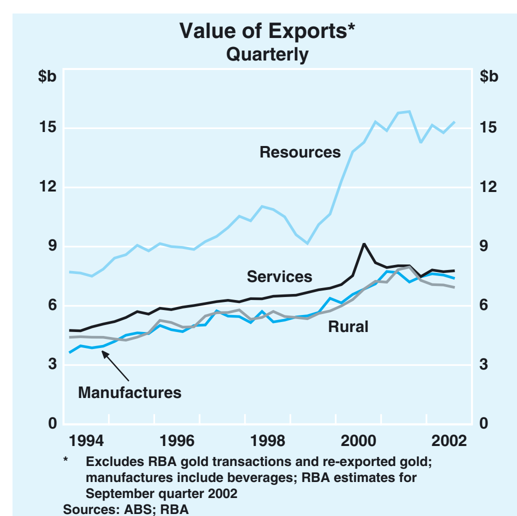
	Share of total 2001	Growth: Year to December quarter 2001	Growth: Three quarters to September quarter 2002[(b)]
East Asia (excluding Japan)	33.7	–8.0	6.3
– of which Korea	7.4	5.6	12.6
– of which China	6.3	10.6	14.6
Japan	19.7	–4.6	4.3
EU	12.2	8.5	1.3
US	9.9	-6.6	–6.1
New Zealand	5.8	3.2	12.1
Middle East	5.2	31.4	–15.2
India	2.0	29.7	–29.5
Rest of world	11.5	–0.8	–3.1
World	**100.0**	**–1.6**	**1.3**

(a) Excludes re-exported gold, seasonally adjusted
(b) September quarter is estimate
Sources: ABS; RBA

exports, which account for about 4 per cent of the value of resource exports, are expected to double over the next five years. In order to meet supply commitments, the consortium is expected to invest in a fifth LNG processing train.

The value of rural exports fell by about 2½ per cent in the September quarter to be around 13 per cent lower over the year. The value of meat exports fell by about 8 per cent in the September quarter, and was more than 17 per cent lower than a year earlier, partly reflecting reduced demand from Japan. The capacity for Australian beef exports to be diverted to other markets is limited, given the existence of quotas in the US, the other major destination for Australian meat exports. Beef prices have declined, exacerbated by drought conditions in the US and Australia, which have led to increased livestock slaughterings. The value of wool exports has risen over the past few quarters, with higher prices offsetting the reduction in flock size. The value of cereal exports fell by around 1 per cent in the September quarter.

Graph 39

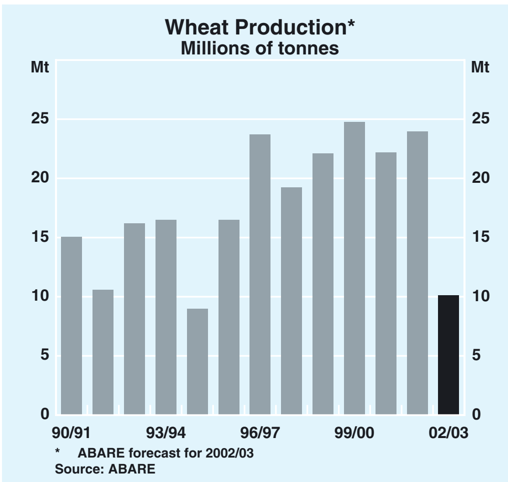


* Excludes RBA gold transactions and re-exported gold; manufactures include beverages; RBA estimates for September quarter 2002
Sources: ABS; RBA

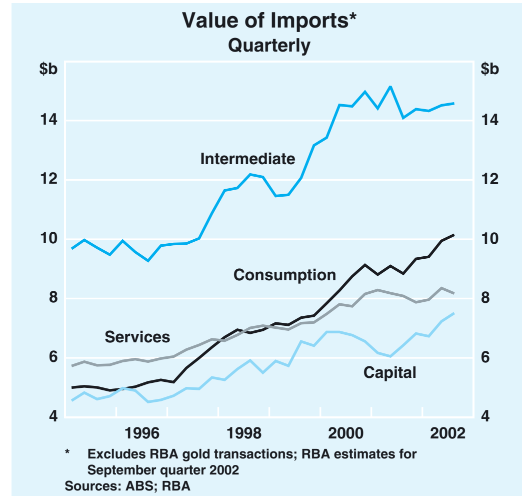
The drought is expected to lead to a significant decline in rural exports in coming quarters (see Box A for a discussion of the economic effects of the drought). ABARE recently revised down its forecast for wheat production in 2002/03 to just over 10 million tonnes, compared with 24 million tonnes in the previous financial year (Graph 40).

Weak growth in our trading partners continues to adversely affect manufactured export earnings, with the value of

Graph 40



Graph 41



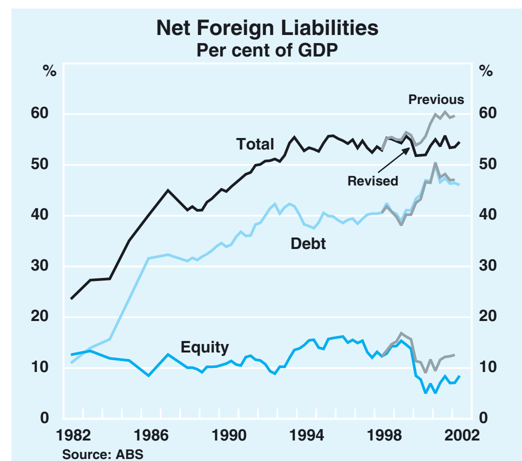
manufactured exports only 2½ per cent higher than a year ago, well down on the average annual rate of growth of 9½ per cent over the past decade. Exports of machinery have declined over the past year, falling by around 4½ per cent over the year to the September quarter. However, receipts from the export of transport equipment continue to rise and have more than doubled over the past six years.

Service exports also continue to bear the effects of slow growth in the world economy and international trade. They rose by about 1½ per cent in the September quarter but remain about 3 per cent lower over the year. Weakness in service export earnings over the past year has been fairly broadly based, with the value of transportation and travel services exports both falling.

Strong growth in domestic demand, coupled with falls in import prices, has resulted in robust growth in import volumes over the past year, with import values around 8 per cent higher over the year to the September quarter. Reflecting the pick-up in business investment, growth in the value of capital imports has been particularly strong, rising by 17 per cent over the year to the September quarter (Graph 41). Imports of civil aircraft have been the largest contributor to the increase over the past year. The value of consumption imports has also risen strongly, and in the September quarter was 15 per cent higher than a year earlier, partly a result of rising imports of motor vehicles.

The net income deficit narrowed slightly in the June quarter to 2.8 per cent of GDP, around the level of the past four years. The ratio of net interest payments to exports was also little changed at around 9 per cent. There were large downward revisions to the estimate of net foreign equity liabilities from the September quarter 1998 owing to improved recording of foreign assets held by Australian fund managers (Graph 42). The revised data show that net foreign liabilities have been broadly unchanged at around 55 per cent of GDP for nearly 10 years, in comparison with

Graph 42



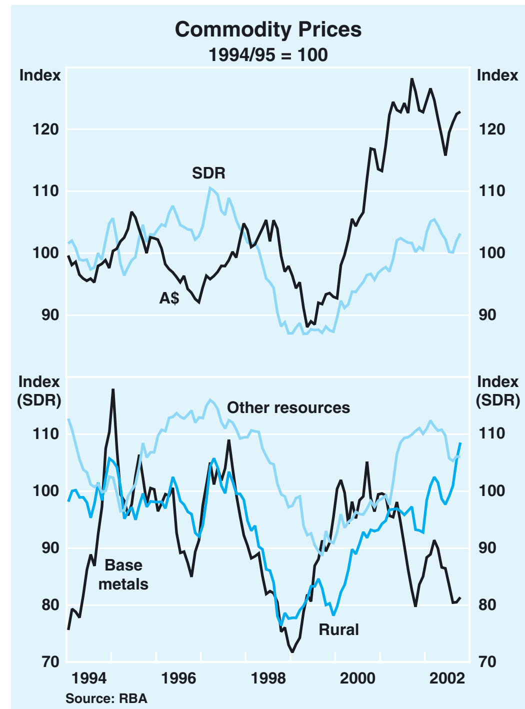
previous data, which suggested that they had increased over the past few years. In the June quarter, Australia's net foreign debt rose slightly to around 46 per cent of GDP, reflecting a continuation of the recent trend of strong net debt inflow. Net foreign equity liabilities also rose, primarily due to valuation effects, with the Australian share market outperforming those abroad in local currency terms. Net equity outflow was again recorded in the June quarter, consistent with the pattern of the past few years during which flows of Australian offshore equity investment have been strong.

Commodity prices

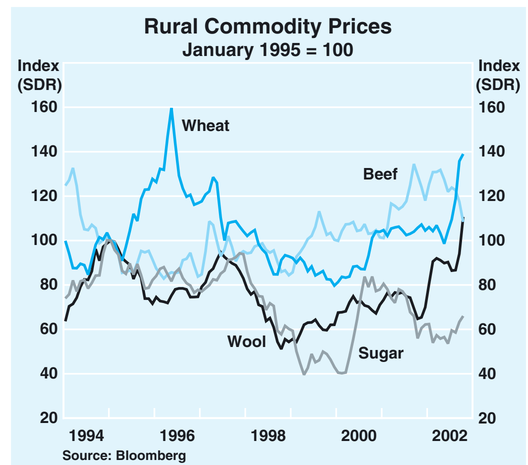
In aggregate, commodity prices have been fairly steady, with the RBA Commodity Price Index falling in SDR terms by 0.2 per cent in the three months to October, though the Index rose by 3.4 per cent in Australian dollar terms (Graph 43). However, this masks some divergent trends across commodities. Rural commodity prices have increased sharply over the past few months to reach their highest level in over 12 years (Graph 44). Wheat prices recorded significant gains, with unfavourable weather conditions in Australia, North America and Europe constraining world supply. In contrast, beef and veal prices have fallen over the past three months because of the drought, which continues to induce higher slaughter rates both in Australia and the US. Strong demand for wool, coupled with an Australian clip that is expected to be the lowest in five decades, has pushed wool prices higher, with the price around 40 per cent higher than a year earlier. These pressures are expected to moderate, however, as processors substitute away from wool to synthetic yarns. Sugar prices have risen over the past few months from very low levels, though these gains are not expected to be maintained as world sugar production is forecast to be close to record levels in 2002/03.

Base metals prices fell in the three months to October to levels near their previous trough in October 2001, largely as a result of the slow recovery in world industrial production. Despite falling over the past six months, nickel prices are still around 27 per cent higher than a year ago, owing mainly to strong demand and tight supply. Most other base metals prices are well below levels of a year ago. Iron ore prices have fallen for most of this year, though they have stabilised in recent months, with increased Chinese steel production raising demand. Falls in prices for coking and

Graph 43



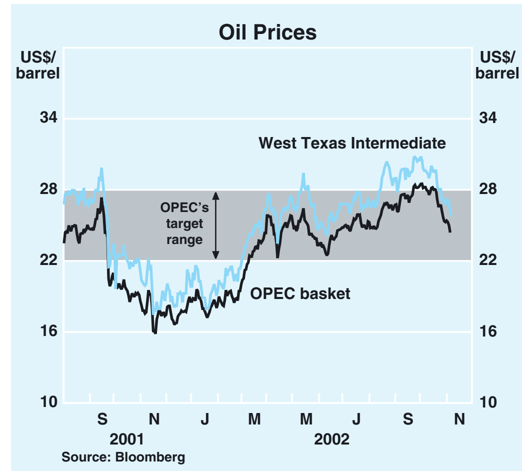
Graph 44



thermal coal have also abated recently in line with rising oil and gas prices.

Recent movements in the gold price have reflected equity market fluctuations, though tensions in the Middle East have kept the price at a relatively high level. Geopolitical tensions have also been a factor in the volatility in oil prices over the past few months (Graph 45). Other factors influencing the price have included the low levels of US oil inventories and OPEC's decision not to increase its existing production quotas.

Graph 45



Domestic Financial Markets

Interest rates in money and bond markets

There has been a small decline in short-term interest rates since the last *Statement* (Graph 46). For much of the past three months, however, market expectations were for the cash rate target to be unchanged in the near term but to rise by 25 basis points some time prior to the middle of 2003. This view was underpinned by a reasonably constant stream of solid domestic economic news, counterbalanced by concerns about the future impact on the domestic economy of a possible deterioration in global growth prospects.

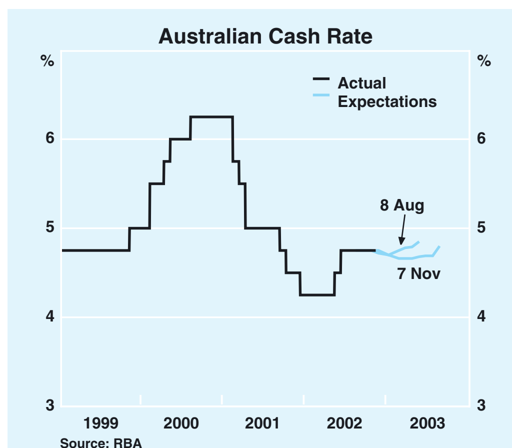
More recently, however, expectations of a rise in the cash rate target in the foreseeable future have disappeared. This shift in expectations has occurred as markets have given greater weight to the possibility that the domestic economy will be weighed down by developments abroad.

Long-term market rates have fallen considerably over the past six months, and have moved within a relatively wide range since the previous *Statement*. Yields on 10-year government bonds stood at around 5.60 per cent in early November, almost one percentage point below the 2002 high of 6.50 per cent recorded in April (Graph 47). In late September bond yields fell to an intra-year low of 5.25 per cent. The driving force behind this decline seemed to be the large falls in share prices in the US and many other major countries, which led to rising risk aversion among investors and concerns about the extent to which global economic growth would be affected. Geopolitical risks added to the uncertainty.

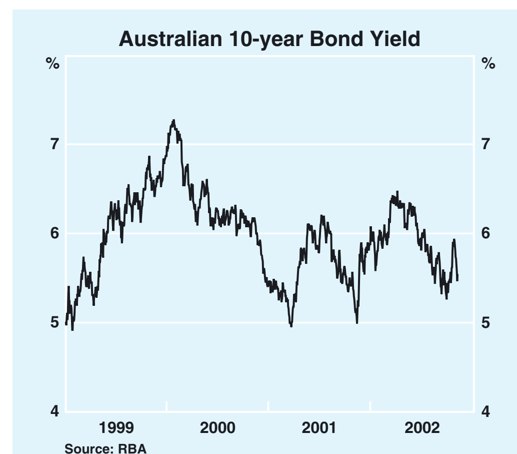
The decline in bond yields was partly reversed in mid October, when the recovery in the US stock market caused US bond yields to rise sharply. The yield on Australian 10-year government bonds rose by 50 basis points in a matter of days, to almost 6 per cent. This increase was, however, short-lived with concerns about the global economy again rising to the fore.

While day-to-day movements in Australian bonds closely followed those in the US market, the spread between long-term bond yields in Australia and the US widened considerably in net terms over the period, at one point reaching almost 200 basis points (Box B). From mid October, however, the spread narrowed to around 165 basis points, but remains considerably above the average levels of the past few years.

Graph 46

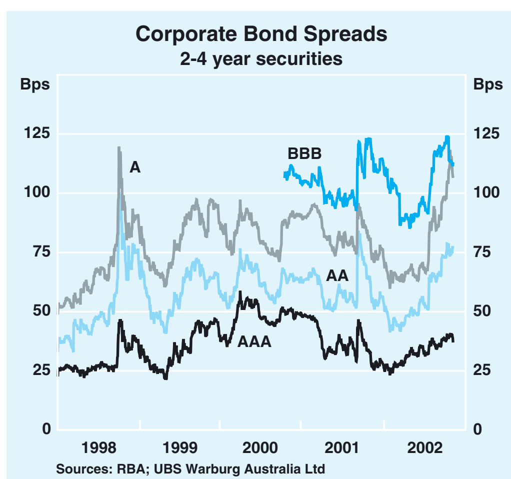


Graph 47

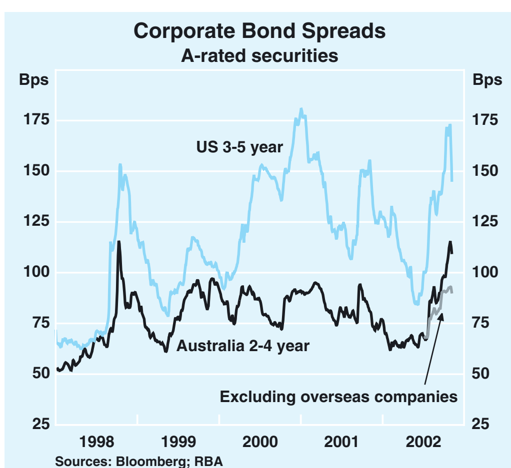


Spreads between yields on Australian corporate and government bonds have widened in recent months (Graph 48), but much of the increase is due to investors' concerns regarding overseas companies (particularly US financial institutions) which have issued bonds in the Australian market. While spreads averaged across all issuers have widened by 10 to 20 basis points, spreads on bonds issued by domestic corporates have risen by just 5 to 10 basis points. Overall, the rise in spreads in the corporate bond market has been much less than that in the US market (Graph 49).

Graph 48



Graph 49



Intermediaries' interest rates

Intermediaries' variable indicator interest rates were unchanged during the three months to end October, reflecting a constant cash rate (Table 16).

Banks' fixed rates for housing and small business have fallen slightly, although not by as much as the market yields against which they are priced. Although fixed-rate mortgages are now slightly cheaper than banks' standard variable-rate mortgages, the proportion of new loans that are at fixed rates has fallen from 9 per cent in June to 6 per cent currently.

Table 16: Banks' Indicator Lending Rates
Per cent

	Current level (end October)	Change since end July
Variable rates		
Cash rate	4.75	..
Household		
Mortgages:		
– Standard variable	6.55	..
– Basic	6.00	..
– Mortgage managers	6.35	..
Personal lending:		
– Residential secured	6.70	..
– Credit cards	16.00	..
Small business		
Residential secured:		
– Overdraft	7.30	..
– Term loan	6.75	..
Other security:		
– Overdraft	8.00	..
– Term loan	7.35	..
Large business		
– Overdraft	8.35	..
– Term loan	8.20	..
Fixed rates (3 years)		
Swap rate	5.25	–0.50
Housing	6.40	–0.35
Small business	6.85	–0.15

Source: RBA

Non-intermediated financing

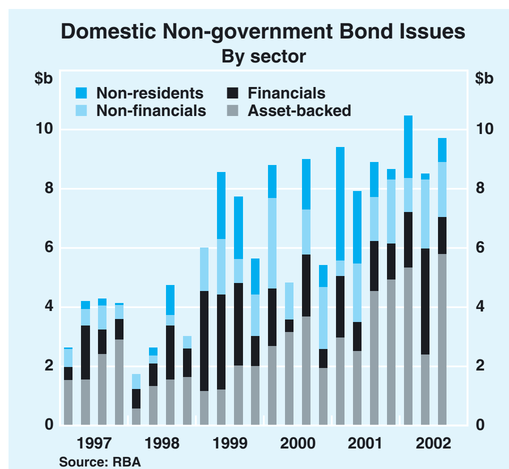
Debt markets

Issuance of domestic non-government bonds in the September quarter rose to $9.7 billion, 15 per cent above the average level of the past year. There was particularly strong growth in the asset-backed category, with record issuance of $5.8 billion, around double the rate of a couple of years ago (Graph 50). The market has digested this increased supply reasonably well, partly helped by interest from foreign investors.

An increasing range of issuers is tapping the market. In particular, there were several issues by non-conforming lenders (those that offer mortgages to relatively high-risk borrowers). In addition, the September quarter saw the first issue of securities backed by loans to medical professionals.

In contrast, domestic corporate bond issuance was well down in the September quarter on levels seen earlier this year, although in October issuance picked up due to a $1.5 billion issue by a transport infrastructure company (Table 17). The fall in the September quarter can, in part, be attributed to the recent volatility in financial markets which has led some companies to defer or cancel planned raisings.

Graph 50



Notwithstanding this, companies with good credit ratings and recent strong share price performance that have approached the market have found their issues oversubscribed. Issues during the September quarter all carried a credit rating above BBB.

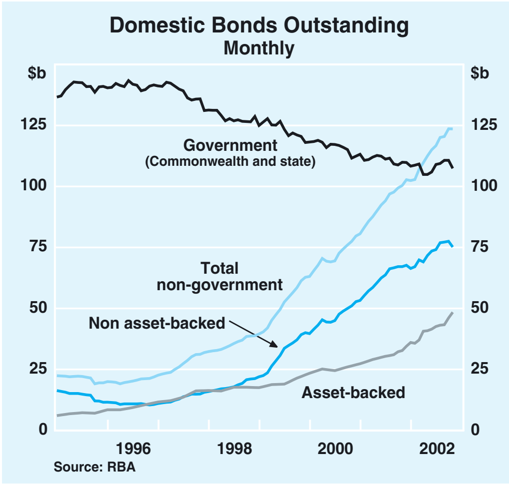
The total amount of domestic non-government bonds outstanding currently stands at just under $125 billion, up from just under $100 billion a year ago (Graph 51). This now exceeds the total amount of government securities on issue (Commonwealth and state combined).

Table 17: New Domestic Issuance by Sector
$billion

Sector	2002 Jun qtr	2002 Sep qtr	2002 October	2001	2000
Domestic corporates					
– Financials	3.6	1.2	0.3	6.0	5.1
– Non-financials	2.3	1.9	2.2	6.1	8.6
Non-residents	0.2	0.8	0.0	7.8	3.5
Total non-asset backed	**6.1**	**3.9**	**2.5**	**19.9**	**17.2**
of which:					
– Credit-wrapped	0.7	0.8	1.5	2.0	3.8
– Floating rate notes	1.6	1.3	0.9	5.3	6.5
Asset-backed	**2.4**	**5.8**	**4.1**	**13.7**	**10.8**
Total	**8.5**	**9.7**	**6.6**	**33.6**	**28.0**

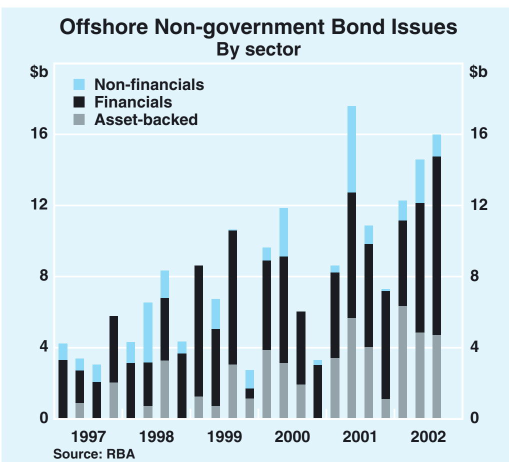
Source: RBA

Graph 51



In addition to domestic issues, Australian entities' offshore issuance has been strong. In the September quarter, Australian entities issued $16 billion of bonds offshore, around 60 per cent more than issued in the domestic market. Banks continue to account for a large proportion (around two-thirds) of the funds raised offshore (Graph 52). These primary raisings have been in a range of foreign currencies, but have mostly been swapped back to Australian dollars.

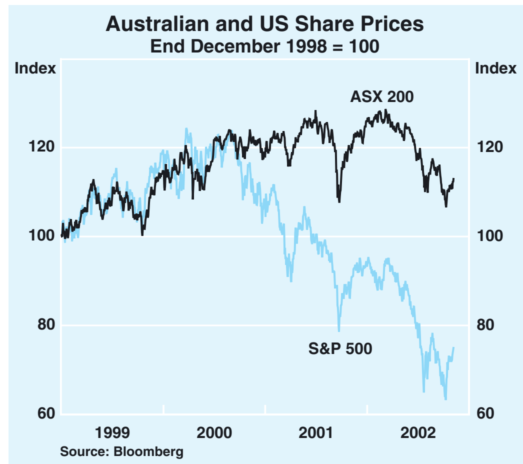
Graph 52



Equity markets

As was the case for the US share market, the recovery in Australian share prices from their post-September 11 lows began to peter out by March (Graph 53). Since then Australian share prices have fallen by 12 per cent. While this is a significant fall, it is only about half that in US share prices over the same period.

Graph 53



The fall has come in two broad phases, both of which mirrored developments in US markets. The first extended through to end July. During this period, share prices were undermined by growing concerns about US corporate governance arrangements. Markets staged a sharp, but brief, recovery in August and early September, but by early October had fallen to new lows. This second phase of falling share prices seemed to owe more to concerns that the world economic recovery may be stalling.

Overall, the Australian share market has continued to exhibit a good deal more stability than its US counterpart. This is borne out by the pattern of daily price movements. While most daily movements in the ASX 200 were no greater than 1 per cent, the S&P 500 moved by more than this amount on around 70 per cent of trading days during the past

three months (Graph 54). Similarly, while options prices suggest that expectations of future share price volatility have risen steadily over the past six months, the Australian market is expected to be considerably less volatile than markets overseas (Graph 55). In the US, expected volatility in recent months has reached levels last seen during the Russian debt default crisis and above the level seen in September 2001.

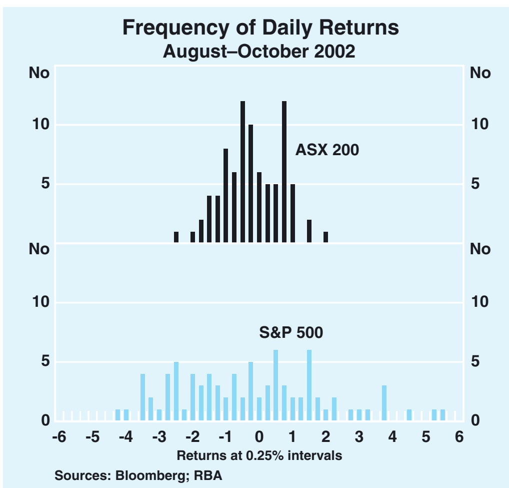
Despite the overall stability of the Australian market over the past three months, share prices of insurance companies have fallen noticeably, dropping 7 per cent to be 37 per cent below their June 2001 peak (Graph 56). Much of the fall reflects concerns about the capitalisation of some insurers' offshore operations, with the weakness in offshore equity markets substantially reducing the value of some insurers' investment portfolios.

Banks' share prices have fallen by more than the overall market decline since end July. While banks had previously proved resilient to general equity market weakness, a global sell-off of the banking sector (reflecting concerns that weaker economic growth will impact on the credit quality of banks' assets) has put downward pressure on their share prices. In addition, the market is pricing in some expectation that credit growth will slow (as housing market activity abates) and that this will reduce the banks' future earnings growth.

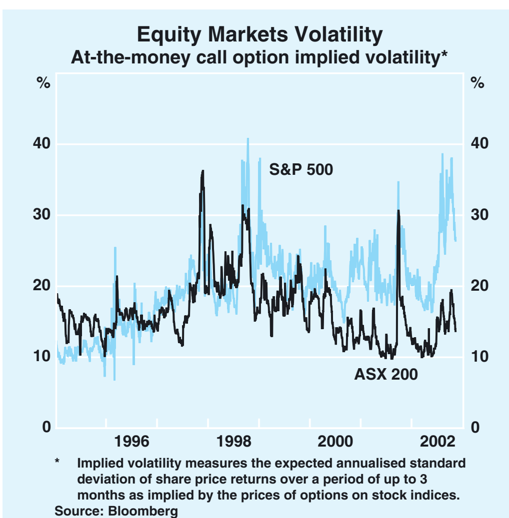
Falls in the share prices of industrial companies also made a substantial contribution to the decline in the overall index. The weakness in the industrial sector reflects, in particular, the impact of the drought on agriculture suppliers and higher oil prices on transport companies.

In August and September most of the largest listed companies in Australia reported their

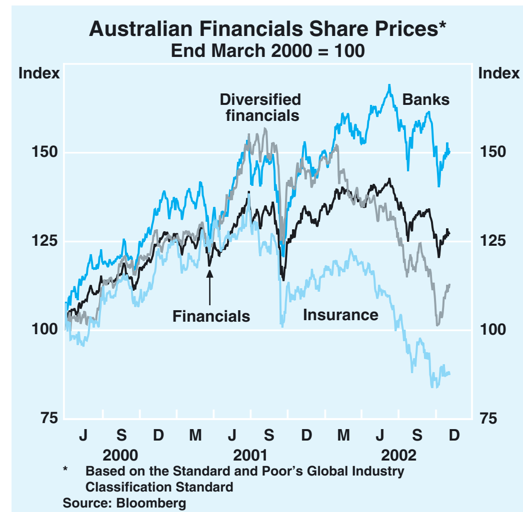
Graph 54



Graph 55



Graph 56



results for the six months to June this year. In aggregate, reported earnings of the top 100 companies dropped sharply in the first half of 2002 (Table 18), but this fall was more than accounted for by News Corporation's large loss from its investment write-downs. Excluding media companies, earnings rose 13 per cent compared to the first half of 2001. This is a strong performance by international standards. The transport and commercial services sectors performed particularly well.

Table 18: Earnings of Top 100 Australian Companies
Change from previous comparable period (per cent)

	First half of 2002	2001/2002
Total	–57	–34
Ex media	13	1
Industrials ex media	23	8
Industrials ex finance and media	48	17
Resources	–22	–18

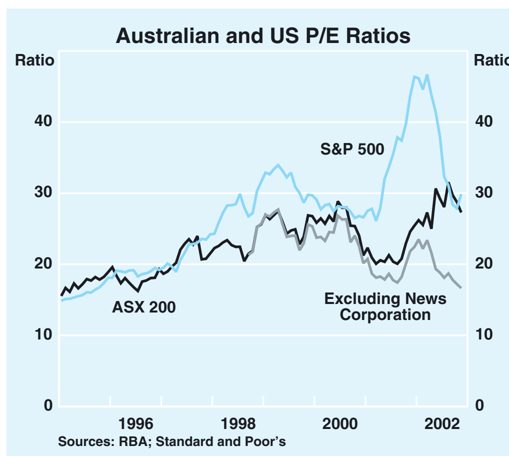
Note: Includes the 92 companies that have reported earnings for the first half of 2002. Overseas-incorporated companies (Telecom NZ, James Hardie Industries and Lion Nathan Limited) are excluded.

Sources: Bloomberg; RBA

Equity market analysts remain optimistic, expecting further strong profit growth. Although they have revised down their expectations of industrial companies' earnings for the coming 12 months, current expectations are for an 18 per cent rise in full year earnings for 2002, followed by a further 13 per cent rise in 2003.

Over the past three months, Australia's 'as reported' P/E ratio has declined slightly to 27 but is well above mid 2001 levels and almost as high as recent readings for the US P/E ratio. However, all of this year's net rise in the Australian ratio is attributable to News Corporation. Excluding News Corporation, the ratio is 17 – the lowest level seen since 1996 (Graph 57).

Graph 57



At the beginning of October domestic share price indices were re-weighted to move from individual company weights based on total market capitalisation to weights based on free float. Free float is that part of market capitalisation available for purchase after excluding holdings by the government and strategic shareholdings of more than 5 per cent. The re-weighting brings the Australian indices into line with the calculation of indices overseas. International indices published by Morgan Stanley Capital International moved to this weighting method last May.

As a result of the changed weights, the measured market capitalisation of the ASX 200 fell by around 7 per cent. Most of this fall occurred in the media industry (a large part of the consumer discretionary sector), reflecting large family holdings in News Corporation (Table19). Financials now account for 45 per cent of the index. There was an increase in turnover prior to the index change, as funds managers rebalanced their portfolios, with the increase most pronounced for banks and media.

Equity raisings were solid during the September quarter, with $4 billion raised

Table 19: GICS Sector Weights in the ASX 200

	Prior to free float (30 September) Per cent	Free float weight (1 October) Per cent	Change Percentage points
Energy	2.7	2.4	–0.3
Materials	16.3	16.4	0.1
Industrials	7.6	7.5	–0.1
Consumer discretionary	11.3	9.7	–1.7
Consumer staples	8.4	8.7	0.3
Health care	2.7	2.8	0.1
Financials	43.1	44.8	1.7
Information technology	0.3	0.2	–0.1
Telecommunication Services	6.3	6.4	0.1
Utilities	1.3	1.2	–0.1

Source: Bloomberg

(Graph 58). Most of the raisings were through placements and rights issues, with initial public offerings amounting to just $0.6 billion. Buybacks remained moderate and significantly below the levels seen in 1999 and 2000.

Growth in margin lending for equities and managed funds slowed considerably in the September quarter after very strong growth in the preceding six months (Table 20). While the number of clients grew, the average loan size fell. In comparison, margin debt in the US fell 11 per cent over the same period. Consistent with the increase in volatility in the Australian market, margin calls were almost double the level seen in the previous quarter but remain a third below their level in the September quarter last year. In line with the overall fall in the share market, the value of security underlying margin debt fell, resulting in a slight increase in the average gearing of borrowers.

Graph 58

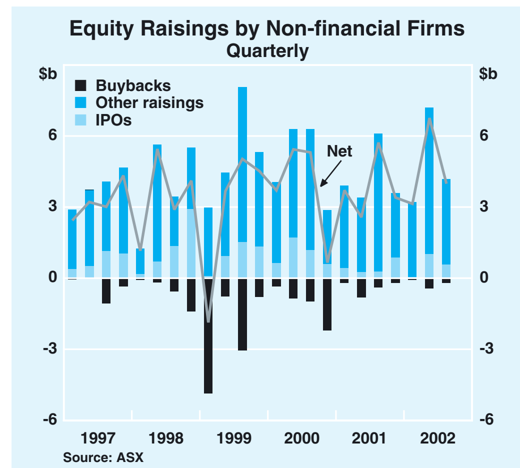


Table 20: Margin Lending

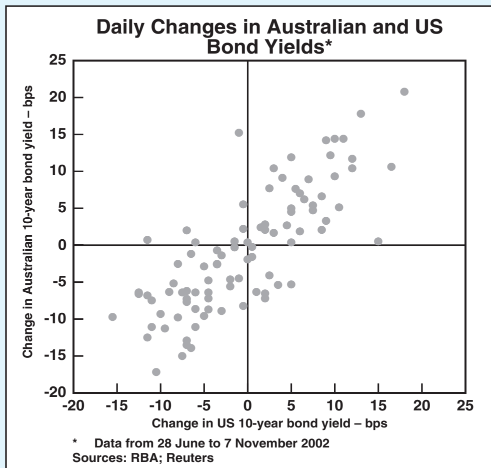
	Level at end		Growth	
	June 2002	**September 2002**	**3 months to September 2002** Per cent	**12 months to September 2002** Per cent
Margin debt ($b)	10.1	9.9	–1.9	21.4
Protected financing ($b)	0.5	0.8	51.7	79.4
Total margin debt ($b)	10.6	10.7	0.9	24.6
Credit limit ($b)	17.6	17.6	0.1	27.0
Value of underlying security ($b)	21.1	20.3	–3.7	16.7
Average number of margin calls per day	273	501	83.9	–34.8
Number of clients	116 126	124 614	7.3	26.9
Average loan size ($)	91 595	86 112	–6.0	–1.9
Credit limit used (per cent)	60	61		
Leverage (per cent)	50	53		

Source: RBA

Box B: The Australian–US 10-year Spread

Movements in Australian bond yields on a day-to-day basis are heavily influenced by movements in US bond yields (Graph B1). Moreover, a significant share of the daily movement in Australian yields tends to occur overnight. Since June, for example, the absolute daily change in Australian 10-year bond yields has averaged almost 6 basis points during the overnight trading session. The comparable figure for the Australian day session is less than 3 basis points. And even movements during the Australian day often track very closely movements in US Treasuries traded in Tokyo.

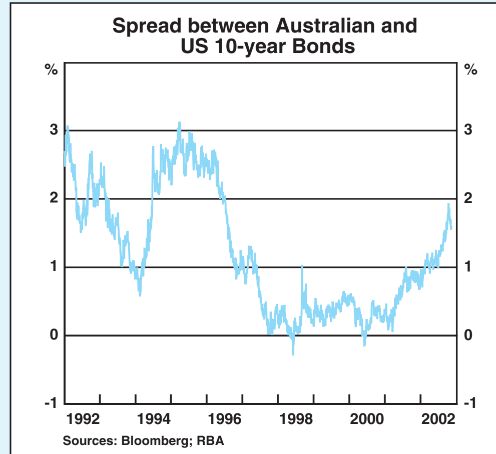
Graph B1



Despite this close correlation, the spread between Australian and US yields has widened considerably over the course of 2002. At one point in October it reached almost 200 basis points, after having been around 90 basis points at the beginning of the year (Graph B2). In early November the spread narrowed somewhat to around 165 basis points.

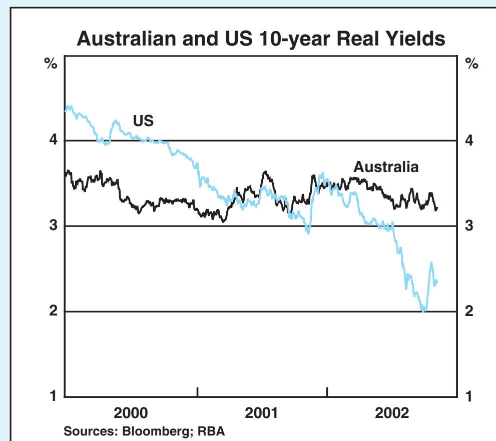
The widening of the spread can be attributed largely to the difference in the growth outlook for the two countries. This is suggested by movements in real bond

Graph B2



yields obtained from 10-year indexed government bonds (Graph B3). In the United States real yields fell by around 1 percentage point between June and early October, to a low of just 2 per cent. This fall can be presumed to reflect one or both of two factors: concerns about future growth prospects for the US economy, which would imply that market interest rates would be low for an extended period; and/or a reduced tolerance for risk, with greater appetite by investors to hold 'riskless' assets.

Graph B3



While real rates rose in the second half of October on the back of relatively positive corporate earnings announcements, they remain significantly below their levels earlier in the year. In contrast, real yields in Australia have been much more stable. The resulting widening of the real yield spread accounts for all the widening of the nominal spread.

Interestingly, most of the movement in the Australian–US spread has occurred in the overnight trading session, rather than in the Australian day (Table B1). This reflects the recent tendency for Australian bond yields to fall by less than US yields on days that US yields decline. This is consistent with the stronger economic indicators in Australia relative to those in the United States. In net terms, the spread has moved little during the Australian trading day since the end of June.

The previous occasion on which the yield spread increased by a significant amount for a sustained period was in the first half of 1994. In contrast to the current episode, on that occasion it was concern about the inflation outlook in Australia that was largely responsible; during the course of 1994 the expected inflation rate (calculated from bond yields) rose by almost 2 percentage points to nearly 5 per cent. In the current episode, expected inflation has, in net terms, changed little (Graph B4); while it declined from end June to early September, it has subsequently increased back to around 2½ per cent, a level consistent with the Bank's medium-term inflation target. ✰

Graph B4

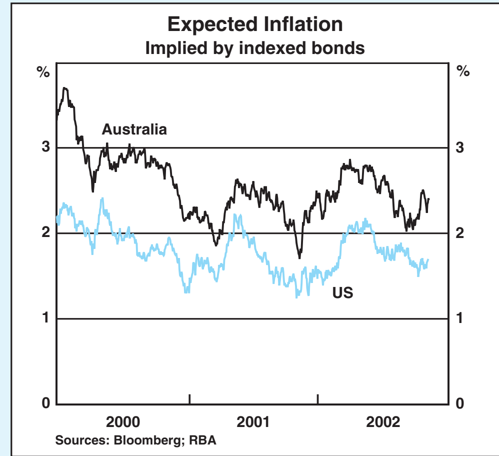


Table B1: Movements in Bond Yields
Cumulative change in basis points between 2 January and 7 November 2002

	Australian day session	Australian night session[(a)]	Total
10-year CGS	2	–30	–28
10-year US Treasury	41	–143	–102
10-year spread	–39	+113	+74

(a) Includes trading between the Australian close and the US open

Sources: RBA; Reuters

Assessment of Financial Conditions

Financial conditions remain expansionary, with real short-term interest rates below their recent averages. Over the past quarter, some fixed-term borrowing rates charged by intermediaries have declined a little, reflecting falls in nominal bond yields. Other indicators also suggest that financial conditions are supportive of growth; credit growth remains strong, and the real exchange rate is low relative to its historical average. With bond yields falling, however, the yield curve now shows less upward slope which could be interpreted as indicating a reduction in the degree of monetary expansion. The effect of lower yields is also being partially offset by the further declines in equity prices and increases in some corporate yield spreads over the past few months.

Interest rates

The cash rate has remained at 4.75 per cent since June, after increasing following the May and June meetings of the Board. Estimates of the real cash rate based on alternative measures of inflation expectations remain lower than recent averages, though there are some noticeable differences among the alternative measures (Table 21). The measure that uses underlying inflation as a proxy for inflation expectations remains around 3/4 percentage point below its average over the period since 1997, a period during which inflation has averaged around 2 1/4 per cent and output growth around 4 per cent. The measure based on inflation expectations derived from the bond market is only a little below its average over this period, reflecting a decline in bond-market inflation expectations over the September quarter.

Lending rates of intermediaries are also below recent historical averages, in both real and nominal terms (Graph 59). Over the past quarter, fixed interest rates charged by intermediaries have fallen slightly, reflecting the decline in longer-term yields. However, the effect of this on aggregate business capital raising activity should be limited, since the stimulatory impact is offset to some extent by the further falls in equity prices, and by increased yield spreads on lower-rated corporate bonds. Further details on these

Table 21: Cash Rate
Per cent

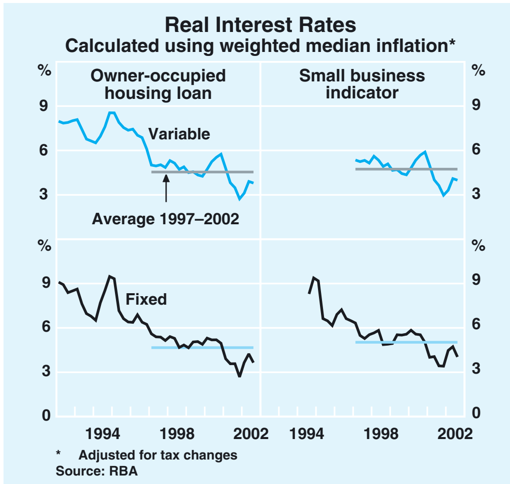
	Nominal	Real – based on:		
		Weighted median inflation[(a)]	Bond market expectations	Consumer expectations[(a)]
Current level	4.75	2.0	2.3	0.6
1992–2002 average	5.7	3.4	2.5	1.4
1997–2002 average	5.1	2.8	2.6	1.0
Current deviation from:				
1992–2002 average	–0.9	–1.4	–0.2	–0.8
1997–2002 average	–0.3	–0.8	–0.3	–0.4

(a) Adjusted for tax changes

Note: Current observations use the latest cash rate, the September quarter 2002 weighted median inflation rate, and average bond market and consumer inflation expectations over the September quarter 2002.

Sources: ABS; Melbourne Institute; RBA

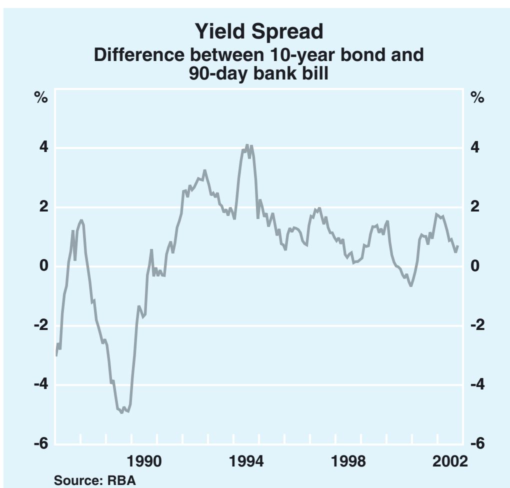
Graph 59



developments are reported in the chapter on 'Domestic Financial Markets'.

The slope of the yield curve, as measured by the difference between long-term and short-term interest rates, provides an alternative indication of the stance of policy. A positive-sloping yield curve (or, more correctly, a yield curve with a larger than average positive slope) is normally interpreted as evidence that policy is expansionary since it implies that short-term interest rates are below the level at which they are expected to be on average over the medium term. Currently the slope of Australia's yield curve remains positive, but it has flattened out over the past few months, reflecting lower bond yields (Graph 60).

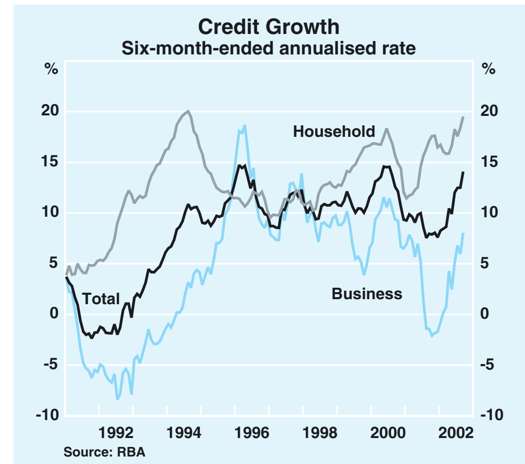
Graph 60



Financing activity

Total credit grew at an annualised rate of 14.1 per cent over the six months to September, an increased pace from the annualised rate of 8³/₄ per cent over the six months to March (Graph 61). The pick-up in credit growth has reflected some further acceleration in household credit as well as a marked pick-up in the rate of business borrowing. The strength in household credit primarily reflects the rapid growth in housing loans, particularly to investors.

Graph 61

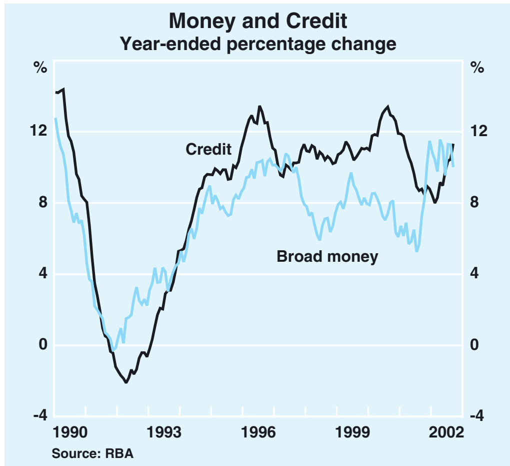


Business borrowing grew at an annualised rate of 8 per cent over the six months to September, a considerable increase from the ³/₄ per cent annualised growth over the preceding six-month period. As detailed in the chapter on 'Domestic Economic Activity', this increased fund-raising by businesses – which is also evident in direct market raisings – is consistent with the favourable investment outlook.

Growth in the monetary aggregates has moderated over the six months to September, with broad money increasing at an annualised rate of 9 per cent, compared with 11 per cent over the six months to March. Growth in business deposits had been particularly strong,

but in the recent period business deposits have barely grown, consistent with the upturn in investment spending. In year-ended terms, growth in money and credit are now more aligned, after a brief period where money growth had outstripped credit (Graph 62).

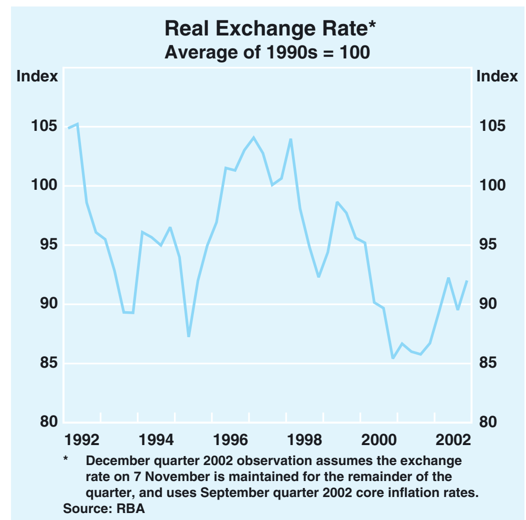
Graph 62



Real exchange rate

As discussed in the chapter on 'International and Foreign Exchange Markets', the Australian dollar has appreciated modestly in recent months on a trade-weighted basis. The real trade-weighted exchange rate, which adjusts for inflation in Australia and across our trading partners, has risen by around 6 per cent over the past year. Notwithstanding the recent rise, the current level of the real exchange rate is around 8 per cent below its 1990s' average (Graph 63).

Graph 63



Inflation Trends and Prospects

Recent developments in inflation

Consumer prices

The Consumer Price Index (CPI) increased by 0.7 per cent in the September quarter and by 3.2 per cent over the year (Table 22, Graph 64). Measures of underlying inflation increased by between 1/2 and 3/4 per cent in the quarter and range between 2 1/2 and 3 1/4 per cent in year-ended terms (Graph 65). The statistical measures based on the quarterly distribution of price changes – the weighted median and the trimmed mean – suggest that underlying inflation is 2 1/2 – 2 3/4 per cent. In contrast, the exclusion-based measures continue to report underlying inflation towards the top end of this range and, in year-ended terms, were similar to CPI inflation in the September quarter. Measures of the weighted median and trimmed mean calculated from the year-ended rather than the quarterly distribution of price changes, are also running closer to 3 per cent. The divergence between the different measures is arising currently because large quarterly price movements have occurred across a broad range of different items over the past year and are removed from the quarterly-based measure. As it is more likely that these movements reflect a series of one-off factors rather than ongoing inflationary pressures, the Bank's assessment of underlying inflation is that it is currently running at around 2 3/4 per cent.

The largest contributor to the rise in the CPI in the September quarter was an increase of 12 per cent in vegetable prices, partly reflecting the drought. The effects of the drought were also apparent in the 3 per cent fall in beef and veal prices, but are not yet evident for other items such as fruit and bread. In year-ended terms, the most significant contribution to CPI inflation was made by holiday travel & accommodation prices, which increased by almost 13 per cent, owing mainly to increases in the cost of overseas holiday

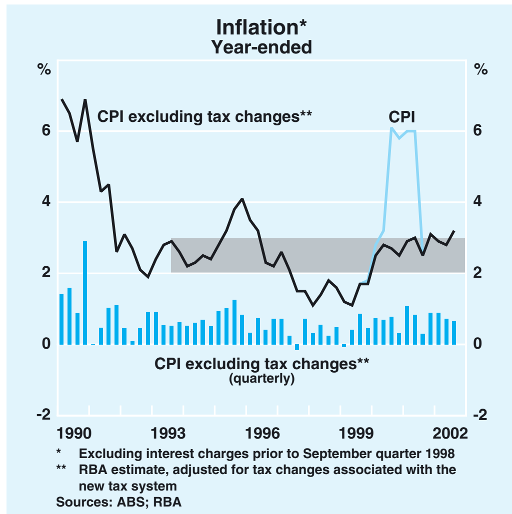
Table 22: Measures of Consumer Prices
Percentage Change

	Quarterly		Year-ended	
	June quarter 2002	**September quarter 2002**	**June quarter 2002**	**September quarter 2002**
CPI	0.7	0.7	2.8	3.2
– Tradables	0.8	0.0	1.8	2.3
– Non-tradables	0.6	1.3	3.8	4.0
Underlying inflation				
Weighted median[(a)]	0.6	0.8	2.5	2.7
Trimmed mean[(a)]	0.5	0.6	2.5	2.5
CPI excluding volatile items	0.6	0.7	3.3	3.3
Market goods and services excluding volatile items	0.6	0.5	3.1	3.0

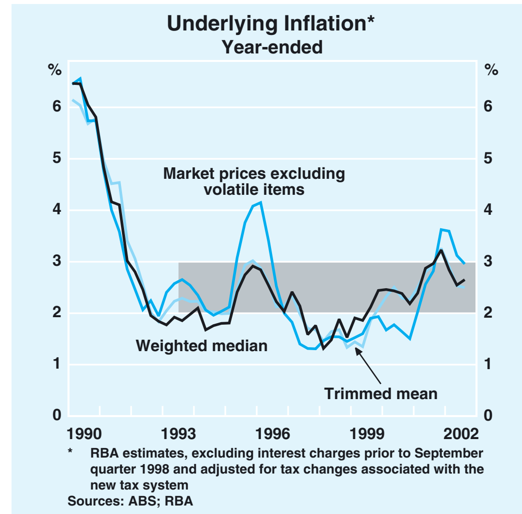
(a) For more information on these measures see 'Box D: Underlying Inflation' in the May 2002 *Statement on Monetary Policy*.

Sources: ABS; RBA

Graph 64



Graph 65



travel, but also reflecting a number of one-off factors such as the introduction of the Ansett and insurance airfare levies at the end of last year. House purchase costs have increased steadily and are now 3³/4 per cent higher than a year ago, driven by ongoing strength in the housing market and the effect of the removal of the Commonwealth Additional Grant for first-home buyers. Reflecting large increases in reinsurance premiums, withdrawals of low cost providers from the industry, increased payouts and weaker investment returns, the price of insurance services has also increased steadily to be 4¹/2 per cent higher over the year. This is likely to have contributed to above-average increases in the prices for child care and sports participation in the September quarter.

There were a number of price falls in the quarter, including motor vehicle prices which fell by 0.9 per cent in the quarter, to be around ¹/2 per cent lower over the year. Fuel prices also fell by 1.2 per cent in the quarter, though they are 2.3 per cent higher over the year. Pharmaceutical prices fell in the quarter reflecting the seasonal effect of the Pharmaceutical Benefits Scheme, though health costs more generally are around 6 per cent higher over the year, owing mainly to higher private health insurance premiums. Audio, visual & computing prices continued to fall, declining by 1.8 per cent in the September quarter to be 4.2 per cent lower than a year earlier.

Tradable goods prices were flat in the September quarter, reflecting the influence of subdued world price movements, but were 2¹/4 per cent higher over the year. In contrast, the strength in the domestic economy has contributed to a general rise in non-tradables inflation over the past year or so, to 4 per cent over the year to the September quarter.

Producer prices

Upstream inflationary pressures remain moderate. In the September quarter, final-stage producer prices increased by 0.5 per cent, and were 1.4 per cent higher over the year (Table 23, Graph 66). The largest contributions to the quarterly rise were from increases in building materials prices and the cost of utilities. These price rises were partially offset by falls in the price of meat products. Petrol prices also fell in the quarter, though they have had little effect on final stage producer price inflation over the year.

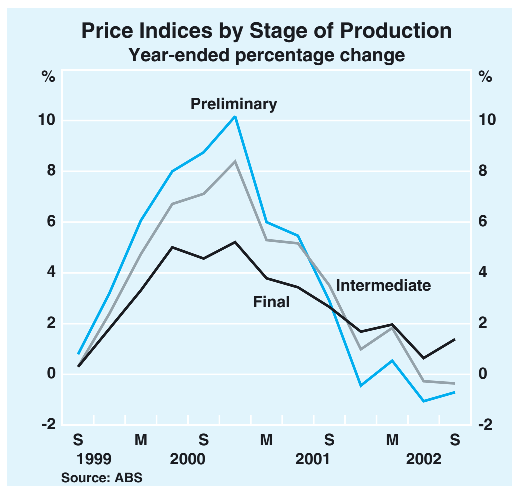
Price increases were less prevalent at the intermediate and preliminary stages of production in the September quarter. Consistent with the pattern for much of this year, domestic price increases in the quarter were small. Rises in iron and steel prices and

Table 23: Stage of Production Producer Prices
Percentage Change

	September quarter 2002	Year to September quarter 2001	Year to September quarter 2002
Preliminary	**0.3**	**2.9**	**–0.7**
– Domestic	0.2	2.9	0.1
– Imported	0.9	3.1	–5.2
– Excluding oil	0.2	3.7	0.1
Intermediate	**0.1**	**3.5**	**–0.4**
– Domestic	0.0	3.4	0.3
– Imported	0.9	3.9	–4.3
– Excluding oil	0.0	4.2	0.2
Final(a)	**0.5**	**2.7**	**1.4**
– Domestic	0.5	2.1	2.7
– Imported	0.2	5.2	–4.0
– Excluding oil	0.6	3.5	1.4

(a) Excluding exports
Sources: ABS; RBA

Graph 66



the cost of technical services, in particular of consultant engineers, were partly offset by significant falls in prices for beef and dairy cattle. Reflecting the depreciation of the exchange rate in the September quarter, the price of imported components, at both the preliminary and intermediate stages of production, rose after falling for much of the past year. The weak world economy appears to be putting continued downward pressure on world prices of a number of manufactured goods, such as industrial machinery and electronic goods.

The various business surveys suggest that upstream cost pressures remain muted. Purchase costs as reported in the NAB survey are only picking up slightly, while according to the ACCI-Westpac survey of manufacturers, the net balance of firms experiencing cost increases remains on a downward trend.

Labour costs

Most labour cost indicators continue to suggest that wage pressures are subdued though, consistent with the on-going recovery in the labour market, there are some signs that the wage cycle may be near a trough. In the June quarter, growth in the wage cost index (WCI) for total pay edged up in quarterly seasonally adjusted terms, though it remained 3.1 per cent higher than a year earlier (Table 24). At the industry level, the WCI continued to record the fastest annual wage growth in the electricity, gas and water industry (4.0 per cent), and the slowest wage growth in transport and storage (2.5 per cent). Wage growth in property and business services

Table 24: Labour Cost Measures
Year-ended percentage change

	June quarter 2001	December quarter 2001	June quarter 2002
Wage cost index (a)	3.7	3.4	3.1
Federal enterprise agreements (b)			
New agreements	4.0	3.8	3.6
Current agreements	3.7	3.7	3.8
Average weekly earnings survey			
AWOTE	5.3	5.7	5.2
AWE	4.4	4.9	3.7
Average compensation of employees (national accounts)			
Total	5.4	4.4	3.2
Excluding superannuation	4.8	4.4	3.2

(a) Total pay excluding bonuses; seasonally adjusted
(b) Average annualised wage increase
Sources: ABS; DEWR

experienced the largest deceleration, falling from a peak of 4.8 per cent in early 2001 to 3.0 per cent, reflecting the weaker labour market outcomes in that sector.

Business surveys suggest a leveling out in wage pressures. Total labour costs, as reported in the NAB survey, appear to have reached a trough in year-ended terms in the March quarter although firms expect labour cost growth to pick up only slightly in the near term. The NAB survey reports that businesses are having increasing difficulty attracting suitable labour. The ACCI-Westpac survey tells a similar story, despite an easing in the difficulty of finding suitable labour in the September quarter.

Data from the Department of Employment and Workplace Relations on enterprise bargaining agreements continue to indicate an easing in the pace of wage growth. New federal enterprise agreements ratified in the June quarter provided an average annualised wage increase of 3.6 per cent, down from around 4 per cent a year earlier. The latest reading, however, was weighed down by an unusually high representation of retail sector agreements, which tend to incorporate relatively low wage increases. As the representation of new agreements shifts towards industries which traditionally pay higher wage increases, such as construction and manufacturing, this trend is likely to be reversed. Wage increases for the stock of existing agreements, which have been on a gradual upward trend over the past couple of years, remained at 3.8 per cent in the June quarter. According to the latest Mercer *Quarterly Salary Review,* executives' base salaries rose by 4.5 per cent over the year to September, at the lower end of the 4½–5 per cent range that has existed over much of the past four years.

Differences between the various wage bill measures persist. Average weekly ordinary-time earnings of full-time adults (AWOTE) grew by 0.8 per cent in the June quarter, to be 5.2 per cent higher over the year. (For a discussion of the interpretation of wage-bill measures, refer to Box B of the August 2002 *Statement on Monetary Policy*.) The national accounts measure of compensation per employee grew by 1.6 per cent in the June quarter to be 3.2 per cent higher over the year; on a per hour basis, compensation grew by 1.3 per cent in the June quarter to be 4.3 per cent higher over

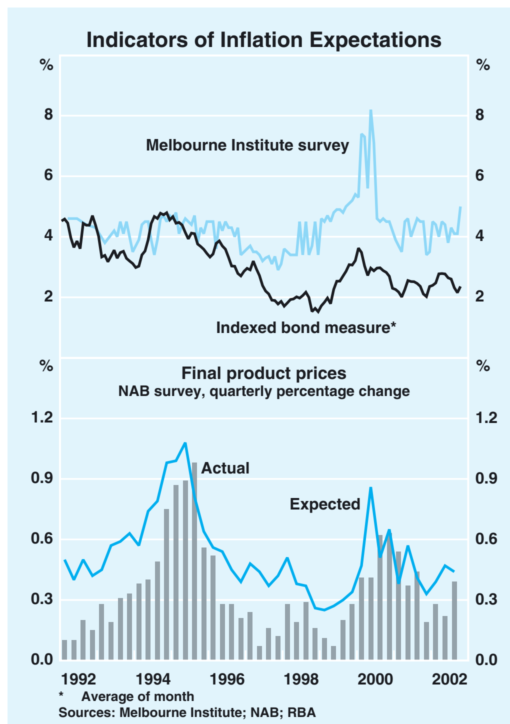
the year. The faster pace over the past year on a per hour basis reflects a decline in average hours worked. Unit labour costs based on compensation per hour worked increased by 2.8 per cent over the first half of this year, but remain subdued in year-ended terms at 1.3 per cent.

Inflation expectations

Most measures of inflation expectations remain contained. The latest NAB quarterly survey reported that businesses expect inflation in both retail and other final product prices to be 0.4 per cent in the December quarter (Graph 67). Similarly subdued expectations were reported in the ACCI-Westpac survey of manufacturers. In contrast, consumer inflation expectations, as measured by the Melbourne Institute survey, rose in October, although this measure of expectations can be volatile.

Longer-term inflation expectations of investors, as measured by the difference between 10-year bond yields and indexed bonds, have fluctuated between 2 and 2½ per cent in recent months. Financial market economists surveyed by the Bank have revised up their median inflation forecast for the year to June 2003, from 2.4 per cent to 2.6 per cent, following the release of the September quarter CPI data (Table 25). The forecast for median inflation over the following year remains at 2.5 per cent. The median inflation forecast of trade union officials, as surveyed by the Australian Centre for Industrial Relations Research and Training (ACIRRT), has been revised up by ½ percentage point to 3.5 per cent for the year to June 2003, while the median forecast for June 2004 has been revised down marginally to 3.4 per cent.

Graph 67



Inflation outlook

The CPI outcome for the September quarter was generally consistent with the short-term outlook presented in previous *Statements*, which suggested that underlying

Table 25: Median Inflation Forecasts
Per cent

	Year to June2003				Year to June 2004	
	February 2002	May 2002	August 2002	November 2002	August 2002	November 2002
Market economists [(a)]	2.4	2.5	2.4	2.6	2.5	2.5
Union officials [(b)]	3.7	3.5	3.0	3.5	3.5	3.4

(a) RBA survey
(b) ACIRRT survey

inflation was likely to remain close to the target mid-point during the second half of 2002. As discussed above, there continues to be divergence among the different underlying measures, though the Bank's assessment is that underlying inflation was around 2³/4 per cent over the year to the September quarter, having fallen from a peak of around 3¹/4 per cent at the end of 2001.

Cost and price indicators provide little evidence of any generalised upward pressure on inflation in the short term. Domestic producer prices have moderated over the past 18 months and business surveys continue to report only moderate upstream price rises, although increases in some non-wage business costs, particularly utility and insurance charges, are putting some pressure on business margins. Wage and labour costs also remain contained, but the improvement in the labour market over the course of the past year suggests that these are unlikely to ease any further.

Looking further ahead, underlying inflation is expected to remain within the target range. Forecasts presented in previous *Statements* had envisaged that upward pressure on inflation would develop, with inflation rising gradually to the top of the target range over the next year or so. This assessment embodied expectations of a gradually improving global situation in which the global recovery would become more firmly established. In that scenario, it was expected that the Australian economy would continue to expand at close to its recent pace, which would lead to gradually increasing capacity utilisation and upward pressures on wages and prices. But with the global situation now looking less favourable, some easing in the pace of growth in the Australian economy appears likely in the coming year from the strong pace maintained over the recent period. That being the case, inflation pressures in Australia are expected to be slightly weaker than was embodied in previous forecasts, and hence underlying inflation is now expected to remain close to its recent level over the next year or so.

The drought is likely to have a noticeable influence on CPI outcomes in the short term. The principal effect of the drought on inflation will be an increase in food prices, which will keep CPI inflation around the top end of the Bank's target range over the next quarter or so. Underlying inflation, however, is likely to be less affected, and indeed there may be a small dampening impact as a result of the adverse effect of the drought on output growth. Over a longer period, as these temporary effects drop out of the calculation, the rate of CPI inflation is expected to converge towards the underlying measures, and therefore to return to a rate that is within the target range.

There are, as always, a number of sources of risk around this forecast. If the global recovery were to regain momentum, somewhat stronger growth in the Australian economy could be expected and hence capacity pressures could well emerge within the forecast period. This would see a somewhat higher inflation outcome than the one envisaged in the current forecast. Reinforcing this risk is that, as noted above, CPI inflation is likely to remain around 3 per cent in the near term and, given relatively firm demand conditions, this could become embodied in ongoing inflation expectations of wage and price setters. On the other hand, a slower-than-expected world recovery would have adverse effects on Australian growth, as well as generating additional downward pressure on world prices, which would result in inflation declining toward the lower end of the target range. At present these risks appear to be evenly balanced.