STATEMENT ON MONETARY POLICY

7 AUGUST 2009

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Statement on Monetary Policy Enquiries

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STATEMENT ON MONETARY POLICY

The global economy is stabilising after contracting sharply in the December and March quarters. Over recent months, the value of international trade and global industrial production have both recorded modest gains after earlier large declines, and the extreme risk aversion seen earlier in the year has receded somewhat. Reflecting this, forecasts for world growth are being revised up for the first time in more than a year.

The pick-up in economic conditions is most evident in China, where growth has been boosted by a large fiscal stimulus and increased bank lending. Elsewhere in Asia, output has retraced part of the earlier sharp falls, with a number of countries benefiting from the stronger growth in China, their own fiscal and monetary stimulus, and the absence of significant problems in their financial systems. There are fewer signs of recovery in the advanced economies, although the rate at which output is contracting has slowed noticeably. In the United States, in particular, there is tentative evidence that the economy is reaching a turning point, with the housing market showing signs of stabilisation.

This improvement in the global economy has been reflected in financial markets. Equity prices are up considerably from their lows in March when risk aversion was at its peak, and credit markets have continued to improve, with many spreads back to the levels prevailing before the failure of Lehman Brothers last year. There has also been a marked pick-up in equity and debt issuance, and banks are relying less on government guarantees to raise funding.

These are encouraging developments and they have lessened the downside risks to the world economy that were very real in late 2008 and early this year. Despite this improvement, significant headwinds remain. Credit conditions are still difficult in many countries and the effect of the global slowdown has yet to show up fully on many banks' balance sheets. More unexpected bad news in the financial sector could again have an unsettling effect on confidence. In addition, many countries face balance-sheet issues not only in the financial sector, but also in the public sector, with the ratio of public debt to GDP forecast to rise rapidly over the next few years, to reach historically high levels. Reducing public-sector debt to more sustainable levels is likely to weigh on growth in many of the advanced economies for some time. In contrast, prospects for growth in the Asian region, which is becoming increasingly important to Australia, look more positive.

Domestically, the economy continues to exhibit considerable resilience in the face of what has been a very difficult international environment. The December and March quarter GDP data, in conjunction with other information on the economy, suggest that output contracted only modestly around the turn of the year, compared with the very sharp contractions experienced in most other countries. More recently, the information that has become available suggests that demand and output have strengthened a little, with household consumption continuing to grow in the June quarter while investment has been weak.

A number of factors have contributed to this comparatively good performance of the Australian economy. One is the strong state of Australia's financial system. Another is the significant monetary stimulus arising from the 4¼ percentage point reduction in the cash rate since September last year, with the lower rates largely passed through to end-borrowers. A third factor has been the fiscal stimulus which, in particular, has provided a considerable lift to household disposable incomes over the past nine months. The depreciation of the exchange rate last year also provided a stimulus to domestic activity, although much of this has been unwound by the appreciation over recent months. Finally, the strong recovery in China, which has boosted commodity prices and demand for Australia's exports, has also been important. While most countries have recorded declines in export volumes of at least 10 per cent since September last year, Australia's exports are estimated to have recorded a small rise over this period.

Over the past few quarters, household consumption in Australia has been stronger than in a number of other countries, with disposable incomes boosted by government transfer and tax bonus payments. Households with a mortgage have also benefited from the large reduction in mortgage rates. Over the past few months, household wealth has also risen – boosted by higher housing and equity prices – unwinding a considerable part of the large decline that took place in 2008. Given these outcomes, consumer sentiment has recovered strongly from earlier declines, and concerns about unemployment, though still prominent, are lower than earlier in the year.

In the housing market, new construction looks to have again been weak in the June quarter, but the outlook for the second half of the year has improved. Lending approvals and information from liaison point to strong demand by first-home buyers since the start of the year, boosted by both low interest rates and the temporary increase in government grants. Housing prices in a broad range of markets have also shown renewed strength this year. Housing credit continues to be widely available, although there has been some tightening of lending standards. Unlike in many other countries, borrowing for housing continues to increase at a solid pace.

Business investment remains the main area of weakness in the economy, although the Bank's liaison and business surveys suggest that as conditions and confidence have improved, some firms are reconsidering earlier decisions to postpone or cancel investment plans. Private non-residential construction is likely to remain weak for some time, with many property developers experiencing difficult funding conditions. In contrast, recently there has been a pick-up in spending on some types of plant and equipment, partly in response to temporary tax incentives. There has also been a marked shift in the composition of business funding, with many larger firms replacing debt with equity to reduce their leverage. With lending standards having also been tightened, especially for commercial property, business credit outstanding has declined over the past six months, although total business funding has been rising at a reasonable pace.

Reflecting the slowdown in the economy over the past year, the labour market has softened, although the rate at which unemployment is increasing has slowed recently with the unemployment rate currently at 5¾ per cent, up from around 4 per cent in early 2008. Importantly, flexibility in the labour market has allowed many firms and their workers to modify working conditions as an alternative to layoffs. Partly as a result, aggregate employment has shown less weakness over the past year than total hours worked in the economy.

Recent data on prices continue to suggest that price pressures in the economy are abating gradually. Over the year to the June quarter, the CPI increased by 1.5 per cent, the lowest annual increase for a decade, while underlying inflation was around 3¾ per cent. This unusually large difference between CPI and underlying inflation reflects significant falls in the price of fuel and the ABS estimate of the price of deposit & loan facilities facing the household sector. Importantly, recent quarterly outcomes for underlying inflation have been below the rates recorded for most of the previous year, and a further reduction is expected over the period ahead. Upstream price pressures are moderating and there are signs that wage growth is slowing in an environment of weaker demand for labour. Measures of inflation expectations also remain relatively low.

Overall, recent economic conditions in Australia have been stronger than expected at the time of the previous *Statement*. The central forecast is now for the economy to record modest growth of around ½ per cent over 2009, with growth gradually firming through 2010. Investment is expected to decline further over the year ahead, although the level of investment relative to GDP is likely to remain high compared with that in most other advanced economies and the Australian experience of recent decades. Consumption over the second half of the year is also likely to be weaker than in the recent past, as the effects of the recent boost to household income from the government transfer payments fade. In contrast, stronger dwelling activity and increased public sector infrastructure spending are expected to provide support to demand. Inflation is still expected to decline gradually, although the expected trough, at around 2 per cent, is higher than anticipated at the time of the previous *Statement*.

In response to the rapid change in the global environment that took place following the financial events of last September, the Board reduced the cash rate by 4¼ percentage points in six steps between September and April. Consistent with the Board's forward-looking approach to monetary policy, this rapid and large easing of monetary policy was made in anticipation of a very weak domestic economy and a decline in inflation from elevated levels. At its meetings since April, the Board has held the cash rate constant at 3 per cent. Over much of this period, it judged that the inflation outlook provided some scope for a further reduction in the cash rate to below 3 per cent if that were needed. However, the recent stronger-than-expected economic data and the general improvement in sentiment both in Australia and abroad have reduced the likelihood that a further reduction will be required.

Given the rapidly evolving international financial and economic conditions, the outlook for the Australian economy continues to be subject to considerable uncertainty, although the risks are more balanced than they have been for some time. With confidence globally still fragile, it remains possible that the outlook could again weaken. On the other hand, with the cash rate at an unusually low level and the global economy stabilising, movement towards a more normal setting of monetary policy could be expected at some point if further signs of a durable recovery emerge. For the time being though, the Board's judgment is that the present accommodative setting of monetary policy is appropriate given the economy's circumstances. Over the period ahead, the Board will continue to monitor economic and financial conditions and how they affect prospects for a sustained recovery in the domestic economy, consistent with achieving the inflation target.

International Economic Developments

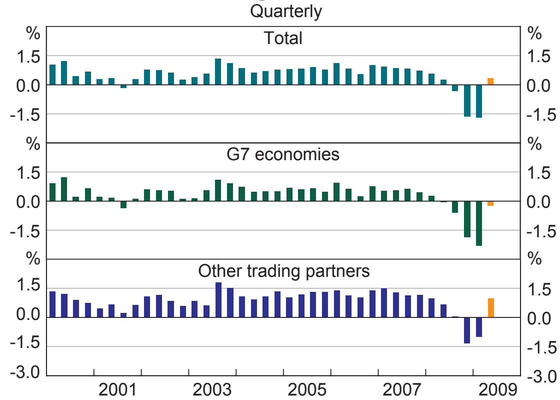
Conditions in the world economy appear to have stabilised in recent months, after deteriorating sharply in the December and March quarters. Available data suggest that output in Australia's trading partners increased slightly in the June quarter, after declining by over 3 per cent in the preceding half year (Graph 1). Global industrial production and international trade have recorded modest gains, after earlier very large declines, and there has been a general improvement in sentiment in financial markets, as well as among businesses and consumers (Graphs 2 and 3).

While these signs of stabilisation are encouraging, the large contraction in output over recent quarters has seen capacity utilisation fall to very low levels in many large advanced economies, with unemployment rising significantly, particularly in the United States and Spain (Graph 4). As a result, there has been a modest decline in underlying inflation in many countries, with further falls likely over the next year or so. In contrast, headline inflation has declined sharply in both the developed economies and China, largely due to the significant reductions in oil and food prices in the second half of 2008 (Graph 5). In a number of countries the price level has declined over the past year.

Looking across regions, there are some marked differences in recent economic performance. While conditions have generally improved in most countries, output in the United States and United Kingdom fell once again in the June quarter, and a further fall is likely to have occurred in the euro area. Conditions also remain weak in central and eastern Europe. In contrast, there has been a pronounced improvement in

Graph 1

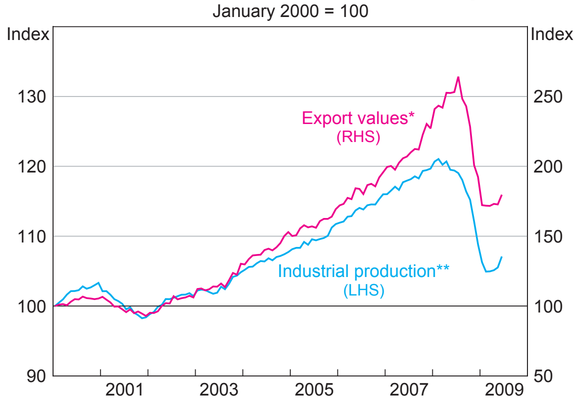
Australia's Trading Partner GDP Growth*



* Weighted using output shares at market exchange rates
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2

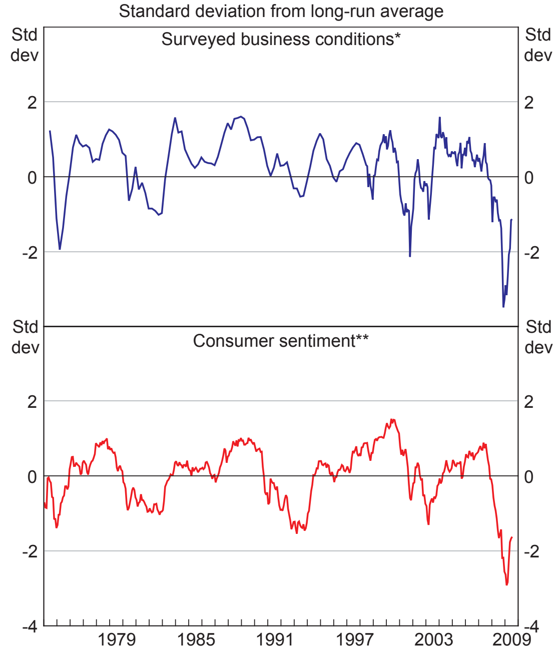
Global Industrial Production and Exports



* Economies that account for more than 80 per cent of world exports at market exchange rates; RBA estimate for June 2009
** Economies that account for 87 per cent of world output at market exchange rates; RBA estimate for June 2009
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 3

Selected Major Economies – Activity and Sentiment Indicators



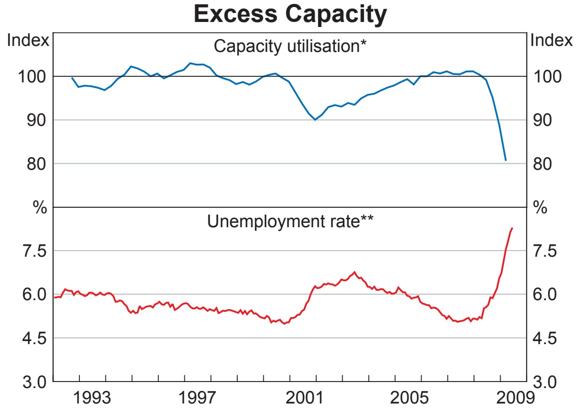
* Global composite purchasing managers index (PMI). Prior to 1998 average business conditions in the euro area, Japan, UK and US, weighted using output shares at market exchange rates

** Weighted average of euro area, Japan, UK and US using output shares at market exchange rates

Sources: IMF; JPMorgan Chase & Co. and Markit; RBA; Thomson Reuters

Graph 4

Excess Capacity



* Weighted average of Germany, Japan and US using output shares at market exchange rates, 2000 = 100

** Unemployment in Germany, Japan and US as percentage of labour force

Sources: CEIC; RBA; Thomson Reuters

economic conditions in east Asia and India, where activity has generally risen strongly. In part, this is a result of substantial policy stimulus in many of these economies, as well as the dynamics of the inventories cycle (see 'Box A: Inventories and the Business Cycle').

Among east Asian economies, the rebound has been most marked in China. RBA staff estimates suggest that after quarterly growth slowed to around ½ per cent in the December quarter, it picked up to around 1½ per cent in the March quarter, and then accelerated to over 4 per cent in the June quarter (Graph 6 and 'Box B: Some Aspects of China's Recent Growth'). This sharp turnaround largely reflects the rapid impact of a major fiscal package announced in November together with a substantial easing of monetary conditions, in contrast to the restrictive conditions seen in early 2008. Measures implemented have included: increased public investment in infrastructure and reconstruction following the earthquake in the Sichuan province; incentives for households to purchase housing, automobiles and a range of other durable goods (especially in rural areas); and the easing of various credit controls, together with directives to banks to substantially increase their lending. Banks' reserve requirement ratios have also been reduced and lending rates have been lowered significantly.

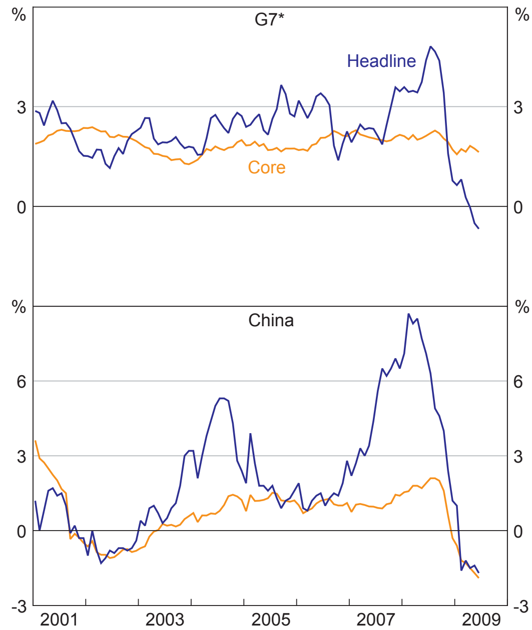
In response to these developments, credit growth in China has increased sharply, to an annualised rate of around 45 per cent over the six months to June (Graph 7). In addition, fixed-asset investment has risen by just over 30 per cent in the seven months since November, and demand for dwellings has grown strongly. Industrial production also picked up sharply over the four months to June, with particular strength in the production of automobiles – passenger car sales have risen by 75 per cent since December. The main area of continuing weakness is the export sector. While export volumes have stabilised in recent months, after falling by around one-quarter between October and February, demand for China's exports remains weak – especially in the euro area, Japan and the United States, which together account for around 60 per cent of China's final external demand.

Elsewhere in non-Japan Asia there has also been a strong rebound in activity in most countries over recent months, following earlier sharp contractions (Graph 8). In Korea, GDP rose by 2.3 per cent in the June quarter, after falling by 5 per cent in the December quarter and stabilising in the March quarter (Graph 9). In part, the rebound reflects the easing of both fiscal and monetary policy in late 2008, with the Bank of Korea cutting its policy rate from 5¼ per cent to 2 per cent between September and February, and the government introducing a series of front-loaded stimulus packages focused on infrastructure spending and direct support to the building industry. In Singapore, GDP grew by nearly 5 per cent in the June quarter after declining significantly in each of the previous four quarters.

Graph 5

Consumer Price Inflation

Year-ended



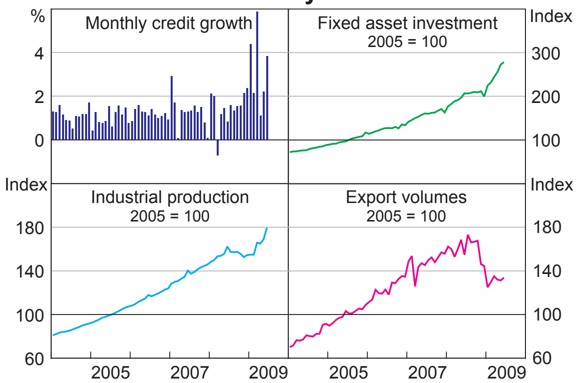
* Weighted by GDP at PPP exchange rates; excludes Japan
Sources: CEIC; RBA; Thomson Reuters

Graph 6

China – GDP Growth

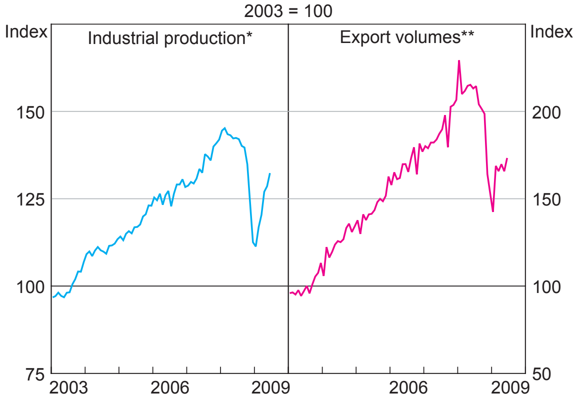
* RBA estimates
Sources: CEIC; RBA

Graph 7
China – Activity Indicators



Sources: CEIC; RBA

Graph 8
Other East Asia – Production and Exports
2003 = 100



* Excludes Hong Kong and Indonesia, RBA estimate for June 2009
** Excludes Philippines and Malaysia, RBA estimate for June 2009
Sources: CEIC; RBA

Graph 9
South Korea – GDP Growth

Source: CEIC

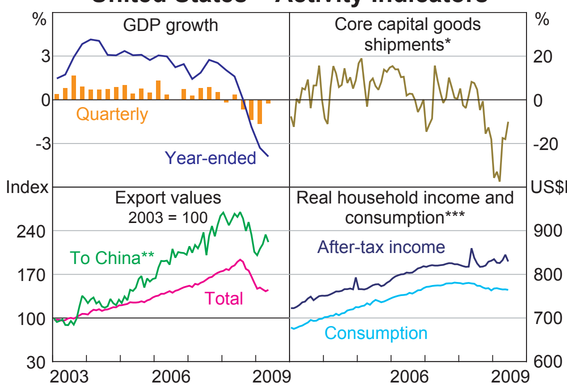
There are also signs that the Japanese economy has begun to grow, following the largest contraction among the major economies over the December and March quarters. Industrial production has increased by 17 per cent over recent months, after falling by one-third between September and February. Export volumes have also begun to increase, although most of the growth has been in exports to China and other east Asia. Consumer spending has shown signs of picking up, supported by an array of fiscal measures. Notwithstanding these more positive signs, capacity utilisation remains at very low levels, business investment is very weak, and the unemployment rate is still increasing.

As noted earlier, outside Asia the extent of improvement in economic conditions has generally been more muted. In the non-Japan G7 economies output is estimated to have recorded another decline in the June quarter, albeit a more modest fall than in the two previous quarters. Private consumption continues to be weak, reflecting large falls in household wealth and ongoing efforts by individuals to consolidate their balance sheets and increase their saving. Business investment has also fallen markedly as firms have responded to the combination of increased uncertainty, a rapid rise in spare capacity, and much tighter financial conditions. In a number of major countries, including Japan, investment has fallen by 10 per cent or more since late 2008, with the ratio of investment to GDP at or approaching multi-decade lows.

In the United States, economic conditions remain weak, although there are growing signs of stabilisation. Business surveys for both the manufacturing and non-manufacturing sectors of the economy have improved noticeably over recent months, with both now at levels historically associated with broadly flat activity. While GDP fell by a further 0.3 per cent in the June quarter, this was a significantly smaller contraction than the 1½ per cent seen in both the December and March quarters (Graph 10). Exports also appear to have bottomed, in large part due to a rebound in exports to China. More positively, stabilisation of the housing market – which has been seen as a necessary condition for a sustained recovery – looks more likely, with housing starts recording a small rise and some measures of house prices increasing.

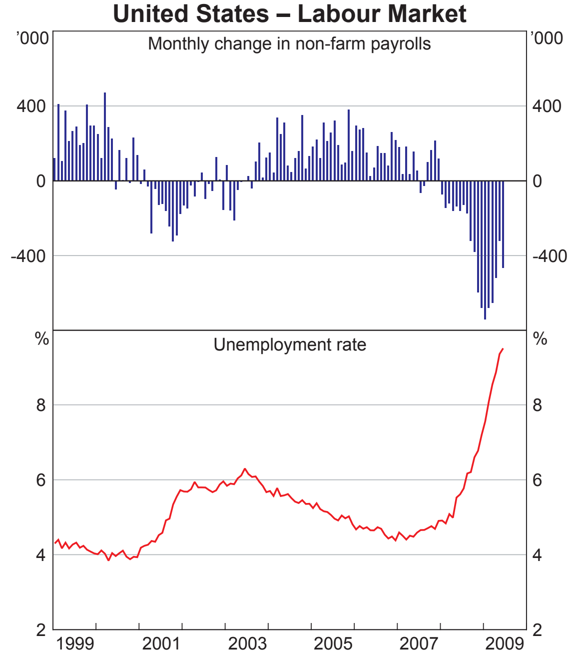
A significant factor continuing to weigh on the US economy is the weakness in consumption as households pay down debt. While car sales are being boosted by a car scrappage scheme, similar to those introduced in a number of European countries, spending on other goods and services is likely to remain subdued as a result of weak wage income growth. Although there are signs that the pace of job shedding has slowed, the unemployment rate increased to 9½ per cent in June, the highest level since the early 1980s (Graph 11). One factor helping to support domestic demand will be the sizeable fiscal stimulus measures currently in train, estimated to amount to around 4 percentage points of annual GDP, which will take effect over the 18 months to September 2010. To date, only a relatively small proportion of this discretionary easing has occurred, with the pace of spending expected

Graph 10
United States – Activity Indicators



* Three-month-ended annualised growth
** Merchandise exports only
*** 2005 prices, monthly
Sources: RBA; Thomson Reuters

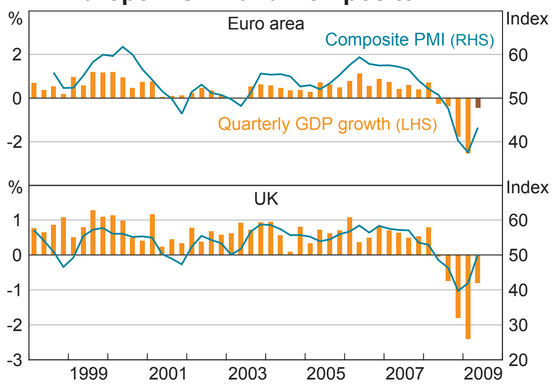
Graph 11
United States – Labour Market



Source: Thomson Reuters

Graph 12

Europe – GDP and Composite PMI



Sources: Consensus Economics; JPMorgan Chase & Co. and Markit; Thomson Reuters

to rise over the second half of the year and into 2010.

Economic activity in the euro area looks to be still contracting, although the pace of the decline has slowed, with the fall in output in the June quarter likely to have been much less than the 2½ per cent fall seen in the March quarter (Graph 12). Weakness remains relatively broad-based, with both retail sales volumes and business investment continuing to decline. While consumer confidence has risen a little over recent months, it remains at a low level, and the unemployment rate has increased to 9.4 per cent. The deterioration in the labour market is most pronounced in Ireland and Spain. In Germany, the unemployment rate has increased by only ¾ of a percentage point, despite very weak GDP outcomes, reflecting the impact of a government short-term work scheme. In the United Kingdom, GDP fell by 0.8 per cent in the June quarter, following a fall of 2½ per cent in the March quarter. The unemployment rate has increased significantly, but there are signs that house prices are stabilising.

Forecasts and policy responses

The IMF recently raised its outlook for world growth, reflecting the rebound in activity under way across Asia and the evidence of slowing in the pace of output decline in most developed economies. Similarly, OECD forecasts for the advanced economies have become less pessimistic. These modest upgrades represent a marked change from the preceding year, during which the growth projections of most forecasters were subject to frequent and substantial downward revision.

In its July update to the *World Economic Outlook*, the IMF forecasts a contraction in global GDP of 1.4 per cent in 2009 in year-average terms (with countries weighted by GDP at purchasing power parities, Table 1). Although March quarter outcomes were weaker than expected in a number of countries, the IMF has generally upgraded its expectations for activity in the second half of the year, with year-average growth revised up for a range of countries, most notably China and India. For 2010, the IMF raised its year-average growth forecast for the world economy by 0.6 percentage points to 2½ per cent. The RBA staff forecasts for global and trading partner growth, discussed in the 'Economic Outlook' chapter, are somewhat stronger than those of the IMF.

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

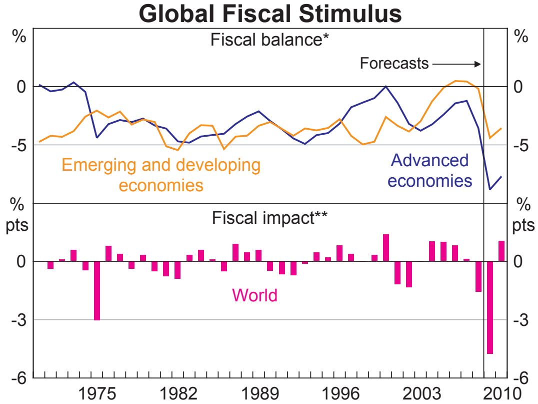
	2007	2008	2009	2010
			IMF forecasts[(d)]	
United States	2.1	0.4	–2.6	0.8
Euro area	2.7	0.8	–4.8	–0.3
Japan	2.3	–0.7	–6.0	1.7
China	13.0	9.0	7.5	8.5
Other east Asia[(b)]	5.8	2.7	–3.2	2.4
India	9.4	7.3	5.4	6.5
World	**5.2**	**3.1**	**–1.4**	**2.5**
Australia's trading partners[(c)]	5.6	2.7	–1.7	3.0

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

An important factor that has underpinned this improved outlook is the substantial easing of both fiscal and monetary policy that took place in many countries in late 2008 and early 2009, as well as efforts to strengthen the financial sector. As discussed further in the 'International and Foreign Exchange Markets' chapter, in many advanced economies official interest rates have been reduced to close to zero, and additional unconventional monetary and financial sector policies have also been implemented. The extent of fiscal easing in advanced economies, both through discretionary measures and from the effect of automatic stabilisers, is also the largest seen for many decades. There has also been a substantial easing of monetary and fiscal policy in a range of other economies (Graph 13).

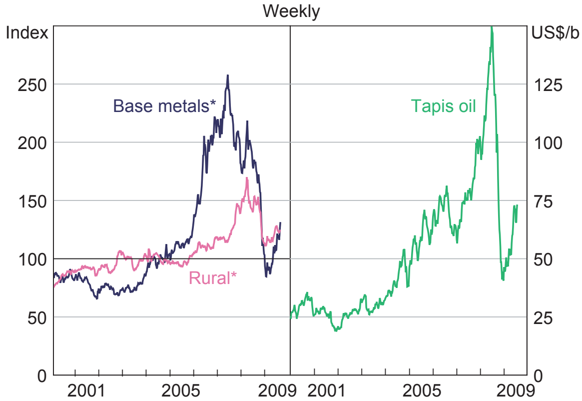
The very large global policy response has significantly reduced the likelihood that the large falls in global activity seen over the December and March quarters will be repeated. Looking ahead, however, the resulting build-up in public debt is likely to pose significant challenges for many of the G7 (and some other) economies over the years ahead, with policy-makers needing to balance the risks of withdrawing the fiscal and monetary stimulus too early, against those arising from concerns about medium-term fiscal sustainability and price stability.

Graph 13
Global Fiscal Stimulus



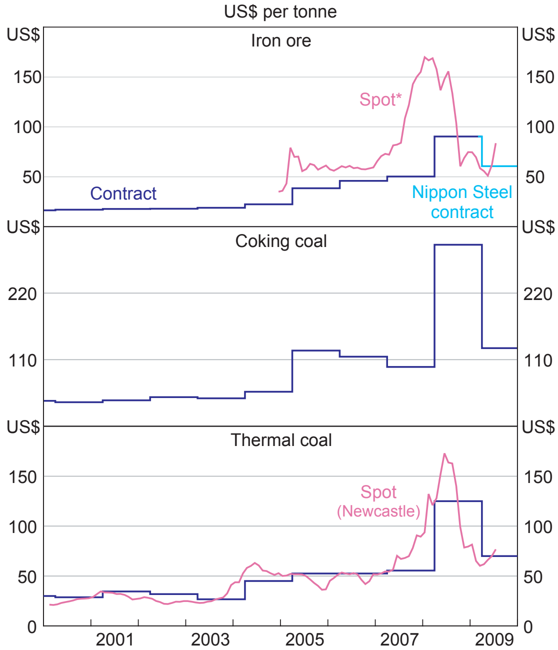
* Per cent of GDP
** Change in fiscal balance as percentage of GDP
Source: IMF

Graph 14
Commodity Prices
Weekly



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

Graph 15
Bulk Commodity Prices
US$ per tonne



* Calculated using the spot import price in China less the spot freight rate from Australia to China
Sources: ABARE; Bloomberg; RBA

Commodity prices

In line with improving economic sentiment, spot prices for both rural and resource commodities have strengthened since the previous *Statement*. Crude oil prices have risen by 30 per cent since April to US$70 per barrel, reflecting improved economic sentiment and a fall in US crude oil inventories (Graph 14). The RBA index of base metals prices has increased by 40 per cent over the past three months, with market participants attributing this to an improvement in the global economic outlook, Chinese demand and investment fund purchases. Nickel, in particular, has benefited from the rebound in Chinese stainless steel production, with prices rising by 65 per cent over the past three months.

Spot market prices for iron ore and coal have also increased over recent months on strong Chinese demand and tentative signs of a recovery in demand from other countries, with prices now above the level of the 2009/10 contracts settled between Japanese steel mills and Australian producers. Under those agreements the contract price for iron ore fines was reduced by 33 per cent (in US dollar terms, Graph 15), while the prices of premium forms of iron ore have seen larger reductions. Nonetheless, these agreements represent the second highest benchmark contract prices on record, with the average price 150 per cent higher than the average for the first half of the decade. Benchmark prices have not been agreed with major Chinese steel mills, which have sought larger reductions than those agreed to with Japanese and

Korean mills. As a result an increasing proportion of purchases are taking place on the spot market. With most of the anticipated adjustment in bulk commodity prices now complete, the RBA's index of commodity prices in July was 35 per cent below its September 2008 peak (in SDR terms), but 65 per cent above the average levels seen in the first half of this decade.

Box A: Inventories and the Business Cycle

Historically, changes to the levels of inventories held by firms have played a significant role in economic cycles. As an economy goes into a downturn, the full extent of the slowdown in demand is generally unexpected, so firms do not adjust their production sufficiently quickly and, as a result, accumulate higher-than-desired levels of inventories. Elevated inventory levels then mean that, for a time, production has to be cut by more than the reduction in demand. Once this adjustment has been completed, production can increase to the new level of demand, providing a short-term boost to the pace of recovery.

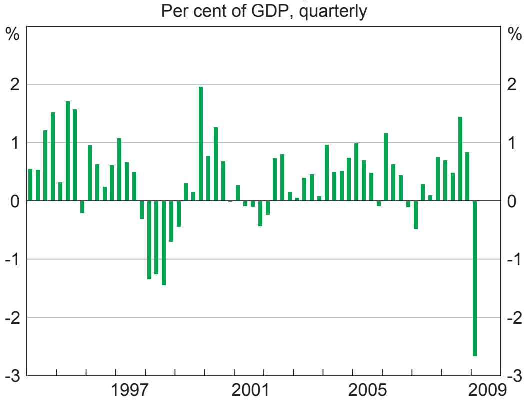
Not surprisingly, the current global slowdown has been accompanied by a significant inventory cycle in many parts of the world. This cycle, however, appears to differ from previous cycles in the greater-than-normal speed with which firms were able to observe the fall in global demand. This reflects both the rapid dissemination of information by the electronic media, especially about financial market developments, and the synchronised nature of the fall in demand. Advances in inventory control techniques have also played a role, allowing firms to respond more quickly than in previous cycles. Another factor shaping the current inventory cycle has been the difficulty some firms have faced in obtaining finance for working capital – leading them to reduce their inventories of inputs to production, as a precautionary measure to conserve cash – as well as trade credit and insurance.

The cuts in inventories have been particularly rapid in east Asia, where a significant proportion of industrial production is accounted for by high-value or discretionary goods for which demand has fallen especially sharply (Graph A1). Taking the region as a whole (excluding China and Japan), inventories had been rising modestly over the first half of 2008. Then, as global demand fell away rapidly through September and October, firms throughout the global production and distribution chain were faced with a significant increase in the stock of unsold goods. This quickly prompted large cuts in production, so that inventories were falling significantly by early 2009, with a decline equivalent to over 2½ percentage points of GDP in the March quarter. This decline was around twice as large as any of the quarterly falls during the Asian crisis, reflecting the compression

Graph A1

Other East Asia – Change in Inventories*

Per cent of GDP, quarterly



* Includes Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand

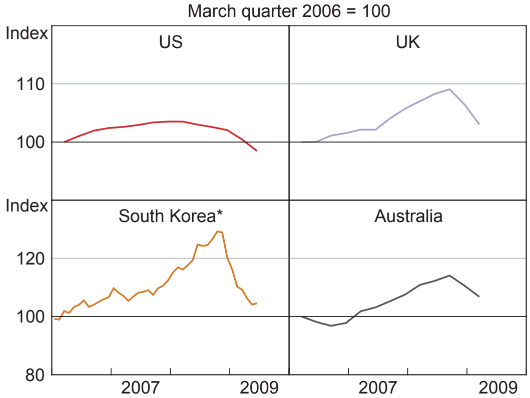
Sources: CEIC; RBA

of the period over which the demand shock has occurred. In South Korea, stocks subtracted around 3 percentage points from GDP growth in both the December and March quarters, and a further 1¾ percentage points in the June quarter (Graph A2). In China, there is also evidence of a substantial run-down in stocks of both raw materials and finished industrial products in the latter part of 2008 and early 2009.

Among industrial countries, the United Kingdom has experienced a particularly large inventory cycle, with stocks running up well into 2008 but then recording the largest declines (in real terms) in more than five decades in the December and March quarters. Stocks have also subtracted heavily from growth in GDP in France. In the United States, inventories have been declining for some time, with the level falling below that seen at the start of 2006. Despite this, the stocks-to-sales ratio has increased significantly in the industrial sector. Australia too has seen recent rapid falls in inventories, with stocks estimated to have subtracted 1.4 percentage points from GDP growth over the December and March quarters.

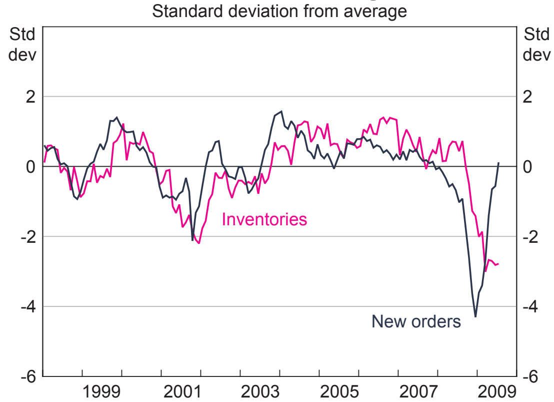
While the extent of inventory adjustment varies across countries, in aggregate, much of the detraction from growth due to global de-stocking seems now to have taken place, with inventories likely to make a positive contribution to growth in many countries over the next few quarters. Recent survey data for the manufacturing sector suggest that the pace of decline in stocks of inputs to production has generally stabilised, while the fall in new orders looks to be coming to an end (Graph A3). Corresponding data on manufacturers' stocks of finished goods for a range of countries also indicate a stabilisation or easing in the rate at which these are being run down. ✠

Graph A2
Level of Inventories
March quarter 2006 = 100



* Industrial inventories, monthly data
Sources: ABS; CEIC; RBA; Thomson Reuters

Graph A3
Global Manufacturing PMI
Standard deviation from average



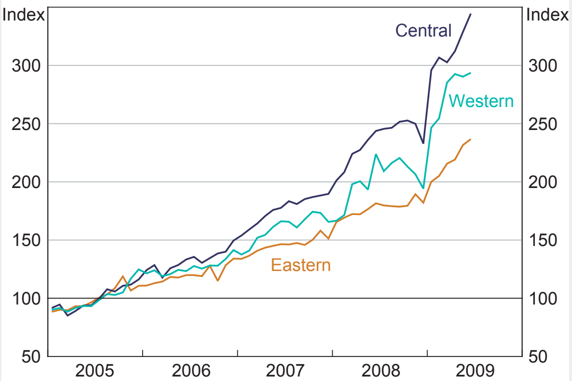
Sources: JPMorgan Chase & Co. and Markit; RBA

Box B: Some Aspects of China's Recent Growth

Graph B1

China – Regional Fixed Asset Investment*

2005 = 100



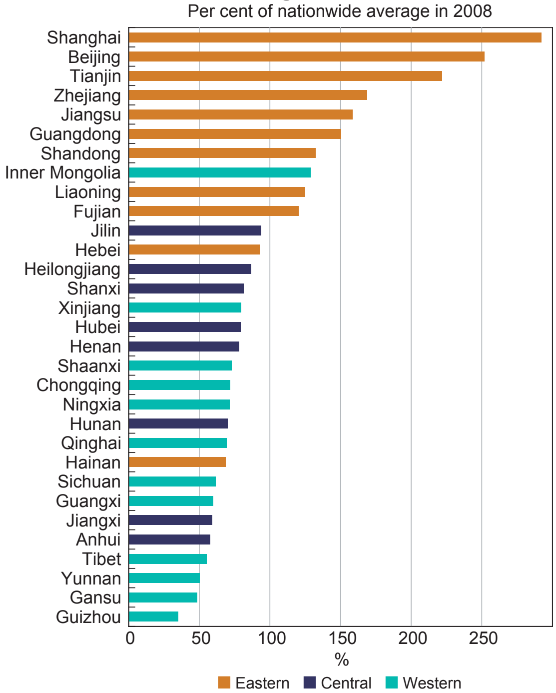
* RBA estimates

Sources: CEIC; RBA

Graph B2

China – Regional Income Levels

Per cent of nationwide average in 2008



Source: CEIC

After a sharp slowing in the second half of 2008, Chinese economic growth has rebounded strongly, underpinned by stimulatory fiscal and monetary measures. On the fiscal front, the stimulus has focused on infrastructure and investment spending, with fixed asset investment increasing by over 30 per cent since November. Investment has been particularly strong in the non-coastal provinces – partly reflecting heavy spending in Sichuan (which was severely damaged by a major earthquake in May 2008) – where incomes are significantly lower than average (Graphs B1 and B2).[1] The strong investment growth in these areas reflects efforts by the authorities to improve transportation and other infrastructure in the less-developed regions.

Industrial production has also rebounded strongly, and is now well above previous peaks. While the pick-up has been broad-based, those components specifically targeted by stimulus measures have recovered particularly strongly (Graph B3). The most striking example is automobile production, which has risen by around 75 per cent since December as sales surged following the halving of the sales tax on most automobiles. Steel and cement production have also rebounded strongly, consistent with the emphasis placed by the authorities on building

1 *The categories eastern, central and western are Chinese National Bureau of Statistics classifications. 'Eastern' broadly corresponds to coastal provinces, but excludes Guangxi, which touches the coast but is classified as western.*

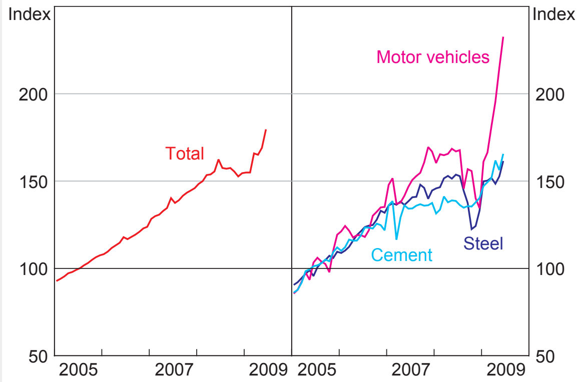
infrastructure and earthquake reconstruction spending.

Construction spending is also being boosted by a recovery in the housing market. In the first half of last year policy was actively restraining housing demand, with fears that the sector was overheating. These policies were subsequently reversed, with the authorities now encouraging activity in the sector. Credit restrictions on developers have been lessened and there has been a range of measures to boost housing demand. These include: an increase in the interest rate discount allowed for first-home buyers; a lowering of the downpayment required by most first-home buyers; and a cut in deed taxes on home sales and purchases. In addition, there have been various changes to business taxes on property sales by individuals. These measures have contributed to the very strong credit growth of recent months and the recovery of the housing market – both the number of home sales and housing prices have increased, with the recovery broadly based across the regions (Graph B4). The pick-up in Chinese growth, and its concentration in sectors involving a high demand for steel, have had a major impact on demand for Australia's commodity exports (see the 'Domestic Economic Conditions' chapter).

Graph B3

China – Industrial Production

2005 = 100

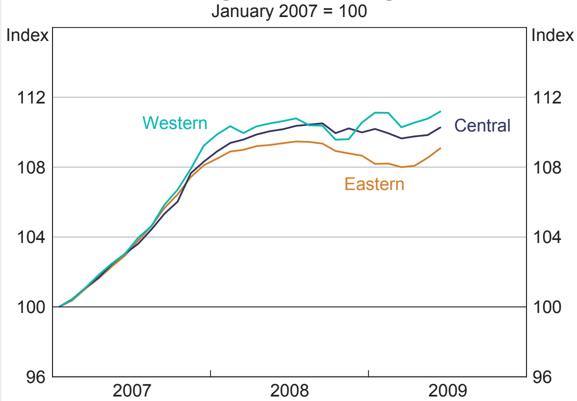


Sources: CEIC; RBA

Graph B4

China – Regional Housing Prices*

January 2007 = 100



* RBA estimates based on official data for year-ended growth in housing prices in 70 medium to large cities

Sources: Bloomberg; RBA

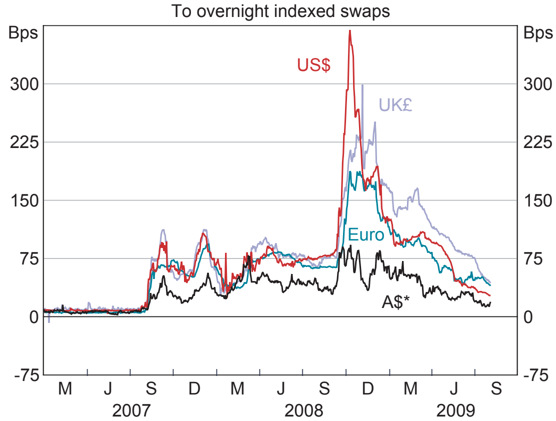
In the near term, the central authorities have considerable scope to continue to support aggregate demand through fiscal measures. While the central government deficit is projected to be between 3 and 5 per cent of GDP in 2009, central government debt is currently relatively low, at around 20 per cent of GDP. Over a longer period, the historical experience of other Asian economies is that at some point in the industrialisation phase the consumption share of GDP rises, with the investment share – currently over 40 per cent in China – falling back to more sustainable levels. In China, the government has recently taken some steps to encourage a move in this direction, including the announcement of a three-year target to establish a national basic health insurance plan. Over time, it is likely that further steps will be taken to increase the scale and scope of the social safety net and to encourage a shift towards stronger domestic consumption.

International and Foreign Exchange Markets

Credit markets

Conditions in global credit markets have continued to improve in recent months, as demonstrated by a further narrowing of spreads across most markets and a substantial increase in issuance. In money markets, spreads between LIBOR and the expected cash rate for the major currencies have narrowed considerably as counterparty concerns have abated. These spreads have fallen below levels prevailing before their sharp rise in September 2008 at the time of the Lehman Brothers default (Graph 16). However, the reduction in perceived bank counterparty risk has not yet resulted in a turnaround in cross-border bank lending, which was the component of international capital flows that contracted most sharply in 2008 (Box C).

Graph 16
3-month LIBOR Spreads
To overnight indexed swaps



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

Credit default swap (CDS) premia have also declined over recent months. In particular, premia for US financials declined substantially following the release of the US stress test results in May (see below), indicating that markets viewed the assessment as positive and the required capital raisings manageable. The gross notional amount of outstanding CDS has levelled out over 2009 after contracting sharply in the second half of 2008, in part because of efforts to reduce operational risks and capital charges through voluntary multilateral terminations. Since the beginning of 2009, there has also been some reduction in the net notional amount outstanding, which is a better measure of exposures to the underlying assets if there are no counterparty defaults.

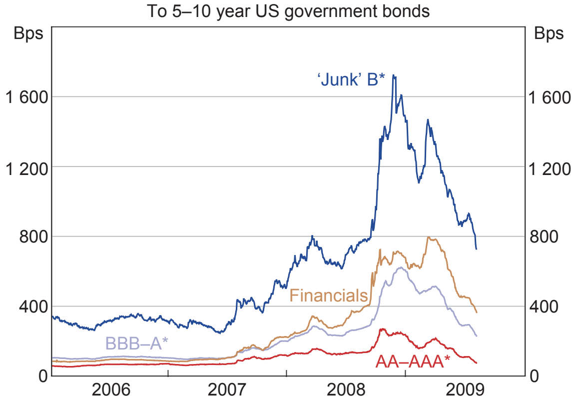
In the United States, spreads between yields on housing agency debt and US Treasuries have narrowed since the Fed announced its plans to purchase agency debt in November, to be lower than they were prior to the crisis (Graph 17). The issuance of mortgage-backed securities (MBS) has steadily increased over the year to date, although the vast majority of this has been issued by the housing agencies and purchased by the Fed (see below).

Longer-term US non-financial corporate bond spreads have narrowed substantially across the rating spectrum to be well below the peaks seen in the aftermath of the collapse of Lehman Brothers (Graph 18). Non-financial corporations have continued to issue substantial amounts

Graph 17
US Agency Debt Spreads
To US government bonds

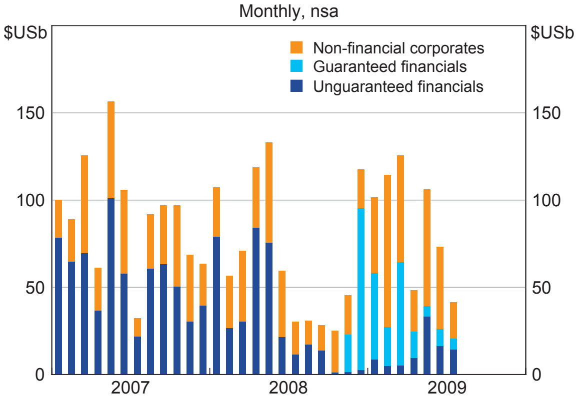
Source: Bloomberg

Graph 18
US Corporate Bond Spreads
To 5–10 year US government bonds



* Industrial corporates
Sources: Bloomberg; Merrill Lynch

Graph 19
US Bond Issuance
Monthly, nsa



Sources: RBA; Thomson Reuters

of debt in both the United States and Europe and the share of sub-investment grade issuance has risen.

Financial institutions have continued to issue bonds under their respective government-guarantee programs, although there has been much less issuance than in the first quarter. The share of European and Australian guaranteed bond issuance in the global total has increased as issuance under the US and UK programs has fallen significantly. This is particularly notable in the United States where, as discussed below, a demonstrated ability to issue unguaranteed debt is one of the preconditions for repaying Troubled Asset Relief Program (TARP) funds (Graph 19). Spreads between yields on government-guaranteed bonds and those on government securities of equivalent maturity have narrowed slightly in the United States, but have narrowed substantially in Europe and the United Kingdom. In a further sign of improving conditions, higher-rated unguaranteed bonds are being issued at spreads similar to those under the guaranteed programs, after fees are taken into account.

Central bank policy

Central banks in both developed and emerging economies have delivered a substantial easing in monetary policy over the past year by lowering policy rates (Table 2). In a number of developed economies, central banks have indicated that policy rates are effectively at their lower bound and have stated that they are expected to remain there for some time. In some cases, including the Federal Reserve,

Table 2: Policy Rates

	Current level Per cent	Most recent change	Change since start of easing phase Basis points
Canada	0.25	↓ Apr 09	↓ 425
Euro area	1.00	↓ May 09	↓ 325
Japan	0.10	↓ Dec 08	↓ 40
New Zealand	2.50	↓ Apr 09	↓ 575
Norway	1.25	↓ Jun 09	↓ 450
Sweden	0.25	↓ Jul 09	↓ 450
Switzerland	0.25	↓ Mar 09	↓ 250
United Kingdom	0.50	↓ Mar 09	↓ 525
United States	0.125	↓ Dec 08	↓ 513

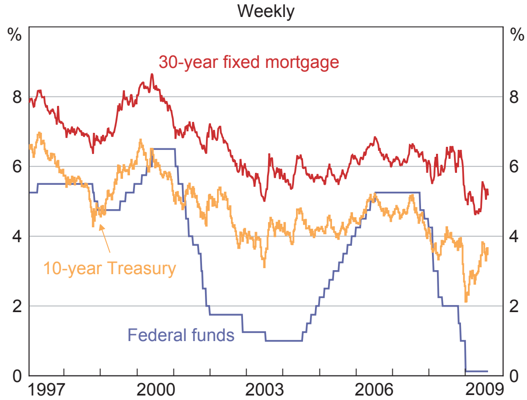
Sources: Bloomberg; Thomson Reuters; central banks

the Bank of Japan (BoJ), the Bank of England (BoE) and the Swiss National Bank (SNB), central banks have further eased their monetary stance by purchasing various financial assets and have expanded their balance sheets considerably. Notwithstanding the current very expansionary stance of policy, financial market pricing suggests that policy rates are not generally expected to begin increasing until at least early 2010.

In the United States, the Fed has eased monetary policy through outright purchases of US Treasuries, agency MBS and agency bonds. To date, the Fed has acquired over US$220 billion in US Treasuries, US$540 billion in agency MBS and US$100 billion in agency bonds, and is well on the way to achieving its targets of purchasing US$300 billion, US$1.25 trillion and US$200 billion of these assets, respectively, by the end of this year. These operations have resulted in mortgage rates being lower than would otherwise have been the case (Graph 20).

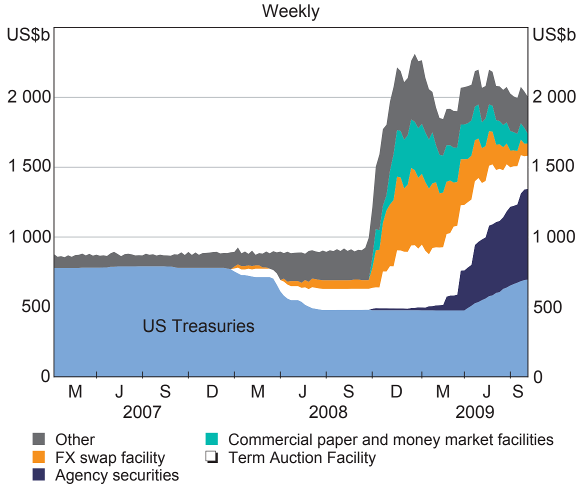
The ongoing improvement in credit market conditions has resulted in a gradual easing in the demand for funds through the Fed's various liquidity facilities such as the Term Auction Facility and the US dollar swap facility with other central banks. For example, the balance on the swap facility with the Reserve Bank of Australia has fallen to zero, from its peak of US$27 billion in November 2008. In addition, there has been a gradual unwinding of facilities aimed at improving the functioning of commercial paper markets and demand for funds through the Term Asset-backed

Graph 20
US Interest Rates
Weekly



Source: Bloomberg

Graph 21
Federal Reserve – Composition of Assets



Source: Board of Governors of the Federal Reserve System

Securities Loan Facility remains modest, despite an extension of eligible collateral to include commercial MBS and securities backed by insurance premium finance loans. As a result, the overall size of the Fed's balance sheet is little changed since the beginning of 2009 (Graph 21), with the increase in securities held outright being largely offset by the fall in the amount outstanding under the other facilities.

The European Central Bank (ECB) lowered its policy rate to 1 per cent at its May meeting, taking the cumulative reduction to 325 basis points since its easing phase began in October 2008. In June, the ECB conducted its first 12-month refinancing operation, providing all the funds demanded (€442 billion – the largest injection since the financial crisis began) at a fixed rate of 1 per cent. Following the settlement of this operation, the effective overnight rate in the euro area fell from around 1 per cent to around 0.4 per cent, where it has remained. The ECB also began outright purchases of euro-denominated covered bonds; it plans to purchase €60 billion of highly-rated covered bonds that are currently eligible for use as collateral in market operations by June 2010 through both primary and secondary markets. Spreads on covered bonds narrowed noticeably following the ECB's announcement and new issuance has resumed, having all but ceased since October.

The BoJ has continued its outright purchases of Japanese government bonds, commercial paper and corporate bonds as a means of easing monetary conditions. It has also purchased a small amount of stock in financial institutions and begun small-scale operations to provide subordinated loans to financial institutions in an effort to preserve their capital bases. The BoJ has also expanded its list of eligible collateral to include foreign currency-denominated sovereign bonds including US Treasuries, gilts and Bunds.

In an attempt to further ease strains in financial markets and boost nominal economic activity, the BoE increased its target for unsterilised asset purchases by £50 billion to £125 billion and achieved this higher target by the end of July. To date the majority of asset purchases have involved gilts, however, in late July the BoE announced that it would also acquire asset-backed commercial paper in both the primary and secondary markets as part of the broader £150 billion Asset Purchase Facility.

The SNB has continued to ease monetary conditions through its purchases of private sector bonds and foreign exchange, with the latter having the publicly stated intention of preventing an appreciation of the Swiss franc against the euro. Elsewhere in Europe, Sveriges Riksbank and the Central Bank of Norway lowered their policy rates by 25 basis points in July and June, respectively, taking the cumulative change in their policy rates since the easing phase began in October 2008 to 450 basis points. Sveriges Riksbank indicated that it expects its policy rate to remain at ¼ per cent until at least mid 2010. Similarly, the Reserve Bank of New Zealand and Bank of Canada have reiterated their commitment to keep policy rates around their current low levels until the second half of 2010.

Central banks in many emerging market economies have continued to lower their policy rates (Table 3). In recent months, the cumulative easing has been particularly large in Brazil, Chile, Mexico, Russia and Turkey, but a considerable amount of stimulus has also been delivered in other countries since they commenced their easing phases.

Table 3: Emerging Market Policy Rates

	Current level Per cent	Change since previous *Statement* Basis points	Change since start of easing phase Basis points
Brazil	8.75	↓ 150	↓ 500
Chile	0.50	↓ 125	↓ 775
China	5.31	0	↓ 216
India	4.75	0	↓ 425
Indonesia	6.50	↓ 75	↓ 300
Malaysia	2.00	0	↓ 150
Mexico	4.50	↓ 150	↓ 375
Poland	3.50	↓ 25	↓ 250
Russia	11.00	↓ 150	↓ 200
South Africa	7.50	↓ 100	↓ 450
South Korea	2.00	0	↓ 325
Thailand	1.25	0	↓ 250
Turkey	8.25	↓ 150	↓ 850

Sources: Bloomberg; central banks

Government financial policy actions

Governments have responded to the current crisis with policy initiatives to support and restructure financial systems. However, with the recent improvement in credit markets and financial markets more generally, there has been a noticeable shift in focus away from crisis management toward putting in place longer-term regulatory reforms. Reflecting this, authorities in the United States, United Kingdom and European Union have proposed initiatives aimed at improving policy makers' ability to effectively supervise and regulate financial systems, including:

- the introduction of councils of financial regulators to help identify emerging systemic risks and improve interagency cooperation;
- strengthening the capital, liquidity and risk management requirements for institutions that pose systemic risks;
- in the United States, extending the Fed's regulatory responsibility to all systemically important institutions and payment, clearing and settlement systems;

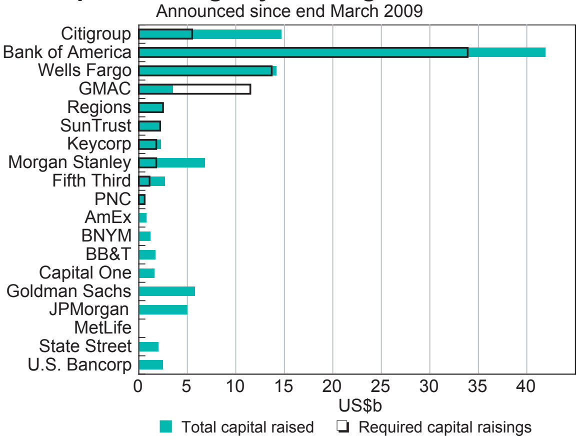
- in the United Kingdom and European Union, providing regulators with more power to ensure that remuneration practices do not encourage excessive risk taking; and
- more comprehensive regulation of over-the-counter (OTC) derivatives markets. To this end, proposed legislative changes in the United States will require all 'standardised' OTC derivatives to be cleared through regulated central counterparties and will subject all large market participants to prudential supervision and reporting standards. Similar changes to the CDS market are being implemented in Europe, with a number of major industry participants in the OTC derivatives market having commenced the use of a central counterparty clearing house for standardised CDS.

In May, US authorities announced the results of the stress tests designed to determine if the major US financial institutions are adequately capitalised. The tests found that 10 of the 19 banks examined needed to raise a total of US$75 billion in common equity capital to meet target capital adequacy ratios by the end of 2010 (Graph 22). Although these banks were given until November to implement a capital plan, most have already implemented or announced measures that allow them to achieve their target. Nonetheless, the US Treasury stands ready to provide funds if banks are unable to raise them from private investors.

Graph 22

Capital Raisings by the Largest US Banks

Announced since end March 2009



Sources: Board of Governors of the Federal Reserve System; company reports

The majority of the US banks subject to the stress tests were able to raise unguaranteed debt and access public equity markets after the announcement of the results, reflecting the improved confidence in the financial sector. This fulfilled two pre-conditions for repaying funds provided under the TARP. As a result, 10 banks have repaid their obligation to the US Government, although a number of second- and third-tier banks have received further injections of TARP funds.

In July, the US Treasury announced details of a scaled-down version of the legacy securities component of the Public-Private Investment Program first proposed in March. Nine asset managers were appointed to purchase commercial MBS and non-agency residential MBS issued prior to 2009 with an initial credit rating of AAA. These purchases will be funded by US$30 billion from the US Treasury and at least US$½ billion from each of the private managers.

The housing agencies Fannie Mae and Freddie Mac reported first-quarter losses of around US$23 billion and US$10 billion, respectively. This resulted in further capital injections of senior preferred stock from the US Treasury as part of the terms of their conservatorship, taking the total contributions to around US$34 billion and US$51 billion, respectively.

Auto makers Chrysler and GM emerged from bankruptcy protection in June and July, respectively. Chrysler was restructured and acquired by Fiat. GM's restructure reduced its overall obligations by over US$40 billion and resulted in the US and Canadian Governments owning around 72 per cent of the common stock, while a further 18 per cent stake is owned by the UAW Retiree Medical Benefits Trust. The remaining 10 per cent stake accrued to existing bond holders in a debt-equity swap.

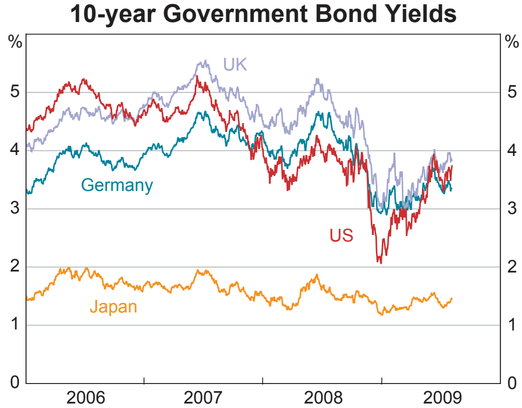
Regulators in the European Union announced that they will conduct EU-wide stress tests on banks using common scenarios, but that the results will remain confidential. Ahead of this, a number of European governments have provided further support to their financial sectors in recent months. In particular, the German Government has approved a scheme to create institution-specific 'bad banks' that will purchase impaired assets from banks in return for government-guaranteed bonds. The Russian Government is planning to inject around US$15 billion into its banking sector in light of a significant increase in non-performing loans, while the Icelandic Government announced a US$2 billion re-capitalisation of the three new banks created following the collapse of the main Icelandic banks in October 2008.

Sovereign debt markets

Longer-term bond yields in Germany, Japan, the United Kingdom and the United States have generally increased since the beginning of 2009 due to the more positive tone of economic data and related strength in equity markets (Graph 23). Concerns about the prospective large increase in supply resulting from the need to finance large fiscal stimulus packages have also contributed to rising longer-term yields at times.

In contrast, yields on shorter-term bonds have been held down by market expectations of policy rates remaining at historically low levels for some time. Consequently, yield curves for sovereign debt have steepened: the difference between yields on 10-year US government bonds and the federal funds rate is around historically high levels (Graph 24).

Graph 23
10-year Government Bond Yields

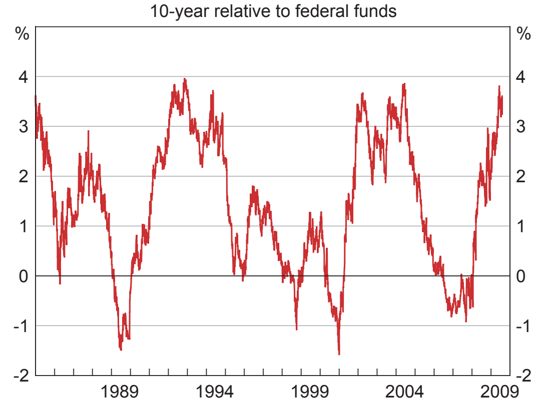


Source: Bloomberg

Graph 24

US Yield Curve

10-year relative to federal funds

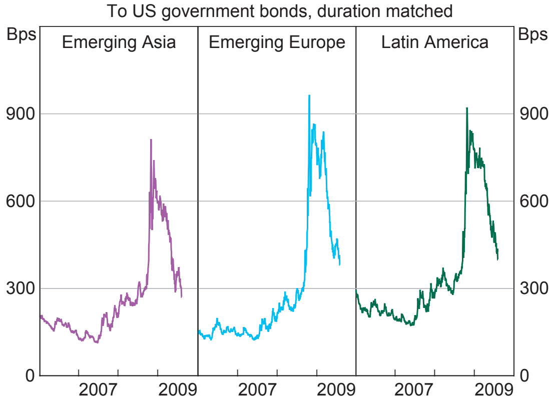


Sources: Bloomberg; RBA

Graph 25

US Dollar-denominated Sovereign Debt Spreads

To US government bonds, duration matched



Source: Thomson Reuters

In Europe, the spread between yields on Irish and German government debt widened after Ireland's sovereign credit rating was downgraded by one notch by both S&P and Moody's due to rising public debt burdens and vulnerability to external factors. Spreads on other European sovereign debt were little changed although spreads on Greek sovereign debt continued to narrow from their peaks in the first quarter of 2009, notwithstanding the fact that Fitch placed the country's sovereign credit rating on negative watch.

Spreads of emerging market US dollar-denominated debt to US Treasuries have fallen sharply since their recent peaks of October 2008 (Graph 25). Although there have been a number of sovereign downgrades in emerging Asia and emerging Europe, rating agencies have also made several positive announcements: Moody's recently upgraded the long-term foreign- and local-currency debt ratings of the Philippines and reviewed Brazil for a possible credit upgrade citing its resilience to the global crisis, while S&P is considering Mexico for a possible credit upgrade. The IMF approved a US$10.5 billion short-term credit line to Colombia, which follows earlier approvals for similar assistance to Mexico and Poland.

Equities

Global equity markets have risen to be almost 50 per cent above the lows posted in early March this year (Table 4). Share prices have been supported by more positive macroeconomic data in the United States and China, the associated rise in commodity prices and more optimism surrounding the prospects for the financial sector. Second quarter earnings have generally been better than expected for US and European financial institutions: investment banking operations accounted for a significant proportion of profits while more traditional banking operations continue to report losses or substantially reduced income. Although investor sentiment remains fragile, volatility in equity markets has continued to decline although it remains above its long-run average.

Emerging market equities, with the exception of China, continue to broadly track those of developed markets, but with more sensitivity to changes in risk appetite and commodity prices (Graph 26). Over the past few months, emerging European share prices have generally suffered from a decline in investor risk appetite triggered by a failed government debt auction in Latvia in June. In contrast, Chinese stock markets have continued to rally on the back of positive economic data and are around 100 per cent above their trough in November 2008.

Hedge funds

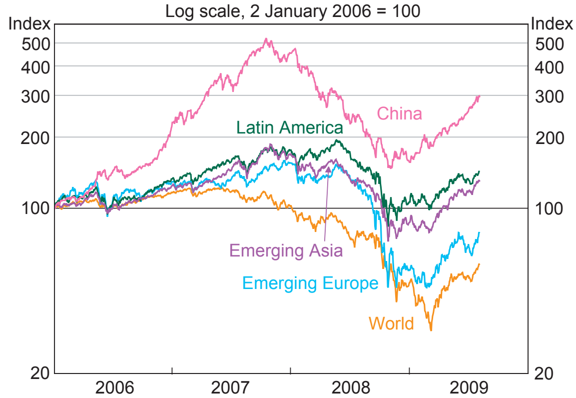
The recovery in equity markets this year has supported a pick-up in the performance of global hedge funds. Funds recorded an average return of 9 per cent in the June quarter, but over the year to June made an average loss of 10 per cent. Funds with large exposures to emerging markets achieved the highest returns in the June quarter, although funds with strategies based around the outlook for the global economy have fared best since early 2008. Investor redemptions slowed in the June quarter following large outflows in the previous two quarters. The recent pick-up in returns and slowing in redemptions saw total investor capital under management in the industry increase marginally in the June quarter, but it is still 25 per cent below the peak prior to the collapse of Lehman Brothers (Graph 27).

Table 4: Changes in Global Share Prices
Per cent

	Peak to trough	Since recent trough
United States		
– Dow Jones	–54	42
– S&P 500	–57	48
– NASDAQ	–56	57
Euro area		
– STOXX	–62	45
United Kingdom		
– FTSE	–48	32
Japan		
– Nikkei	–61	45
Canada		
– TSE 300	–50	46
Australia		
– ASX 200	– 54	36
MSCI indices		
– Emerging Asia	–61	79
– Latin America	–57	71
– Emerging Europe	–71	70
– World	–56	46

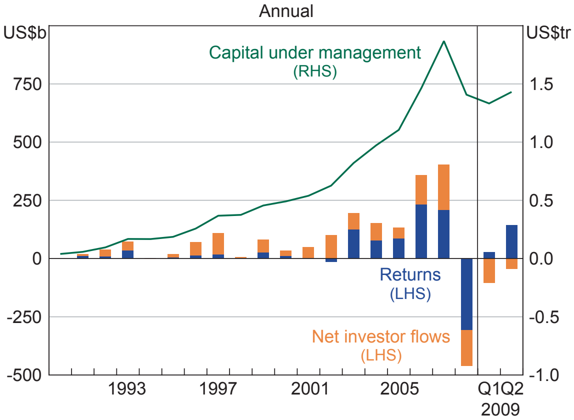
Source: Bloomberg

Graph 26
MSCI Share Price Indices
Log scale, 2 January 2006 = 100



Source: Bloomberg

Graph 27
Global Hedge Fund Capital



Source: Hedge Fund Research, Inc.

Table 5: Change in US Dollar against Other Currencies
Per cent

	Past year	Since recent peak (March 2009)
Mexico	32	–16
South Korea	20	–21
Sweden	17	–22
Brazil	15	–24
United Kingdom	15	–19
India	13	–8
Indonesia	9	–18
Australia	9	–25
Philippines	9	–1
New Zealand	8	–27
Euro area	7	–12
South Africa	7	–26
Malaysia	7	–6
Taiwan	6	–6
Singapore	4	–7
Canada	3	–18
Thailand	1	–6
Switzerland	1	–8
China	0	0
Japan	–12	–4
Majors TWI	**3**	**–14**
Broad TWI	**7**	**–10**

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

Foreign exchange

Developments in foreign exchange markets have been largely consistent with changes in general financial market sentiment. Overall, volatility in foreign exchange is well below the peaks seen late last year but nonetheless remains above average.

The US dollar has depreciated against most currencies since its recent peak in March (Table 5). Much of this movement occurred over May as risk appetite improved on better-than-expected global economic data and equity markets rallied. Several other factors also placed downward pressure on the US dollar during this period, including discussion about the long-term viability of the US dollar as a reserve currency, the downgrade of California's credit rating and the unwinding of expectations that the federal funds rate would increase before year end. In trade-weighted terms, the US dollar is now 14 per cent below its March peak and 8 per cent lower than it was three month ago against major currencies.

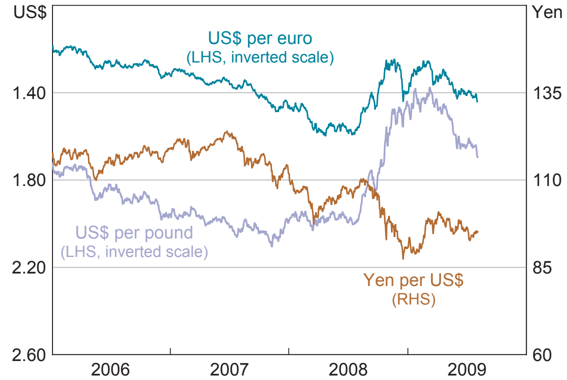
Consistent with these developments, the euro appreciated against the US dollar throughout May and early June although it has been little changed since then (Graph 28). The British pound appreciated against both the euro and the US dollar reflecting better-than-expected data, despite the BoE's decision in June to expand its quantitative easing program and S&P's announcement that the outlook for the United Kingdom's AAA sovereign debt rating was less certain. The Japanese yen has also appreciated against the US dollar although it has depreciated against most other major currencies, reflecting the general improvement in risk appetite.

The Swiss franc depreciated against both the euro and the US dollar after the SNB intervened in the foreign exchange market to ease monetary conditions and prevent the franc from appreciating against the euro. The Swedish krona depreciated significantly against the euro over May and June, primarily as a result of the Swedish banks' exposure to the Baltic economies, especially Latvia. During this period, Sveriges Riksbank announced that it was increasing its foreign reserves and activated €3 billion of a €10 billion swap line with the ECB to potentially assist the Swedish banks in meeting euro funding needs. In July, the krona more than reversed this depreciation following stronger-than-expected economic data.

The continued rise in commodity prices to levels last seen around November 2008 has contributed to an appreciation of the currencies of commodity-exporting economies, including Australia (see below), Brazil, Canada, Chile, New Zealand and South Africa (Graph 29).

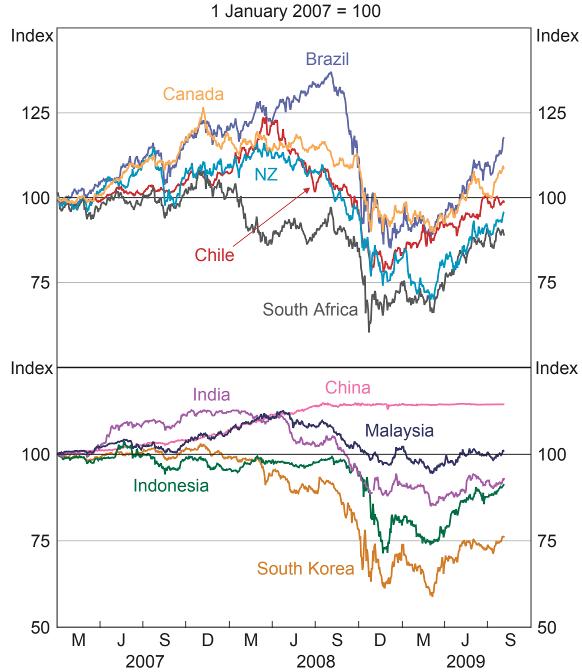
Currencies of the emerging Asian economies also generally continued their appreciation, which began in March as global growth prospects improved. The Indian rupee appreciated sharply on the result of the country's general election in May. In contrast, emerging European currencies were mixed against the euro. Speculation of an imminent devaluation of the Latvian lats, which is pegged to the euro, intensified after the failed debt auction by the Latvian Government in June and led to a broad-based depreciation of emerging European currencies against the euro, even as sentiment improved in other emerging markets. Expectations that the IMF and the European Commission would release the next tranches of their assistance packages

Graph 28
US Dollar against Euro, Pound and Yen



Source: Bloomberg

Graph 29
Selected Currencies against US Dollar
1 January 2007 = 100



Source: Bloomberg

to Latvia then saw the lats appreciate to the top of its trading band by mid June, with most emerging European currencies following suit. The Polish zloty has also been supported by official comments suggesting that Poland may begin the euro-adoption process this year, as well as the World Bank's approval of a US$4.5 billion loan. The Russian ruble depreciated sharply in mid July after the central bank unexpectedly lowered its policy rate but this was retraced as oil prices recovered. The non-deliverable forwards market indicates that the ruble is expected to depreciate over the next year.

Australian dollar

The Australian dollar has generally appreciated since March, reaching its highest level since last September (Graph 30, Table 6). On a trade-weighted basis the Australian dollar has appreciated by 22 per cent from the trough in early March and is now 12 per cent above its post-float average. The appreciation in the currency continues to be underpinned by the pick-up in commodity prices and by the general improvement in global investor sentiment. Most of the appreciation has occurred during offshore trading when global developments, rather than Australian developments, tend to influence exchange rate movements. Consistent with this, the correlation between daily changes in the exchange rate and US equity prices, which are also influenced by changes in investor risk appetite, remains high.

The recent appreciation in the currency has allowed the Bank to replenish the foreign exchange reserves used late last year during its intervention to provide liquidity to the foreign exchange market.

Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

	Since recent peak (July 2008)	Since recent trough (March 2009)	Deviation from post-float average
South Korea	4	3	52
United Kingdom	1	11	12
New Zealand	–2	–2	2
India	–4	22	52
Euro area	–5	16	–12
Malaysia	–7	25	33
Indonesia	–7	9	129
Canada	–8	12	–4
Singapore	–8	23	–3
South Africa	–10	3	52
Switzerland	–10	20	–17
Thailand	–12	25	22
China	–14	33	24
United States	–14	33	17
Japan	–23	29	–15
TWI	**–11**	**22**	**12**

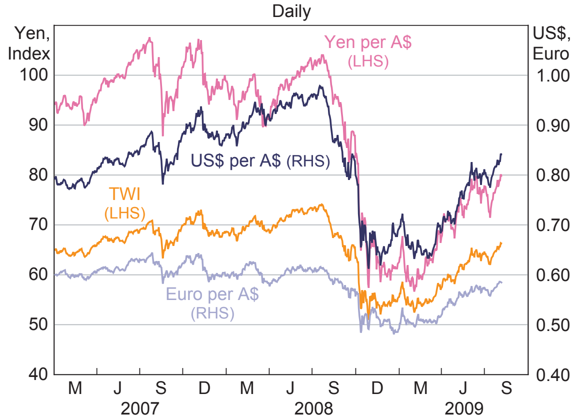
Sources: RBA; Thomson Reuters; WM/Reuters

Volatility in the exchange rate of the Australian dollar against the US dollar, as measured by the intraday range, has continued to fall from its peak in late 2008, but remains well above the long-term average (Graph 31). Measures of liquidity in the inter-bank foreign exchange market are currently around levels seen prior to the collapse of Lehman Brothers.

Graph 30

Australian Dollar

Daily

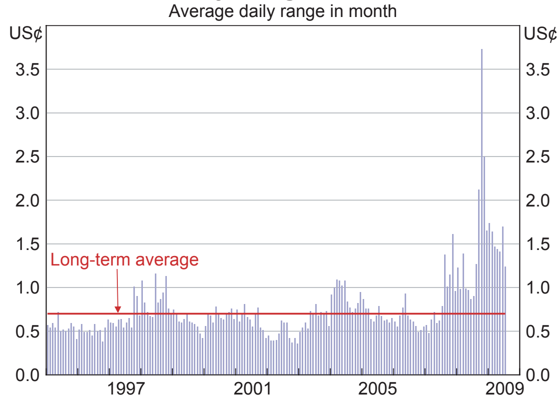


Sources: RBA; Thomson Reuters; WM/Reuters

Graph 31

Intraday Range in A$/US$

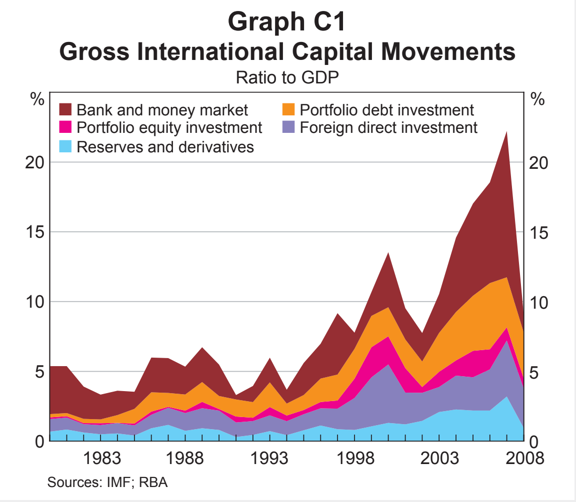
Average daily range in month



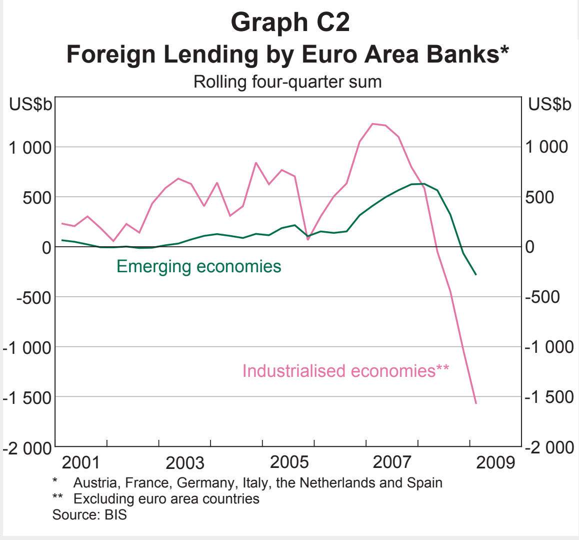
Sources: Bloomberg; RBA

Box C: Gross International Capital Movements

One of the defining characteristics of the financial crisis has been a sharp rise in risk aversion. One aspect of this has been a reduction in capital flows to emerging markets in Eastern Europe, Asia and Latin America. These regions are generally seen as attractive in times of global macro-financial stability but particularly risky in times of global instability. In previous episodes of global instability, reductions in flows to emerging markets have tended to be associated with increased capital flows between industrialised economies. In the most recent episode, however, this has not been the case and total capital flows have fallen sharply from their peak in 2007.



Capital flows between countries had been rising rapidly since 2002 in an environment of low interest rates, solid economic growth and generally favourable financial conditions (Graph C1). The most notable rise was in cross-border bank lending and the purchase of debt securities. Not surprisingly, given the nature of the financial crisis and the rise in counterparty risk following the failure of several high profile institutions, cross-border bank lending has been sharply curtailed in 2008.



Looking at more detailed data on cross-border bank lending from the Bank for International Settlements, it is evident that cross-border lending by European banks both increased most rapidly going into the crisis and subsequently contracted most sharply. Given that financial stress was concentrated in industrialised economies it is also noteworthy that lending to other industrialised economies peaked earlier than lending to emerging markets, which was curtailed only much later into the financial turbulence (Graph C2). This pattern is also evident in the sharp reversal of (net) flows between the United States and the United Kingdom as a result of reduced cross-border lending by European banks headquartered in London as institutions sought to unwind their exposures.[1]

The most recent fall in gross capital flows is very sharp by historical standards. However, previous episodes of instability, such as the one around the time of the equity bubble earlier this decade, resulted in reasonably short-lived falls in capital flows.

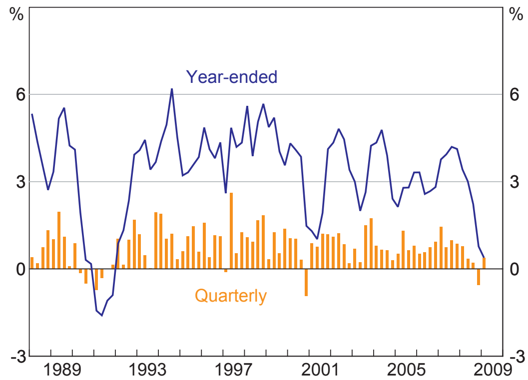
1 *For more detail see also Bank for International Settlements (2009),* BIS Quarterly Review, *June.*

Domestic Economic Conditions

The global recession has had a significant effect on the Australian economy, although growth has been stronger than in most other advanced countries. The latest available GDP data suggest that the economy contracted slightly over the six months to the March quarter, compared with the significant falls in output in many other countries (Graph 32). More recent indicators, including private-sector surveys and information from the Bank's liaison program, suggest some modest strengthening, with consumer and business confidence having bounced back after the steep falls of late last year (Graph 33).

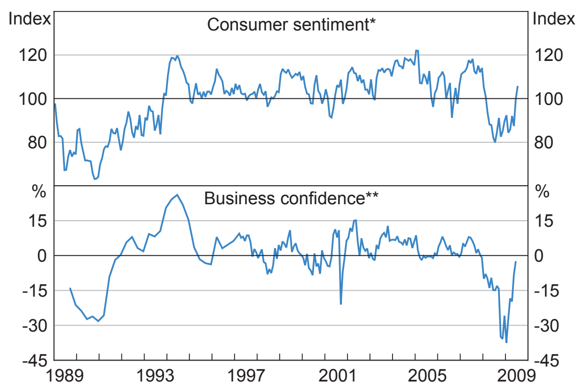
The initial estimates suggest that real GDP increased by 0.4 per cent in the March quarter, following a decline of 0.6 per cent in the December quarter (Table 7). Interpreting these data has, however, been made difficult by the unusually large gap between the different measures of GDP, which suggests that the initial estimates are subject to more uncertainty than usual (Graph 34). Looking through the measurement difficulties, and taking into account the many partial indicators of economy activity, it appears that there was a small contraction in the economy in late 2008 and early 2009. In any event, real gross domestic income has been substantially weaker than real GDP, reflecting the significant decline in the terms of trade over this period.

Graph 32
GDP Growth



Source: ABS

Graph 33
Sentiment Indicators



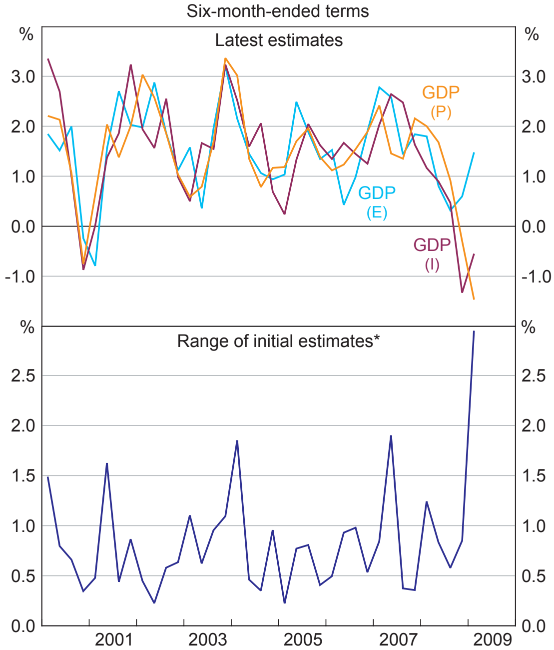
* Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index; long-run average = 100
** Net balance; deviation from long-run average
Sources: Melbourne Institute and Westpac; NAB; RBA; Roy Morgan Research

Table 7: Demand and Output Growth
Per cent

	December quarter 2008	March quarter 2009	Year to March quarter 2009
Domestic final demand	0.0	–1.0	0.5
GNE	–1.3	–1.0	–1.4
Net exports[(a)]	1.7	2.2	3.2
Statistical discrepancy[(a)]	–0.9	–0.7	–1.4
GDP	–0.6	0.4	0.4
Non-farm GDP	–0.8	0.5	0.0
GDP adjusted for changes in the terms of trade	–1.3	–1.4	1.7

(a) Contribution to GDP growth
Sources: ABS; RBA

Graph 34
GDP Growth Measures
Six-month-ended terms



* Absolute value of the largest difference in the real-time GDP measures
Sources: ABS; RBA

As has been the case in many other countries, both business and dwelling investment have fallen noticeably over the past couple of quarters. In contrast, Australia's export performance has been surprisingly strong, underpinned by a pick-up in Chinese demand for resources and a rise in farm output. Household consumption has also been stronger than in many other countries, supported by the fiscal stimulus and the significant falls in mortgage rates. Another factor supporting GDP growth in Australia, relative to other advanced economies, has been faster growth in the population, with the working-age population increasing by around 2 per cent over the past year, compared with an average increase in the G7 economies of roughly ½ per cent (Graph 35).

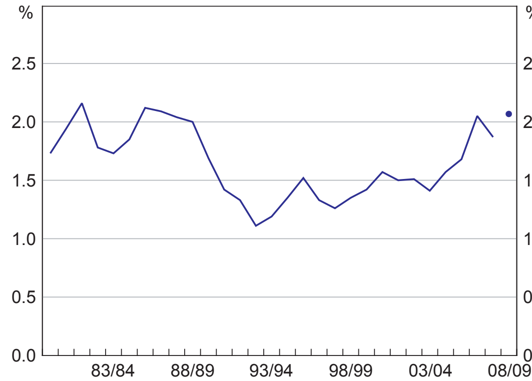
Household sector

In contrast to most other developed economies, indicators of household activity in Australia have been fairly resilient over the past year. Retail sales and the housing market have been quite buoyant since late 2008 and there has been a significant rebound in consumer sentiment, particularly over the past few months. The main exception has been household purchases of motor vehicles, which have trended lower over the past year.

The volume of retail sales increased at an annualised rate of around 6 per cent in the first half of 2009 (Graph 36) and consumer sentiment has recovered noticeably, to be back at or above long-run average levels. These developments appear to reflect a number of factors including some recovery in household wealth and a boost to household incomes from monetary and fiscal policy measures. After falling by 10 per cent over 2008, household net worth has increased in the first half of 2009, with both housing and equity prices rising (Graph 37). In addition, household incomes have been boosted by budget measures, in particular transfers amounting to around $20 billion (2¾ per cent of annual household disposable income) to low- and middle-income households between December and May. Many indebted households have also benefited from the significant decline in mortgage rates since September 2008. The reduction in interest payments is estimated to be equivalent to nearly 5 per cent of disposable income, though, at the aggregate level, this has been partly offset by a reduction in receipts on household deposits.

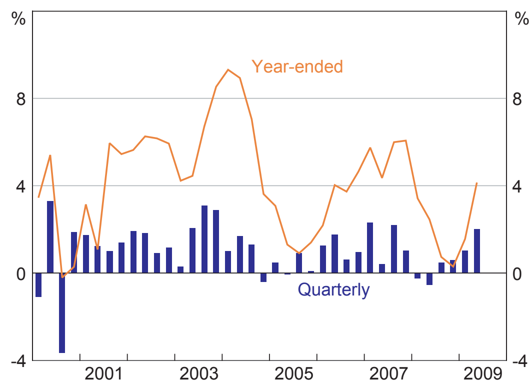
In addition to the stimulus provided to household spending, the boost to households from fiscal and monetary policy measures has allowed some consolidation of

Graph 35
Working-age Population Growth*
Year-ended



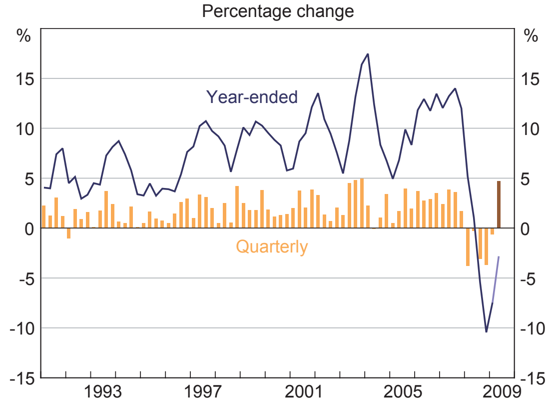
* Estimate for 2008/09 based on ABS national accounts data to March quarter 2009
Sources: ABS; RBA

Graph 36
Real Retail Sales Growth



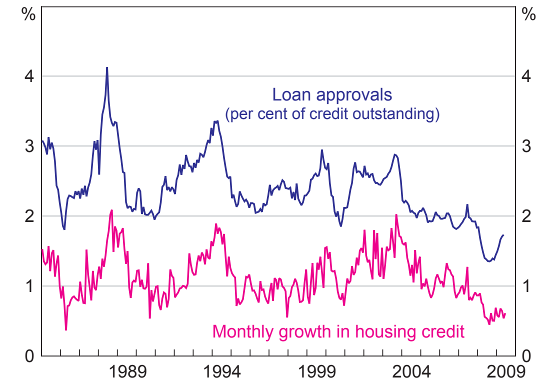
Source: ABS

Graph 37
Household Net Worth*
Percentage change



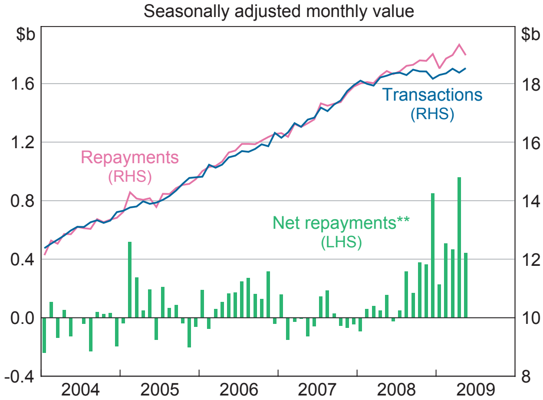
* RBA estimate for June quarter 2009
Sources: ABS; RBA

Graph 38
Housing Loan Approvals* and Credit



* Excludes owner-occupier refinancing and investor approvals for new construction
Sources: ABS; RBA

Graph 39
Credit and Charge Card Activity*
Seasonally adjusted monthly value



* Seasonal and calendar adjustment with X-12-ARIMA package
** Repayments less transactions (excludes interest and charges)
Source: RBA

household balance sheets. While new housing loan approvals have increased significantly over the past year, housing credit growth has been little changed, suggesting that repayments by the household sector have increased (Graph 38). Credit card repayments have also risen over the past six months, with particularly large payments in December and April, suggesting some households used the government transfers to pay down credit card debt (Graph 39).

Nationwide dwelling prices have increased since the beginning of the year, and have largely recovered the falls experienced in 2008 (Table 8). Prices have generally increased in all capital cities for both houses and apartments. Prices in the less expensive suburbs have risen, reflecting the boost to housing accessibility from increased grants for first-home buyers (Graph 40). However, prices have also increased in the more expensive suburbs, after significant falls over 2008. This is consistent with activity in residential auction markets, where auction clearance rates in Sydney and Melbourne are well above their long-run average levels.

Table 8: National Dwelling Price Growth
Per cent

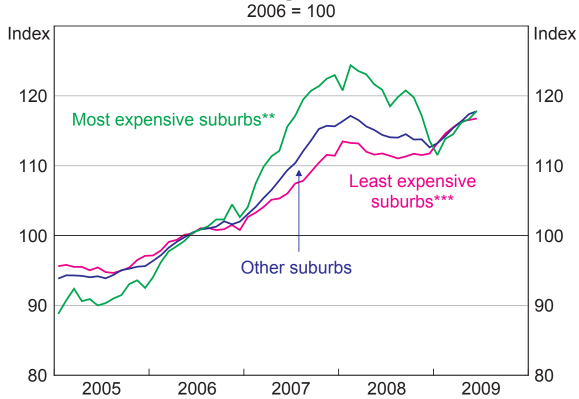
	March quarter 2009	June quarter 2009	Year to June quarter 2009
House prices			
ABS	–1.5	4.2	–1.4
APM	0.1	3.4	0.1
RP Data-Rismark	0.5	2.3	0.8
Apartment prices			
APM	0.1	2.1	1.9
RP Data-Rismark	2.0	2.1	3.6

Sources: ABS; APM; RBA; RP Data-Rismark

Spending on housing construction has been weak, but is expected to pick up over the remainder of this year. Demand for new housing is being stimulated by low mortgage rates and the temporary increase in grants to first-home buyers. Information from the Bank's liaison program indicates that home builders generally expect a significant increase in construction activity in the second half of the year, consistent with survey-based measures, such as the AIG-HIA Performance of Construction Index and the Master Builders Association survey. Conditions in the housing sector are discussed further in 'Box D: The Expected Pick-up in the Home-building Sector'.

Graph 40

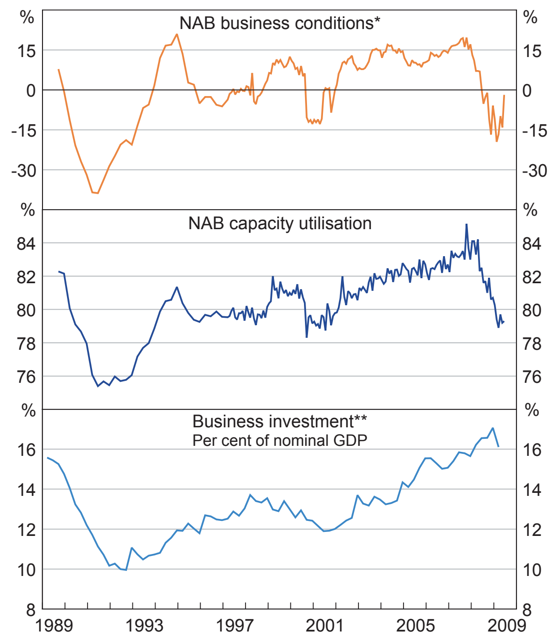
Dwelling Prices*



* Weighted average of houses and apartments in Adelaide, Brisbane, Melbourne, Perth and Sydney
** Most expensive 20 per cent of suburbs
*** Least expensive 20 per cent of suburbs
Source: RP Data-Rismark

Graph 41

Business Sector Indicators



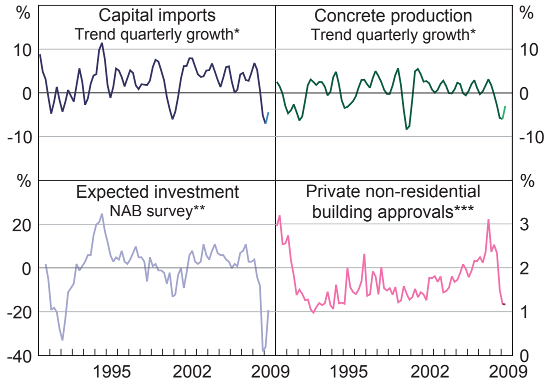
* Net balance; deviation from long-run average
** Business investment adjusted for Telstra's privatisation and for second-hand assets transfers between the private and other sectors
Sources: ABS; NAB; RBA

Business sector

There have recently been some encouraging signs in the business sector, following the significant deterioration in conditions and expectations in late 2008. In a range of business surveys, measures of business confidence have improved from very low levels around the start of the year. Firms have also reported that actual business conditions have picked up considerably in recent months, to be back at more normal levels (Graph 41). Capacity utilisation has also levelled out, after falling sharply in late 2008 and early 2009. While it is too early to tell whether these positive trends will persist, it is encouraging that the improvement is evident across a range of surveys, such as the monthly NAB and AIG surveys, and is reasonably widespread across industry sectors and states.

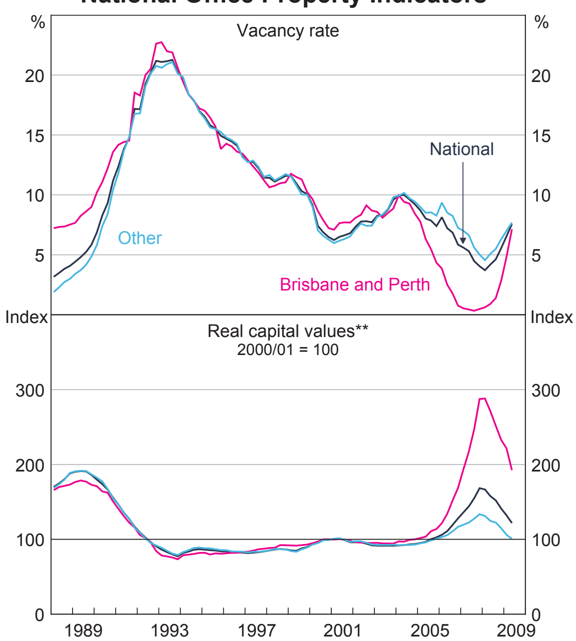
In the near term, however, the level of business investment is likely to decline further given the sharp scaling back of firms' spending plans in response to the deterioration in the

Graph 42
Business Investment Indicators



* This is a 7-period Henderson trend
** Deviation from long-run average; non-farm sector
*** Current prices, per cent of GDP, RBA estimate for June quarter 2009 GDP
Sources: ABS; NAB; RBA

Graph 43
National Office Property Indicators*



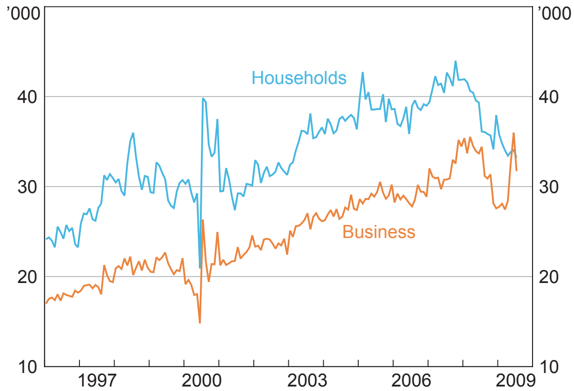
* Capital city CBDs (excluding Hobart)
** Deflated by trimmed mean CPI
Sources: ABS; Jones Lang LaSalle; Property Council of Australia; RBA

outlook for the world and domestic economies in the latter part of 2008. Businesses investment fell by 6 per cent in the March quarter, with a number of indicators suggesting a further decline in the June quarter and continued weakness over the remainder of 2009 (Graph 42).

The area of greatest weakness is likely to be the private non-residential construction sector, where the value of building approvals fell by a further 3 per cent in the June quarter, to be around 50 per cent lower than its peak in mid 2008. According to the Bank's liaison with businesses, this partly reflects the difficulties that commercial (and some residential) property developers are having accessing finance. The weakness also reflects softening demand for office and retail space. The deterioration in office market conditions has been most pronounced in the Perth and Brisbane markets, which were tightest prior to the current downturn (Graph 43). Office vacancy rates have increased since the beginning of 2008, but nevertheless remain below the average of the past two decades. Nationwide office capital values in the June quarter were estimated to be 23 per cent below their peak in late 2007, although sales volumes have been low, making it difficult to measure price movements accurately.

The Bank's liaison indicates some moderation in the scale of firms' planned cuts to investment spending over the past three months. This is consistent with recent private-sector business surveys that have reported that firms were less pessimistic about their investment intentions in the June quarter than they were during the previous six months. In part, this may reflect the tax credits introduced for business, particularly small businesses, which provide tax deductions for new tangible depreciating assets, such as machinery and equipment. Private-sector surveys suggest that around a third of small businesses have increased their investment in response to this tax concession, with motor vehicle deliveries to businesses rising by 27 per cent in May and June but then falling by 12 per cent in July (Graph 44). Another factor supporting the outlook for business investment is the gradual improvement in financial conditions, with the ACCI-Westpac Survey of Industrial Trends suggesting some easing in the financing constraints facing firms, although, as noted above, some sectors of the economy continue to face difficulty accessing finance.

Graph 44
Motor Vehicle Sales by Sector



Sources: FCAI; RBA

While aggregate capacity utilisation has fallen significantly, it remains well above levels of previous downturns. Indeed, with the recent rebound in demand from China, some mining firms are now almost back to full capacity. Although mining investment is likely to decline somewhat over the coming year – due to the fall in the amount of new projects that were commenced over the first half of 2009 – further increases in petroleum exploration and the recovery in energy prices and demand for bulk commodities could significantly boost investment spending in the medium term, especially in the LNG and iron ore sectors. As a result, although there will be some near-term decline in investment from its historically high share of the economy (Graph 41), the medium-term outlook remains strong.

More broadly, notwithstanding isolated areas of weakness, the overall financial health of the business sector remains strong. After rising through 2008, corporate insolvencies have levelled out in the first half of 2009. Business profits have declined reflecting the more difficult trading environment, but larger businesses have continued to shore up their balance sheets by raising equity and paying down existing debt (for further details, see the 'Domestic Financial Markets' chapter). In addition, there has been a shift in the sources of debt financing, with a pick-up in debt issuance in capital markets largely offsetting a decline in intermediated credit. Overall, total business funding has continued to expand, albeit at a slower rate than occurred in the past few years.

Government budgets

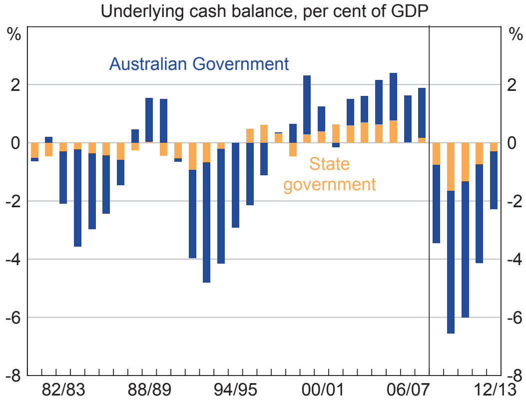
Australian Government and state budgets released since the start of May indicate that fiscal policy has exerted significant stimulus over the past year and that there will be some additional stimulus in 2009/10 (Table 9). In total, the general government (Australian plus state) deficit is budgeted to increase from 3.9 per cent of GDP in 2008/09 to 6.4 per cent in 2009/10, before narrowing in future years (Graph 45). The expected widening of the deficit in 2009/10 reflects both policy decisions and the automatic stabilisers (the impact of the weaker economy on the budget). In addition, state government trading enterprises plan to increase capital expenditures significantly in 2009/10. Total capital expenditure by the state public sector (including both public trading enterprises and the general government sector) is expected to rise by $13 billion, equivalent to 1.1 per cent of GDP in 2009/10, including significant investment in schools and public housing as part of the Australian Government's fiscal stimulus measures.

Table 9: Fiscal Balance – General Government Sector[(a)]
Budget estimates

	$billion		Per cent of GDP	
	2008/09	2009/10	2008/09	2009/10
General government				
Australian government	–32.9	–53.1	–2.7	–4.5
State governments	–12.3	–21.9	–1.1	–1.9
Total (Australian and state)	–45.2	–75.0	–3.9	–6.4
State public trading enterprises				
Capital spending	25.9	29.9	2.2	2.6

(a) ABS Government Finance Statistics basis
Sources: Australian Treasury; RBA; state Treasuries

Graph 45
General Government Budget Balance
Underlying cash balance, per cent of GDP



Sources: ABS; Australian Treasury; state Treasuries

Farm sector

Most rural areas have had a good start to the winter cropping season, with a near-record area planted with wheat. However, the Bureau of Meteorology is predicting a hotter and drier-than-average spring in eastern Australia cropping regions, reflecting the emergence of an El Niño weather pattern. Based on information from the Australian Bureau of Agricultural and Resource Economics (ABARE) and other rural agencies, a wheat crop of around 22 million tonnes is expected in 2009, up modestly from the 2008 crop, and farm output is expected to rise by around ½ per cent in 2009/10. Below-average rainfall over the first half of 2009 continues to result in historically low inflows into the Murray-Darling system, with irrigation water allocations from this system remaining at low levels.

External sector

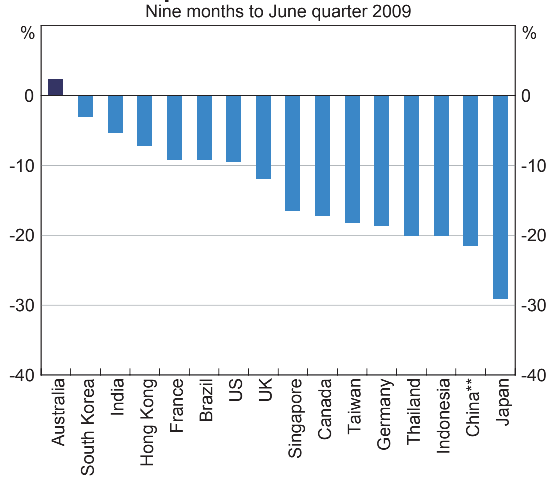
Despite the sharp slowing in the world economy and the accompanying decline in global trade since late last year, Australia's exports have held up remarkably well to date. This is in stark contrast to many of Australia's major trading partners, which have seen falls in export volumes of 10 per cent or more over the same period (Graph 46). Australian export volumes are estimated to have increased slightly in the June quarter, after growing by around 2 per cent over the six months to the March quarter. The relative strength of Australian exports reflects a strong recovery in Chinese demand for resources, a recovery in rural exports following the larger wheat harvest in 2008, and resilience in service exports, offset by weakness in manufactured exports (Graph 47).

Australian resource export volumes are estimated to have been broadly flat over the three quarters to June, although values have declined by nearly 30 per cent, with prices bearing the adjustment rather than volumes. The strong recovery in the Chinese economy and particularly China's demand for resources has been an important part of the resilience of Australian resource export volumes. For example, Chinese steel production has risen by 20 per cent since the end of last year, to be around 5 per cent above its mid-2008 peak, which has boosted demand for iron ore and coking coal. Consistent with this, Australian iron ore exports picked up strongly in the March and June quarters, with China's share of Australia's iron ore export volumes rising to 80 per cent (Graph 48). Coking coal exports have also risen in the June quarter, underpinned by stronger exports to China and India. China's share of Australian coking coal exports has risen to 28 per cent in June – from less than 1 per cent in 2008 – as Chinese steel mills have substituted away from more expensive domestic sources of coal. There are also some tentative signs that demand is recovering elsewhere, with exports to Japan and South Korea increasing modestly towards the end of the June quarter. While strong demand from China helps explain much of the resilience of Australian resource exports, there have also been some other factors at work, such as an expansion of LNG supply with the ramping up of production at the North West Shelf's fifth compression plant.

Graph 46

Export Volumes Growth*

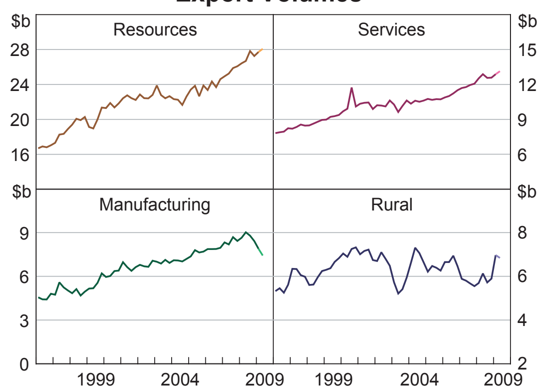
Nine months to June quarter 2009



* Includes June quarter 2009 estimates where data are not available
** Merchandise only
Sources: ABS; CEIC; Deutsche Bundesbank; Office for National Statistics; RBA; Thomson Reuters

Graph 47

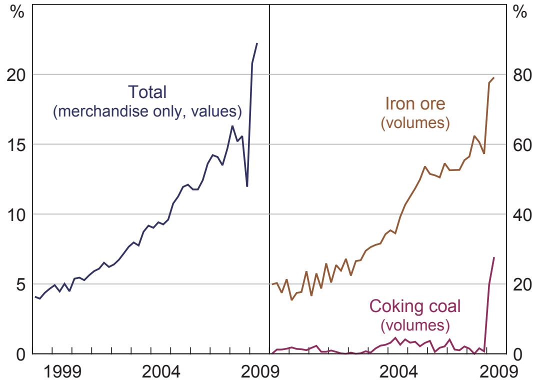
Export Volumes*



* Excludes RBA gold transactions; RBA estimate for June quarter 2009
Sources: ABS; RBA

Graph 48

China's Share of Australia's Exports



Sources: ABS; RBA

Rural export volumes have risen by nearly 20 per cent over the three quarters to June, reflecting the recovery in rural production following a return to more normal seasonal conditions in 2008. Wheat exports have more than doubled over this period as the relatively large 2008 wheat crop has been exported. Service exports have also held up comparatively well and are estimated to have risen by 4 per cent over the three quarters to the June quarter. This has reflected continued solid growth in travel services, which includes education services.

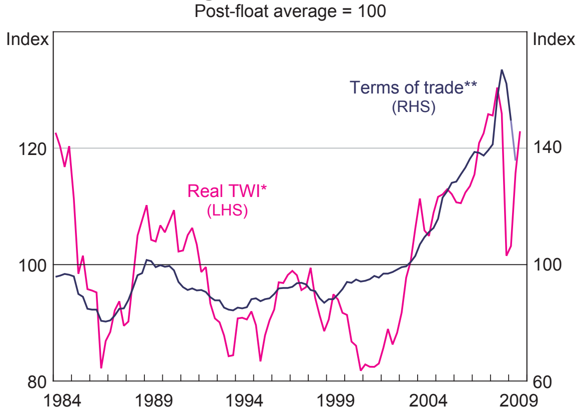
In contrast, the volume of manufactured exports is estimated to have declined by around 15 per cent over the three quarters to June, led by sharp falls in transport equipment exports. This is broadly consistent with the experience in other economies, but in Australia manufactured goods account for only around 20 per cent of total merchandise exports compared with 80 or 90 per cent for many countries.

Import volumes appear to have been broadly unchanged in the June quarter, after falling by 7 per cent in each of the December and March quarters, the sharpest falls in import volumes since 1975. The recent moderation appears to have been led by a modest rise in consumption imports, broadly consistent with growth in household consumption; the rise in the Australian dollar since the start of the year has also lowered the cost of imported goods. After a significant depreciation over the second half of 2008, associated with a weakening in commodity markets, the real exchange rate has appreciated in recent months (Graph 49). It has now reversed much of the earlier depreciation, to be 6 per cent lower than its mid-2008 peak. In contrast to consumption imports, capital imports appear to have fallen further in the June quarter, consistent with ongoing weakness in machinery and equipment investment.

Graph 49

Real Exchange Rate and Terms of Trade

Post-float average = 100



* September quarter 2009 observation assumes that nominal exchange rates on 5 August are maintained for the remainder of the quarter, and uses the latest core inflation rates.
** RBA estimate for June quarter 2009
Sources: ABS; RBA; Thomson Reuters

With import values having declined by more than export values, the trade surplus widened in the March quarter, to its highest level since 1973. However, the trade balance is estimated to have been a small deficit in the June quarter, reflecting the fall in export prices and the terms of trade (Graph 50).

Labour market

Conditions in the labour market have softened this year, with unemployment increasing and employment being broadly flat. In July, the unemployment rate stood at 5.8 per cent, around 1¾ percentage points above its trough in early 2008 (Graph 51). The level of employment is 0.2 per cent below its peak in late 2008. Thus far, though, the fall in the number of employed persons has been smaller than expected.

However, total hours worked have declined more noticeably than the level of employment (Graph 52). Flexibility in the labour market has allowed many firms and their workers to modify working conditions as an alternative to layoffs. This has enabled many firms to reduce the number of hours worked by employees in a bid to reduce labour costs while holding on to workers; as a result, average hours worked have fallen for both full-time and part-time employees in recent months. There has also been a shift in the composition of employment, with full-time employment declining by around 2 per cent since its peak in mid 2008, while part-time employment has risen by more than 4 per cent in trend terms over the same period. A significant proportion of the fall in full-time employment is accounted for by the manufacturing industry, which employs a relatively large proportion of full-time workers and has traditionally been quite cyclically sensitive (Graph 53).

Graph 50

Current Account Balance*

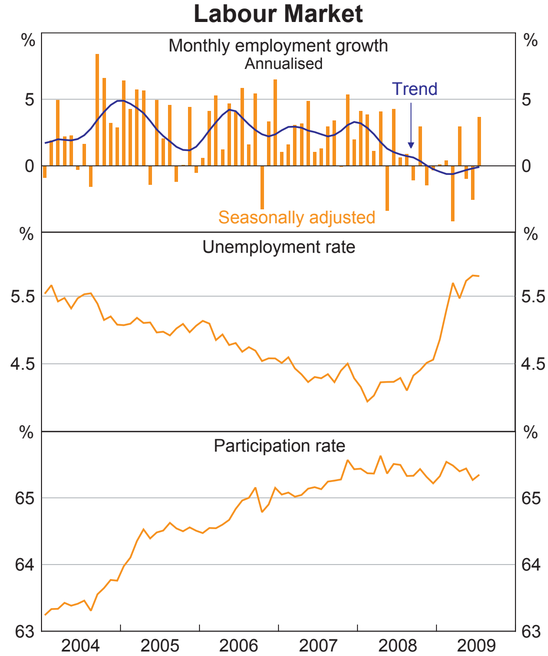
Per cent of GDP

* Excludes RBA gold transactions; RBA estimate for June quarter 2009

Sources: ABS; RBA

Graph 51

Labour Market

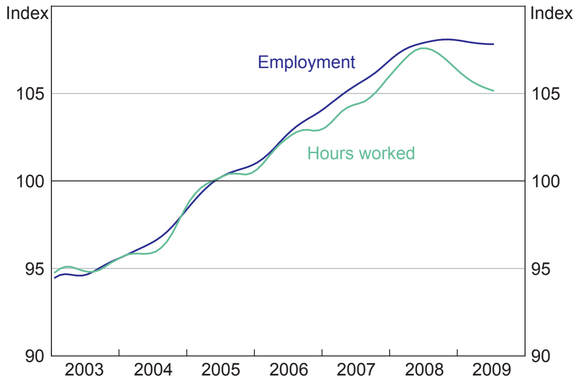


Source: ABS

Graph 52

Hours Worked and Employment

Trend, 2005 = 100

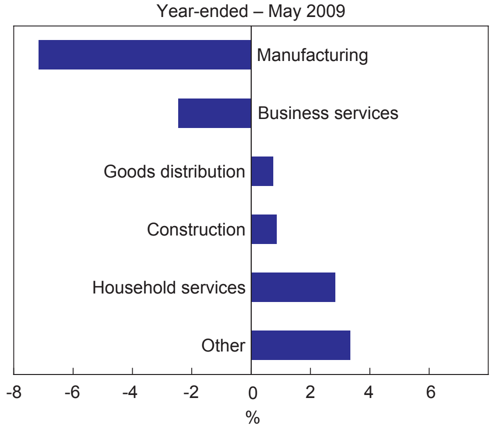


Source: ABS

Graph 53

Employment Growth by Sector

Year-ended – May 2009

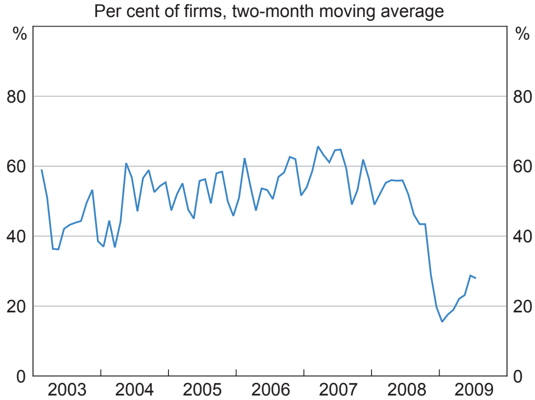


Source: ABS

Graph 54

Firms Expecting to Increase Employment

Per cent of firms, two-month moving average



Source: RBA

Labour force participation has remained relatively close to its historical high in recent months, despite the weakening of the labour market. In previous downturns the participation rate has tended to fall as discouraged workers exit the labour force when employment prospects diminish. While the absence of any significant fall in participation to date may reflect longer lags in the current episode, the participation rates of married women and persons aged 55 or more have risen. In the latter case, it appears that some older workers may be delaying retirement due to the significant loss of wealth in 2008.

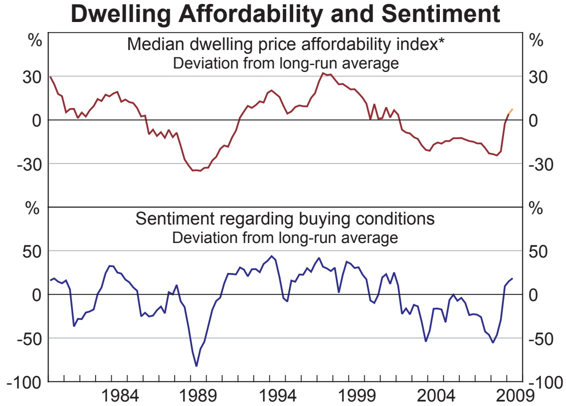
While conditions in the labour market are likely to weaken further in coming months, some forward-looking indicators are suggesting that the pace of deterioration may ease. Measures of hiring intentions in business surveys have risen from their lows in recent months, and this is consistent with the Bank's liaison with firms, which points to a pick-up in the number of firms expecting to increase employment in the next year (Graph 54). Aggregate job advertisements, as reported by ANZ Bank, have continued to fall, though at a slower pace than in early 2009.

Box D: The Expected Pick-up in the Home-building Sector

Over the past few years, between 140 000 and 150 000 dwellings have been built annually, which is well below most estimates of underlying demand. However, in late 2008 the flow of monthly residential building approvals had fallen to a level that, if maintained, would imply only around 115 000 commencements per year. Since then, the improvement in affordability from the significant fall in mortgage rates, as well as the boost in grants to first-home buyers, has seen a noticeable improvement in the outlook for dwelling construction. Surveys now show that households generally consider that it is a relatively good time to buy a home (Graph D1).

The First Home Owners Boost (FHOB) was introduced in October 2008 to provide a temporary increase in the value of the grants already available under the First Home Owner Grant (FHOG) scheme.[1] In addition to the $7 000 provided by the FHOG, the FHOB provides a further $7 000 for established housing and $14 000 for new housing (completed dwellings not yet resided in and dwellings yet to be constructed). Although the FHOB was initially set to expire at end-June 2009, an extension to end-September was announced in the Budget. At that time the FHOB will be reduced by half before being removed completely at end-December 2009. Under the scheme, purchase contracts must be signed by these dates, with construction of new housing to be completed within 18 months to two years, depending on the circumstances.

Graph D1
Dwelling Affordability and Sentiment



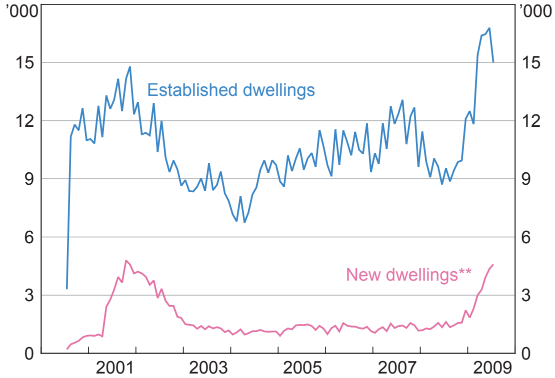
* Index constructed as the ratio of average household disposable income to the required monthly repayment for the median priced home (houses and apartments) financed with a 25-year loan assuming an 80 per cent LVR at the full-doc prime mortgage rate; RBA estimate for June quarter 2009

Sources: ABS; Melbourne Institute and Westpac; RBA; REIA

Reflecting the combination of the higher grants and lower mortgage rates, the number of grant applications in recent months has been approximately double the level of late 2008 (Graph D2). Around 75 per cent of applications have been for the purchase of existing housing, but over the past nine months there have been around 14 000 more applications for new dwellings than would be implied by the rate of applications before October 2008. Initially, almost all

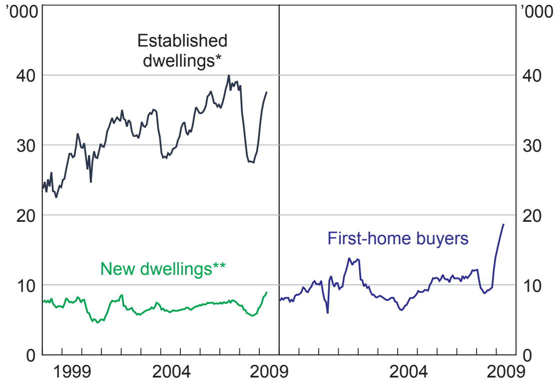
1 *Some states have also introduced or augmented state- administered grants for first-home buyers.*

Graph D2
First Home Owner Grant Payments*



* Not seasonally adjusted
** Includes newly constructed dwellings and dwellings yet to be constructed
Source: NSW Office of State Revenue

Graph D3
Owner-occupier Housing Loan Approvals
Number



* Excludes refinancing
** Includes approvals for new construction and newly erected dwellings
Sources: ABS; RBA

of the increase in grant applications for new dwellings was for existing newly-built dwellings, but over the past few months there has been a significant pick-up in applications for dwellings yet to be constructed. While there is some evidence that the flow of grant applications has peaked for existing and newly-built housing, applications for new construction continued to increase in July.

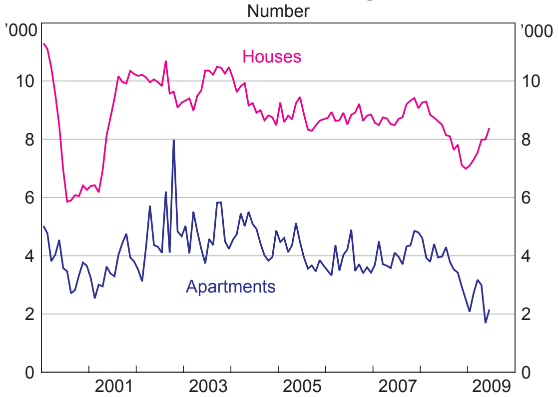
Lending finance data also show a strong pick-up in overall housing lending, particularly to first-home buyers. The share of loans going to first-time buyers has risen from just below 20 per cent in late 2008 to almost 30 per cent in May. The bulk of the increase in lending approvals has been for existing dwellings, although the number of approvals for loans for new owner-occupier dwellings has risen significantly since late 2008 (Graph D3). Over the seven months to May, there were around 13 000 additional loans for new dwellings, relative to the rate of lending seen prior to October.

The prospective boost to housing construction has so far been less apparent in building approvals, which may partly reflect lags in the process. In contrast to the modest strengthening seen in building approvals for houses, approvals for apartments have continued to weaken (Graph D4). Bank liaison with builders indicates that high-rise developments remain constrained by the availability of finance.

Overall, it seems likely that there will be a significant increase in private housing commencements in 2009/10. There will also be some additional activity from the public sector, reflecting the Australian Government’s Social Housing Initiative to build around 20 000 new dwellings by the end of 2010. However, the number of housing starts is likely to remain at levels well below most estimates of underlying demand. Lifting home-building in the longer-run will require further progress on the supply side, including addressing factors that are increasing the cost of development of new housing, both on the edges of cities and closer to the city centres. ✠

Graph D4

Private Residential Building Approvals



Source: ABS

Domestic Financial Markets

Money markets and bond yields

Domestic money market conditions have improved significantly over the course of the year. The spread between the bank bill rate and the expected cash rate, which has been a good guide to the tension in money markets over the past two years, has now fallen back to around 20 basis points, only a little higher than the levels that prevailed prior to the financial turmoil (Graph 55). The narrower spread, in part, reflects relatively lower short-term issuance by banks (see below). Bank bill rates are also closer to the yields the Australian Government pays on Treasury Notes – for most maturities, the spread between these rates has declined from 30 basis points earlier in the year to be around 10 basis points currently. This is about the same spread that prevailed when Treasury Notes were last issued earlier in the decade.

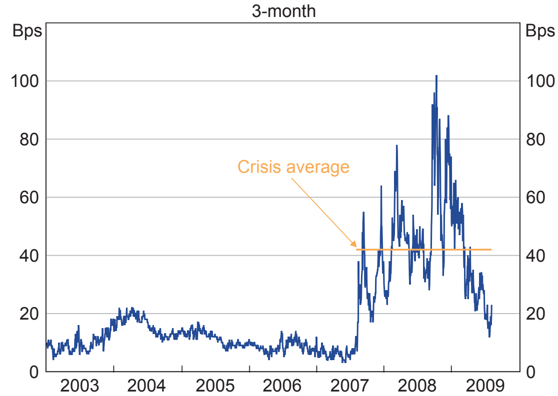
As funding conditions for money market participants have improved, the Bank has unwound most of the earlier measures it had taken to address the market turbulence. Aggregate exchange settlement (ES) balances held at the Reserve Bank by the commercial banks have been reduced from over $2 billion in May (and over $10 billion at their peak late last year), to be a little over $1 billion currently (Graph 56). This, together with the lower money market spreads, reflects the considerable diminution in concerns about bank counterparty risk.

Although the Bank's US dollar swap facility with the Federal Reserve was recently extended until February 2010 in line with those of other central banks, the improvement in market conditions has meant that the Bank has not seen the need to

Graph 55

Bank Bill Spread to OIS

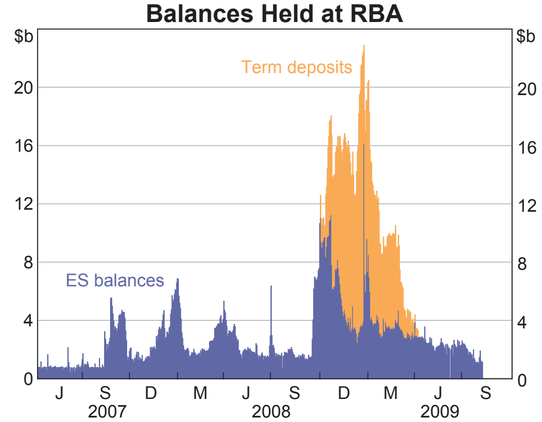
3-month



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Graph 56

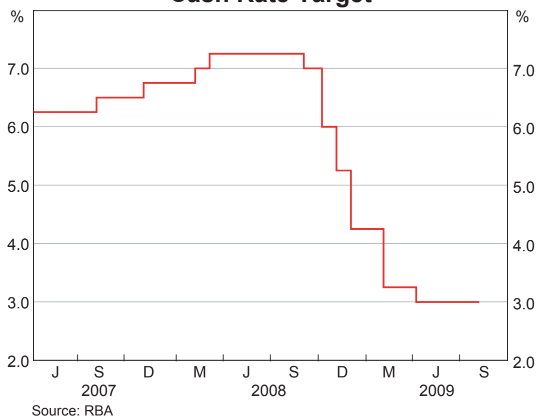
Balances Held at RBA



Source: RBA

auction funds from this facility since April. By July, all of the transactions under this facility had matured.

Graph 57



Having reduced the target for the overnight cash rate by 425 basis points since last September, the Reserve Bank has maintained the cash rate at 3 per cent since April (Graph 57). At the time of the last *Statement*, money market pricing pointed to further reductions in the cash rate during 2009. However, the strength of recent economic data and more positive sentiment within financial markets generally has seen these expectations recede.

Graph 58

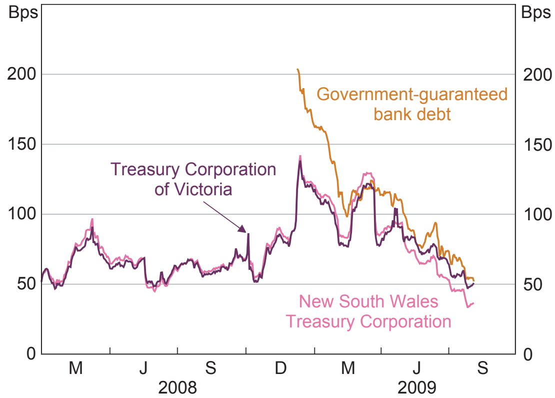
Long-term bond rates have continued to rise in recent months, with the yield on the 10-year Commonwealth Government security (CGS) now around 5.6 per cent (Graph 58). Largely reflecting the better economic performance of the domestic economy, the rise in domestic yields has generally exceeded that seen in overseas markets, with the spread between US and Australian 10-year government rates widening by 30 basis points to almost 200 basis points.

The volume of CGS issuance has increased in recent months, but coverage at bond tenders declined during June and yields on CGS are now above those of equivalent investments based on futures contracts that reference CGS. CGS are also being issued into a market in which a large volume of other AAA-rated bonds have been issued, many of which carry a guarantee from the Australian Government. Both the NSW and Queensland Governments have had their eligible long-term debt guaranteed. While the yields on this debt have narrowed relative to CGS, as have spreads on guaranteed bank paper, both still remain relatively wide for what is a very similar credit risk. Spreads on unguaranteed semi-government debt (such as that issued by the Victorian

Government) have declined only marginally less (Graph 59).

There was also strong issuance of AAA-rated Australian-dollar denominated bonds by non-residents in the domestic market (Kangaroos) in the June quarter, after issuance recommenced in late April. During the quarter, this AAA-rated issuance totalled almost $6 billion, close to the volume typical for all issuance by non-residents in the pre-crisis period. A further $2 billion has been issued in July and August to date. While spreads on Kangaroo bonds have narrowed, the relatively high level of the cross-currency basis swap spread (received by entities swapping out of A$) continues to provide a significant pricing incentive for these issuers.

Graph 59
Spreads to 5-year CGS

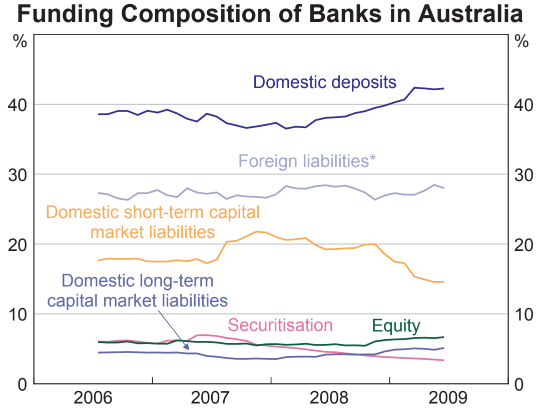


Sources: RBA; Yieldbroker

Financial intermediaries

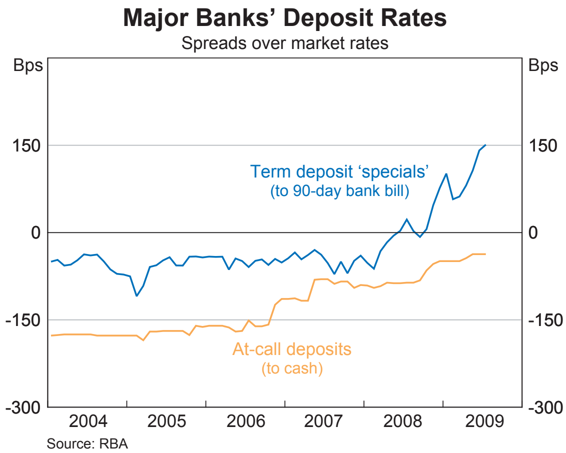
While dislocations in many markets have eased, the effects of the turbulence in capital markets continue to be seen in the cost and composition of financial intermediaries' funding. Banks have continued to reduce their use of short-term capital market debt (Graph 60). Banks' domestic short-term debt outstanding – predominantly bank bills and CDs – have fallen below $400 billion from a peak of $490 billion in November last year. During the June quarter 2009, the share of banks' funding that was sourced from deposits was little changed at 42 per cent, after rising by 5 percentage points over 2008 and early 2009. The shares of banks' funding that come from long-term capital market debt and equity increased slightly as banks continue to manage their balance sheets conservatively. There have been some differences across the main bank types, with the regional banks relying mainly on deposits to grow their funding bases but the major banks increasing both their deposits and long-term capital market debt.

Graph 60
Funding Composition of Banks in Australia



* Adjusted for movements in foreign exchange rates
Sources: APRA; RBA

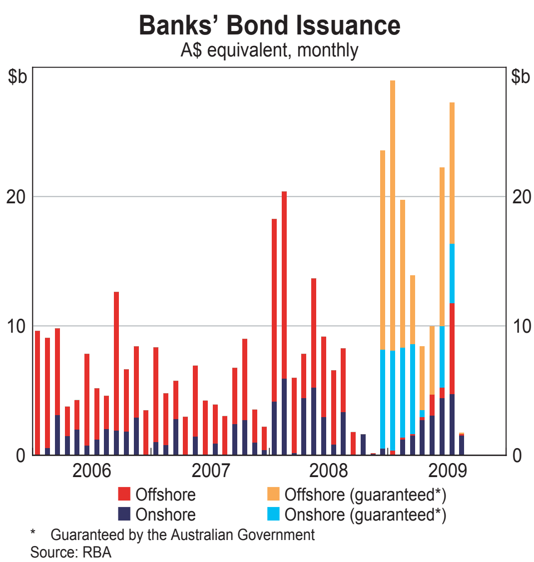
Graph 61



Competition for deposits, which are perceived as a more stable source of funding than short-term raisings in wholesale markets, remains strong. The average rate offered on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has increased by around 90 basis points since end April. At 4.75 per cent, it is 150 basis points above the 90-day bank bill rate compared with 50 basis points below the bill rate prior to the onset of the capital market turbulence (Graph 61). The smaller Australian banks have increased their average 'special' term deposit rates by around 70 basis since end April; their rates are currently in line with the major banks' rates.

The average rate on the major banks' existing at-call deposits (including online savings, cash management, and bonus saver accounts) has risen slightly over the past three months, and at 2.6 per cent, is currently only 40 basis points below the cash rate. In mid 2008, the average rate on at-call deposits was 90 basis points lower than the cash rate.

Graph 62



Australian banks have issued \$61 billion of bonds since the previous *Statement*. Issuance has been into a number of different markets, providing banks with a diverse range of funding sources. Around 35 per cent of issuance has been onshore, with the remainder issued offshore, mostly in US dollars. Bonds have also been issued in yen, British pounds, and for the first time in nearly a year, euros.

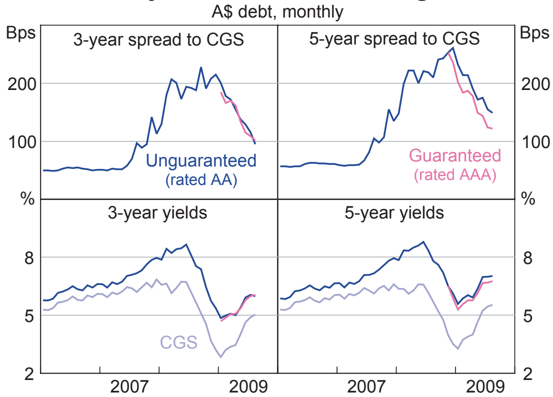
An increasing amount of issuance by the major banks in recent months has been unguaranteed (Graph 62). Most unguaranteed bonds have been issued onshore and have been met by strong demand from investors, with many issues upsized. Much of the demand has come from fund managers, making up over half of investors in some recent issues, although other banks continue to purchase these bonds as relatively high-yielding assets to hold in their liquidity portfolio. In recent weeks, there have also been some large unguaranteed issues offshore by the major banks, which attracted strong investor interest.

In contrast to the major banks, the smaller, lower-rated Australian-owned banks continue to issue only guaranteed bonds, mostly offshore. However, the Australian subsidiaries of foreign banks have been active in recent months in issuing bonds under the Australian Government Guarantee Scheme, raising $6 billion. Branches of foreign banks have also issued unguaranteed bonds and foreign-government guaranteed bonds, totalling $8 billion.

Graph 63

Major Banks' Bond Pricing*

A$ debt, monthly



* Includes fee for guaranteed issues

Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

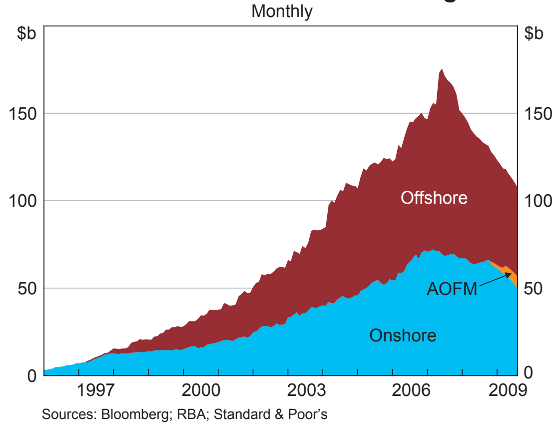
Reflecting the solid investor demand for bank debt, spreads on guaranteed and unguaranteed bonds have continued to decline in recent months and are now at their lowest level since early 2008 (Graph 63). At the 3-year maturity, Government-guaranteed debt (including the fee) and unguaranteed debt are both trading at around 100 basis points above CGS. At longer tenors, guaranteed debt remains cheaper to issue than unguaranteed debt. The decline in spreads across all tenors has only partially offset the increase in CGS yields, so that yields on the major banks' bonds have risen in recent months.

In addition to accessing a wide range of bond markets, Australian banks have continued to raise equity at a strong pace. In the past three months, $8 billion of equity has been raised, bringing banks' equity raisings over the past year to a record $27 billion – well above the annual average since 2002 of around $4 billion. Most equity has been raised by placements of shares to institutional and retail investors, usually at modest discounts to prevailing market prices. Investor demand for the additional equity has been strong.

In contrast, securitisation markets remain dislocated, with all residential mortgage-backed securities (RMBS) issued since October last year having the Australian Office of Financial Management (AOFM) as a cornerstone investor. Five RMBS have been issued in the past few months, amounting to $2.6 billion. Of this, $1.9 billion was purchased by the AOFM, with private investor demand continuing to be relatively limited. These investors have tended to purchase only the most senior tranches (rated A–1+ or AAA) that have a weighted-average life of less than one year, reflecting their preference for liquid, high-quality assets. The AOFM's purchases of RMBS now amount to $6.7 billion, with the remainder of the Government's $8 billion injection into the market expected to be allocated in coming months.

Graph 64

Australian RMBS Outstanding



Reflecting the slowing of issuance and the ongoing amortisation of principal (i.e. mortgage repayments), the value of Australian RMBS outstanding has fallen by around 40 per cent since its peak in June 2007, to $110 billion (Graph 64). RMBS outstanding offshore have declined by more (around 50 per cent) because there has been no offshore issuance, while paper outstanding onshore has fallen around 15 per cent. The AOFM's holdings amount to around 6 per cent of all Australian RMBS on issue (and 10 per cent of the domestic market).

The AAA-rated tranches of the RMBS issued over the past few months have priced around 130 basis points above BBSW. While spreads on equivalently-rated RMBS trading in the secondary market are higher, between 200 and 300 basis points currently, they have continued to fall in recent months as the market works through the overhang of supply that resulted from the deleveraging of structured investment vehicles (SIVs). These entities are estimated to have accounted for around a third of the investor base for Australian RMBS prior to the onset of the financial turbulence. However, it appears that the bulk of their holdings have now been liquidated in the secondary market.

The elevated spreads on RMBS in both primary and secondary markets do not appear to reflect concerns about credit quality. While the arrears rate on Australian RMBS has picked up over the past year, it remains at less than 1 per cent, a low level relative to international standards. Losses on Australian RMBS (after proceeds from property sales) remain very low as a share of the stock outstanding, at 5 basis points per annum for prime and 95 basis points for non-conforming loans. The bulk of losses continue to be covered by credit enhancements, including lenders mortgage insurance and the profits of securitisation vehicles. No losses have been borne by investors in a rated tranche of an Australian RMBS.

Short-term securitisation markets also continue to be strained. Asset-backed commercial paper (ABCP) outstanding has roughly halved from its peak in mid 2007 to around $35 billion, though it appears to have stabilised around this level in recent months. Spreads on ABCP have fallen a little since the previous *Statement*, though remain elevated at around 60 basis points above BBSW.

Intermediated credit

While financial intermediaries continued to be readily able to raise funds, moderating demand for borrowing and some tightening in lending standards, meant that total outstanding credit was little changed over the June quarter (Table 10, Graph 65). This follows growth at an annualised rate of around 3 per cent over the December and March quarters. Solid growth in housing credit was largely offset by declines in business and personal credit.

Graph 65

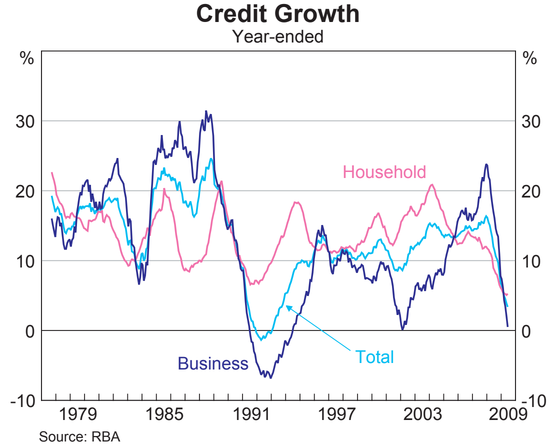


Table 10: Credit Aggregates
Average monthly growth, per cent

	September quarter 2008	December quarter 2008	March quarter 2009	June quarter 2009
Total credit	0.6	0.2	0.3	0.0
Household	0.4	0.4	0.5	0.5
– Owner-occupier housing	0.6	0.7	0.8	0.8
– Investor housing	0.4	0.2	0.3	0.2
– Personal	–0.5	–1.0	–0.5	–0.4
Business	0.9	0.0	–0.0	–0.6

Source: RBA

Household financing

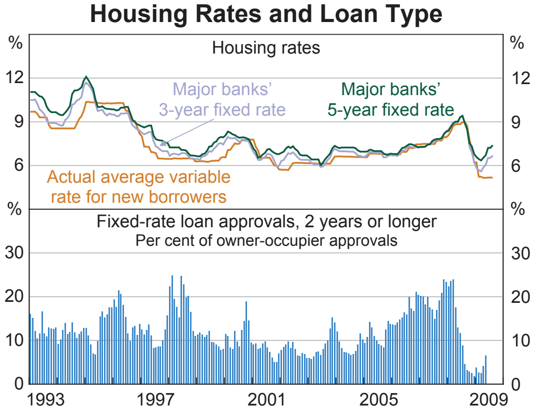
Interest rates on variable-rate household loans are little changed since end April, consistent with the unchanged cash rate, though interest rates on new fixed-rate housing loans have risen in line with the increases in capital market yields (Table 11). Overall, the interest rates faced by households remain very low by historical standards.

Table 11: Intermediaries' Variable Lending Rates
Per cent

	Current level	Change since	
	5 August 2009	End April 2009	End August 2008
Cash rate	3.00	0.00	–4.25
Housing loans			
Prime-full-doc	5.17	0.02	–3.81
Prime low-doc	5.84	–0.07	–3.65
Non-conforming	9.35	–0.05	–2.56
Personal loans	10.92	0.03	–2.08
Small business loans			
Term residentially secured	7.11	0.03	–2.99
Overdraft residentially secured	7.92	0.03	–2.99
Average actual rate[a]	7.16	0.04	–3.00
Large business loans			
Average actual rate, variable and bill funding[a]	5.21	0.16	–3.41

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

Graph 66
Housing Rates and Loan Type



Sources: ABS; APRA; Perpetual; RBA

The average variable interest rate on prime full-doc housing loans (including discounts), at 5.17 per cent, remains around its lowest level since 1964. Interest rates on riskier housing loans have fallen by somewhat less since August 2008 but also remain at low levels.

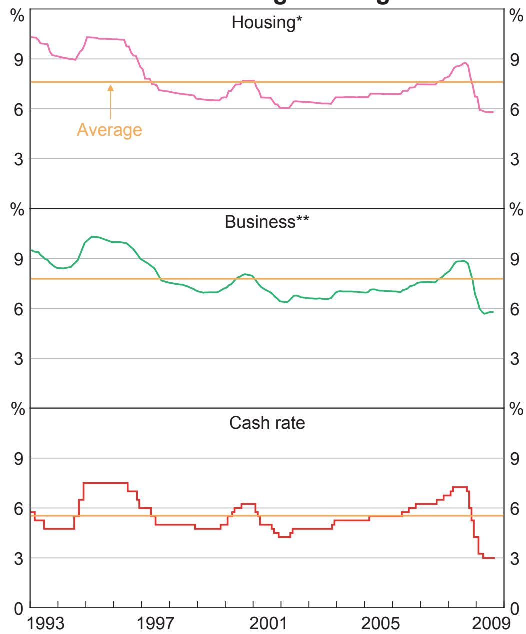
The major banks have raised their interest rates on new 3- and 5-year fixed-rate housing loans by about 85 basis points since end April to 6.69 per cent and 7.39 per cent respectively (Graph 66). Nonetheless, rates are still well below their averages over the past two decades. Despite fixed rates being 1½–2 percentage points higher than variable rates, the share of owner-occupier loan approvals at fixed rates has risen noticeably over recent months.

Overall, the average interest rate on all outstanding housing loans (variable and fixed) is estimated to have declined slightly since end April, to 5.80 per cent (Graph 67). This is around 300 basis points lower than its peak in August 2008 and 180 basis points below its post-1993 average.

The value of housing loan approvals has risen significantly over the past year and, in May, was 36 per cent above its trough in mid 2008 (Graph 68). There has been particularly strong growth in approvals to first-home buyers. This reflects the additional incentives currently available to first-home buyers, but also that for much of this decade, demand from first-home buyers has been subdued given reduced housing affordability.

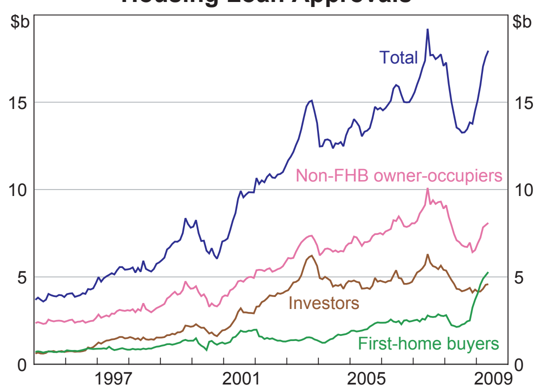
The five largest banks' share of gross owner-occupier loan approvals has stabilised at about 82 per cent over the past few months, up from 60 per cent just before the onset of the financial market turbulence in mid 2007 (Graph 69). The market shares of the smaller banks, credit unions and building societies and wholesale lenders have also been

Graph 67
Average Interest Rates on Outstanding Lending



* RBA estimates prior to 2000
** RBA estimates prior to 1994
Sources: ABS; APRA; Perpetual; RBA

Graph 68
Housing Loan Approvals*

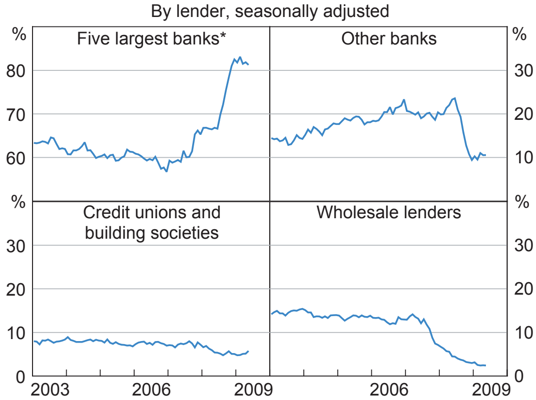


* Excludes owner-occupier refinancing and investor approvals for new construction
Sources: ABS; RBA

Graph 69

Share of Owner-occupier Loan Approvals

By lender, seasonally adjusted



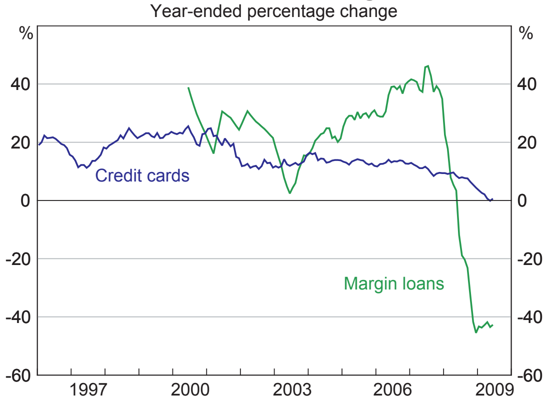
* Includes BankWest from December 2008

Sources: ABS; APRA

Graph 70

Personal Lending

Year-ended percentage change



Sources: APRA; RBA

little changed over recent months, but they have all ceded significant market share over the past two years.

While housing loan approvals have increased further in the June quarter, housing credit growth has been steady at a monthly average pace of 0.6 per cent. Owner-occupier housing credit continues to grow at a faster pace than investor housing. The significant increase in new loan approvals but stable housing credit growth implies that principal repayments on housing loans have increased (for further details, see the 'Domestic Economic Conditions' chapter).

Financial institutions' average variable rates on unsecured personal loans, margin loans and credit cards are all little changed since end April. Across all loan products, the current rates are a little below their post-1993 averages. Credit card lending has continued to slow as households focus upon repaying debt (Graph 70). Over the 12 months to June, there has been little growth in outstanding credit card balances.

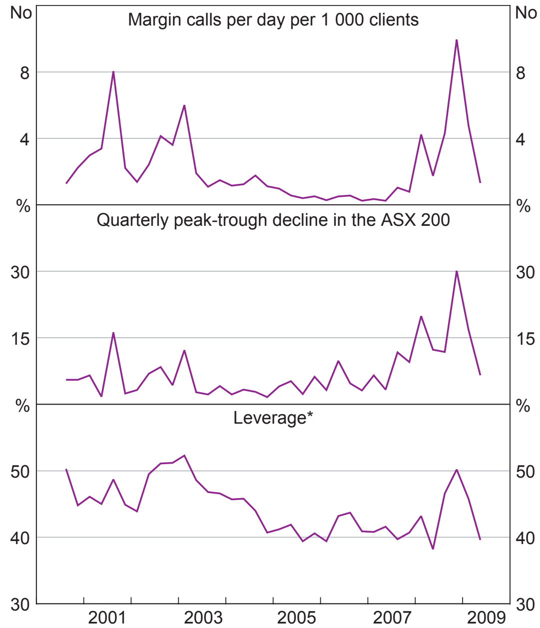
The value of margin loans outstanding decreased by 2 per cent over the June quarter 2009 to $18 billion, however the pace of decline has moderated from the falls of 15–25 per cent over recent quarters. Stronger equity markets meant that the incidence of margin calls declined to be below the decade average (Graph 71). Borrowers' gearing levels also declined significantly over the June quarter to 40 per cent, as the value of investors' collateral rose by 14 per cent, and outstanding debt fell slightly. Borrowers' average leverage is now reasonably low by historical standards.

Business financing

Interest rates on business loans have risen a little since end April. Overall, the interest rates faced by businesses remain low by historical standards, though there is some dispersion in lending rates across industries.

Graph 71

Margin Calls



* The total value of margin loans outstanding divided by the total value of the underlying securities

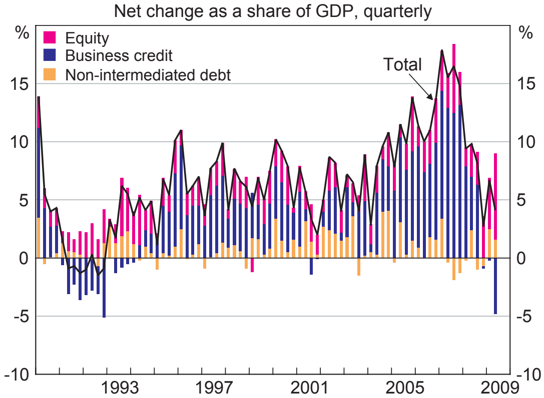
Sources: Bloomberg; RBA

Increases in risk margins have meant that interest rates on new and refinanced business facilities have fallen by much less than interest rates on existing facilities over the current easing cycle. The available evidence suggests that risk margins on loans to large businesses have generally risen by 100–200 basis points since mid 2008. Liaison with banks and businesses suggests that there has been significant dispersion in the changes in risk margins across industries, with transport and commercial property companies experiencing large increases in risk margins. With 90-day bank bill rates and 3-year swap rates having fallen by 460 and 260 basis points respectively since mid 2008, this means that the interest rate faced by most large businesses on new and refinanced borrowings will have declined. Overall, the average rate on outstanding large business loans is still 335 basis points lower than at the beginning of the current easing cycle, although the ongoing gradual repricing of existing business lending will continue to push up this average.

The major banks' average indicator rate on residentially secured term loans to small businesses is 300 basis points lower than in mid 2008. The average indicator rate for 3-year fixed-rate loans to small businesses has risen by 100 basis points since end April, reflecting the increases in capital market yields. Nonetheless, it is still 230 basis points lower than its peak in 2008.

Graph 72

Business External Funding



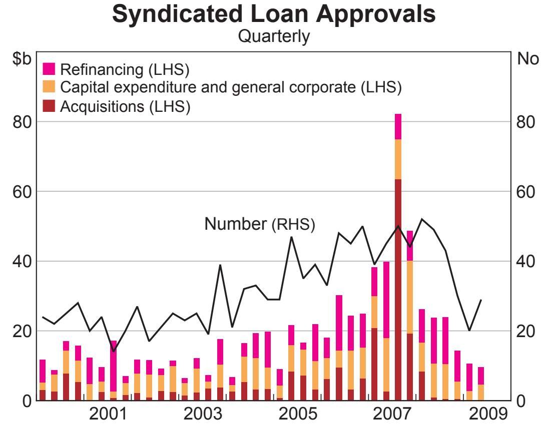
Sources: ABS; APRA; ASX; Austraclear Limited; RBA

Australian corporates continue to restructure their balance sheets in response to the strains in financial markets and the deterioration in the economic outlook. This has been reflected in an increase in equity funding and a fall in the use of debt as corporates deleverage – a trend that was also evident during the recession of the early 1990s. As a result of the strong equity raisings, and some bond issuance, in net terms corporate funding continued to increase in the June quarter despite the fall in business credit (Graph 72).

Total business debt declined slightly in the June quarter, with further declines in business credit partially offset by an increase in non-intermediated debt. Over the June quarter, intermediated business credit contracted at an annualised rate of 7 per cent, with the weakness broadly based across industry sectors, and evident for banks and non-bank financial institutions. The decline in business credit since its peak in November 2008 has been due mainly to falls in foreign-currency-denominated lending to domestic businesses. These falls reflect both the appreciation of the Australian dollar over this period and some reduction in the stock of foreign currency denominated lending. These loans are mainly used to fund the offshore operations of Australian companies. The contraction in business credit over the June quarter was evident for both large loans (those greater than $2 million) and small loans (those less than $2 million).

Graph 73

Syndicated Loan Approvals



Sources: RBA; Thomson Reuters

Commercial loan approvals have levelled out in recent months, following significant declines in 2008. In the syndicated lending market, there was just $10 billion of new lending to Australian corporates in the June quarter, compared to a quarterly average of $19 billion during the period 2000–2009 (Graph 73). A little over half of these loans were used to refinance existing debt, with most of the remainder being used for capital expenditure or 'general corporate' purposes.

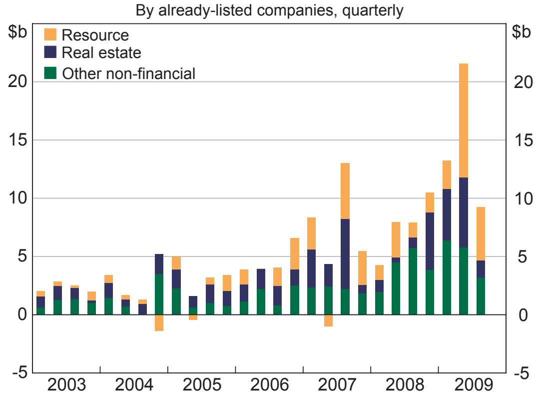
Reflecting corporates deleveraging and the relatively small amount of bonds maturing in coming months, corporate bond issuance has been modest in the past few months. Around half of funds were raised offshore, and there is evidence of some broadening of the type of companies able to raise funds in the bond market, with a few medium-sized companies issuing bonds domestically. Consistent with some pick-up in investor demand, spreads in the secondary market have fallen. BBB-rated corporate bonds are currently trading around 380 basis points above CGS in the domestic market, down from their peak of 580 basis points in April 2009. The robust investor demand was also evident earlier this year when BHP Billiton and Rio Tinto issued large bonds offshore.

Listed corporates (excluding banks) raised a record $21½ billion of equity during the June quarter, with resource companies accounting for almost half of this amount and the remainder evenly split between real estate companies and other non-resource companies (Graph 74). Equity raisings for the September quarter are also proceeding at a rapid pace. Around half of these raisings reflect the Australian component of Rio Tinto's rights issue ($4 billion) which settled in July; a further $15 billion was raised by Rio Tinto from the rights issue associated with its UK-listed shares. Corporates – including Rio Tinto – have tended to use these funds to reduce the leverage on their balance sheets by paying down debt, mostly bank loans, though some medium-sized resource companies plan to use the capital to fund investment.

Graph 74

Listed Corporates' Net Equity Raisings*

By already-listed companies, quarterly



* Excludes IPOs and hybrid conversions. Data for the September quarter 2009 are estimated using announcements from large companies.
Sources: ASX; RBA

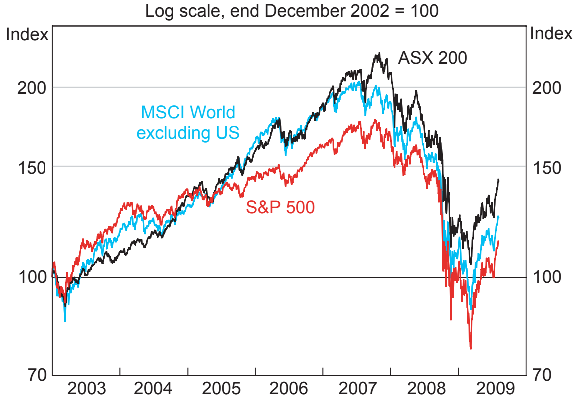
It is estimated that equity raisings undertaken so far this year have reduced listed corporates' debt level by around 10 per cent since end 2008, to around $370 billion. Taken literally, this implies that the gearing ratio – the ratio of the book value of debt to equity – has declined from around 85 per cent to around 70 per cent (abstracting from profits, dividend distributions and further asset sales/writedowns). While there has been a tendency for more highly geared companies to raise equity, the deleveraging has been relatively broadly based. The bulk of new equity has been raised through placements and rights issues. Buybacks remain limited, reflecting corporates' preference to retain cash to strengthen their balance sheets given the uncertain outlook.

Some companies, particularly real estate investment trusts (REITs) (which tend to be more highly leveraged than other companies), have also been pursuing asset sales to raise cash and pay down debt. Last year, the leverage of many REITs increased due to falling property values, to the extent that some were in danger of breaching loan covenants. While they have undertaken significant equity raisings so far this year to reduce gearing, much of this is likely to be offset by further asset write-downs.

Equities

Graph 75

Share Price Indices



Sources: Bloomberg; Thomson Reuters

The ASX 200 has risen broadly in line with the increases in share markets overseas since the last *Statement* (Graph 75). Gains have been broadly based, with resources' share prices increasing the most. The ASX 200 is now up around 35 per cent since the trough in early March, but still remains around 35 per cent below its peak in November 2007 and around the same level as in July 2005.

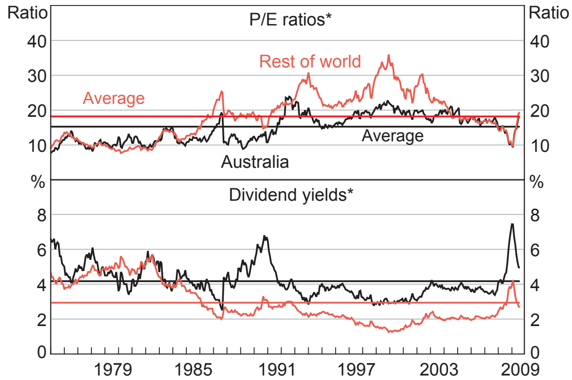
For most of this calendar year, volatility of the Australian share market has remained below the average since the onset of turbulence in financial markets in 2007, and well below the very high levels reached after the collapse of Lehman Brothers last year. However, with daily movements of the ASX 200 averaging a little over 1 per cent, volatility is nearly twice its long-run historical average.

Analysts have continued to modestly revise down their forecasts for ASX 200 companies' earnings in recent months, albeit at a slower pace than earlier in the year. For the 2008/09 financial year – the reporting season which has just started for the bulk of companies – profits are expected to fall by 14 per cent, reflecting a combination of weakening domestic demand and lower commodity prices for resource companies. This outcome would be the largest fall in earnings for the Australian market since the recession in the early 1990s. Around half of ASX 200 companies announced dividend cuts in the first half of the 2008/09 financial year and market commentary suggests that dividend reductions as well as asset write-downs will continue to be major themes of the forthcoming reporting season. REITs and infrastructure companies, in particular, are expected to report significant asset write-downs, with some companies having already announced large asset write-downs for the June half. Market analysts expect profits to decline a further 6 per cent in 2009/10, before increasing by around 20 per cent in 2010/11 as economic growth picks up. However, uncertainty about the outlook persists with the dispersion of analysts' forecasts remaining at an elevated level.

Given the increases in share prices since early March and some falls in earnings and dividends, measures of share market valuation have moved closer to their historical averages in recent months. The Australian trailing P/E ratio – which is based on earnings for the past year – currently stands at around 18, a little above its long-run average (Graph 76). Of the 8 point increase in the P/E ratio since March, a little under half owes to increases in share prices, with the remainder accounted for by falls in earnings. The dividend yield for the Australian share market, at 5 per cent, has fallen significantly since the start of the year, though remains well above its average level. Of the 2½ percentage point fall in the dividend yield, around two-fifths owes to falls in dividends as companies have sought to conserve cash, and the remainder to increases in share prices.

Graph 76

Measures of Share Market Valuation



* Calculated using earnings and dividends from the past year
Sources: MSCI; RBA; Thomson Reuters

Price and Wage Developments

Recent developments in inflation

Inflationary pressures in the domestic economy continue to moderate. Upstream price pressures have eased considerably over the first half of 2009 and there are signs of moderation in wage growth. In addition, inflation expectations remain well contained. Year-ended consumer price index (CPI) inflation has recorded its lowest outcome in a decade. Measures of underlying inflation remain quite high, but are declining gradually, in line with the Bank's expectations.

The CPI increased by 0.5 per cent in the June quarter, to be 1.5 per cent higher over the year (Table 12, Graph 77). The main contributors to the quarterly rise were price increases for automotive fuel, hospital & medical services and rents, partly offset by falls in the prices of deposit & loan facilities, fruit and vegetables. Excluding volatile items and deposit & loan facilities, prices rose by 0.8 per cent in the quarter to be 3.6 per cent higher over the year. Based on a range of measures, the Bank's assessment is that underlying inflation was around 0.8 per cent in the quarter and 3¾ per cent over the year, compared with a rate of just over 4½ per cent in September 2008.

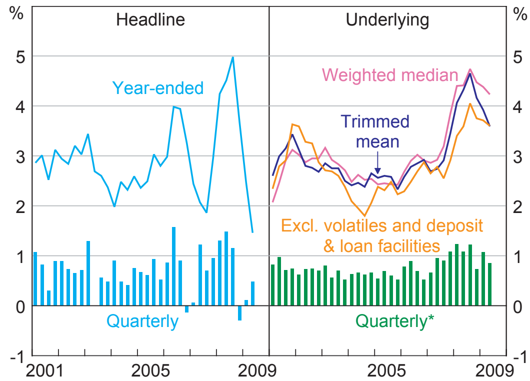
Table 12: Measures of Consumer Price Inflation
Per cent

	Quarterly		Year-ended	
	March quarter 2009	June quarter 2009	March quarter 2009	June quarter 2009
CPI	0.1	0.5	2.5	1.5
– Tradables	0.5	0.7	0.8	0.0
– Tradables (ex food & fuel)	0.9	1.0	2.0	1.9
– Non-tradables	–0.1	0.4	3.4	2.4
Underlying measures				
Weighted median	1.2	0.8	4.4	4.2
Trimmed mean	1.0	0.8	3.9	3.6
CPI ex volatile items[(a)] and deposit & loan facilities	1.1	0.8	3.7	3.6

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

The current divergence between measures of underlying inflation and headline CPI inflation is larger than it has been for almost 25 years. The divergence is largely attributable to two factors. The first is a 21 per cent decline in fuel prices over the past year, which has subtracted 1 percentage point from CPI inflation (Graph 78). This decline has been driven by movements in global oil prices, which fell sharply from elevated levels in mid 2008, before recovering somewhat

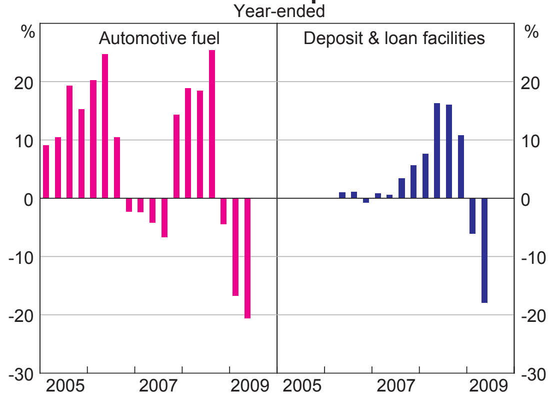
Graph 77
Consumer Price Inflation



* Average of the trimmed mean and weighted median

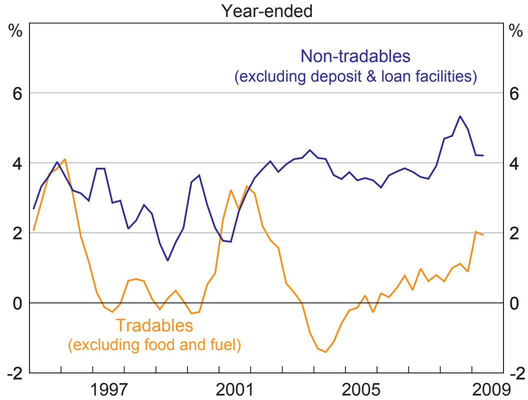
Sources: ABS; RBA

Graph 78
Inflation Components
Year-ended



Source: ABS

Graph 79
Tradables and Non-tradables Inflation*
Year-ended



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

in the June quarter. The second factor is an 18 per cent fall in the price of deposit & loan facilities over the past year, which has subtracted nearly a further percentage point from CPI inflation. This fall is the result of a narrowing in the ABS estimate of the difference between interest rates on deposit and loan products used by households.

The moderation in underlying inflation over recent quarters reflects an easing in non-tradables prices (Graph 79). Excluding deposit & loan facilities, year-ended non-tradables inflation has moderated by a percentage point since the September quarter 2008, to be 4.2 per cent in the June quarter. This is mostly accounted for by an easing in inflation for housing and a number of food items. Housing cost inflation has slowed from almost 7 per cent to just over 5 per cent in recent quarters, with an easing in inflation for both new housing and rents. Similarly, inflation in food items classified as non-tradable has slowed from nearly 7 per cent to 4 per cent in recent quarters, reflecting a broad-based easing. In contrast, tradables prices (excluding food and fuel) rose solidly for a second consecutive quarter, increasing by 1.0 per cent to be 1.9 per cent higher over the year. This pick-up in tradables inflation has been broad-based and continues to reflect the effect of the currency depreciation in the second half of 2008, although this impact is likely to moderate over the coming year as the more recent appreciation begins to flow through.

Costs and margins

Official measures suggest that there was some moderation in the growth in labour costs in the March quarter, driven by an easing in private-sector wage growth. More timely indicators suggest that this has continued over recent months, consistent with the weakening of the labour market.

The wage price index (WPI) increased by 0.8 per cent in the March quarter, a below-average outcome for this series, after growing at a firm pace throughout 2008 (Graph 80). In year-ended terms, WPI growth moderated slightly to 4.2 per cent, reflecting a decline in growth in the private-sector component. Growth in the measure that includes bonuses has moderated more noticeably over the past year, after picking up in 2007.

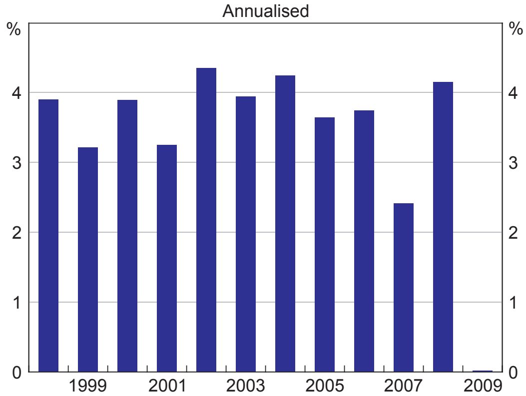
Graph 80

Other measures of wage growth also moderated in the March quarter. Ordinary-time earnings as measured by the average weekly earnings survey grew by 1.2 per cent in the quarter, following strong growth of around 1¾ per cent in the previous two quarters. Growth in the national accounts measure of average earnings – in principle the broadest measure of earnings, but quite volatile – was very weak in the quarter, possibly reflecting declining bonus payments. In contrast, the average annualised wage increase in new federal enterprise bargaining agreements certified in the quarter picked up somewhat, from 4.3 per cent to 4.6 per cent. However, the coverage of agreements certified in the quarter was relatively small and recent agreements in the construction industry had a larger than usual influence.

More timely indicators of labour cost growth point to further moderation in coming quarters. The Bank's business liaison suggests that the proportion of firms expecting to increase wages over the year has fallen from over 90 per cent to around two-thirds. Business surveys taken in the March and June quarters also suggest that labour cost growth is likely to continue to moderate over the period ahead.

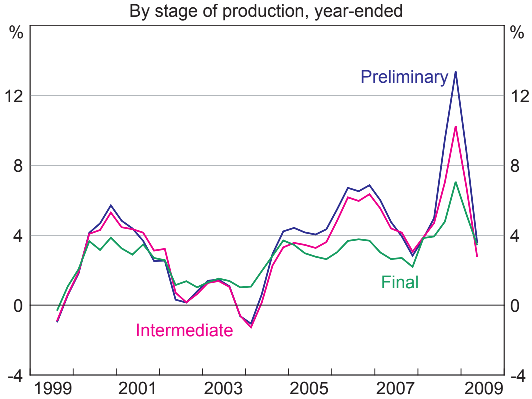
The recent decision by the Australian Fair Pay Commission (AFPC) to leave the federal minimum wage and basic award rates unchanged in 2009 will also contribute to wage moderation over the coming year (Graph 81). The principal reason given for the decision, which followed a 4 per cent increase in 2008, was the risk of higher unemployment from increasing wages in a time of labour market weakness. The AFPC argued that the social impact on low-paid employees of job losses or reduced working hours is more significant than the impact of leaving the minimum wage unchanged. It also argued that the safety net has been maintained by changes to the tax/transfer system and government stimulus packages. The AFPC's decision is estimated to directly affect around 15 per cent of the workforce, with various estimates suggesting that at

Graph 81
Minimum Wage Increase*
Annualised



* RBA estimates, based on AIRC/AFPC increases in dollar terms
Sources: AIRC/AFPC; RBA

Graph 82
Producer Price Inflation*
By stage of production, year-ended



* Excluding oil
Sources: ABS; RBA

least as many employees may also be indirectly affected.

Upstream price pressures continued to abate in the June quarter, with the easing relatively broad-based (Graph 82). Excluding oil, preliminary stage producer prices fell by 2.8 per cent and final stage prices fell by 0.9 per cent in the quarter. Earlier declines in global commodity prices contributed – coal, steel and chemicals prices all fell – along with a 6 per cent decline in final stage import prices as the currency appreciated (although import prices remained 16 per cent higher over the year). All industries recorded lower prices in the quarter, with the weakest outcomes in property & business services and manufacturing, both of which recorded price falls of over 1 per cent. Construction prices fell slightly in the quarter, reflecting persistent weakness in non-residential prices which were down by 3½ per cent over the year.

Recent estimates of business margins, based on ABS profits data, suggest that margins in the broader economy declined slightly in the March quarter, to be somewhat below the average level of recent years. The NAB survey also suggests that margins have declined in recent quarters, although fewer firms are now expecting margins to continue to contract.

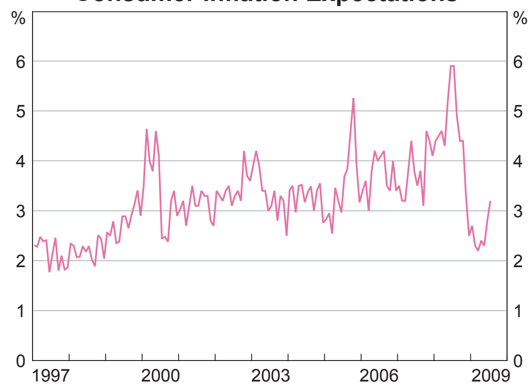
Inflation expectations

Inflation expectations remain well below the elevated levels of mid 2008, although they have risen a little in recent months. Consumer inflation expectations, as measured by the Melbourne Institute survey, drifted up to 3.2 per cent in July, which is around the average level over the past decade (Graph 83). Measures of inflation expectations derived from financial markets have also drifted up a little over recent months, to be a little over 2½ per cent.

Market economists surveyed by the Bank following the release of the June quarter CPI expect headline inflation to remain at relatively low levels in the near term. The median expectation for headline inflation over 2009 is now 1.7 per cent, compared with 2.1 per cent in May (Table 13). Over 2010, the median inflation expectation is unchanged at 2.4 per cent. Surveys of both union officials and businesses also generally suggest that inflation expectations remain well below their average level over recent years (Table 13, Graph 84).

Graph 83

Consumer Inflation Expectations*



* Median expectation of average annual inflation over the next year
Source: Melbourne Institute of Applied Economic and Social Research

Table 13: Median Inflation Expectations
Per cent

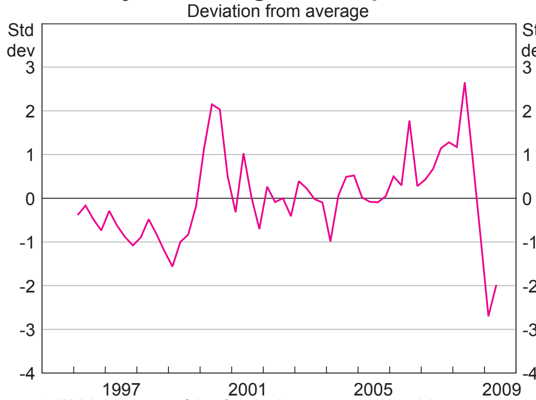
	Year to December 2009			Year to December 2010	
	February 2009	May 2009	August 2009	May 2009	August 2009
Market economists[a]	2.5	2.1	1.7	2.4	2.4
Union officials[b]	3.0	2.1	1.9	2.7	2.5

(a) RBA survey
(b) Workplace Research Centre

Graph 84

Surveys of Selling Price Expectations*

Deviation from average



* Weighted average of data from business surveys, with weights calculated by the RBA using the principal component method
Sources: ACCI; CBA; NAB; RBA; Sensis; Westpac

Economic Outlook

The international economy

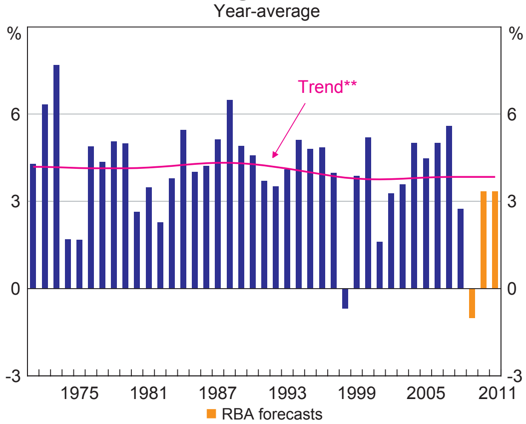
At the time of the May *Statement*, there were only tentative signs of stabilisation in the global economy. Since then, conditions in global financial markets have improved and measures of household and business confidence suggest that the extreme pessimism that took hold in late 2008 has eased noticeably. More generally, the significant policy stimulus in a number of countries is having a marked effect, particularly in China and some other economies in east Asia.

Given these developments, the RBA staff's central forecast for global economic growth has been revised upwards. This revision is mostly in Asia, with growth prospects improving in the large emerging economies (China and India), some of the higher-income economies (Korea, Singapore and Taiwan) as well as in Japan. The outlook in North America is also somewhat firmer, but there has been limited improvement in prospects for European growth. Overall, output in Australia's trading partners (weighted by export shares) is expected to grow in the second half of 2009, although given the earlier weakness, a contraction in year-average terms of around 1 per cent is expected for the year as a whole. Year-average growth of nearly 3½ per cent is then expected in 2010 (Graph 85). This outlook is somewhat more positive than that implied by the July forecasts from the IMF, especially for the rest of 2009 and for east Asia.

More broadly, the pace of the global recovery over the next few years is still expected to be relatively subdued, especially in the larger advanced economies. Notwithstanding previous experience that recoveries out of deep recessions can be quite strong, many advanced economies will face significant headwinds as the household and financial sectors consolidate their balance sheets. In addition, governments will be under pressure to consolidate their budgetary positions after a very significant easing in the past year or so, which in some cases may raise medium-term sustainability concerns unless remedial action is taken.

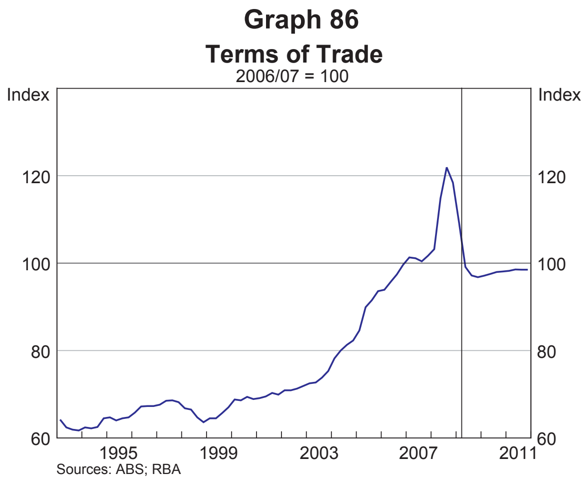
The weakness in the global economy over the past year has contributed to a significant decline in commodity prices and Australia's terms of trade, although spot prices for coal and iron ore and for exchange-traded commodities have generally strengthened over the past three months. Overall, given the earlier large decline in

Graph 85
Australia's Trading Partner GDP Growth*
Year-average



* Weighted using merchandise export shares at market exchange rates
** Estimated using a Hodrick-Prescott filter
Sources: CEIC; RBA; Thomson Reuters

bulk commodity contract prices, the terms of trade are expected to record a fall of just over 20 per cent from their 2008 peak (Graph 86). This would nonetheless still leave the terms of trade around 45 per cent above the average level that prevailed between 1980 and 2000.



Domestic activity

Recent data suggest that the domestic economy is also performing better than had been expected, benefiting from the significant stimulus delivered by fiscal and monetary policy as well as the stronger growth in China. In contrast to the experience in most other countries, export performance has remained solid. In addition, consumer and business confidence have rebounded, and there has been a fairly broad-based improvement in the outlook for domestic spending.

The forecasts presented below are based on the assumption that the exchange rate remains around its current level and that oil prices move broadly in line with near-term futures pricing. In previous *Statements* the forecasts were prepared using the additional technical assumption that the cash rate remained constant throughout the forecast period. In the current environment, however, it is not particularly realistic to assume that the cash rate remains at the historically low level of 3 per cent out to the end of 2011. Given this, the current forecasts have been prepared on the technical assumption of a return towards a more normal setting of monetary policy over the forecast horizon. This use of a more realistic technical assumption by the Bank staff in no way constitutes a commitment by the Board to a particular future path of the cash rate.

As discussed in the 'Domestic Economic Conditions' chapter, the different measures of GDP growth in the March quarter suggest quite different pictures about the underlying momentum of the economy in the first part of the year, although the average of the measures showed stronger growth than was generally expected. These measurement issues – which raise the possibility of larger-than-usual revisions – make forecasting the growth outcome for 2009 more difficult than usual. With this qualification in mind, the Bank's central forecast is now for the economy to grow by around ½ per cent over 2009, compared with a forecast contraction of 1 per cent at the time of the May *Statement* (Table 14). About half this revision reflects the stronger-than-expected March quarter outcome. But the forecasts also embody more genuine strength in the economy than had been expected a few months ago.

The composition of spending over the second half of the year is expected to be somewhat different from that in the first half, when household consumption was quite strong and business investment and home-building were weak. Looking forward, consumption spending is likely to slow as the boost from the fiscal payments to households fades. In addition, while asset prices have recovered over recent months, the decline in net worth over 2008 is likely to continue to contribute to higher rates of household saving than seen over much of this decade. In contrast, home-building is likely to pick up, reflecting the lower level of mortgage rates and the increase in grants for first-home buyers, although the outlook for apartments looks less promising due to financing difficulties in that sector. Public spending is now also growing strongly as a result of the stimulus-related expenditure on schools, home insulation and public infrastructure.

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

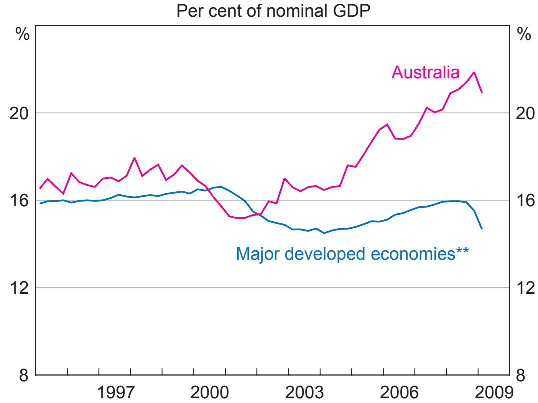
	Mar 2009	June 2009	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011
GDP growth	0.4	¼	½	1	2¼	3¼	3¾
Non-farm GDP growth	0.0	0	¾	¾	2¼	3¼	3¾
CPI inflation	2.5	1.5	2¼	2¾	2	2	2
Underlying inflation	4	3¾	3¼	2½	2	2	2

(a) Actual GDP data to March 2009 and actual inflation data to June 2009. For the forecast period, technical assumptions include A$ at US$0.84, TWI at 66, and WTI crude oil price at US$80 per barrel and Tapis crude oil price at US$83 per barrel.
Sources: ABS; RBA

The economy is forecast to gradually strengthen through 2010 and 2011, with growth expected to be around 3¾ per cent, or moderately above-trend, by the end of the forecast period. In year-average terms, GDP is expected to grow by ½ per cent in 2009/10 and 2½ per cent in 2010/11. These would represent better outcomes than those expected for most other advanced economies, with Australia's medium-term growth prospects bolstered by its relatively fast rate of population increase and the strong growth in the capital stock over recent years (Graph 87). In addition, Australia's exposure to China, India and elsewhere in Asia – where the demand for resources continues to rise – supports a robust outlook for resources investment in the medium term. While exports are expected to increase only slightly in 2009, they are forecast to grow more strongly in 2010 and 2011 as global demand recovers, especially in the emerging economies.

Although some further weakness in labour market conditions is expected in coming months, leading indicators suggest that the pace of deterioration is easing, with the unemployment rate now expected to rise by less than had been expected.

Graph 87
Investment*
Per cent of nominal GDP



* Total private and public investment, excluding dwelling investment
** Canada, euro area, Japan, UK and US; weighted using output shares at average market exchange rates in 2006–2008
Sources: ABS; RBA; Thomson Reuters

Inflation

Although underlying inflation remains high in year-ended terms, it has begun to fall. Inflation is expected to continue to moderate due to the easing in capacity pressures and labour costs. Recent weakness in economic conditions has led to some moderation in private sector wage growth, and evidence from business surveys and liaison suggests that further slowing is likely. The easing in inflation is, however, expected to be gradual, given that price pressures in the non-tradables component have been significant and broad-based in recent years and have only begun to moderate recently. In addition, the depreciation of the exchange rate in the second half of 2008 will exert some further upward pressure on tradables prices, although the recent appreciation will help moderate these pressures.

Overall, the Bank's central forecast is for underlying inflation to decline, reaching a trough of around 2 per cent by mid 2011. This is an upward revision relative to the forecasts at the time of the May *Statement*, mainly reflecting the improvement in the outlook for the domestic economy.

The near-term profile for year-ended CPI inflation is noticeably different from that for underlying inflation. This reflects large movements in a few CPI components in recent quarters, particularly petrol prices and the ABS estimate of deposit & loan facilities prices, which together are likely to subtract nearly 2 percentage points from CPI inflation in the year to the September quarter 2009. Year-ended CPI inflation is expected to remain at around 1½ per cent in the September quarter, and then is projected to move broadly in line with underlying inflation from around mid 2010 once these factors have dropped out of the calculation of the annual rate.

Risks

The risks around these central forecasts are viewed to be broadly balanced. This follows a period in which the downside risks appeared larger than those on the upside.

Internationally, the risk of a further sharp downturn in the global economy is lower than at the time of the May *Statement*. Notwithstanding this, the possibility of another adverse shock in some part of the global financial system cannot be ruled out, and this could serve as the catalyst for a return to the very low levels of confidence seen late last year. There is also some possibility that the current strong rebound in Asia may not be sustained in the face of continuing weak consumer demand in the advanced economies. In the other direction, there is some probability that the recent global pick-up in confidence becomes self- reinforcing, particularly given the substantial monetary and fiscal stimulus that remains in place, contributing to a more rapid recovery than is currently expected by most forecasters.

Domestically, the main downside risk is that some of the recent improvement in economic indicators simply reflects changes in the timing of overall spending, partly due to fiscal measures, and that over the second half of the year private sector demand will weaken again. In the other direction, the recent pick-up in confidence could see the economy grow more strongly than expected and, over a slightly longer horizon, there is an increasing probability that investment will recover more strongly than in the central forecast, particularly in the resources sector. In this scenario, inflation would be unlikely to fall as much as in the central forecast.