# STATEMENT ON MONETARY POLICY

The Australian economy has remained robust in the recent period, notwithstanding a more difficult international environment. Domestic demand and activity have remained strong and capacity usage is high after a long period of economic expansion. These conditions have been associated with a rise in inflation. Hence Australian monetary policy has had to take into account sharply contrasting domestic and international developments.

The global economic situation in recent months has been marked by ongoing turbulence in financial markets, reflected most obviously in a decline in world equity prices. The primary drivers have been the ongoing write-downs of credit exposures by major global financial institutions and increased concerns about the US and global economic outlook. Equity markets in the major industrial economies have fallen back to around their levels at the beginning of 2007, as has the Australian market. Emerging stock markets, which initially had been relatively resilient, have also experienced declines.

In addition to these equity market developments, the turmoil in global credit markets that began in the middle of last year has continued. There have been a number of aspects to this, including a general widening of credit spreads and continuing difficulty for private borrowers in accessing capital markets. Strains in money markets around the world reached a peak in September and again in mid December, with the latter reflecting concerns about funding over the year end. Since mid December these strains have eased, but money market term funding costs remain significantly higher than they were before the turmoil began. Central banks have acted to supply liquidity as needed. The RBA increased exchange settlement balances to record levels at the end of the year, but has since wound back liquidity as conditions calmed, though both settlement balances and money market spreads have settled at higher levels than before the turmoil.

The deterioration in financial market sentiment has been associated with a weakening in the outlook for global economic growth. The US economy posted only modest growth in the December quarter and most observers have revised down their expectations for 2008, with some forecasting a US recession. Labour market conditions have been softening over recent months and the housing sector is still very weak, with the fall-out from the sub-prime crisis likely to remain a dampening factor for a while yet. Growth in the euro area and Japan is also slowing.

The extent to which the weakness in the major industrial economies will affect the developing world is still unclear. At this stage, conditions in China, India and the smaller east Asian economies remain strong. In China, GDP grew by 11 per cent over the year to the December quarter. While Chinese export growth has moderated, domestic spending is expanding rapidly. In the rest of east Asia, production and export growth generally strengthened through most of 2007. Overall, the recent run of indicators seems consistent with the view that global growth is slowing to a pace somewhat below trend, with significant weakness in the major industrial

economies but relatively strong growth in the developing world. Despite the weaker global conditions, inflation remains a source of concern in a number of countries.

Some central banks have responded to the weaker conditions in their economies by reducing their policy interest rates. In the United States, the Federal Reserve has cut the federal funds rate by 150 basis points in the past two months. A significant fiscal stimulus has also been proposed and is likely to take effect in the months ahead. Interest rates in the UK and Canada have also been reduced a little. But other central banks, including the ECB, the People's Bank of China and a number of emerging market central banks, while acknowledging the increased downside risks to growth, remain concerned about inflation pressures and have left policy unchanged or have tightened. In Australia, financial market expectations about monetary policy have fluctuated over recent months, though following the release of the December quarter CPI, markets largely anticipated the February increase in the cash rate.

Global commodity prices have generally stayed high in the recent period, and this continues to boost incomes and spending in Australia. Rural commodity prices have picked up over the past year. While base metals prices have dropped back from the peaks they reached in mid 2007, they are still high relative to their average levels over the past few years. Conditions in coal and iron ore markets have tightened further, and most analysts have revised up their forecasts for contract prices of those commodities in 2008. Based on these developments, the prospects are that Australia's terms of trade will rise further this year, after the sharp increases already seen over the past four years.

The performance of the Australian economy has to date remained robust. The latest national accounts showed growth of more than 4 per cent over the year to the September quarter, with domestic demand expanding by 5½ per cent, well in excess of the trend growth in the economy's productive capacity. Both the private and public sectors made significant contributions to the growth in spending over the year. Consumer demand has been driven by rapid growth in household incomes, which in turn has reflected rising employment and real wages as well as cuts in income taxes. Business investment spending has also grown at a fast pace. More recent indicators suggest that the strength of domestic demand continued in the December quarter, although the pace of output growth may have moderated as more of the demand was met by imports.

With demand still growing strongly after a long period of expansion, there have been persistent signs that productive capacity is stretched. Business surveys have for some time been indicating both high rates of capacity utilisation and high levels of concern about labour scarcity. The unemployment rate in recent months has remained around a 30-year low and the job vacancy rate has increased further. The high levels of business investment now underway will undoubtedly assist in alleviating bottlenecks over time and hence adding to the growth of the economy's productive potential. Nonetheless, with the economy having grown at an above average pace last year, capacity pressures were probably increasing during that time.

Financial conditions facing household and business borrowers in Australia have become more restrictive in the period since the middle of last year, reflecting the combination of higher interest rates, reduced access to capital markets and, for some borrowers, tighter credit standards. In addition to passing on the recent increases in the cash rate, lenders have raised the interest rates

on their loan products in response to higher wholesale funding costs. It remains to be seen how far funding difficulties in wholesale markets will curtail the ability of lenders to provide credit to households and businesses. While the major banks have been able to continue to access funding broadly in line with their pre-crisis experience, albeit at higher cost, other institutions have had more difficulty. Consequently, a number of the smaller players have sharply scaled back their lending. To date, the indications from housing loan approvals suggest that the major banks have increased their lending to an extent that has broadly offset the contraction from their competitors. For the business sector, there has been a marked contraction in access to funding in the capital markets but, to date, lending by banks has grown strongly to fill the gap.

The tighter financial conditions prevailing since the middle of last year seem to have had a modest restraining influence on household borrowing, though the effect on businesses has been less clear. Housing-related credit has expanded at an average rate of around 0.8 per cent a month recently, which is at the lower end of the range in which it has fluctuated over recent years. At this stage, there is little sign of any dampening effect on the market for established houses. Lending to businesses has remained strong, expanding by 24 per cent over the year to December, its fastest pace since the late 1980s. Even allowing for the sharply reduced borrowing by businesses on capital markets in recent months, the growth of total business debt has nonetheless remained very rapid, at a rate of 19 per cent over the year, noticeably faster than in the preceding period.

The December quarter consumer price index provided further evidence of a pick-up in Australia's inflation rate. The CPI rose by 0.9 per cent in the quarter, lifting the year-ended rate to 3 per cent. Temporary factors held down the CPI increase in net terms over the year, most notably falls in fruit prices and a recent change to the child-care rebate, while petrol price fluctuations have also affected the recent quarterly outcomes. Estimates of underlying inflation which smooth out these volatile influences suggest an underlying rate of around 1 per cent in the December quarter and 3½ per cent over the year.

A number of factors are likely to have contributed to the pick-up in underlying inflation over recent quarters. As noted, domestic demand was strong in 2007 and constraints on productive capacity have persisted for some time. Significant rises in the prices of oil and other raw materials in world markets over the past couple of years have added to business input costs, though there has been a partly offsetting influence from the appreciation of the Australian dollar. Wage pressures until now have been mostly confined to the mining and construction industries. Nonetheless, labour market conditions are tight, and there is some evidence of higher growth in aggregate wages in the most recent period. In particular, while the wage price index has continued to show a relatively stable rate of wage inflation, the average earnings measure, which captures a broader range of labour costs, has picked up appreciably over the latest year. Measures of inflation expectations have also been picking up gradually in recent quarters.

In the short term, inflation as measured on a year-ended basis is likely to increase further, reflecting in part the quarterly pattern of price increases that have already occurred. Given the current strength of domestic demand and pressures on capacity, a significant moderation in demand will be needed if inflation is to be satisfactorily reduced over time. There are a number of forces at work that could contribute to such an outcome, though the extent of the downward pressure they will exert on inflation is uncertain. The level of interest rates has been lifted to a

position that is on the restrictive side of neutral, reflecting increases in both the cash rate and lending rates. The deterioration in global growth can also be expected to dampen demand and activity in Australia. On the supply side, the high level of business investment will help to raise the growth of the economy's productive potential over time. Taking into account these factors, including the Board's decision to increase the cash rate in February, inflation is forecast to decline gradually from late this year, but would still be around 3 per cent in two years time.

The situation in the global economy and financial markets remains a major source of uncertainty for this outlook. It is possible that there will be a sharper downturn in the world economy than is currently forecast, and there is also a risk that tighter credit supply could constrain demand and activity in Australia to a greater extent than is assumed. Should those risks eventuate, inflation would fall more quickly than is currently forecast. On the other hand, domestic demand has to date shown considerable momentum, and there are further income gains from the terms of trade and other factors ahead. There thus remains a risk under the current monetary policy setting that demand does not moderate sufficiently to achieve the forecast reduction in inflation. A further risk is the possibility that inflation expectations could rise, which would make the reduction in inflation more difficult to achieve.

On the current outlook, then, and allowing for the inevitable uncertainties in forecasting, the risk of inflation remaining uncomfortably high for some time is considerable. Absent a further shift in economic risks to the downside, therefore, monetary policy is likely to need to be tighter in the period ahead. ✠

# International Economic Developments

Growth in the world economy has slowed in recent months as the credit market turmoil and tightening in financial conditions in the major developed economies have started to weigh on the household and corporate sectors in those economies. However, conditions in the emerging-market economies, particularly China and the smaller east Asian countries, have thus far remained strong.

There is significant uncertainty as to the likely size of the eventual impact of recent financial market tensions on economic activity in the United States and other developed economies, and the effect this will have on the rest of the world. This uncertainty is evident in the larger-than-usual spread of analysts' forecasts in the January Consensus Economics survey. Half the forecasters expected US GDP growth in 2008 of more than 2 per cent in year-average terms, while a number of other forecasters expected growth of around 1 per cent, which would probably imply a couple of quarters of contracting economic activity. More recently, an increasing number of forecasters appear to be taking the latter view, and it is likely that the period of weak growth in the US economy will be accompanied by a noticeable slowing in some of the other major developed economies.

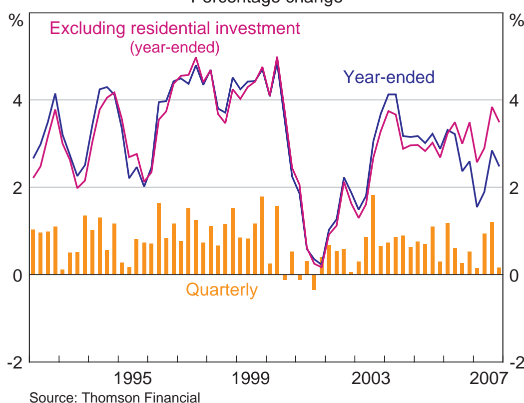
Slower growth in the developed world can be expected to have some impact on growth in the developing countries through both trade and financial channels. There is little sign of the recent financial turmoil itself being a problem for the emerging east Asian economies, which are not major borrowers in international capital markets, although recent falls in their equity markets could dampen sentiment. The current expectation is that the bulk of the impact will be through the trade channel, particularly as these economies have high degrees of trade openness. While slower export growth is expected to weaken GDP growth in east Asia somewhat, domestic demand is expected to remain solid in the region in 2008. Some slowing in the pace of growth in China is expected and may in fact be welcomed by the Chinese authorities, particularly as they have recently ramped up their policy efforts to slow growth and inflation.

Overall, both private and official forecasts are for a period of weak growth in the G7 countries in 2008, although growth in emerging economies is expected to remain relatively strong. The Consensus forecasts of world growth (on a purchasing power parity basis) imply a modest slowing, from 4.9 per cent in 2007 to 4.4 per cent in 2008. However, these forecasts are from early January and so do not take account of more recent developments. The latest IMF forecasts, released on 29 January, are for world growth to slow to 4.1 per cent in 2008, which would be roughly in line with the average since the beginning of the decade (Table 1). The Bank's forecasts for the domestic economy presented in the 'Economic Outlook' chapter assume that world growth slows to a pace somewhat below trend, which is weaker than the IMF forecasts.

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

| | 2006 | 2007 estimates | 2008 IMF forecasts[d] |
|---|---|---|---|
| United States | 2.9 | 2.2 | 1.5 |
| Euro area | 2.9 | 2.6 | 1.6 |
| Japan | 2.4 | 1.9 | 1.5 |
| China | 11.1 | 11.4 | 10.0 |
| Other east Asia[b] | 5.4 | 5.6 | 4.9 |
| India | 9.6 | 8.6 | 8.2 |
| **World** | **5.0** | **4.9** | **4.1** |
| Australia's trading partners[c] | 5.2 | 5.1 | 4.4 |

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified. PPP weights have been updated to reflect the most recent data from the International Comparison Program.
(b) Weighted using GDP at market exchange rates
(c) Weighted using merchandise export shares
(d) Forecasts from the 29 January *World Economic Outlook (WEO) Update* where available, otherwise lowest of January Consensus and October *WEO*
Sources: CEIC; Consensus Economics; IMF; RBA; Thomson Financial

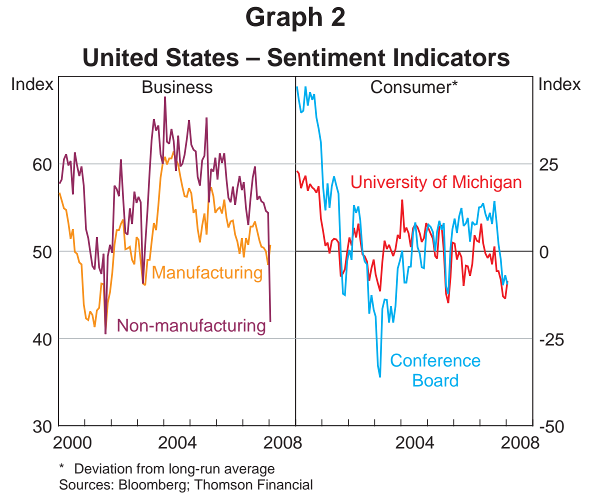


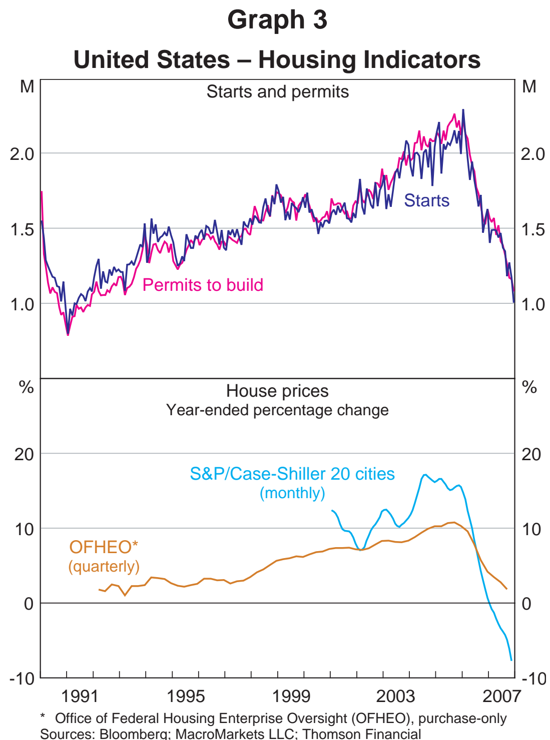

## Major developed economies

In the United States, conditions in the housing market have deteriorated further and there are some signs that this weakness is spilling over into other areas of spending. In the December quarter, GDP grew by 0.2 per cent, although in year-ended terms growth remained firm at 2.5 per cent due to the stronger outcomes recorded earlier in the year (Graph 1). Household consumption, business investment and exports increased in the quarter, while dwelling investment again fell sharply. Sentiment indicators suggest that the deterioration in household and business conditions seen over the latter part of last year continued into January (Graph 2).

In the housing sector, starts and permits are now down by more than 50 per cent from their peaks around the end of 2005 (Graph 3). The stock of unsold homes has remained high and house prices are falling; in late 2007 the Case-Shiller measure of house prices, which covers houses sold in 20 major cities, was 9 per cent below its mid-2006 peak and the pace of decline has been increasing. The Federal Reserve's Senior Loan Officer Survey also reports that an increasing number of banks have tightened their mortgage lending standards for both sub-prime and prime borrowers.

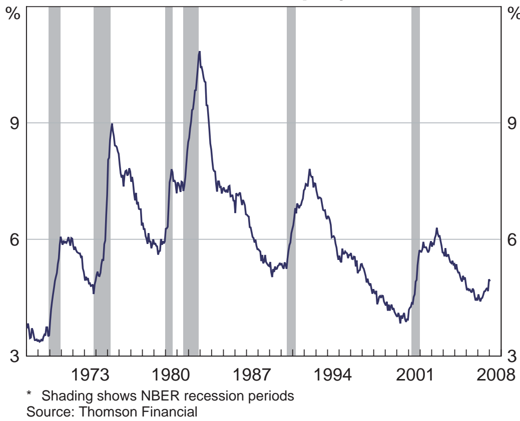
A key risk to the outlook for the US economy is that weakness in the housing market will feed through to a more significant slowing in household consumption spending. Until recently, consumption growth had been strong, supported by increasing wealth and solid growth in household wages and employment. However, consumption slowed noticeably during the December quarter, household wealth has been affected by the weakness in house prices and the stock market, and the labour market has weakened in recent months. Monthly growth in payrolls employment has slowed to around 40 000 jobs in the three months to January from around 100 000 in the previous three months and around 170 000 a year ago. The unemployment rate has risen by ½ percentage point over this period (Graph 4). The softening in the labour market has been largely due to falling employment in the construction and manufacturing industries, although in the past few months employment is also down in the financial services industry.



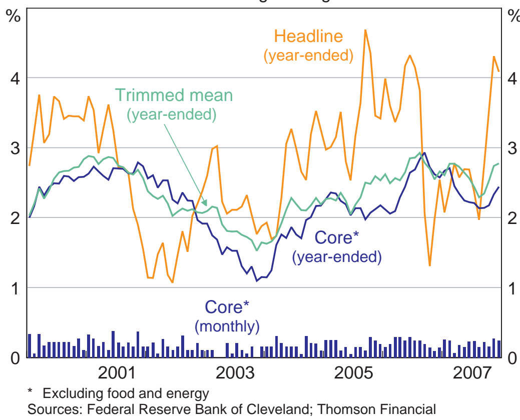

In response to weakening conditions in the US economy, the authorities have proposed a fiscal stimulus package worth US$146 billion (1.1 per cent of GDP), which includes tax rebates for households and incentives for businesses to invest. In addition, the Federal Reserve cut the federal funds rate by 25 basis points in December and by a further 125 basis points in January. While the Fed has acknowledged that some inflation risks remain, the expected slowdown in economic growth was considered to pose the greater risk to the economy. The sharp pick-up in headline inflation in recent months is mostly due to higher oil and food prices; core CPI inflation has risen more modestly, to 2.4 per cent over the year to December (Graph 5).

**Graph 4**
**United States – Unemployment Rate***



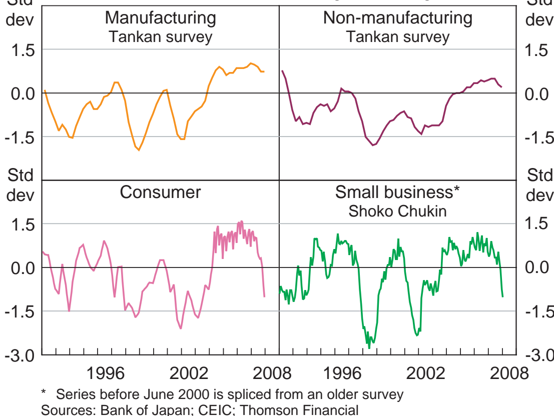

* Shading shows NBER recession periods
Source: Thomson Financial

**Graph 5**
**United States – Consumer Prices**
Percentage change




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

**Graph 6**
**Japan – Sentiment Indicators**
Standard deviation from long-run average




* Series before June 2000 is spliced from an older survey
Sources: Bank of Japan; CEIC; Thomson Financial

In other major developed countries, economic conditions have also weakened after a period of quite strong growth, although to date this trend is more apparent in the survey data than in the official macroeconomic indicators. In Japan, domestic conditions appear to have softened, with business sentiment weakening and conditions in the household sector deteriorating. The unemployment rate rose slightly in the December quarter and consumer sentiment has fallen sharply (Graph 6). In the euro area, tighter bank lending standards and the appreciation of the euro are expected to weigh on growth. Retail sales fell by 0.7 per cent over the year to the December quarter and export growth has slowed. Business and consumer sentiment have fallen, although as of January they remained at or above average levels. Conditions in the UK economy have also moderated in recent months, particularly in the housing market. The Bank of England responded by cutting its policy rate by 25 basis points in early December.

## Other major trading partners

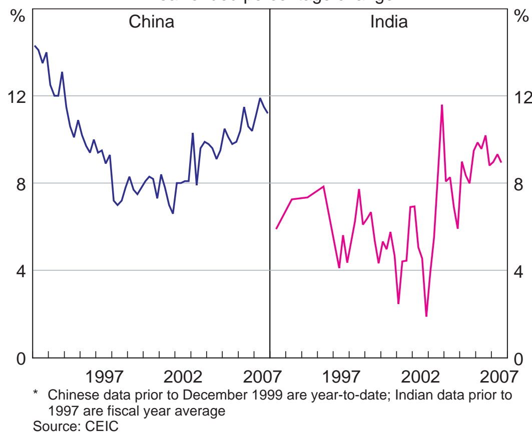
In contrast to the major developed economies, growth has remained strong across the Asian region, including in China, India and the smaller east Asian economies. China's economy has continued to grow strongly, with GDP estimated to have increased by 11.2 per cent over the year to the December quarter (Graph 7).

Available indicators suggest that the expansion of the domestic economy continued to make a significant contribution to growth. Nominal spending on fixed-asset investment increased by 20 per cent over the year to December and retail sales volumes are estimated to have grown by around 15 per cent over the same period. The value of imports also grew by 25 per cent over the year to December, outpacing export growth which slowed to 22 per cent over the same period. Slower growth of exports to the United States and Japan over the past year has been partly offset by a pick-up in exports to Europe. In India, strong growth has continued, with GDP rising by almost 9 per cent over the year to the September quarter and industrial production growing at a similar pace over the year to November.

**Graph 7**

**China and India – GDP***

Year-ended percentage change



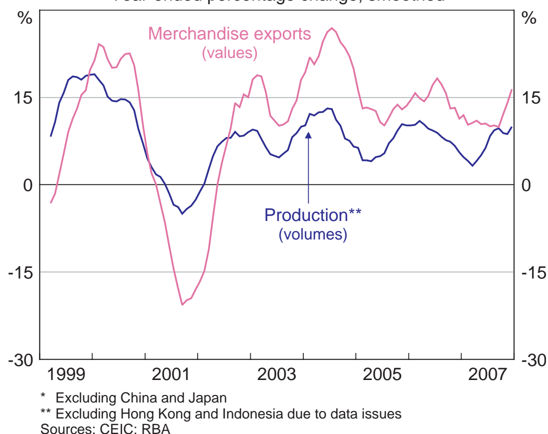

* Chinese data prior to December 1999 are year-to-date; Indian data prior to 1997 are fiscal year average

Source: CEIC

**Graph 8**

**East Asia* – Business Indicators**

Year-ended percentage change, smoothed




* Excluding China and Japan

** Excluding Hong Kong and Indonesia due to data issues

Sources: CEIC; RBA

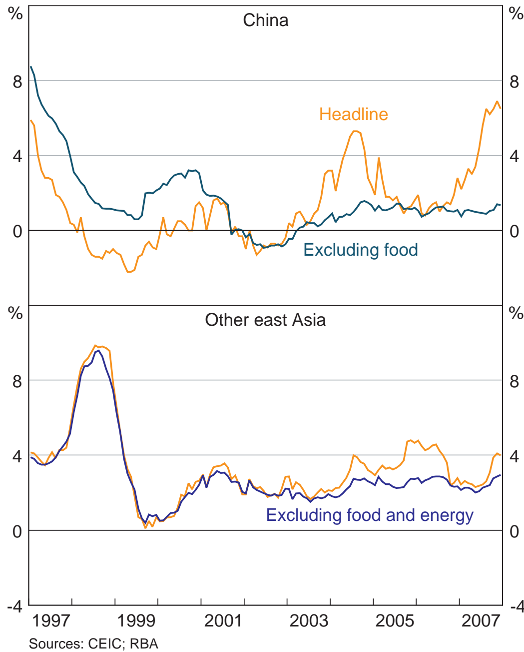
Strong growth has also continued elsewhere in the region. Growth in industrial production in east Asia (excluding China) remained solid at 10 per cent over the year to December, partly reflecting continued strength in ITC production (Graph 8). Growth in the value of exports from east Asia has also continued to be rapid, as slower growth to the major developed economies has been offset by increased exports to China and other emerging economies. Preliminary estimates suggest that in the December quarter GDP growth remained strong in Korea. While GDP is estimated to have fallen in Singapore in the quarter, this largely reflected a sharp fall in pharmaceutical production, which is a particularly volatile sector owing to frequent changes in the product mix.

Inflation has continued to rise in east Asia, driven by increasing prices of food and other commodities. In China, headline CPI inflation was 6.5 per cent over the year to December, which is around its highest rate in more than a decade. While this has mostly been driven by food prices – which account for around one-third of the CPI basket – there are some tentative signs that price pressures are starting to become more widespread. Excluding food, inflation picked up a little in December, although it remains relatively low at 1½ per cent over the year (Graph 9). Reflecting

## Graph 9

### East Asia – Consumer Prices

Year-ended percentage change

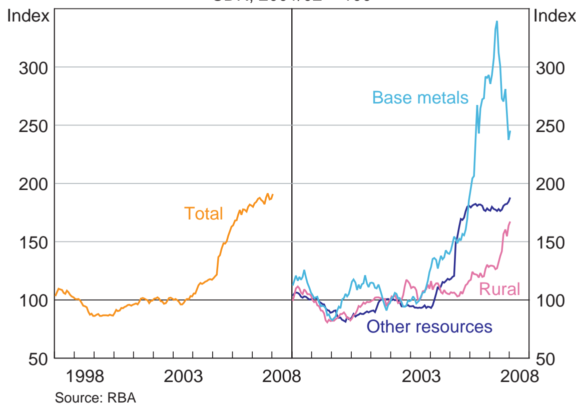



Sources: CEIC; RBA

## Graph 10

### RBA Index of Commodity Prices

SDR, 2001/02 = 100




Source: RBA

concern about the rapid pace of growth and inflation, the Chinese authorities have made further efforts to tighten monetary policy via tighter credit controls and increases in the banks' reserve requirement ratio and interest rates, as well as a faster pace of appreciation of the renminbi. Recently, price controls were also introduced for fuel, transport and some food items. Inflation has continued to pick up in the rest of east Asia, driven by higher food and energy prices and core inflation has risen somewhat in recent months.

## Commodity prices

Commodity prices generally remain at very high levels. Over the past three months, the RBA's index of commodity prices was little changed, as weaker base metals prices have been offset by higher prices for rural commodities and gold. The index is around 6 per cent higher (in SDR terms) than a year ago and around 80 per cent higher than four years ago (Graph 10).

The RBA index of base metals prices has fallen by 13 per cent over the past three months, with most of the fall occurring during November. All base metals except aluminium recorded sizeable falls. Concerns about the slowing in world growth and the turmoil in global financial markets have weighed on base metals prices, and an improvement in supply conditions of some metals has also contributed to the easing in prices. Despite the recent weakness, in real terms base metals prices generally remain well above their levels of a few years ago, and futures markets suggest this will remain the case for some time. Gold prices have increased by more than 30 per cent over the past year to around US$900 per ounce, underpinned by strong growth in investor and consumer demand. Gold prices have now surpassed their

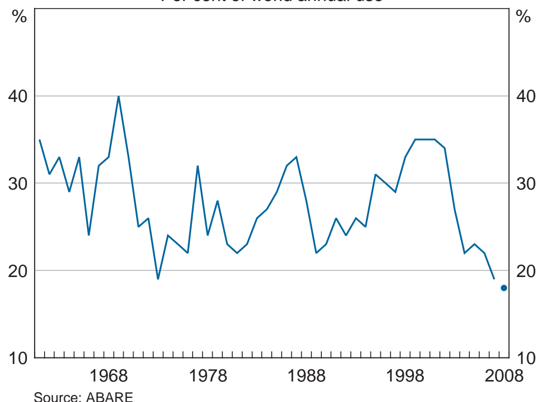
previous nominal peak in 1980 and are at their highest level in real terms in more than 20 years.

Rural commodity prices rose by 4 per cent over the three months to January, supported by further strength in wheat prices. Although global wheat production appears to have picked up in the 2007/08 season, inventories have remained low, and wheat prices have risen by around 50 per cent since mid 2007 (Graph 11). Prices for crops used in the production of biodiesel and ethanol, such as canola and sugar, have also risen strongly over recent months, partly reflecting the high level of oil prices.

In contrast to base metals, coal and iron ore markets tightened considerably over the second half of 2007. Weather-related disruptions to production, constraints on the speed at which supply can be expanded, and the depreciation of the US dollar have contributed to expectations that contract prices for coal and iron ore will increase sharply this year. Market analysts are generally forecasting iron ore, coking coal and thermal coal contract prices to rise by 40–50 per cent for the year starting April 2008 (Graph 12). Given that these commodities account for nearly one-fifth of the total value of Australian exports, these price rises, if realised, would amount to a 7 per cent boost to the terms of trade around the June quarter.

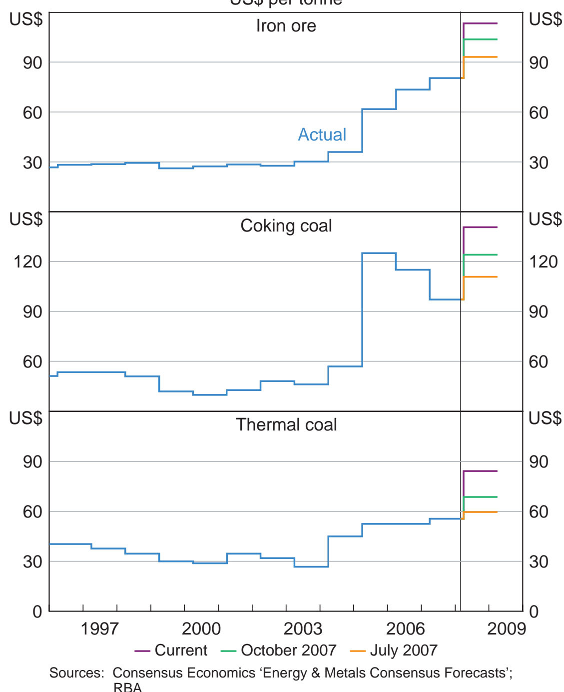
**Graph 11**

**Wheat Inventories**




**Graph 12**

**Bulk Commodity Contract Prices**



# International and Foreign Exchange Markets

There has been ongoing turbulence in international financial markets since the last *Statement*, including a large correction in global equity prices. The turbulence has been underpinned by two main factors: further adverse news of substantial sub-prime related losses at financial institutions and growing pessimism among investors about the outlook for the US economy and, by extension, for global growth.

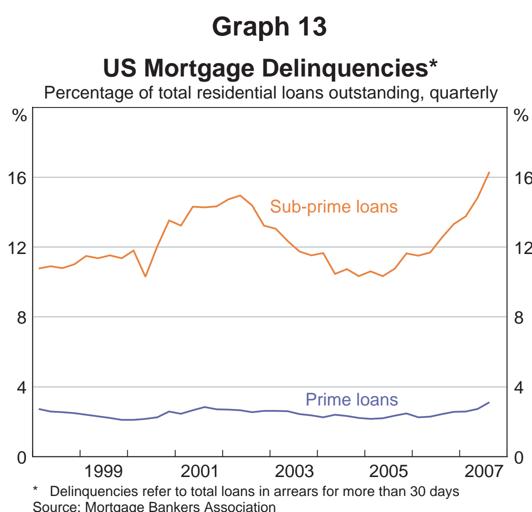
## Financial institutions

The decline in sentiment in global financial markets has had much to do with the steady stream of poor fourth-quarter results from the major international banks. These have revealed further substantial credit related write-downs, mainly for sub-prime exposures, which in some cases have led to large losses. Data for the third quarter show that sub-prime delinquencies have risen above their previous cyclical peak, with most estimates pointing to a further sharp rise in the fourth quarter (Graph 13).

**Graph 13**

**US Mortgage Delinquencies***

Percentage of total residential loans outstanding, quarterly




* Delinquencies refer to total loans in arrears for more than 30 days
Source: Mortgage Bankers Association

Since the onset of the crisis, the major banking institutions have announced around US$125 billion of sub-prime related write-downs. At the same time, their capital position is being stretched by the need to take onto their balance sheets around US$120 billion of assets previously held in off-balance-sheet vehicles. The capital of banks is also being constrained by their need to retain loans on their balance sheets that would have previously been on-sold into structured finance and syndicated loan markets. These markets have remained largely closed.

Reflecting these developments, some of the major banks have sought sizeable capital injections in the order of US$75 billion, primarily from Asian and Middle Eastern sovereign wealth funds. These equity injections have returned capital ratios to their pre-crisis levels.

Concerns are continuing to mount about the prospects for the US 'monolines' – specialised companies that provide insurance against losses on credit instruments. These companies are an important source of credit enhancement in global bond markets, often allowing bonds that would otherwise have a lower investment-grade rating to achieve the highest possible rating.

They are estimated to have insured around US$2.3 trillion of debt, of which more than half is public debt including municipal bonds.

The capital of monolines is being depleted by losses on mortgage-related debts, jeopardising the high credit ratings that they need to stay in business. If their ratings are cut, the rating of the bonds they insure may also be reduced. The ratings of Ambac and FGIC, the second and fourth largest monolines, were cut by Fitch from AAA to AA after both failed to meet the agency's deadline to raise US$1 billion in capital. Concern about monolines has led some banks to provision or write off their insurance exposures to these companies.

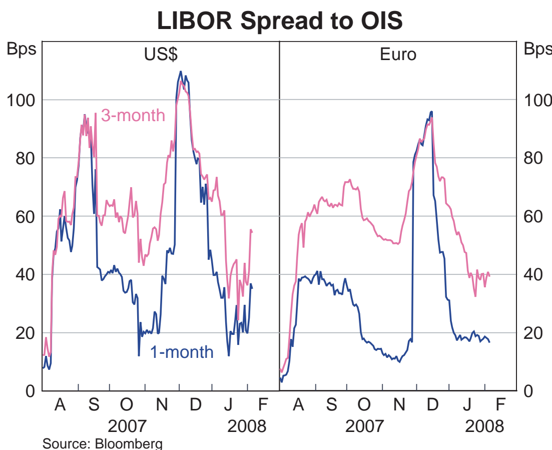
## Money markets

A major challenge for central banks in the run-up to the year end was the elevated level of short-term interest rates as financial intermediaries hoarded liquidity (Graph 14). In an effort to ease term funding pressures, the US Federal Reserve, the European Central Bank (ECB), the Bank of England (BoE), Bank of Canada (BoC) and Swiss National Bank launched co-ordinated money market operations. In particular, the Fed introduced a 'term auction facility' to make funding of terms up to 35 days available to all depository institutions rather than just the limited group of primary brokers that can participate in its routine lending operations. The ECB and the Swiss National Bank also made US dollars available to European banks, with a total of US$48 billion provided at auction. These measures, along with the passing of year-end funding pressures, have seen spreads in interbank lending markets fall markedly since mid December.

Some positive signs are also evident in other funding markets. In particular, the asset-backed commercial paper (ABCP) market started growing again in December following several months of sustained decline (Graph 15). Issuance in US corporate debt markets also

**Graph 14**

**LIBOR Spread to OIS**

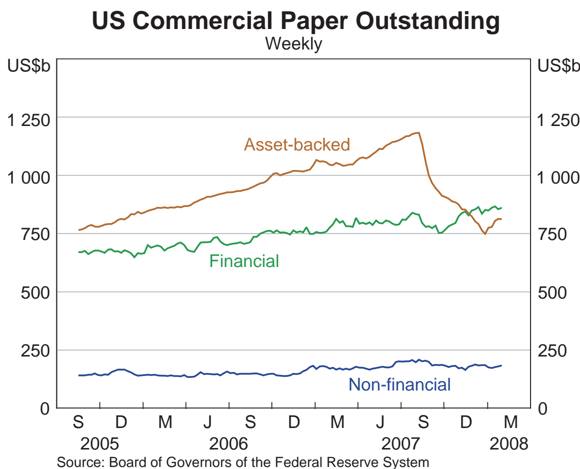



Source: Bloomberg

**Graph 15**

**US Commercial Paper Outstanding**

Weekly




Source: Board of Governors of the Federal Reserve System

rebounded somewhat in January, to more than US$65 billion from less than US$45 billion in the previous two months.

## Official policy rates

Since the previous *Statement*, the US Federal Reserve and a number of other developed country central banks have eased monetary policy, as they have assessed that the implications of the financial sector difficulties for growth have outweighed inflation concerns (Table 2, Graph 16). However, some major central banks have opted to keep their rates unchanged due to persistent inflationary pressures and policy has been tightened in a number of emerging-market economies, where inflation pressures continue to build.

**Table 2: Changes in Monetary Policy**

| | Current level<br>Per cent | Most recent change | Expectations for next 6 months |
|---|---|---|---|
| United States | 3.00 | ↓ Jan 08 | ↓ 100 bps |
| Euro area | 4.00 | ↑ Jun 07 | ↓ 50 bps |
| Japan | 0.50 | ↑ Feb 07 | No change |
| United Kingdom | 5.50 | ↓ Dec 07 | ↓ 75 bps |
| Canada | 4.00 | ↓ Jan 08 | ↓ 75 bps |
| New Zealand | 8.25 | ↑ Jul 07 | No change |

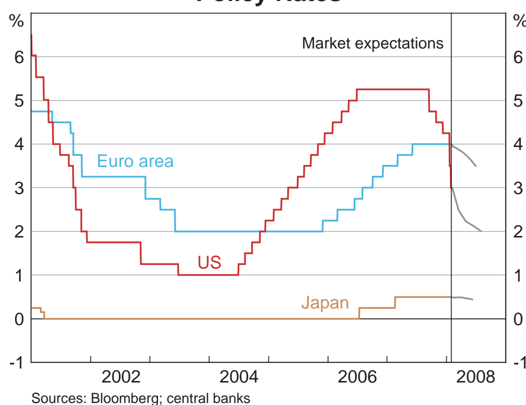
Sources: Bloomberg; central banks; Reuters

In the United States, the Federal Open Market Committee (FOMC) cut its policy rate by a cumulative 150 basis points in three moves over December and January, including an inter-meeting cut of 75 basis points. The unscheduled inter-meeting move followed very sharp falls in global equity markets on 21 and 22 January. The easing came as the Fed acknowledged that the weakness in the housing market was likely to see growth slow significantly this year. The market now expects the Fed funds rate to fall by 100 basis points over the next six months to 2 per cent.

In contrast, inflationary concerns have led the ECB to maintain its policy rate at 4 per cent, judging the downside risks to growth posed by recent financial developments to be offset by the upside risks to inflation. The Bank of Japan also left its policy rate unchanged at ½ per cent.

**Graph 16**

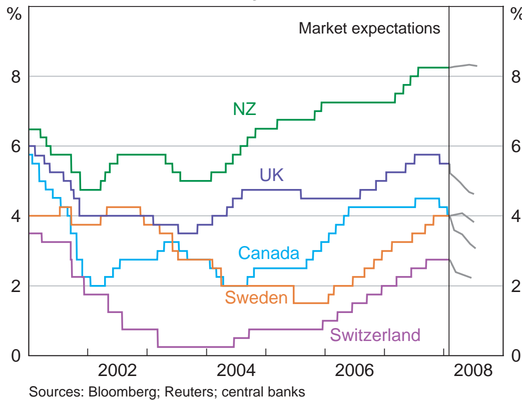
**Policy Rates**

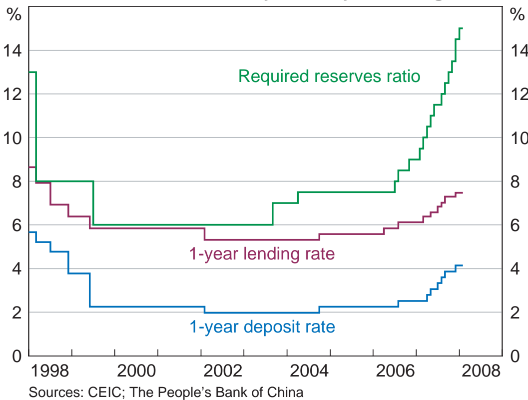


Sources: Bloomberg; central banks

The BoE lowered its policy rate by 25 basis points in December to 5½ per cent, but left it unchanged at its January meeting. In Canada, the policy rate was lowered by 50 basis points to 4 per cent, with cuts in December and January. The BoC judged that increased downside risks from a slower US and global economy outweighed the upside risks to inflation from a strong domestic economy operating above its production capacity.

In contrast, the Norges Bank increased its policy rate by 25 basis points to address inflation concerns. Rates were kept on hold in Sweden and Switzerland, at 4 per cent and 2¾ per cent respectively (Graph 17). The Reserve Bank of New Zealand also kept its policy rate on hold at 8¼ per cent, citing ongoing inflationary pressures.




Strong growth and increased inflationary pressures remain a significant concern for a number of emerging-market economies. In China, authorities are seeking to contain inflation, which is currently around 6½ per cent. The People's Bank of China raised its 1-year lending rate and 1-year deposit rate in December (Graph 18). This marked the sixth increase since the start of 2007, leaving policy rates at nine-year highs. The required reserves ratio was also raised three times since the previous *Statement*, with the increases totalling 200 basis points.

In other emerging markets, policy rates were raised in a number of countries to combat inflation pressures including: South Africa, Chile, the Czech Republic, Poland, Israel and Taiwan. In contrast, policy rates were cut in Indonesia, the Philippines and Turkey.

## Bond yields

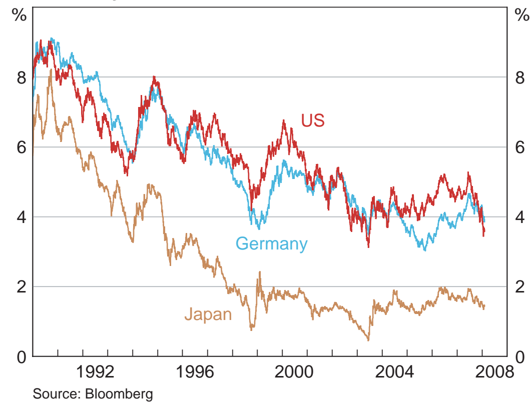
There have been some sharp movements in major market government bond yields since the last *Statement*, with daily volatility at its highest level in a number of years. US bond yields have traded in an 85 basis point range over the period, but have ended markedly lower amid ongoing concerns about global credit markets and the weaker US economic outlook (Graph 19). Yields on 2-year debt have declined by over 150 basis points.

German and Japanese bond markets have largely taken their lead from the US since the last *Statement*, although the overall decline in yields has been less pronounced. As a result, the spread between German and US 10-year yields has widened to around 30 basis points.

Moody's global speculative-grade default rate continued to fall in December, down by 10 basis points to 0.9 per cent, the lowest default rate since December 1981 (Graph 20). However, Moody's is forecasting a sharp rise in defaults to around 5 per cent by December 2008 on expectations of weaker economic conditions in the US. Consistent with the worsening outlook, credit spreads for speculative grade debt have widened by around 200 basis points as investor appetite for high-risk, high-yield debt has diminished (Graph 21). However, a significant

**Graph 19**

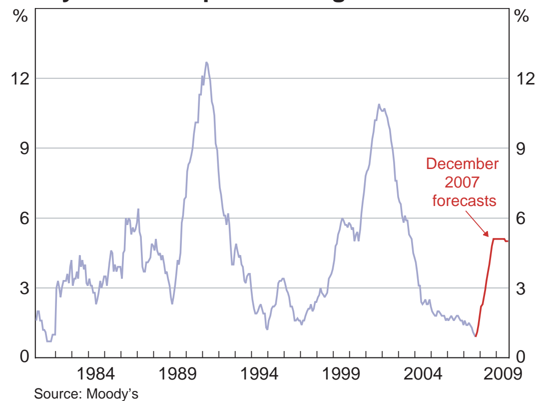
**10-year Government Bond Yields**




Source: Bloomberg

**Graph 20**

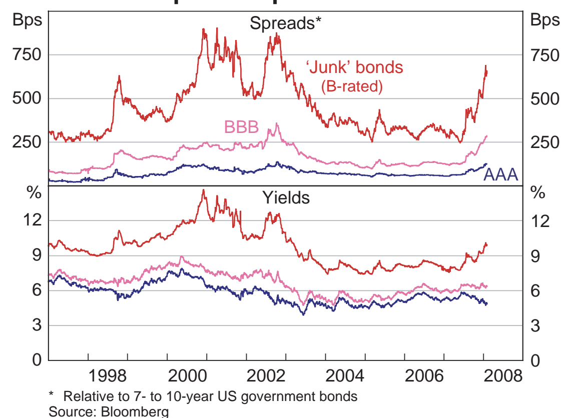
**Moody's Global Speculative-grade Default Rate**




Source: Moody's

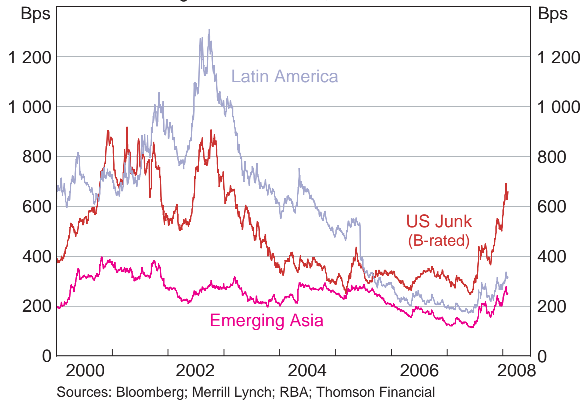
**Graph 21**

**US Corporate Spreads and Yields**




* Relative to 7- to 10-year US government bonds

Source: Bloomberg




part of this move has reflected the decline in US Treasury yields. Borrowing costs for highly rated corporates are little changed or have even fallen in recent months. Spreads on emerging-market sovereign debt have also continued to widen but again this largely reflects the decline in US Treasury yields, with borrowing costs for emerging Asian and Latin American sovereigns largely unchanged (Graph 22).

## Equities

There has been a fall in global equity prices since the previous *Statement* (Graph 23). The decline has been broad-based across sectors and markets (Table 3). There were particularly sharp falls in mid January, although markets pared back some of those losses following the Fed's unscheduled rate cut. In the US, the sub-prime write-offs saw financial

**Table 3: Changes in Global Share Prices**
Per cent

| | Since 2000 peak | Past year | Since previous *Statement* |
|---|---|---|---|
| United States | | | |
| – Dow Jones | 4 | –4 | –8 |
| – S&P 500 | –13 | –9 | –10 |
| – NASDAQ | –55 | –9 | –17 |
| Euro area | | | |
| – STOXX | –23 | –13 | –15 |
| United Kingdom | | | |
| – FTSE | –15 | –8 | –8 |
| Japan | | | |
| – TOPIX | –26 | –25 | –17 |
| Canada | | | |
| – TSE 300 | 13 | –2 | –9 |
| Australia | | | |
| – ASX 200 | 61 | –5 | –16 |
| MSCI Emerging Asia | 52 | 18 | –17 |
| MSCI Latin America | 245 | 19 | –6 |
| MSCI World | –7 | –8 | –11 |

Source: Bloomberg

sector share prices fall to levels last seen in 2003, while the broader market reached lows around its late 2006 level.

After remaining relatively immune to the risk retrenchment which took hold in major markets in the second half of 2007, shares in emerging markets have fallen sharply in the latest bout of turbulence. Nevertheless, Asian and Latin American markets have still posted solid gains over the past year.

## Exchange rates

Foreign exchange markets have been volatile in recent months, as the flow of negative credit news and economic data has generated large shifts in market sentiment. On a trade-weighted basis, the US dollar has moved modestly higher since the last *Statement* (Table 4), though it still remains around its lowest level in over 30 years (Graph 24). This reflects a continued depreciation of the US dollar against the yen (Graph 25), offset by appreciation of the dollar against some other major currencies, notably the Canadian dollar and UK pound. Heightened risk aversion and the liquidation of yen carry-trade positions in high-yield currencies saw the yen appreciate sharply in January, pushing the yen to its highest level against the US dollar since around mid 2005.

The Chinese renminbi has appreciated against the US dollar since the last *Statement* (Graph 26)

**Graph 23**

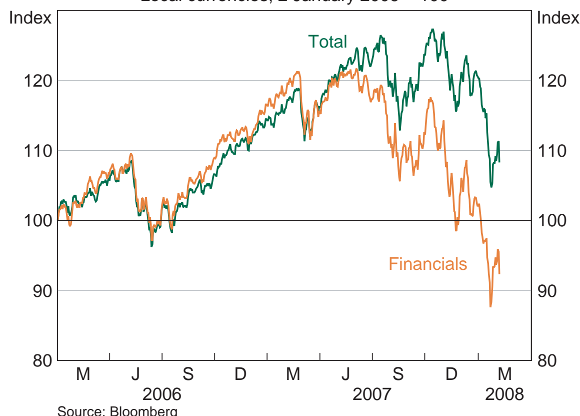



**Table 4: Changes in the US Dollar against Other Currencies**
Per cent

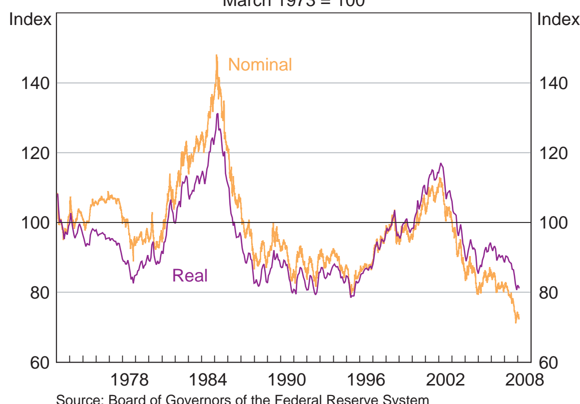
| | Past year | Since previous *Statement* |
|---|---|---|
| Philippines | –17 | –7 |
| Brazil | –16 | 0 |
| Canada | –15 | 8 |
| Australia | –13 | 5 |
| New Zealand | –13 | –1 |
| Euro area | –11 | 0 |
| Switzerland | –11 | –3 |
| Japan | –11 | –5 |
| India | –10 | 0 |
| Sweden | –8 | 2 |
| Thailand | –8 | –3 |
| Singapore | –8 | –2 |
| Malaysia | –8 | –3 |
| China | –7 | –4 |
| Taiwan | –3 | –1 |
| Mexico | –1 | 0 |
| UK | 1 | 7 |
| South Korea | 1 | 4 |
| Indonesia | 2 | 1 |
| South Africa | 7 | 18 |
| **Majors TWI** | **–12** | **2** |
| **Broad TWI** | **–9** | **1** |

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

Graph 24

US Major TWI

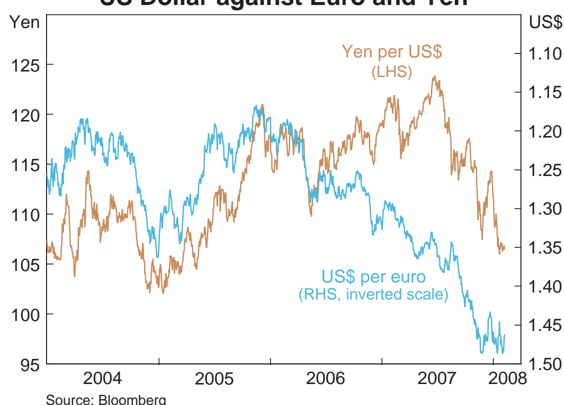
March 1973 = 100




Source: Board of Governors of the Federal Reserve System

Graph 25

US Dollar against Euro and Yen

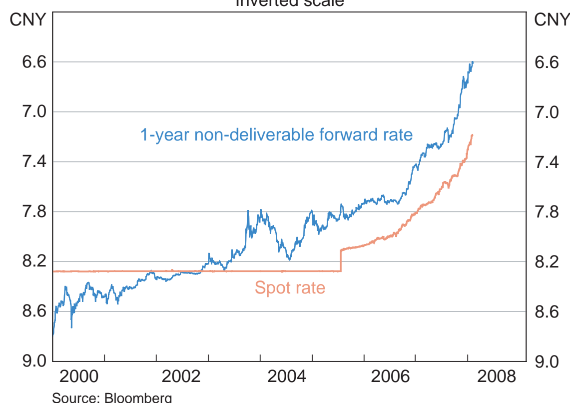



Source: Bloomberg

Graph 26

Renminbi per US Dollar

Inverted scale




Source: Bloomberg

at its fastest pace since the revaluation in mid 2005. Against the dollar, the Chinese currency has now appreciated by around 13 per cent since its revaluation, but has appreciated more modestly on a trade-weighted basis. Pricing in the non-deliverable forwards market suggests that the renminbi will appreciate by around 9 per cent over the next year.

## Australian dollar

The Australian dollar has traded in a large range in the period since the last *Statement*. Movements over the past few months have been largely driven by shifts in market risk appetite, with the correlations between Australian dollar crosses and US equity markets, for example, currently at very high levels (Graph 27).

Australian dollar volatility has declined after spiking in November, although it remains above its long-term average. Moreover, since the beginning of January the Australian dollar has traded in an average daily range of around 1¼ cents, reflecting the substantial intraday movements that continue to be recorded in both directions (Graph 28).

In recent months, the Australian dollar has depreciated against most major currencies, particularly the yen and the Swiss franc (Table 5). However, the strong domestic economy and relatively high Australian dollar yields have provided support. Looking through

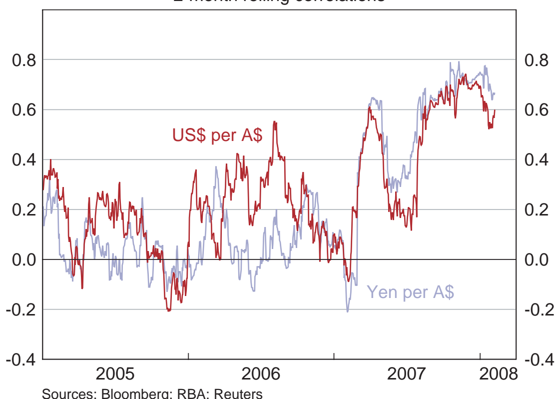
recent fluctuations, the Australian dollar has appreciated in trade-weighted terms over the past year and is still well above its post-float averages (Graph 29).

Reflecting the decline in sentiment towards the Australian dollar following developments in global credit markets, as well as year-end position squaring, net long speculative positions in Australian dollar futures at the Chicago Mercantile Exchange have been unwound since the previous *Statement*.

**Graph 27**

**S&P 500 and the Australian Dollar**

2-month rolling correlations




Sources: Bloomberg; RBA; Reuters

The Bank has made net foreign exchange purchases of around $420 million since the previous *Statement*. As a result, net reserves have risen from their end-October levels, and now stand at $36¾ billion. The Bank's holdings of foreign exchange under swap arrangements have been markedly reduced in recent months. As discussed in Box A, this has occurred for two reasons: to accommodate the shift in domestic operations towards bank bill repurchase agreements

**Table 5: Australian Dollar against Selected TWI Currencies**

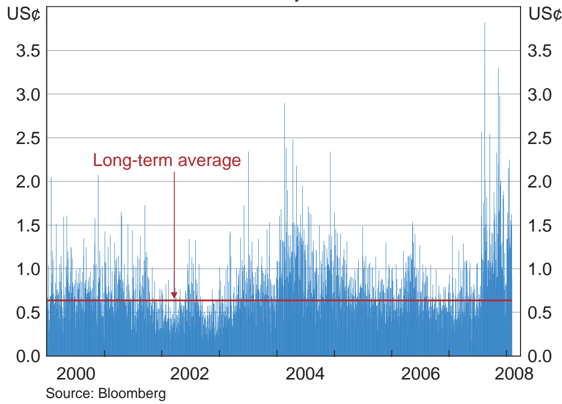
Percentage change

| | Past year | Since previous *Statement* | Deviation from post-float average |
|---|---|---|---|
| South Africa | 24 | 14 | 66 |
| Indonesia | 18 | –2 | 146 |
| South Korea | 17 | 1 | 28 |
| UK | 16 | 4 | 3 |
| US | 15 | –3 | 25 |
| Taiwan | 12 | –4 | 28 |
| PNG | 8 | –3 | 96 |
| China | 7 | –6 | 40 |
| Singapore | 7 | –5 | 1 |
| Sweden | 6 | –1 | 9 |
| Euro area | 2 | –3 | –8 |
| Japan | 2 | –8 | 0 |
| Switzerland | 2 | –6 | –9 |
| New Zealand | –1 | –5 | –8 |
| Canada | –2 | 5 | –4 |
| **TWI** | **8** | **–4** | **18** |

Source: RBA

## Graph 28

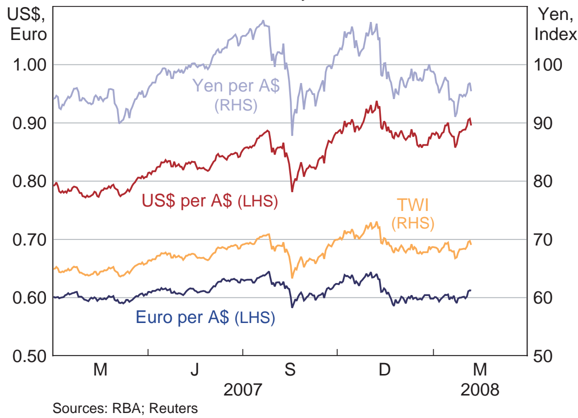
### Intraday Range in AUD/USD



Source: Bloomberg

## Graph 29

### Australian Dollar



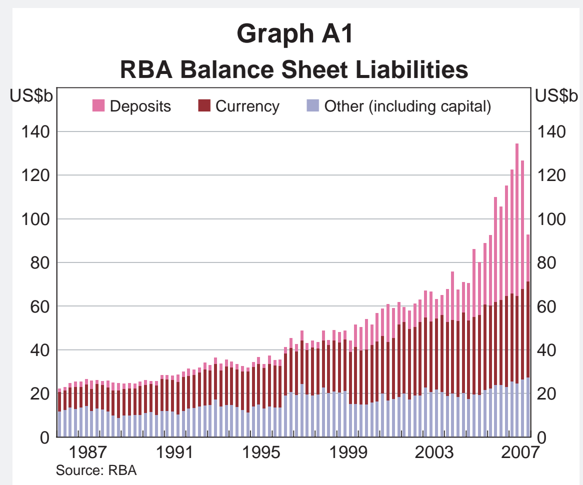
Sources: RBA; Reuters

that began during the recent turmoil in credit markets, as well as the reduction in the overall balance sheet. This process has now run its course with the foreign exchange swap book around zero.

# Box A: The RBA's Foreign Exchange Swaps

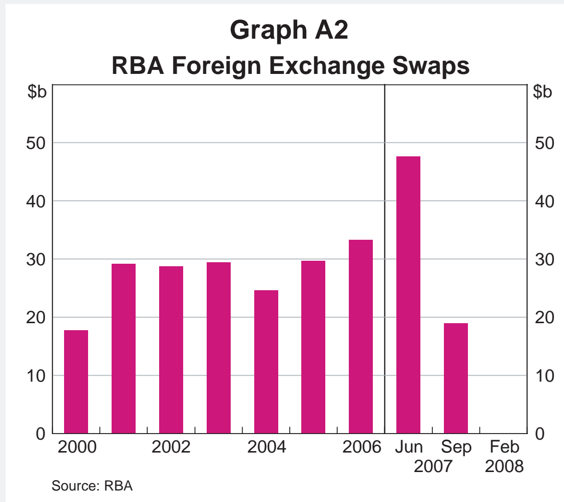
Foreign exchange swaps are transactions which involve the purchase of one currency against another at an initial date and an agreement to reverse that transaction at a future date and at a specified rate. For many years now, the Bank has routinely used foreign exchange swaps to supplement its open market operations in domestic securities to manage domestic liquidity. To inject liquidity, for example, the Bank may enter into a swap arrangement involving the delivery of Australian dollars in exchange for US dollars at the prevailing exchange rate and a commitment to reverse the transaction at a specified rate and agreed date in the future. As such, the swap is similar to a repurchase agreement in domestic securities, the only difference being that the Bank is temporarily providing Australian dollars in exchange for foreign currency rather than in exchange for domestic securities. As the price is agreed for the term of the swap, the Bank is not exposed to any foreign currency risk. Importantly, as the swap involves both a sale and a purchase of foreign currency the transaction has no effect on the exchange rate.

This recourse to foreign exchange swaps for managing domestic liquidity came about due to a combination of growth in the Bank's balance sheet and a decline in the stock of Commonwealth Government securities (CGS) on issue. These developments meant that from the late 1990s onwards, the Bank held an increasingly large proportion of government securities on issue, particularly around the times of seasonal peaks in its balance sheet. By undertaking foreign exchange swaps, rather than always purchasing domestic securities, the Bank aimed to limit the distortions that its open market operations might otherwise have had on the CGS market. This became increasingly important as the Bank's balance sheet was temporarily expanded in recent years by deposits from the Australian Government and its agencies, in particular the Future Fund, pending their investment in a wider range of assets (Graph A1). This preference for using swaps largely reflects the liquidity of the foreign exchange swap market: average daily turnover in Australia of foreign exchange swaps involving the local currency is around $60 billion, compared with average daily turnover in the CGS market of less than $1.5 billion.




Over the past six months the Bank has wound back its holdings of foreign exchange under swap for two reasons. The first is the significant contraction in the Bank's balance sheet which occurred over the second half of 2007, as the Future Fund

withdrew its deposits. The second reflects a shift in the Bank's open market operating procedures, as the Bank responded to the global financial turbulence by providing banks in Australia with liquidity through repurchase agreements secured against a wider range of domestic collateral. This shift was designed to ease liquidity pressures in the domestic money market as conditions in global financial markets deteriorated.




As a result, the Bank's holdings of foreign exchange swaps, which were $45 billion in early August, had been completely run off by November. In fact, as the Bank subsequently drained some of the liquidity from the domestic money market, it temporarily entered into a number of short-term exchange swaps involving the *delivery* of foreign currency in return for Australian dollars (Graph A2).

None of these shifts in the Bank's foreign currency portfolio have had any implications for the level of the Australian dollar exchange rate. This is because swap transactions, in and of themselves, have no bearing on the net foreign currency position of market participants and, by extension, no impact on the underlying demand for Australian dollar assets. In a swap transaction, the Bank and its counterparties – generally banks in Australia – are simply exchanging currencies between themselves at previously agreed prices. ✠

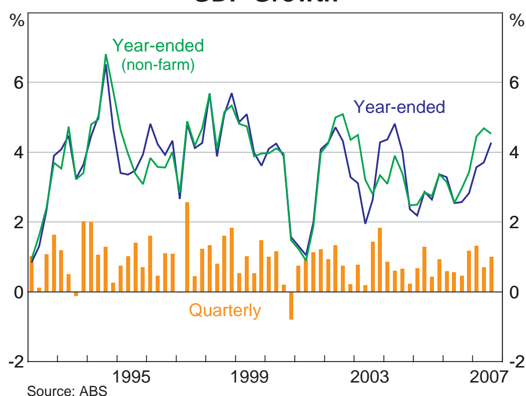
# Domestic Economic Conditions

Economic activity has continued to grow strongly, although data revisions suggest the pace of growth in 2006/07 was somewhat lower than initially estimated. In the September quarter, real GDP increased by 1.0 per cent, to be 4.3 per cent higher over the year (Graph 30, Table 6). Domestic spending appears to have remained firm in the December quarter, with retail trade and sales of motor vehicles increasing in the quarter, surveys suggesting business conditions remain well above average, labour market conditions staying tight, and imports rising strongly. In contrast, recent export growth has been subdued due to the effect of the drought on rural production and temporary supply and infrastructure disruptions in the resources sector. Following the recent rainfalls, the outlook for the rural sector in the year ahead has improved substantially.

The available data suggest the recent difficulties seen in global credit markets have not significantly affected domestic demand and activity to date. As discussed below, while the pace of household borrowing has slowed a little in response to a tightening of financial conditions during the second half of 2007, business borrowing has continued to grow strongly. However, the pass-through of higher funding costs to borrowers has become more

**Graph 30**

**GDP Growth**



Source: ABS

**Table 6: Demand and Output**

Percentage change

| | June quarter 2007 | September quarter 2007 | Year to September quarter 2007 |
|---|---|---|---|
| Domestic final demand | 1.4 | 0.8 | 5.5 |
| Change in inventories[(a)] | –0.5 | 0.3 | 1.1 |
| GNE[(b)] | 0.9 | 1.0 | 6.0 |
| Net exports[(a)] | –0.2 | –0.1 | –1.9 |
| GDP | 0.7 | 1.0 | 4.3 |
| Non-farm GDP | 1.0 | 0.6 | 4.5 |
| Farm GDP | –13.0 | 24.0 | –6.9 |
| *Memo item:* | | | |
| Real GDP adjusted for changes in the terms of trade | 0.7 | 0.8 | 4.9 |

(a) Contributions to GDP growth

(b) Adjusted for the statistical discrepancy

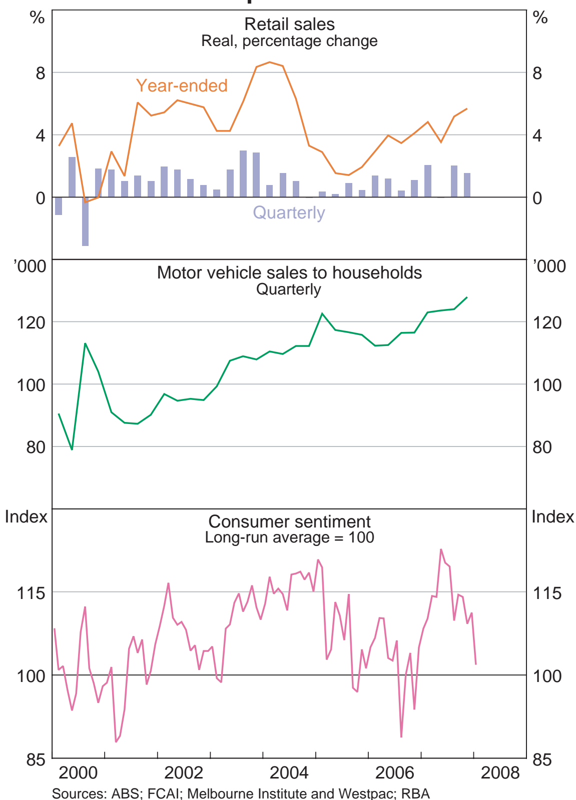
Sources: ABS; RBA

widespread over the past month or so – most banks have now increased interest rates across their lending products – and this could dampen credit growth and activity somewhat further in the period ahead. In addition, the persistence of significantly tighter conditions in capital markets may lead to some easing of growth in business borrowing.

## Household sector

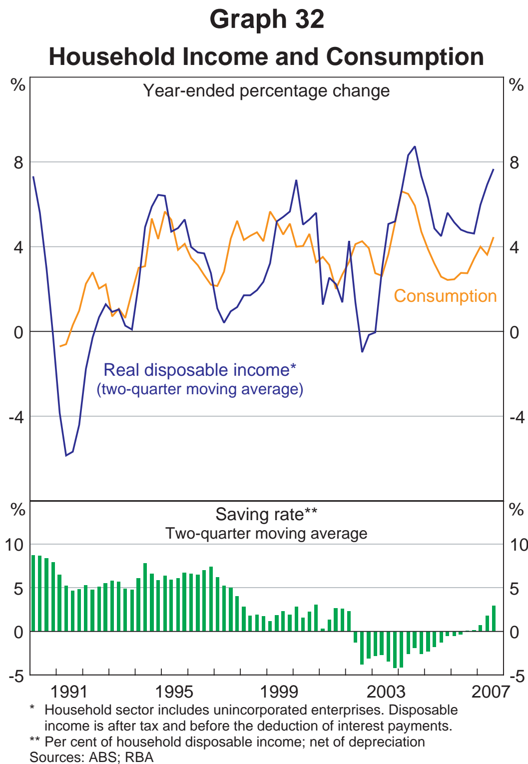
The household sector has remained relatively resilient to the tightening in financial conditions to date. Consumer spending picked up in recent quarters; consumption grew by 1.2 per cent in the September quarter, to be 4.5 per cent higher over the year. More timely indicators suggest the pace of consumption growth remained solid in the December quarter, with real retail sales increasing by 1.6 per cent to be 5.7 per cent higher over the year (Graph 31). Motor vehicle sales to households have been firm, increasing by 3 per cent in the December quarter and by 10 per cent over the year. Measures of consumer sentiment in January were modestly above their long-run average levels, although they have been declining over recent months. Liaison with retailers indicates that spending remains solid across different classes of expenditure.

The ongoing strength of consumption expenditure reflects the strong financial position of the household sector. Real household disposable income has been increasing rapidly, rising by almost 2 per cent in the September quarter and by 8 per cent over the year (Graph 32). Growth in disposable income has been driven by the favourable labour market conditions, while the income tax cuts that came into effect in July 2007 provided additional impetus in the September quarter. Household assets grew strongly over 2007; equity prices increased by 12 per cent over the year, although most of this gain was reversed in the first weeks of 2008. The household sector overall appears to be handling its debt-servicing obligations well, with only a small share of households experiencing difficulties making their required payments. The household saving rate has also been rising; net saving was around 3 per cent of household disposable income in the September quarter, its highest rate in seven years.

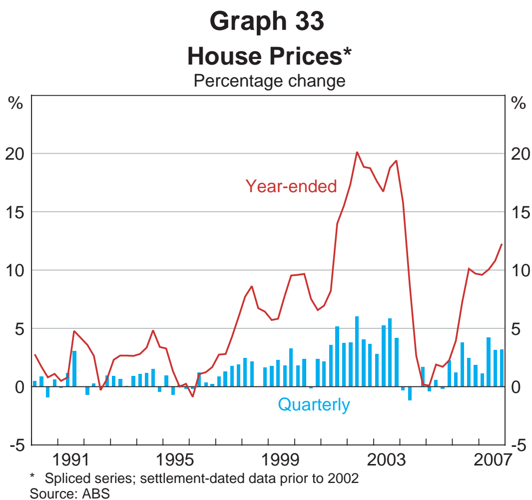



The generally healthy state of finances has provided support to the housing sector, especially the established housing market. Average

nationwide house prices increased strongly in 2007; ABS data show that capital city house prices rose by 3 per cent in the December quarter, to be 12 per cent higher over the year (Graph 33, Table 7). These data are broadly in line with other measures of house prices, which use different techniques to control for changes in the composition of houses sold. House price growth was strongest in Adelaide, Brisbane and Melbourne over 2007, with average increases of close to 20 per cent. Sydney house prices increased more moderately, while house prices in Perth were broadly flat following very strong growth over the previous three years. Consistent with the strength seen in the upper end of the Melbourne and Sydney housing markets, residential auction markets in these cities remained buoyant through to the end of 2007. Nonetheless, recent data suggest housing credit growth and loan approvals slowed slightly in late 2007 compared with the first half of the year (Graph 34); these data would not yet reflect much of an impact from the November tightening in the cash rate nor any impact from the latest cash rate rise and the additional increases in bank lending rates early this year.



* Household sector includes unincorporated enterprises. Disposable income is after tax and before the deduction of interest payments.
** Per cent of household disposable income; net of depreciation
Sources: ABS; RBA



* Spliced series; settlement-dated data prior to 2002
Source: ABS

Growth in housing construction has remained relatively subdued, following several years of weakness. Dwelling investment increased modestly over the first three quarters of 2007. Although there was a large fall in December, the number of building approvals increased by 7.5 per cent over the year to the December quarter; the strength was mostly in the medium-density sector. Compared with previous cycles, trends in housing construction have been quite divergent across the states in recent years (Graph 35). The shortfall in the supply of new dwellings relative to underlying demand remains evident in the rental market; vacancy rates are close to historical lows in most

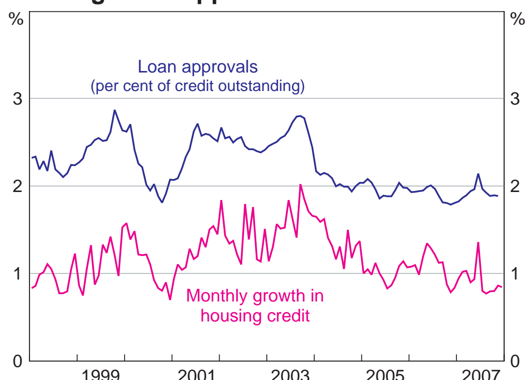
**Table 7: House Prices**
Percentage change

| | September quarter | December quarter | Year to December quarter |
|---|---|---|---|
| Sydney | 1.8 | 2.4 | 8.0 |
| Melbourne | 4.8 | 3.4 | 18.1 |
| Brisbane | 4.1 | 5.4 | 21.6 |
| Adelaide | 5.1 | 6.0 | 20.2 |
| Perth | 1.6 | 0.9 | 1.1 |
| Canberra | 3.3 | 4.4 | 14.3 |
| Hobart | 2.2 | 3.7 | 11.1 |
| Darwin | 4.3 | 2.3 | 11.1 |
| **Australia** | **3.2** | **3.2** | **12.3** |

Source: ABS

**Graph 34**

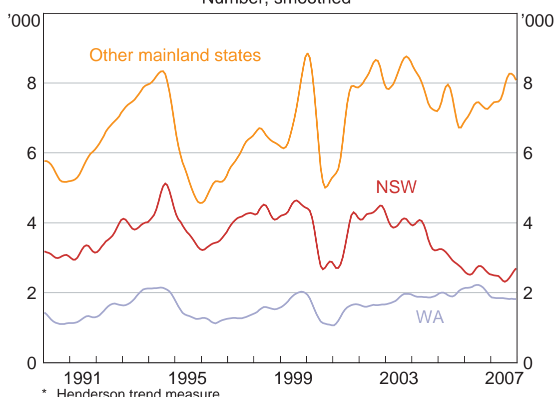
**Housing Loan Approvals* and Credit Growth**




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

**Graph 35**

**Private Dwelling Approvals**
Number, smoothed*




* Henderson trend measure
Sources: ABS; RBA

cities, and rents have continued to accelerate.

## Business sector

Business conditions in the non-farm sector are favourable. Private-sector surveys suggest that, while overall conditions eased slightly in the second half of 2007, they were still well above average levels, and that conditions in the manufacturing sector remained stable (Graph 36). The NAB survey reported that non-farm capacity utilisation is at its highest level since the survey began in 1989, while capacity utilisation in the manufacturing sector also remained high (Graph 37). Nonetheless, liaison suggests there remains a divergence in outcomes within the manufacturing sector, with conditions for firms relatively exposed to the resources and non-residential construction sectors stronger than for firms exposed to the farm sector and foreign competition.

The pace of growth of private-sector profits eased to around 6 per cent over the year to the September quarter, compared with average annual growth of 10 per cent over the previous two years. Profits outside of the mining sector grew solidly over the year, while mining profits declined due to the slowing of growth in commodity prices and an increase in costs. However, at 31 per cent of GDP, the profit share was close to its highest level in more than three decades (Graph 38). Equity analysts' expectations for private non-financial sector profit growth

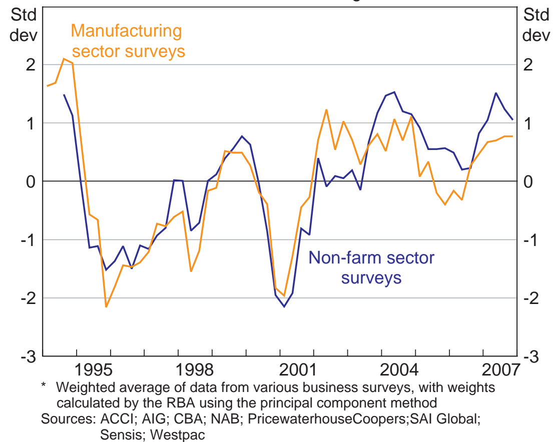
in 2007/08 have been revised lower over the past six months, although they expect a rebound in profit growth in both the mining and non-mining sectors in 2008/09.

New business investment increased by ½ per cent in the September quarter, to be 10 per cent higher over the year (abstracting from the reclassification of Telstra). As has been the case for some time, the growth in investment was driven by increased spending on buildings and structures. Forward-looking indicators point to further solid growth. There is a substantial stock of work already in the pipeline and additional infrastructure and resource-related projects are close to commencement, which should boost non-residential construction in the period ahead. The October/November capital expenditure survey's estimate of spending plans for 2007/08 pointed to moderate growth in machinery & equipment investment. While disruptions in capital markets over the past six months have resulted in an increase in external funding costs for businesses, the rapid growth in business credit suggests that firms retain a strong appetite for, and ready access to, debt to fund their investment plans. The ongoing high level of investment is supporting growth in the capital stock, and hence adding to the growth of the economy's productive capacity (for further details see 'Box B: Investment and the Productive Capacity of the Economy').

## Graph 36

### Actual Business Conditions*

Deviation from average

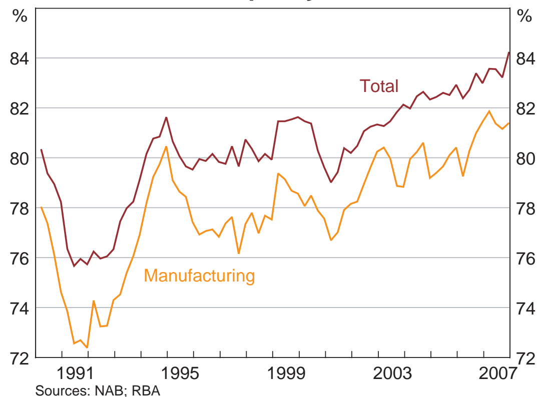



* Weighted average of data from various business surveys, with weights calculated by the RBA using the principal component method

Sources: ACCI; AIG; CBA; NAB; PricewaterhouseCoopers;SAI Global; Sensis; Westpac

## Graph 37

### Non-farm Capacity Utilisation

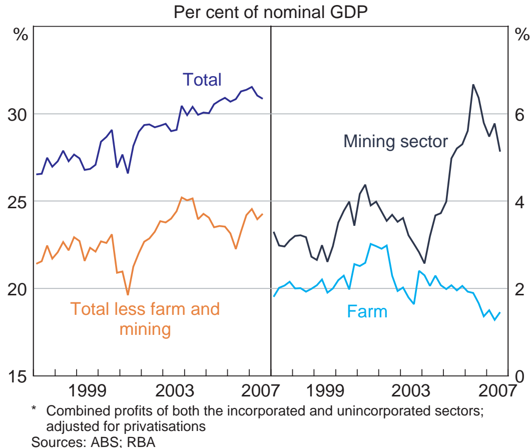



Sources: NAB; RBA

## Graph 38

### Profits*

Per cent of nominal GDP




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

Sources: ABS; RBA

## Farm sector

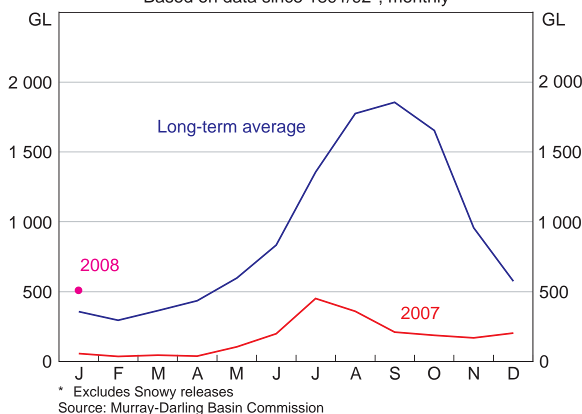
Overall conditions in the rural sector have been weak. Based on information from the Australian Bureau of Agricultural and Resource Economics (ABARE) and other rural agencies, farm output is expected to increase only slightly in 2007/08, after falling substantially in 2006/07 (Table 8). The 2007 wheat crop was estimated by ABARE in December to be 12.7 million tonnes; although this was around 30 per cent higher than the 2006 crop, it was well below the average annual crop. Overall, the growth in cereals output in 2007/08 is expected to be mostly offset by weakness in other components of farm production.

**Table 8: Volume of Farm Production**
Per cent

| | Share of gross production | Growth | |
|---|---|---|---|
| | 2005/06 | 2006/07 | 2007/08(f) |
| **Crops** | **45** | **–31** | **8** |
| Cereals | 17 | –61 | 37 |
| Non-cereal crops | 29 | –14 | 0 |
| **Livestock products** | **43** | **–5** | **–1** |
| **Farm GDP**[(a)] | | **–23** | **2** |

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

However, climatic conditions in the farm sector have improved over recent months. A La Niña weather system (which is normally associated with higher-than-average rainfall) has become firmly established in the Pacific region. Consistent with this, recent rainfall across many of the major cropping regions has been well above average; severe flooding was experienced in north-east New South Wales and south-east Queensland. While heavy rains are likely to disrupt farm production in the short term, the outlook is becoming more positive for 2008/09.

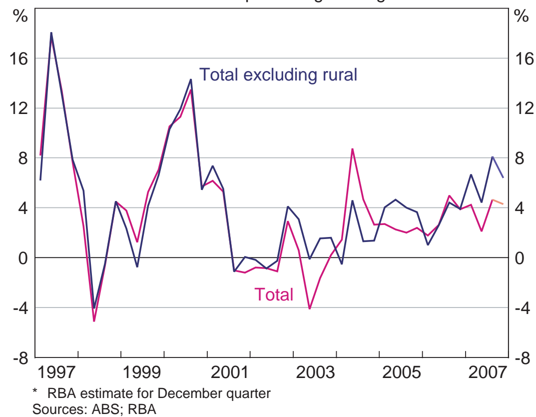



The recent rain has resulted in a significant improvement in flows into the Murray-Darling system in January, while water storage in Queensland has also increased significantly (Graph 39). Nevertheless, given the earlier degree of dryness in most agricultural regions, it is likely that a sustained period of well-above-average rainfall will be needed to return the irrigated sector to more normal conditions over the medium term.

## External sector

Following strong growth in the September quarter, export volumes are estimated to have increased slightly in the December quarter, to be 4¼ per cent higher over the year (Graph 40).

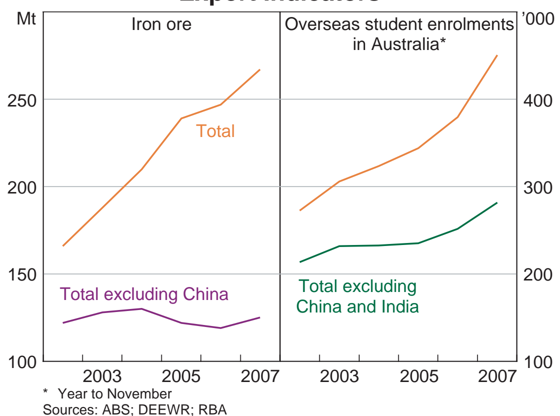
Graph 40




Resource export volumes are estimated to have risen modestly in the December quarter, with year-ended growth – at around 6½ per cent – above the average rate of the past decade. Exports of oil grew strongly in the quarter, and recently completed projects are expected to provide additional support in coming quarters. Coal exports also increased in the December quarter, though growth was somewhat hampered by port construction activity. Continued strong growth in iron ore exports is expected over the next few years as new capacity comes on line and demand conditions remain favourable, particularly in China. Since 2002, iron ore export volumes to China have expanded at an average annual rate of about 25 per cent, while volumes to more traditional export markets – such as Japan – have increased only modestly (Graph 41). China now accounts for one-half of Australia's iron ore exports.

Services exports volumes have expanded solidly over the past year, underpinned by strong growth in education exports. Since 2002, the volume of education exports has increased at an average annual rate of 11 per cent, primarily reflecting strong growth in the number of Chinese and Indian students studying in Australia – which has almost tripled over this period – although there has also been solid growth in the number of students from other parts of the Asian region (Graph 41).

Graph 41




Import volumes have grown strongly, rising by around 4 per cent in the December quarter and 10 per cent over the year, reflecting the strength of domestic demand and the appreciation of the exchange rate over the past few years. The trade deficit is expected to have widened to around 2½ per cent of GDP in the December quarter, from 1.6 per cent in the September quarter. Assuming the net income deficit remained

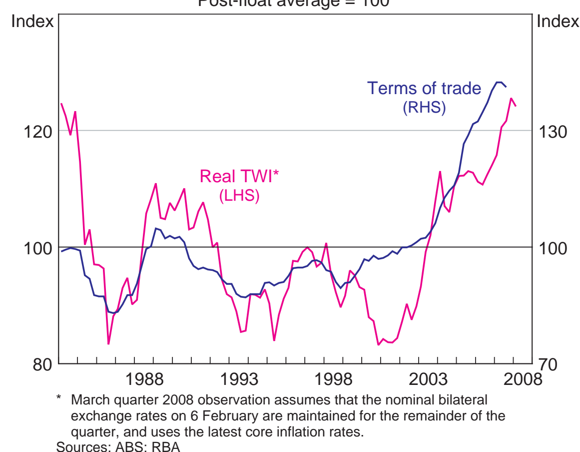
constant at around 4 per cent of GDP, the current account deficit is estimated to have widened to around 6½ per cent of GDP in the quarter.

The real trade-weighted exchange rate has depreciated slightly in recent months, although it remains high at 24 per cent above its post-float average (Graph 42). While the appreciation of the exchange rate over recent years has had a contractionary impact on some exports, the economy as a whole has benefited from the increase in Australia's terms of trade, which are more than 40 per cent above their post-float average.

**Graph 42**

**Real Exchange Rate and Terms of Trade**

Post-float average = 100




* March quarter 2008 observation assumes that the nominal bilateral exchange rates on 6 February are maintained for the remainder of the quarter, and uses the latest core inflation rates.

Sources: ABS; RBA

**Graph 43**

**Employment Growth and Unemployment**

Source: ABS

## Labour market

Labour market conditions remain strong across most industries and states. In the December quarter, employment increased by 0.6 per cent, to be 2.7 per cent higher over the year (Graph 43). Growth has been stronger for full-time employment, which increased by 3.3 per cent over the year. The participation rate also increased further, reaching a new high of 65.2 per cent in the December quarter. Part of this increase may reflect additional labour supply in response to welfare-to-work policies that became effective in mid 2007, although any effect of these reforms on the measured unemployment rate appears to have been muted; the unemployment rate has been largely unchanged since July, at around 4¼ per cent.

Employment growth in 2007 was broad-based across industries. Over the year to the December quarter, the largest increase in employment was in retail trade, with the transport & storage, education, health & community services and manufacturing industries also showing strength. Construction and mining made relatively small contributions to employment growth after a period of exceptional strength.

Across the states, employment growth continued to be strong in the resource-rich states. Nonetheless some convergence has been observed over the past two years as year-ended growth eased in Queensland while most other states saw employment growth increase (Graph 44, Table 9).

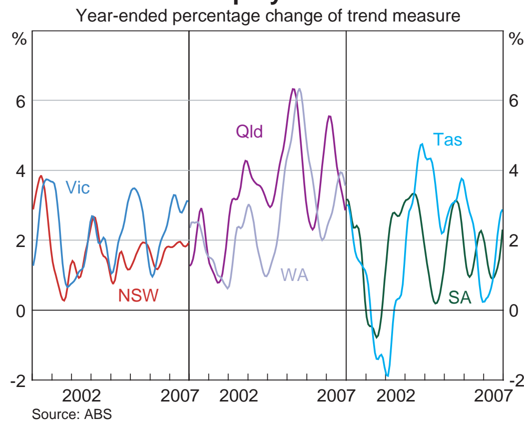
**Table 9: Labour Market by State**
Trend measure, per cent

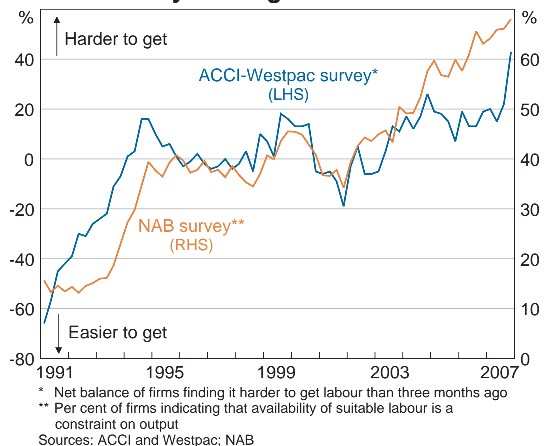
| | Employment growth | Unemployment rate | |
|---|---|---|---|
| | Year to December 2007 | December 2006 | December 2007 |
| NSW | 1.9 | 5.0 | 4.7 |
| Victoria | 3.1 | 4.8 | 4.6 |
| Queensland | 2.9 | 4.1 | 3.7 |
| WA | 3.6 | 3.2 | 3.3 |
| SA | 2.3 | 5.2 | 5.0 |
| Tasmania | 2.9 | 5.9 | 5.4 |
| **Australia** | **2.6** | **4.6** | **4.4** |

Source: ABS

Unemployment rates fell in all states except Western Australia over 2007 (where unemployment was already very low), while participation rates rose across the country.

Job vacancies data from the ABS continue to signal a tight labour market. At the national level, the ratio of vacancies to employment reached a three-decade high of 1.7 per cent; vacancies rose by 6 per cent in the three months to November and by 13 per cent over the year. Firms continue to experience difficulty in finding suitable labour, with some surveys suggesting that labour shortages have worsened in recent months (Graph 45).

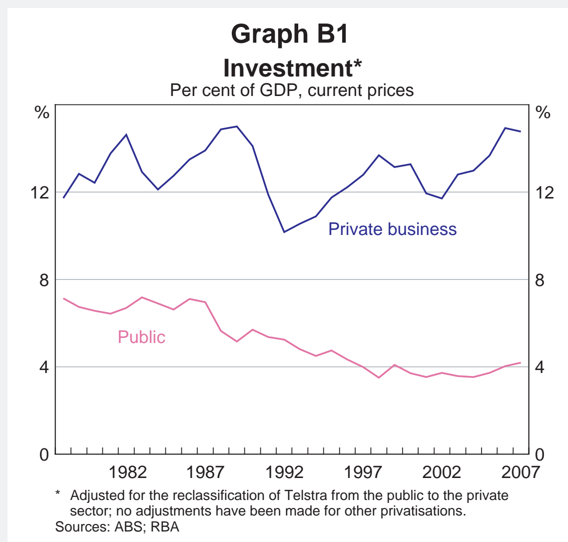


# Box B: Investment and the Productive Capacity of the Economy

Strong growth in investment spending over the past five years has lifted investment to a relatively high level as a share of GDP. As a consequence, the capital stock is now growing at its fastest pace since the early 1970s, thereby adding to growth of the economy's productive capacity. This box uses data from the annual national accounts to examine medium-term trends in investment and the implications for Australia's productive capacity.[1]

Private business investment is usually the starting point in thinking about increments to the capital stock and the productive capacity of the economy. Over the past five years, real business investment has grown by an average of 13 per cent a year, underpinned by high profitability and the ready availability of funding. As a share of GDP, private business investment has increased strongly and is now around levels last seen in the late 1980s (Graph B1).

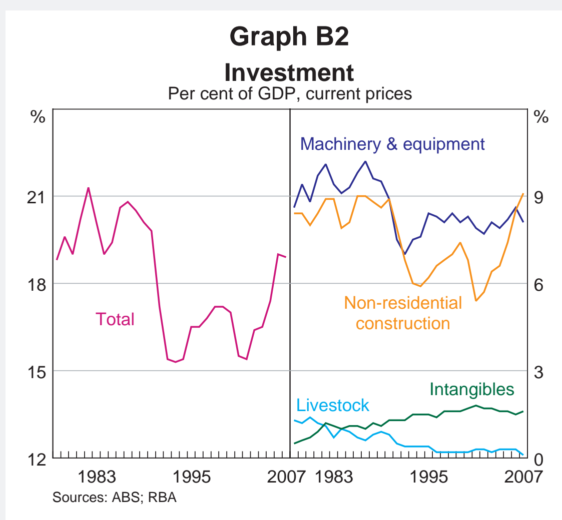



While private business accounts for most of the investment undertaken in Australia, public investment – which covers a broad range of spending including on transport infrastructure, hospitals, educational facilities and state-owned utilities – also plays an important role. Public investment declined significantly through the 1990s as a share of GDP, although it has started to pick up over the past couple of years. The earlier decline partly reflected the fiscal consolidation that started in the 1990s, the shift towards the private provision of services, and the privatisation of public enterprises; more than 80 enterprises were privatised in the 1990s alone, including Qantas, the Commonwealth Bank and the Loy Yang power station in Victoria. Given these structural changes, examining broader measures of investment that include both the public and private sectors provides a more complete picture of changes in Australia's productive capacity.

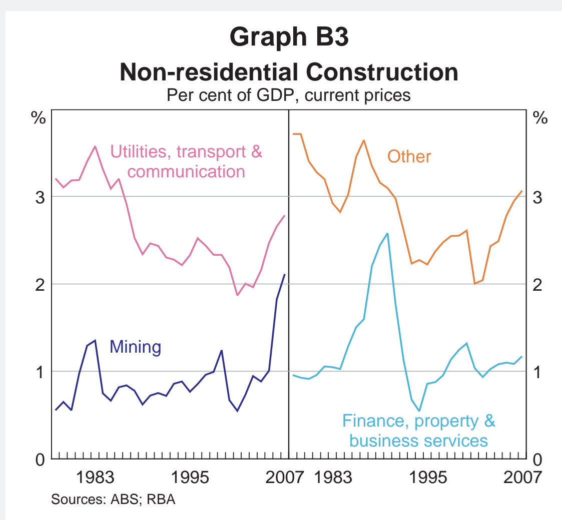
While total private and public investment has increased in recent years, as a share of GDP it is not unusually high by historical standards; the current level of total investment is close

1 *The investment and capital stock measures used here exclude dwellings since they are not directly utilised by businesses and the government to produce output. However, since dwellings provide a stream of income to households, dwellings are included in the investment and capital stock measures published in the annual national accounts.*

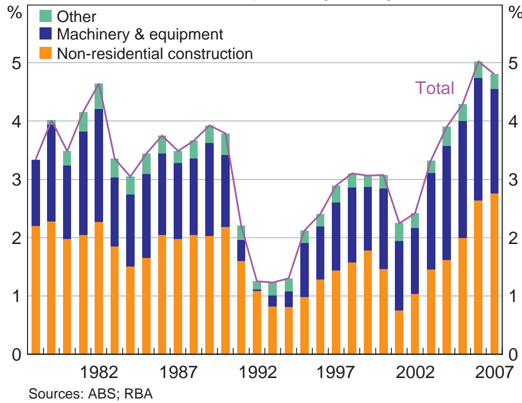
to the average of the period from the late 1970s to the late 1980s (Graph B2). Indeed, the picture that emerges suggests that investment was unusually weak over the 1990s rather than being especially high at the moment. Given the relatively low share of investment in GDP over the 1990s, it may not be surprising that capacity pressures have now become an important issue following several years of strong growth of domestic demand.




The increase in investment over the past five years has been largely due to the strong upswing in non-residential construction, which has increased from 5¾ per cent of GDP to 9 per cent (Graph B2). The mining industry has accounted for the largest increase, with its investment rising by 1½ percentage points of GDP over the past five years in response to the boom in commodity prices (Graph B3). Nevertheless, the rise in non-residential construction has been broad-based. The main infrastructure industries (utilities, transport and communication) have increased their investment in buildings and structures, in part to meet the needs of the mining sector, and spending on buildings and structures has also increased solidly in a range of other industries. Despite the boom in office building in Brisbane and Perth, construction for the finance, property & business services industry has remained far below the levels seen in the property boom of the late 1980s (for further discussion, see 'Box B: Recent Developments in the Office Property Market' in the November 2007 *Statement*).




Higher investment can raise the productive potential of an economy by contributing to the capital stock and lifting labour productivity. Conceptually, the value of the capital stock is given by the net present value of the future stream of income arising from past investment. This is inherently difficult to measure. In practice, the ABS publishes estimates on an annual basis calculated by adding past investment and subtracting depreciation, making assumptions




about the useful lives of assets and the rate at which they lose value.[2] On this measure, the annual growth rate of the capital stock trended down from 6¾ per cent during the 1960s to average 3¾ per cent during the 1980s and then to around 2¼ per cent over the 1990s (Graph B4). To put this in perspective, in the 1990s the growth rate of the capital stock fell below the growth rate of the broader economy for several years, which had not occurred over the previous three decades.

From this low base, the recent surge in investment has had a marked effect on the capital stock, which is now estimated to be increasing at around 5 per cent a year – the fastest pace of growth since the early 1970s. The strength of investment in non-residential construction has a particularly large effect, since assets such as buildings and structures have considerably longer useful lives than other types of investment, such as computers and software that depreciate more rapidly. As a result, the boost to productive capacity from the recent upswing in investment is likely to be felt for some time. However, even after the strong growth of recent years, the estimates suggest that the level of the capital stock is smaller relative to GDP than in the 1980s and early 1990s. This could help explain why firms continue to report very high levels of capacity utilisation, particularly in sectors relatively exposed to the commodity price boom. ✠

2 *The ABS produces several measures of the capital stock. The one used here is the 'net capital stock', which is published for the aggregate economy and has been adjusted to exclude dwellings.*

# Domestic Financial Markets and Conditions

## Money market and bond yields

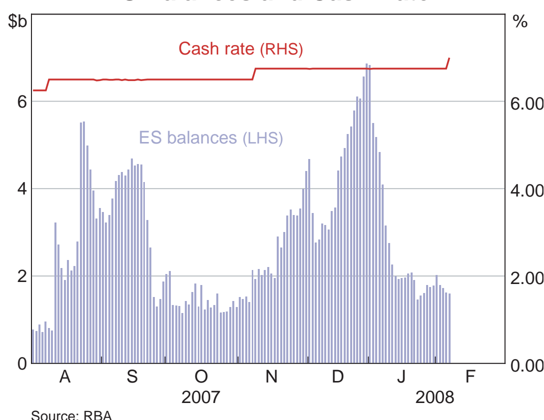
The volatile conditions described in the chapter on 'International and Foreign Exchange Markets' were also evident in Australian markets. Domestic money markets came under renewed strain in November, with the spread between 90-day bank bill yields and the expected cash rate path rising to a peak of 55 basis points in mid December, around the highs reached back in September (Graph 46). The primary cause of the rise was year-end funding pressures evident in global money markets. Because of the disruptions to foreign exchange swap markets reflecting reduced ability to access USD funding markets and tight limits from counterparties, the cost of raising short-term Australian dollar funding through offshore markets such as LIBOR rose more than the cost in domestic markets.

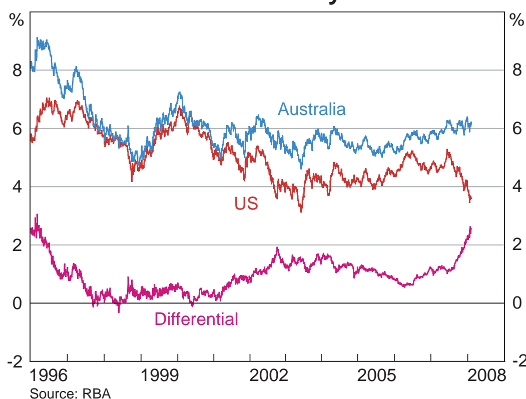
The RBA responded to the increased demand for liquidity by frequently dealing more than the projected system deficit and making term funding available in its open market operations, ensuring that the bulk of repurchase agreements extended over year-end. As a result the aggregate volume of exchange settlement (ES) balances rose to a peak of $6.8 billion, well above the levels of less than $1 billion that had prevailed prior to August (Graph 47). The aim of the Bank's monetary operations, as always, was to ensure that the cash rate remained at the target set by the Reserve Bank Board. In the event, this goal was achieved with the cash rate only falling 1 basis point below target on two days.

While financial markets in general have remained volatile into

**Graph 46**

**Graph 47**



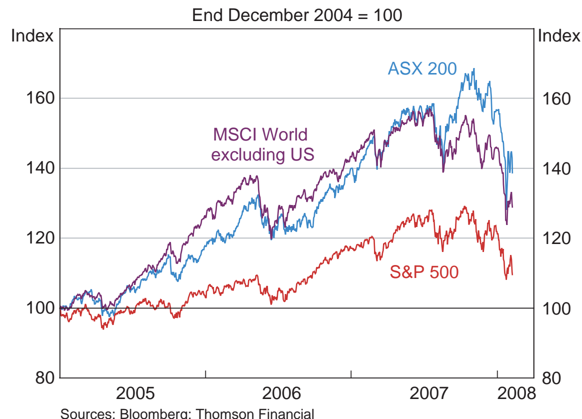



2008, conditions in money markets appear to have improved. The spread between 90-day bank bills and the expected cash rate has narrowed back to around 30 basis points. The RBA has wound back its supply of short-term liquidity which has seen ES balances decline to around $1¾ billion. Short-term bill rates, however, remain above their levels at the time of the last *Statement*, as the narrowing in spreads was offset by an increase in the expected cash rate.

Domestic long-term interest rates are around the same level as at the time of the last *Statement*, although the yield on 10-year government bonds has fluctuated within a 60 basis point band over the period. This is in contrast to yields in the US and other major economies which have declined significantly. As a result, the spread between Australian and US 10-year government yields widened further to be at its highest level since the mid 1990s (Graph 48). The widening spread reflects the difference in economic outlook for the two economies.

## Equities

After increasing strongly through most of 2007, the fifth consecutive year of strong gains, the Australian equity market has fallen sharply in recent months in line with the weakness in global equity markets (Graph 49). Volatility has also increased: on 22 January the ASX 200 fell 7 per cent – the largest daily fall since 1989 – only to recover this fall in the following two days. The ASX 200 is down 12 per cent in 2008 to date, and is 18 per cent below its peak on 1 November 2007.




The fall in the Australian market has been broad-based, but has been more pronounced for financials (Graph 50). Australian banks have been marked down along with banks globally, despite having relatively little exposure to the US sub-prime housing market. Concerns about US growth and weakening commodity prices have weighed on resource stocks. In addition, the share prices of a few companies that are having perceived or actual difficulties refinancing short-term debt have

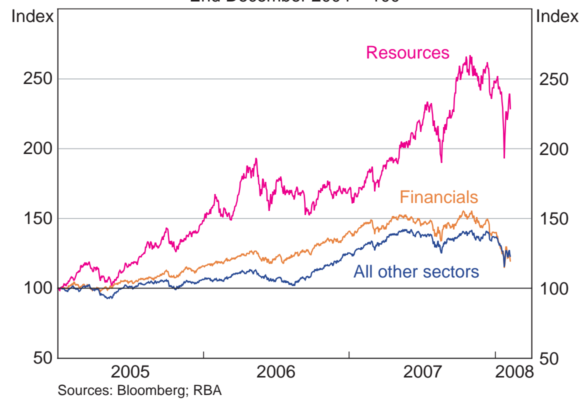
fallen very sharply. While there may be further instances of corporates running into difficulties rolling over debt, this does not appear to be a large risk to the Australian corporate sector. Overall, the current level of gearing in the Australian corporate sector is not high on an historical basis and the reliance on short-term debt among medium to large companies is moderate.

Following the fall in share prices in January, P/E ratios fell so as to be a few points below their average levels across all sectors (Graph 51). Similarly, the dividend yield picked up in January to 4.1 per cent, slightly higher than its longer-term average.

Over the last few months, analysts have lowered their earnings growth estimates for 2007/08 by a couple of percentage points. Resources sector earnings growth is expected to slow from 29 per cent in 2006/07 to 3 per cent in 2007/08 and then pick up to 23 per cent in 2008/09. Financials' earnings are expected to grow at around 9 per cent for each of the next two years, while other companies' forecast earnings growth is only expected to be 2 per cent in 2007/08, but to rebound to 11 per cent the following year.

**Graph 50**

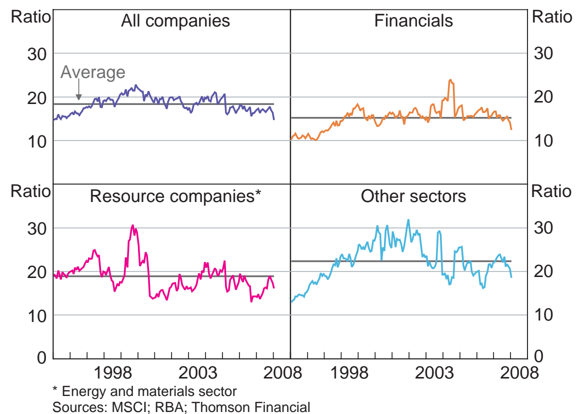
**Australian Share Price Indices**



Sources: Bloomberg; RBA

**Graph 51**

**Australian P/E Ratios**



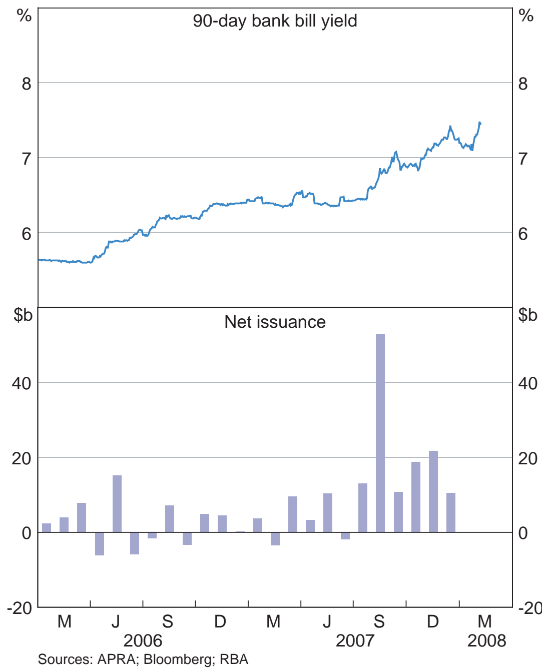
* Energy and materials sector

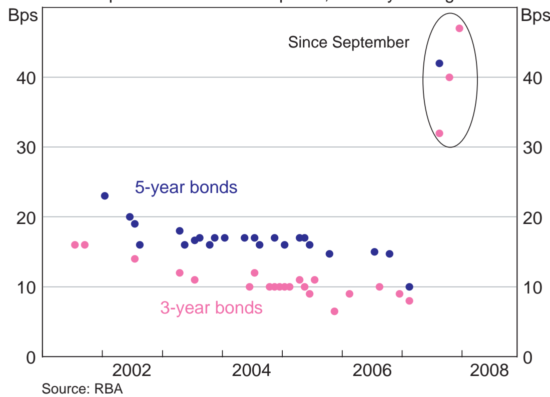
Sources: MSCI; RBA; Thomson Financial

## Financial intermediaries

The turbulence in capital markets has increased the cost and affected the composition of funding of financial intermediaries. Institutions that rely more heavily on capital markets to fund their lending (such as mortgage originators) have been most affected compared with other institutions which have a larger deposit base. Securitisation markets remain particularly difficult, limiting this source of funding.

Banks have continued to raise significant amounts of short-term funding, particularly in domestic capital markets, despite the cost of that funding rising markedly (Graph 52). Domestically, banks have increased their issuance of bank bills to around $20 billion a month since July from an average of $5 billion a month in the 18 months prior. The major banks have also maintained a



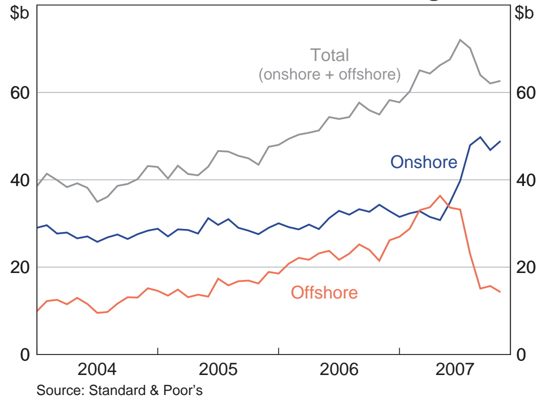

significant presence in public longer-term capital markets, with issuance being particularly strong in January. Moreover, in recent months, private placements – for which details are often not publicly available – have been higher than usual. However, the spreads on banks' bonds at issuance have widened noticeably. Some of the major banks issued 3-year bonds at an average spread to swap of 47 basis points in January, well above their average spreads of around 10 basis points prior to the credit market disruption, and an increase from the 30–32 basis points in September 2007 and 40 basis points in November 2007 (Graph 53). Mirroring the rise in bank bond spreads, CDS premia on the major Australian banks have increased by around 20 basis points since their recent trough in December. While elevated, they remain significantly lower than those on US banks, in part reflecting the limited exposure Australian banks have to the US sub-prime market.

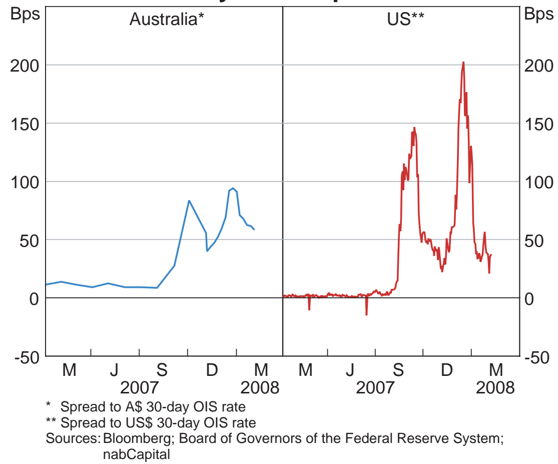
While on-balance sheet funding in the form of bank bills and bonds has been strong, securitised funding has been particularly affected by the financial turbulence. The latest issuance data available indicate that in November the value of asset-backed commercial paper (ABCP) outstanding stabilised after several months of falls (Graph 54). Between end July and end November, Australian conduits' ABCP fell 13 per cent, significantly less than the 31 per cent decline in US ABCP outstanding. In part, the somewhat better performance of the Australian market probably reflected the different purpose of ABCP conduits in Australia, which are predominantly used to fund loans; in the United States they are more frequently used

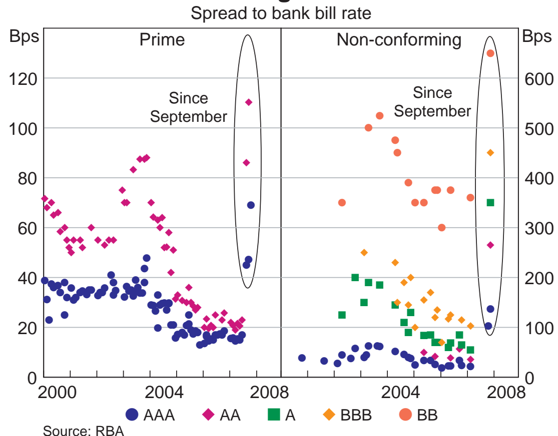
to fund securities. Liaison with local counterparties suggests that access to funding has improved a little but remains tight, with investors requiring more transparency regarding the collateral backing ABCP. Spreads remain at elevated levels and most paper continues to be issued at short maturities (Graph 55).

Issuance in the longer-term securitisation market has been very low and spreads on RMBS at issuance remain wide (Graph 56). Both the number of RMBS and the average size of each issue have been small – deal size has averaged $370 million since September, well below the average of $1.6 billion prior to August 2007. Those financial institutions which were highly reliant on securitised funding have significantly curtailed their lending.

Overall, banks, which supply about 85 per cent of intermediated finance, have been able to continue to expand their funding at a solid pace, with around average growth in foreign liabilities and in deposits from both households and non-financial corporates, and above-average growth in domestic capital market liabilities (Graph 57). Consequently, despite the turbulence, bank lending continued to grow at a brisk pace during the December quarter. Total credit grew by 16 per cent over 2007, its fastest pace since the late 1980s (Graph 58, Table 10).

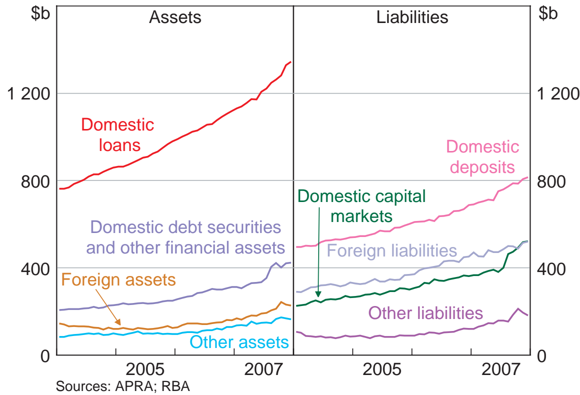


**Graph 57**

**Balance Sheets of Banks in Australia**

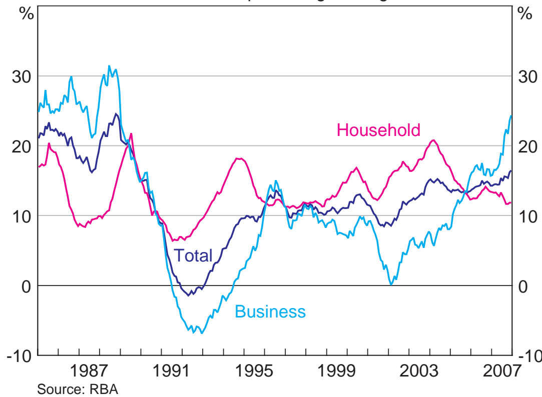



Sources: APRA; RBA

**Graph 58**

**Credit**

Year-ended percentage change




Source: RBA

## Household financing

At the time this *Statement* was finalised, the February increase in the cash rate had only just started to flow through to borrowing rates.

Over the past couple of months, intermediaries have raised interest rates on loans to households in response to the higher cost of funds. In January, the five largest banks increased their variable housing rates on prime full-doc loans by an average of 15 basis points (Graph 59). Most of the smaller banks and several credit unions and building societies also increased their variable housing rates by a similar amount. Mortgage originators have increased their variable housing rates only slightly in January, as their rates had risen by more than the cash rate in late 2007. By the end of January, the average variable housing rate across all lenders had risen by around 40 basis points since the previous *Statement* to 8.06 per cent.

Interest rates on riskier housing loans have also continued to rise. The

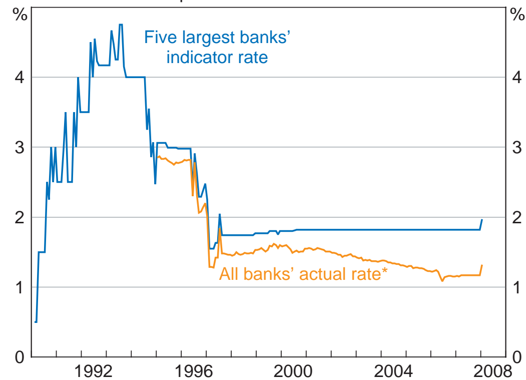
**Table 10: Financial Aggregates**

Average monthly growth, per cent

| | March quarter 2007 | June quarter 2007 | September quarter 2007 | December quarter 2007 |
|---|---|---|---|---|
| Total credit | 1.2 | 1.4 | 1.2 | 1.3 |
| Household | 1.0 | 1.2 | 0.7 | 0.9 |
| – Owner-occupier housing | 1.0 | 1.1 | 0.8 | 0.9 |
| – Investor housing | 0.9 | 1.0 | 0.7 | 0.7 |
| – Personal | 1.0 | 2.2 | 0.0 | 1.0 |
| Business | 1.6 | 1.8 | 2.1 | 1.9 |
| Broad money | 1.2 | 1.5 | 1.0 | 2.2 |

Source: RBA

average variable rate on prime low-doc loans (7 per cent of outstanding housing loans) rose by 36 basis points between the last *Statement* and the end of January (Table 11). Interest rates on non-conforming loans (1 per cent of outstanding housing loans) rose by 56 basis points, and, as noted above, institutions in this market have slowed their lending volumes in response to the market turbulence.



* Actual rate paid on new loans; based on securitised loans data
Sources: Perpetual; RBA

The five largest banks' average 3-year fixed rate on prime full-doc housing loans is currently 8.47 per cent, 60 basis points higher than at the time of the last *Statement* (Graph 60). Smaller banks' and mortgage originators' 3-year fixed rates have increased by about 50 basis points. Despite these increases, the share of owner-occupier loans approved at fixed rates continues to rise, reaching 24 per cent in November, well above its decade average of 12 per cent.

With fixed and variable rates having risen sharply over the past year, we estimate that by the end of January the average interest rate on all outstanding household loans had risen to 8.5 per cent, 30 basis points above the post-1993 average and around 200 basis points above the

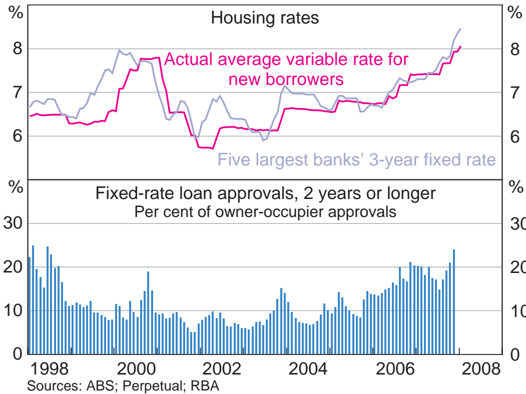
**Table 11: Intermediaries' Variable Household Lending Rates**
Per cent

| | Level as at | Change since: | |
|---|---|---|---|
| | 31 Jan 2008 | End Oct 2007 | End Jul 2007 |
| Cash rate | 6.75 | 0.25 | 0.50 |
| **Housing loans** | | | |
| Prime full-doc | | | |
| Banks | 8.07 | 0.40 | 0.65 |
| Credit unions and building societies | 7.89 | 0.34 | 0.59 |
| Mortgage originators | 8.07 | 0.34 | 0.69 |
| Prime low-doc | | | |
| Banks | 8.39 | 0.36 | 0.71 |
| Mortgage originators | 8.53 | 0.36 | 0.78 |
| Non-conforming | 10.59 | 0.56 | 1.51 |
| **Personal loans** | | | |
| Margin loans | 9.66 | 0.33 | 0.69 |
| Standard credit cards | 18.57 | 0.39 | 0.78 |
| Low-rate credit cards | 11.76 | 0.41 | 0.60 |
| Unsecured term loans | 13.89 | 0.46 | 1.28 |

Sources: Cannex; Perpetual; RBA

## Graph 60

### Housing Rates and Loan Type

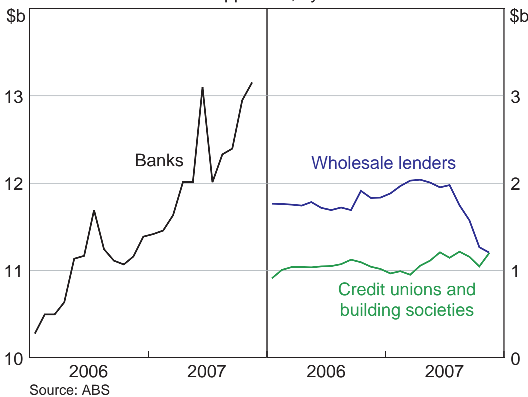



Sources: ABS; Perpetual; RBA

## Graph 61

### Value of Owner-occupier Loan Approvals

Gross approvals, by lender




Source: ABS

low in 2002. Reflecting this increase in borrowing costs, housing credit growth has slowed to 11.6 per cent over the year to December, around the slowest pace in almost a decade. The value of home loan approvals has also slowed. The value of owner-occupier housing loans approved by mortgage originators – which are heavily reliant on capital market funding – fell by almost 40 per cent over the four months to November. However, the banks appear to have picked up most of this business (Graph 61).

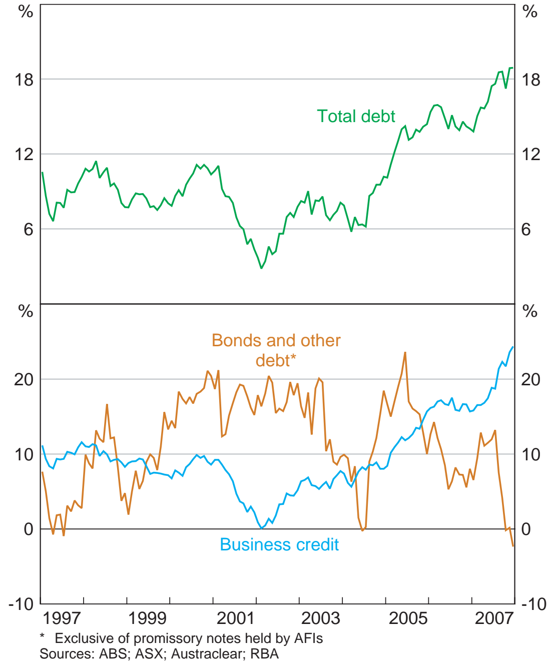
Interest rates on personal loans have also risen over recent months. Between the last *Statement* and the end of January, average variable interest rates on margin loans, unsecured personal loans and credit cards have increased by between 30 and 45 basis points. Nevertheless, personal credit grew by 13.1 per cent over 2007, around the average pace of growth over the past decade. A significant contribution to this growth came from margin lending, which grew by 40 per cent, as investors continued to borrow to buy equities, despite sharp equity market corrections in August and in December. The number of margin calls per day per 1 000 clients averaged 0.9 in the second half of 2007. This was roughly double its average over the past three years, but was still low by historical standards, largely due to borrowers' low average gearing levels. The sharp fall in the Australian share market in January saw a significant increase in margin calls.

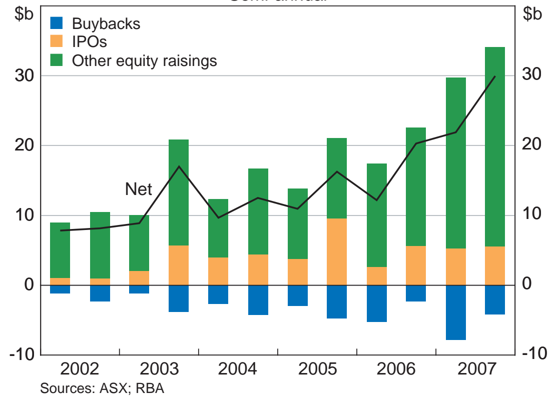
## Business financing

There has been a marked change in the composition of business financing as a result of the financial market turmoil. Corporate debt issuance was almost non-existent in the second half of 2007, with businesses increasingly turning to the banking sector for funds. Total business debt increased by 19 per cent over 2007, the fastest growth since the late 1980s (Graph 62). Equity raisings have not been significantly affected by the credit market volatility. Net equity raisings totalled $30 billion in the second half of 2007, up from $22 billion in the first half (Graph 63).

While this partly reflected very strong raisings in July, activity for the rest of the period was around average levels.

Business credit growth was broad-based across borrowers over 2007. Strong growth was recorded for lending to both corporations and unincorporated entities, although lending to corporations (which makes up around 60 per cent of total business credit) has grown particularly rapidly. Consistent with this, syndicated lending is estimated to have increased by about 45 per cent over 2007. Syndicated loans have been a particularly attractive source of finance for large corporates compared with capital market raisings over the past six months as they are quicker to arrange, offer greater certainty of pricing, and are negotiated privately rather than in public markets. These loans have been mainly used to fund merger and acquisition (M&A) activity, which remained strong in the second half of 2007 despite the dislocation in securities markets. There has also been a pick-up in lending for general corporate purposes and capital expenditure.




The rapid growth in business credit has occurred notwithstanding an increase in borrowing rates, as businesses have continued to experience significant pass-through of the increase in banks' wholesale funding costs. Around 45 per cent of large business loans (those greater than $2 million) are directly priced off bank bills, which remain at elevated levels. The four largest banks have increased their large and small business variable indicator rates by an average of 50 basis points between the last *Statement* and the end of January (Table 12). Small business 3-year fixed rates have risen by 25 basis points. We estimate that the average interest rate on all outstanding business loans was around 8.0 per cent at the end of January,

**Table 12: Intermediaries' Variable Business Lending Rates**
Per cent

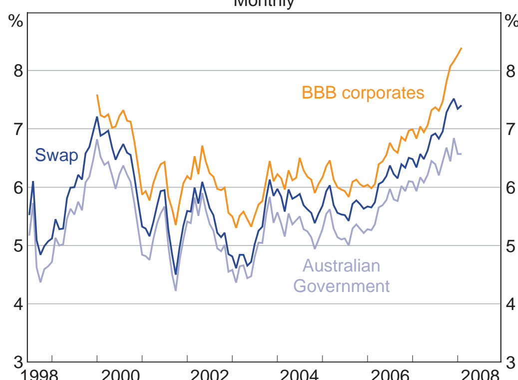
| | Level as at | Change since: | |
|---|---|---|---|
| | 31 Jan 2008 | End Oct 2007 | End Jul 2007 |
| Cash rate | 6.75 | 0.25 | 0.50 |
| **Small business** | | | |
| Term loans | | | |
| Residentially secured | 9.07 | 0.50 | 0.77 |
| Other security | 9.67 | 0.50 | 0.78 |
| Overdraft | | | |
| Residentially secured | 9.79 | 0.57 | 0.85 |
| Other security | 10.69 | 0.57 | 0.85 |
| Average actual rate(a) | 9.31 | 0.50 | 0.73 |
| **Large business** | | | |
| Average actual rate(a) | 7.64 | 0.42 | 0.73 |

(a) RBA estimate
Sources: APRA; Cannex; RBA

**Graph 64**

**Australian Corporate Bond Yields***

Monthly




* Yields on bonds issued by the Australian Government and swap rates are 3-year maturities. Corporate bond yields are a weighted average of bonds with remaining maturities of 1 to 5 years.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

25 basis points above the post-1993 average and about 185 basis points higher than the low in 2002.

Yields on corporate bonds have also moved higher (Graph 64). Perceptions of higher corporate credit risk have also intensified in CDS premia. CDS premia on A-rated and BBB-rated corporates increased 65 and 80 basis points respectively since end October. This has brought premia back to around levels prevailing in late 2002.

There has been little impact on outstandings of insured corporate bonds – or credit-wrapped bonds – from the downgrade of several insurers. Spreads on these bonds have increased by around 15 basis points, similar to other AAA bonds, and, at this stage, only a few Australian credit-wrapped bonds have been downgraded from AAA in line with the insurers' lower rating. Insured bonds currently make up about 7 per cent of the domestic non-government bond market.

# Price and Wage Developments

## Recent developments in inflation

The CPI data for the December quarter confirmed that inflation pressures have increased over the past year. CPI inflation increased to 3.0 per cent over the year to the December quarter. Based on a range of measures, underlying inflation appears to have increased to around 1 per cent in the December quarter, and 3½ per cent over the past year (Table 13, Graph 65).

**Table 13: Measures of Consumer Prices**
Percentage change

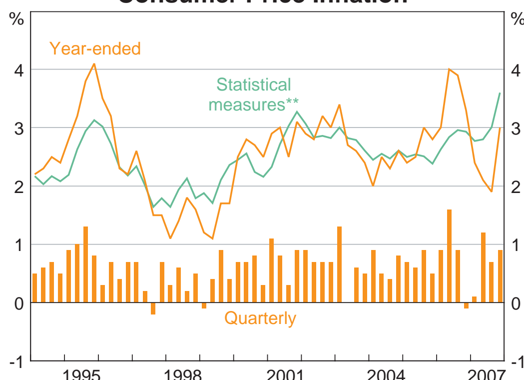
| | Quarterly | | Year-ended | |
|---|---|---|---|---|
| | September quarter 2007 | December quarter 2007 | September quarter 2007 | December quarter 2007 |
| CPI | 0.7 | 0.9 | 1.9 | 3.0 |
| – Tradables | 0.2 | 0.3 | –0.3 | 1.4 |
| – Tradables (ex food and petrol) | 0.0 | 0.0 | 0.6 | 0.8 |
| – Non-tradables | 1.1 | 1.3 | 3.5 | 4.1 |
| *Underlying measures* | | | | |
| Weighted median | 1.0 | 1.1 | 3.1 | 3.8 |
| Trimmed mean | 0.9 | 1.0 | 2.9 | 3.4 |
| CPI ex volatile items[a] | 0.7 | 1.0 | 2.6 | 3.0 |

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

The 0.9 per cent outcome for headline inflation in the December quarter reflected broad strength across a range of items. Overall, around 70 per cent of items in the CPI (by expenditure weight) grew at an annualised rate of more than 2.5 per cent in the December quarter (Graph 66). There were particularly large increases in petrol prices, housing costs, and financial & insurance service costs, which were only partly offset by a sharp fall in fruit & vegetable prices.

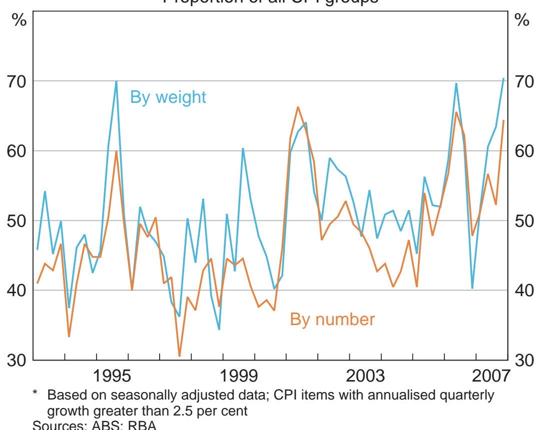
**Graph 65**

**Consumer Price Inflation***



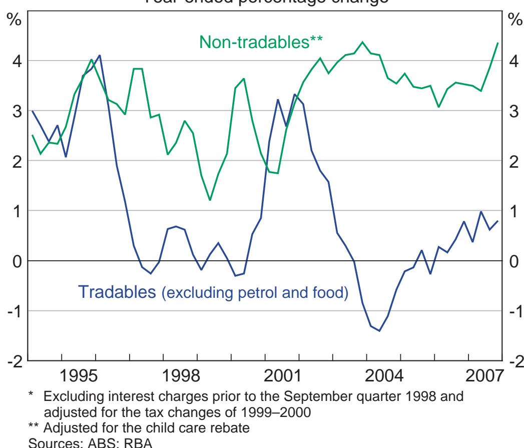

* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000
** Average of the trimmed mean and weighted median
Sources: ABS; RBA

Graph 66
CPI Items Rising Faster than 2.5 Per Cent*
Proportion of all CPI groups



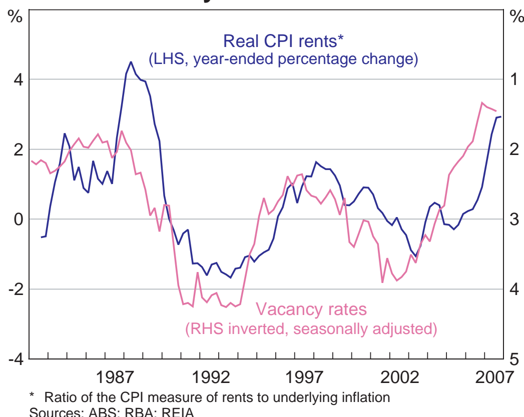

* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent
Sources: ABS; RBA

Graph 67
Tradables and Non-tradables Prices*
Year-ended percentage change




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

Graph 68
Vacancy Rates and Rents




* Ratio of the CPI measure of rents to underlying inflation
Sources: ABS; RBA; REIA

Non-tradables inflation increased to 1.3 per cent in the quarter, and to 4.4 per cent for the year (after adjusting for the change to the child care rebate in the September quarter), which is equal to the fastest annual rate since 1992 (Graph 67). This reflected strong increases in prices of a wide range of items, including housing, financial & insurance services, and various food items, such as milk and bread. Higher housing costs were the largest contributor to the increase in non-tradables prices both in the quarter and for the year as a whole, with house purchase costs, utilities and in particular rents growing strongly. Rents, which have a weight of around 5½ per cent in the CPI, rose by 1.6 per cent in the December quarter, to be 6.4 per cent higher over the year. This was the largest annual increase since early 1990. With rental vacancy rates around historical lows, it is likely that there will be continued strong growth in rents for some time (Graph 68).

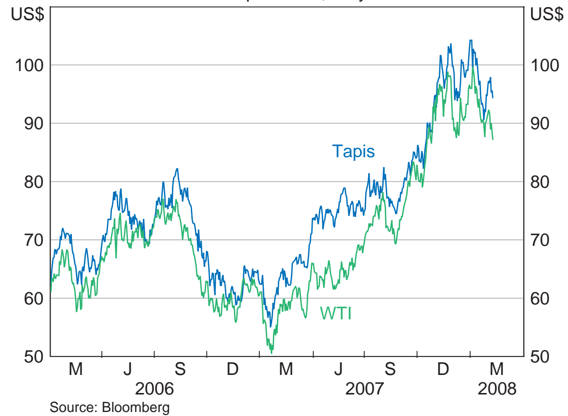
Retail petrol prices increased by 7 per cent in the December quarter and by 14 per cent over the year, largely driven by the recent sustained strength in world oil prices (Graph 69). Excluding the volatile fuel and food components, tradables prices were unchanged in the quarter and 0.8 per cent higher over the year (Graph 67). Tradables inflation is likely to have been restrained somewhat by the trend appreciation of the exchange rate over the past few years and by declines in the prices

of many manufactured goods. For example, motor vehicle prices have fallen by 0.5 per cent over the past year, while prices of audio, visual & computing equipment fell by 4 per cent in the quarter, to be 11 per cent lower over the past year.

Producer prices increased solidly in the December quarter. Final-stage prices increased by 0.6 per cent in the December quarter, to be 2.8 per cent higher over the year, with strong increases in domestic producer prices but falls in prices of imported items (Graph 70). Abstracting from movements in oil and fresh food prices, domestic producer prices rose by 4.0 per cent over the year, driven by price increases in the construction and property services sectors, and some manufactured food products. Producer prices for imports fell by around 6 per cent over the year, largely reflecting the appreciation of the exchange rate.

**Graph 69**

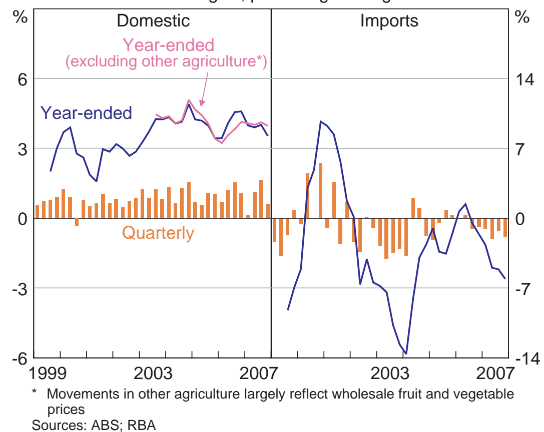
**Oil Prices**



Source: Bloomberg

**Graph 70**

**Producer Prices at Final Stage of Production**



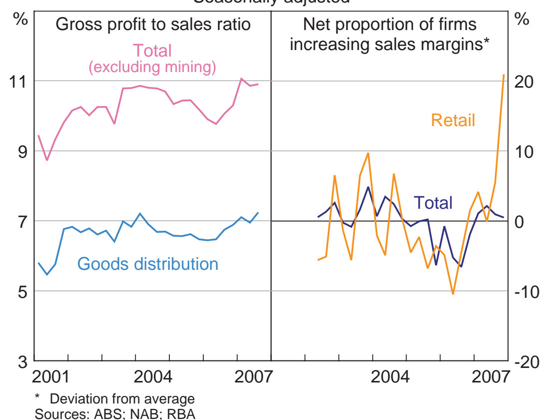
* Movements in other agriculture largely reflect wholesale fruit and vegetable prices

Sources: ABS; RBA

Overall, the data on domestic inflation indicate a pick-up in pressures over the past year, with underlying inflation in 2007 running noticeably higher than expected by the Bank and other forecasters a year ago. A number of factors appear to have contributed, with the appreciation of the exchange rate over 2007 being the only significant offsetting factor. Most notably, the growth in the domestic economy has been stronger than expected. Whereas non-farm growth had been expected to be around 3¼ per cent over 2007, the available data indicate growth of 4½ per cent over the year to the September quarter 2007; this is presumably partly related to the fact that growth in Australia's major trading partners in 2007 was stronger than expected. Associated with the strength in output, the labour market tightened further through 2007, with strong employment growth and a fall in the unemployment rate. Finally, materials cost pressures have been significant, with oil prices rising from around US$60 per barrel in early 2007 to more than US$90 per barrel at year-end and high prices for a range of other commodities, especially food.

Graph 71

Business Margins



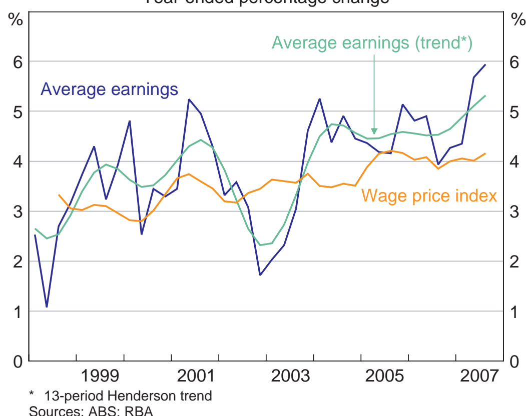

As discussed below, the strength of the domestic economy and the heightened pressures on capacity have resulted in strong growth in labour costs and a pick-up in surveyed inflation expectations, which are both likely to have contributed to the pick-up in underlying inflation. In addition, it is likely that the strength of demand has allowed some growth in business margins. Although they are difficult to measure, estimates based on ABS profits data suggest that margins in the goods distribution sector (retail and wholesale trade, plus transport) and the broader economy have recently been at fairly high levels (Graph 71). Data from the NAB survey on the net balance of respondents increasing margins also suggest some increase in margins in 2007 in both the retail sector and the broader economy, after a period when they had been declining.

## Labour costs

Recent data indicate strong growth in labour costs, in line with conditions in the labour market and reported shortages of suitable labour. The wage price index (WPI) grew by 1.0 per cent in the September quarter, to be 4.2 per cent higher over the year, which is around the level of recent years, but above the average for the period for which this series is available (Graph 72). The average annualised wage increase for federal enterprise bargaining agreements (EBAs) certified in the September quarter eased a little to 3.8 per cent (adjusted for changes in industry composition). While EBA outcomes have been volatile over the past two years or so, they have been broadly tracking growth in the WPI measure. Both EBAs and the WPI have narrower coverage than the measure of average earnings in the national accounts which includes wage and non-wage labour costs. This increased by 5.9 per cent over the year to the September quarter, the strongest increase since 1996. While the national accounts measure can be quite volatile, the underlying trend seems to have picked up in recent quarters. Overall these data suggest that there has been somewhat more pressure on wages and benefits

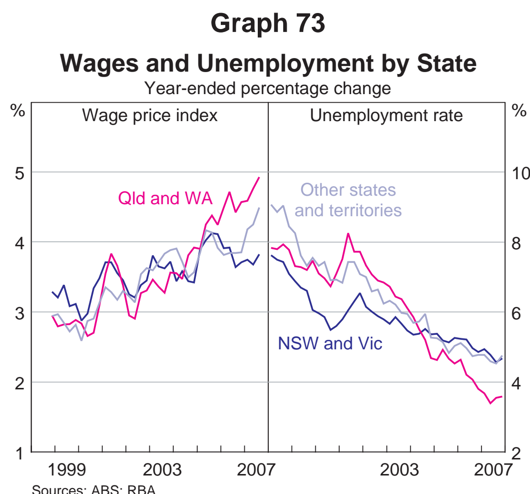
Graph 72

Wage Growth



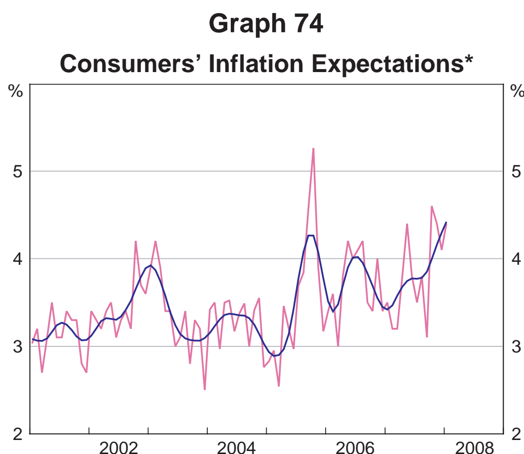
than indicated by the growth of the wage price index, and that growth in labour costs has been running at a higher level than is consistent with inflation remaining near the centre of the target range.

While economy-wide WPI wages growth has been relatively contained over recent years, state-level outcomes have been quite diverse. Over the past two years, wages growth was strongest in the resource-rich states of Queensland and Western Australia, where labour markets were also tightest; they have the lowest unemployment rates and business surveys and the Bank's liaison program indicate that skilled labour shortages are particularly prevalent in these states (Graph 73). The relatively high wages growth has been fairly broad-based across industries in these states. In contrast, wages growth has been lower across most industries in New South Wales and Victoria, moderating national WPI growth.




## Inflation expectations

Inflation expectations in the economy seem to have picked up in recent quarters to be relatively high. The Melbourne Institute survey of households reports that the median expectation for consumer price inflation over the year ahead has averaged 4.3 per cent over the three months to January, up from 3.8 per cent over the previous three months, and well above the average of 3.0 per cent over the inflation-targeting period (Graph 74). Medium-term inflation expectations implied by indexed bond yields are also around their highest levels in a number of years, although this may partly be because real yields are being compressed by the tight supply of indexed bonds in Australia. In addition, business surveys indicate that the proportion of businesses expecting to increase prices in the near term remains above long-run average levels.




Market economists surveyed by the Bank following the release of the December quarter CPI have increased

their inflation forecasts. The median expectation for headline inflation over the year to the December quarter 2008 rose to 3.0 per cent, with the expectation for the following year at 2.7 per cent (Table 14). These one- and two-year ahead forecasts are around the highest levels seen in the past decade. Union officials have also increased their inflation expectations.

**Table 14: Median Inflation Expectations**
Per cent

| | Year to December 2008 | | | Year to December 2009 |
|---|---|---|---|---|
| | August 2007 | November 2007 | February 2008 | February 2008 |
| Market economists[a] | 2.7 | 2.7 | 3.0 | 2.7 |
| Union officials[b] | 3.0 | 3.0 | 3.5 | 3.4 |

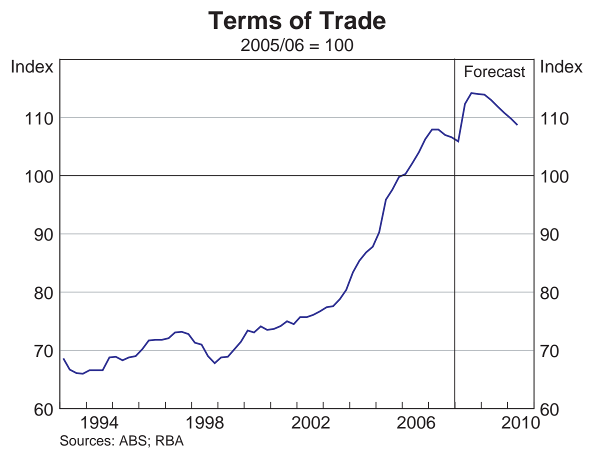
(a) RBA survey
(b) Workplace Research Centre

# Economic Outlook

## The international economy

While there is considerable uncertainty over the outlook for the world economy, our baseline assumption is that GDP growth in Australia's major trading partners will slow significantly in 2008, following four years of well-above-average growth. Growth in the G7 economies is forecast to be noticeably below its average rate (Graph 75). While growth in the emerging economies is also expected to moderate in 2008, it is forecast to be around average, with domestic demand growth staying strong despite a slowdown in export growth. Given that the emerging economies – particularly China, India and some of the smaller economies in east Asia – account for a large share of Australia's merchandise exports, total growth in our major trading partners is expected to be only slightly below its long-run average rate. Overall, GDP growth in our major trading partners is assumed to slow from around 5 per cent in 2007 to around 3¾–4 per cent in 2008 and 2009. These forecasts are a little lower than the recent IMF forecasts and more significantly below the January Consensus forecasts.

Despite the slowing in the world economy, Australia's terms of trade are forecast to rise in the near term (Graph 76). This outlook is largely driven by expected large increases in coal and iron ore contract prices in mid 2008, reflecting ongoing strength in commodity demand from Asian countries, particularly China. The effect of these increases is forecast to be partially offset by declines in base metals and rural export prices from their recent high levels. Together, these developments imply that the terms of trade will reach fresh highs



in mid 2008, before declining somewhat due to the slowing in global growth and as demand and supply respond to the current high commodity price levels.

## Domestic activity

The forecasts for the domestic economy are based on the technical assumption that the cash rate will remain at its current level of 7.0 per cent through to the end of the forecast period (June quarter 2010). The forecasts incorporate an effect from developments in credit markets over the past six months. Lending rates have increased and some modest further contractionary effect is expected from tighter lending standards and reduced access to capital markets. The forecasts assume that the exchange rate remains around its current level.

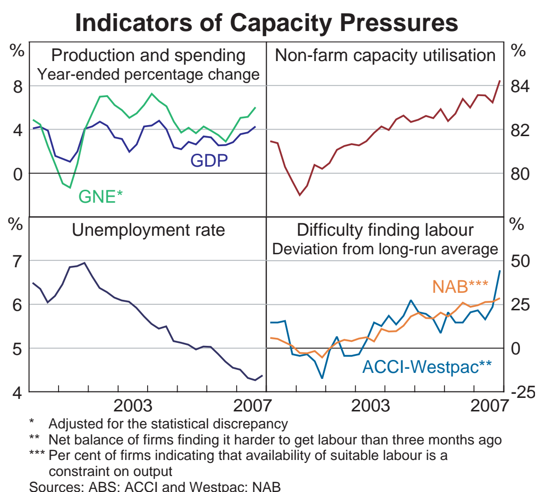
The large rise in the terms of trade in recent years and projected further increase in 2008 are expected to continue to support domestic activity over the forecast period. Nonetheless, the outlook has softened since the previous *Statement* as a result of the tightening in financial conditions and downward revisions to the forecasts of global growth. Growth in non-farm GDP is expected to slow from the strong rate of 4½ per cent seen over the year to the September quarter 2007, to around 2¾ per cent over 2008 and 3 per cent over 2009. With farm sector output expected to recover over the next year or so, total GDP growth is forecast to be stronger than non-farm growth over 2008, at around 3¼ per cent. Given the recent and projected strong growth in the capital stock, these rates of output growth imply some easing in capacity pressures in the economy. Excluding growth in production in the mining and farm sectors, where outcomes are predominantly driven by changes in supply, average annual output growth over the forecast period is expected to be around 2½–2¾ per cent.

The slowing in growth is expected to be spread over most of the major expenditure components of GDP. Announced tax cuts over coming years and the tight labour market should continue to support household income and consumption growth, although higher interest rates, lower confidence and negative wealth effects from recent falls in equity markets are forecast to weigh on consumer spending. Dwelling investment is expected to recover gradually in response to strong demand, as reflected in rising rents and house prices. Nevertheless, the tightening of credit market conditions is likely to restrain the recovery in that sector. Business investment growth is expected to slow, although the forecasts imply that business investment will remain at a high level as a share of output, which would ensure strong growth in the capital stock and help ease capacity pressures in the economy. Public demand growth is also projected to moderate somewhat from the relatively strong pace of recent years. Exports are expected to grow solidly, largely due to a pick-up in resource exports, although growth in export volumes in the near term will be restricted by the fall in rural production due to the drought.

Employment growth is expected to slow from its recent strong pace, reflecting the forecast slowing in output growth and the relatively tight conditions – the low rate of unemployment and high participation rate – on the supply side of the labour market. Overall, employment is forecast to grow by a little under 1½ per cent in year-ended terms over the forecast period, a little below the growth rate of the working-age population. The unemployment rate is forecast to increase modestly.

## Inflation

The inflation outlook is affected by opposing forces. The strong growth in demand, output and employment in recent years has resulted in a reduction of spare capacity in the business sector and the labour market (Graph 77). This has contributed to a pick-up in cost pressures and pricing power, with a rise in underlying inflation to around 3½ per cent over the past year. However, the worsening of the global outlook and the turmoil in financial markets are expected to result in some moderation of domestic growth. The forecasts described below represent the most likely central path reflecting both these effects.




The inflation forecasts have been revised upwards following the high December quarter outcome. Underlying inflation is forecast to be around 3½ per cent over the year to the December quarter 2008 (Table 15). The forecast of a continuing high level of underlying inflation reflects the expectation that pressures on capacity will remain for some time. Indeed, in the near term, it is likely that the year-ended rates of underlying and headline inflation will rise somewhat from current levels, reflecting the succession of large quarterly increases in the three latest quarters.

Underlying inflation is expected to fall gradually in 2009 and beyond, to around 3 per cent at the end of the forecast period in mid 2010, with CPI inflation forecast to follow a similar pattern. This reflects the forecast moderation in demand growth and a gradual easing in capacity pressures which are expected to reduce the pricing power of businesses and alleviate wage pressures. Over the next year, the recent pattern of subdued tradables inflation and very strong non-tradables inflation is forecast to continue. However, further out in the forecast period,

**Table 15: Output and Inflation Forecasts[(a)]**

Percentage change over year to quarter shown

| | Sep 2007 | Dec 2007 | June 2008 | Dec 2008 | June 2009 | Dec 2009 | June 2010 |
|---|---|---|---|---|---|---|---|
| GDP | 4.3 | 3½ | 3¼ | 3¼ | 3 | 3 | 3 |
| Non-farm GDP | 4.5 | 3¾ | 2¾ | 2¾ | 2¾ | 3 | 3 |
| Consumer price index | 1.9 | 3.0 | 3½ | 3½ | 3¼ | 3¼ | 3 |
| Underlying inflation | 3.0 | 3.6 | 3¾ | 3½ | 3¼ | 3¼ | 3 |

(a) Actual GDP data to September 2007 and actual inflation data to December 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A$ at US$0.89, TWI at 69, cash rate at 7.0 per cent, and WTI crude oil price at US$86 per barrel and Tapis crude oil price at US$90 per barrel.

Sources: ABS; RBA

the dampening impact of the appreciation of the exchange rate can be expected to wane, and tradables inflation could be expected to contribute a little more to overall inflation. Hence the forecast slowing in overall inflation will require a significant slowing in non-tradables inflation, which will depend on a noticeable easing of capacity pressures in the domestic economy.

Risks to these forecasts can be identified in both directions. A further deterioration in the outlook for global growth represents the main source of downside risk to the forecasts for domestic activity. In particular, if the weakness in the developed world were to lead to a more marked slowing in China and the other developing Asian economies than currently assumed, it is likely that the outlook for the Australian economy and commodity markets would deteriorate significantly. This would be expected to lead to some easing in growth of domestic incomes, spending and activity, and hence some further moderation in inflation over time. In addition, there is also a risk that the current dislocations in capital markets could worsen and result in a significant reduction in credit to households and businesses, which could lead to a more considerable slowing in domestic growth.

There are also upside risks to the domestic growth and inflation forecasts. It is possible that the boost to the terms of trade over recent years will provide a larger ongoing stimulus to the domestic economy than has been assumed, and that domestic demand does not slow as much as forecast. If demand were to be stronger than expected, the forecast easing in the inflation rate would be unlikely to eventuate with the current policy settings. Most importantly, if it is not reversed reasonably quickly, the recent pick-up in inflation carries the risk of generating an upward drift in inflation expectations, which could feed back into wage- and price-setting behaviour. ✣