Statement on Monetary Policy

FEBRUARY 2010

Contents

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Statement on Monetary Policy

The global economy continues to recover following the sharp contraction in output in late 2008 and early 2009. The recovery is most advanced in Asia, although almost all economies are now growing again, albeit weakly in some cases. International trade is also continuing to recover and a degree of stability has returned to financial markets.

This is a much better environment than was feared likely in the early part of last year and forecasts for global growth have been revised up accordingly. The world economy is now widely expected to grow by around 4 per cent in each of the next couple of years. This is around the average pace of growth over the past decade or so, although it would represent only a relatively mild recovery from what has been a severe global downturn. The recovery in the advanced economies is likely to remain subdued for some time, with these economies continuing to operate with considerable excess capacity. In contrast, relatively strong growth is expected in the Asian region.

Although the outlook for the world economy as a whole has improved, significant uncertainties remain. One question is the durability of the recent growth in the major advanced economies. In many of these economies, current growth rates are being boosted by the dynamics of the inventory cycle and temporary fiscal measures. This is to be expected at this stage, but for a sustained recovery to take hold, a substantially stronger pick-up in private demand than has been evident to date will be required. Many of these countries also face very significant fiscal challenges that will need to be addressed over time and have banking systems that are still experiencing credit losses from the weak economic conditions.

In Asia, the issues are somewhat different. The Chinese economy has expanded very strongly and a number of other countries have been favourably affected as a result. Industrial production and international trade have rebounded, with the economies in the region operating with much less spare capacity than is the case for the advanced economies. Reflecting this, unemployment rates have started to fall and inflation pressures are emerging, with some countries taking steps to reduce the degree of policy stimulus that is in place.

There has also been a general improvement in sentiment in financial markets, although there continue to be occasional bouts of heightened risk aversion. Over the past couple of months these have tended to be associated with concerns about fiscal sustainability and the creditworthiness of some governments, rather than concerns about the creditworthiness of financial institutions as was the case in 2008 and much of 2009. As a result, spreads on government debt in some countries have increased significantly, although for most countries government bond yields remain at low levels. More broadly, credit market conditions have continued to improve gradually, with central bank support facilities being wound back further and issuance of government-guaranteed bank debt declining. Stock markets are also up significantly from their lows of last year, although most have moved broadly sideways over recent months. Despite the various signs of increasing normalisation, bank credit growth remains very weak or negative in almost all advanced economies. Many banks have a limited appetite for new lending, and many borrowers are still seeking to reduce their debt levels.

In Australia, economic conditions were better than expected in 2009. After contracting in the final quarter of 2008, the economy expanded through 2009 at a reasonable pace, particularly in light of developments in the global economy. Activity has been supported by the stimulatory settings of monetary and fiscal policy, Australia's strong trade links with Asia, a relatively high rate of population growth and a sound financial system.

Recent labour market outcomes, in particular, have been positive. Employment grew strongly over the final months of 2009 and average hours worked also increased after having fallen earlier in the year. Given these developments and a pick-up in hiring intentions by firms, it now looks likely that the unemployment rate has peaked at around 5¾ per cent, a much better outcome than thought likely early last year.

The stronger employment data have helped lift consumer confidence which, together with a recovery in household wealth, has supported consumer spending, despite the fading of the effects of the earlier cash payments to households. Notwithstanding this resilience, many households are still taking a more cautious approach to their spending than was the case a few years ago, with the household saving rate having risen.

Housing construction is also now providing a boost to domestic demand, with a significant pick-up in home-building under way. The recovery is mostly in the detached housing sector, with financing for the construction of apartments remaining tight. Aggregate measures of house prices also increased strongly over 2009, although prices at the bottom end of the market appear to have stopped rising recently, with the demand from first-home buyers declining after the scaling back of the additional government grants. Household credit outstanding continues to grow at a solid pace, although loan approvals have declined a little over recent months.

Business investment in Australia, particularly in the resources sector, is at a very high level, although many businesses remain cautious about increasing their capital spending despite confidence having improved significantly. One area of particular weakness is non-residential building, with private-sector building approvals remaining at quite low levels. An important offset to the weakness has been a large increase in public-sector infrastructure spending, especially in the education sector. In terms of business financing, total credit outstanding has continued to fall, reflecting both demand and supply factors. On the demand side, many businesses are using equity raisings and retained earnings to reduce their debt levels while, on the supply side, lending conditions for the commercial property sector remain very tight.

Inflation in Australia has moderated over the past year or so, in line with the Bank's expectations. In underlying terms, year-ended inflation is running at around 3¼ per cent, down from just over 4½ per cent in September 2008. This moderation reflects the significant easing of wage growth in the private sector, weaker domestic demand pressures, and more recently the substantial appreciation of the exchange rate. As these factors continue to work their way through, a further gradual moderation in the year-ended rate of underlying inflation is expected. In contrast, the rate of increase in the Consumer Price Index has picked up recently, to around 2 per cent, as temporary factors which were previously holding it down have abated.

Globally, many commodity prices have risen significantly since the middle of last year. Iron ore and coal prices, in particular, are up strongly as a result of renewed strength in demand from Asia. The prices of many rural commodities have also risen after earlier declines. This lift in commodity prices has resulted in an improvement in the outlook for Australia's terms of trade, which are now expected to rise over the next year, after falling in 2008/09.

The central forecast is for the economy to grow at around 3¼–3½ per cent in both 2010 and 2011. Private demand is likely to strengthen through 2010, with growth in the early part of the year being supported by strong public demand. The improvement in the global economy and the increase in commodity prices are expected to support continuing high levels of investment in the resources sector, and dwelling investment is expected to grow strongly. While overall growth in the economy is forecast to be reasonably strong, the appreciation of the Australian dollar that has taken place as the outlook for the resources sector has improved will restrain activity in a number of industries that are exposed to international competition.

Underlying inflation is expected to continue moderating in year-ended terms to reach a low of a little under 2½ per cent in the second half of 2010, before rising a little thereafter. Inflation expectations remain contained and the effects of the significant slowing in wage growth seen last year and the appreciation of the exchange rate have yet to fully work their way through. Notwithstanding this, these current forecasts represent a modest upward revision to those in the November *Statement*, with recent data suggesting that the economy starts the current upswing in activity with somewhat less spare capacity than earlier thought likely. Year-ended CPI inflation is expected to pick up over the next couple of quarters, as the temporary factors that have held it down drop out of the calculations. By late 2010, CPI and underlying inflation are expected to be running at similar rates and consistent with the medium-term target.

With the risk of a serious economic contraction in Australia having passed, the Board decided in October last year that it was prudent to lessen the degree of monetary stimulus that was put in place when the outlook appeared much weaker. Given this assessment, the cash rate was raised by 25 basis points at each of the October, November and December meetings to 3.75 per cent. Banks increased interest rates on loans by more than this, with most loan rates increasing by close to a percentage point over this period. While interest rates on loans remain below average, these increases have materially reduced the amount of monetary stimulus to the economy.

At its February meeting, the Board decided to keep the cash rate unchanged. With inflation moderating as expected, interest rates no longer at exceptionally low levels, and relatively little information available as to the impact of the recent increases, the Board judged it appropriate to hold the cash rate steady for the time being. Looking forward, if economic conditions gradually strengthen as expected, it is likely that monetary policy will need to be adjusted further over time to ensure that inflation remains consistent with the target over the medium term.

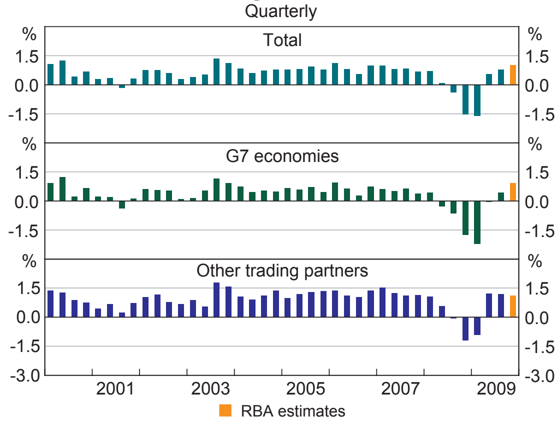
International Economic Developments

The world economy continues to recover from the large decline in output seen in late 2008 and early 2009. The recovery remains most advanced in emerging Asia, although output is estimated to have grown at a solid pace in the second half of 2009 in most regions of the world (Graph 1). World trade and global industrial production have both picked up, and the extreme risk aversion evident earlier has continued to ease.

Reflecting these developments, both private sector and official forecasts for the world economy have been revised up. The IMF is now forecasting that the world economy will expand by just under 4 per cent in 2010 – around ¾ percentage points stronger than had been expected in October – and by around 4¼ per cent in 2011 (Graph 2, Table 1). The Bank's forecasts for world and trading-partner growth in 2010 (outlined in the 'Economic Outlook' chapter) have also been raised, although by a smaller amount, reflecting the fact that they were somewhat above those of the IMF at the time of the November *Statement*.

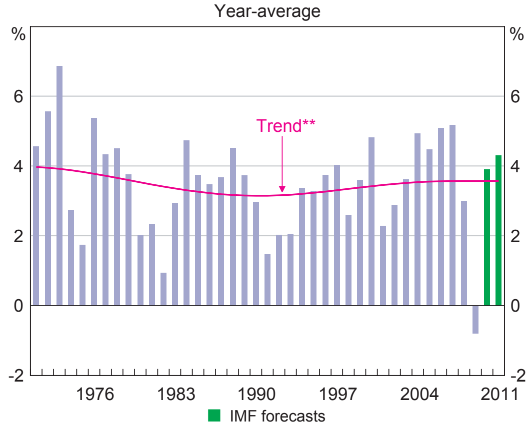
Notwithstanding this improvement in global activity, many advanced economies continue to operate at well below full capacity. While industrial production has picked up from the low levels of early to mid 2009, in many economies it has recovered only a relatively small proportion of its earlier sharp falls (Graph 3), and much of this recovery has reflected the inventory cycle rather than a significant pick-up in final demand. Capacity utilisation remains very low, with the IMF estimating that output in the major

Graph 1
Australia's Trading Partner GDP Growth*
Quarterly



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

Graph 2
World GDP Growth*
Year-average



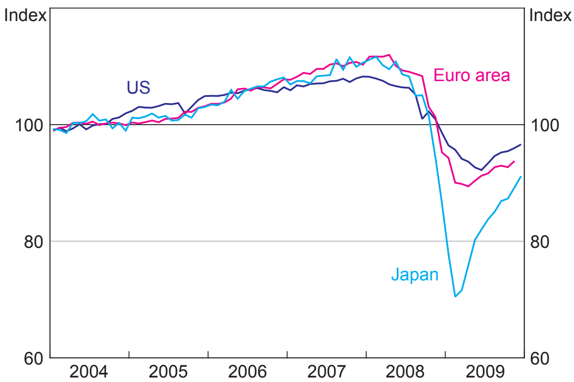
* Weighted by GDP at PPP exchange rates
** Estimated using a Hodrick-Prescott filter
Sources: IMF; RBA

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

	2008	2009	2010	2011
		Estimate	IMF forecasts[(b)]	
United States	0.4	–2.4	2.7	2.4
Euro area	0.7	–3.9	1.0	1.6
Japan	–1.2	–5.2	1.7	2.2
China	9.6	8.7	10.0	9.7
Other east Asia[(c)]	2.7	–0.3	4.8	5.0
India	7.5	6.9	7.7	7.8
World	**3.0**	**–0.8**	**3.9**	**4.3**
Australia's trading partners[(d)]	2.7	–0.3	4.4	4.6

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

Graph 3
Industrial Production
2004 = 100



Source: Thomson Reuters

advanced economies is currently running at around 5 per cent below potential, and unemployment has reached double-digit rates in the United States and euro area. In contrast, the pace of recovery in many economies in Asia has been strong, following the sharp declines in growth in late 2008 and early 2009. As a result, the level of spare capacity is now much reduced and unemployment rates have begun to fall in most Asian economies. These differences are some of the factors contributing to different trends in consumer price inflation, with core inflation tending to pick up in Asia in recent months after earlier sizeable falls, in contrast to continuing gradual declines in the United States and across most of Europe. A more detailed discussion of recent and prospective trends in world consumer price inflation is provided in 'Box A: Global Developments in Inflation'.

As noted, economic recovery is most advanced in Asia, where strong growth resumed in the second quarter of 2009. A broad range of indicators suggest that the Chinese economy continues to grow strongly and that price pressures have increased. Output is estimated to have expanded by around 2¼ per cent in the December quarter, to be 10¾ per cent higher over the year (Graph 4). Recent monthly activity data show that the composition of China's growth is shifting away from investment and back towards the export sector, which had weakened sharply in late 2008. After expanding by around 35 per cent over the first three quarters of 2009, nominal urban fixed-asset investment fell by 4 per cent in the December quarter (Graph 5). In contrast, the recovery in exports under way since mid 2009 has continued, with export volumes estimated to have risen by 13 per cent in the December quarter, after growing by 7 per cent in the September quarter. Despite the recent slowing in investment spending, credit continued to expand at a rapid pace in the second half of 2009, with a moderation in business credit growth from the extremely high rates seen in the first half of the year partly offset by a strengthening in household credit growth. Retail sales data suggest that growth in household spending remains firm.

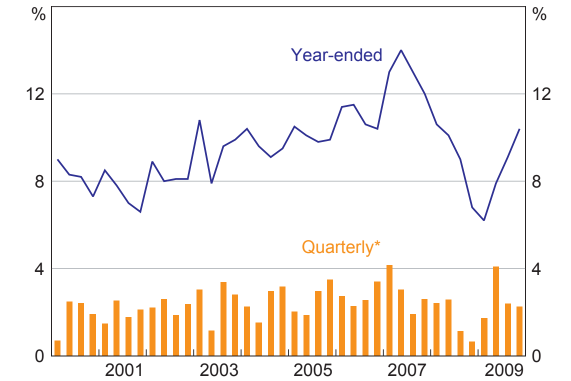
There has also been a strong bounce-back in India, where GDP growth in the September quarter exceeded 3 per cent. While growth looks to have moderated more recently, various indicators suggest that it has remained solid. Industrial production in October and November was around ½ per cent above its strong September quarter level. Wholesale price inflation has also picked up noticeably, reaching over 7 per cent in year-ended terms in December, compared with a negative rate in mid 2009, suggesting ongoing strength in domestic demand. Rapid growth over recent years in both industrial output and consumer demand has seen India become an increasingly important part of the world economy and destination for Australia's exports, as discussed further in 'Box B: The Growing Importance of the Indian Economy'.

Elsewhere in Asia (excluding Japan), growth in the December quarter appears to have been solid in aggregate, but slower than the rapid rate seen in mid 2009. Some differences in the pace of expansion are apparent, with growth slowing in Korea and Singapore, but looking to have firmed a little in Taiwan. Both exports and industrial production increased strongly across the region in December after tracking sideways in October and November. More broadly, following the extraordinary declines in trade observed in late 2008 and early 2009, growth in export volumes over the past nine months has been very strong in the higher-income economies (Hong Kong, Singapore, Korea and Taiwan), but more limited thus far in the ASEAN-4 nations (Graph 6).

With growth now well under way in most economies in Asia but macroeconomic policies still quite stimulatory, attention is turning to the buoyant conditions in some property and other asset

Graph 4

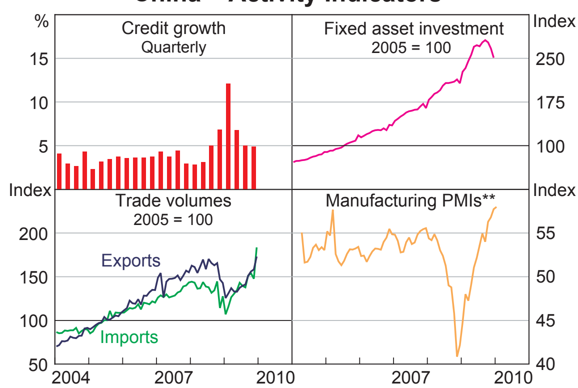
China – GDP Growth



* RBA estimates
Sources: CEIC; RBA

Graph 5

China – Activity Indicators*

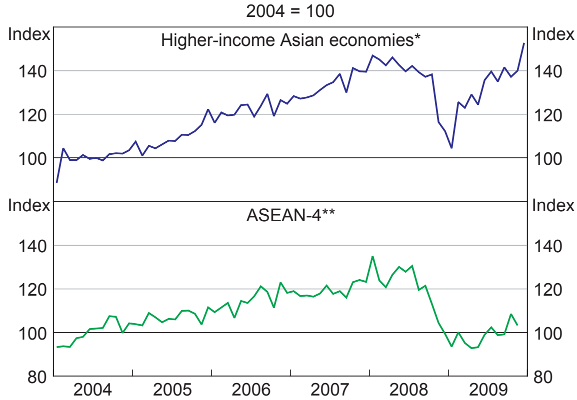


* RBA estimates
** Average of HSBC and National Bureau of Statistics of China PMIs, each seasonally adjusted by RBA; HSBC PMI only prior to January 2005
Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

Graph 6

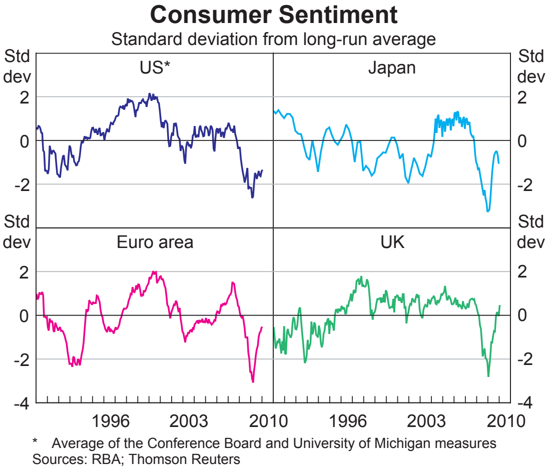
Asia – Export Volumes

2004 = 100

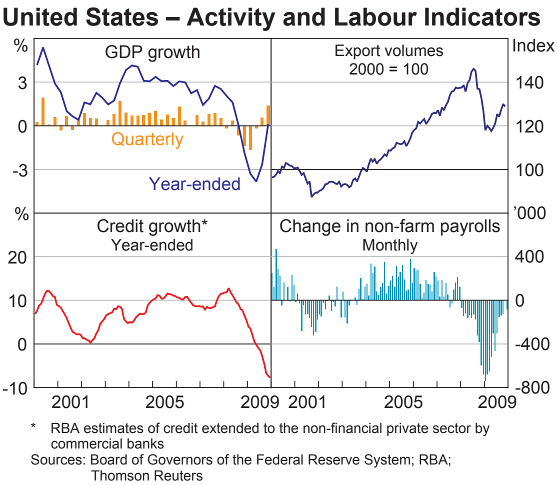


* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC; RBA

Graph 7



Graph 8



markets, and the risk that consumer price inflation could rise further. While policy-makers in a number of economies are concerned about these risks, financial conditions, including the current settings of interest rates and exchange rates, generally remain accommodative. However, in several countries steps have been taken to contain credit growth. In China and India, the authorities have increased reserve requirements for banks, while in China they have reportedly also taken administrative steps to curtail recent rapid lending growth. Lending criteria for housing loans have also been tightened in a number of economies, including Hong Kong and Singapore, and a number of other steps have been taken to address pressures in housing markets.

While most advanced economies are now also expanding, economic conditions generally remain quite weak. Consumer confidence remains below average in most economies, especially the United States (Graph 7). Nevertheless, US GDP expanded by 1.4 per cent in the December quarter, the strongest outcome since the September quarter 2003 (Graph 8). In addition to a major contribution from inventories – as firms sharply reduced their pace of de-stocking – growth was supported by strength in exports (especially to China) and by a modest pick-up in business investment following a decline of more than 20 per cent over the preceding five quarters. While prospects for further recovery in investment appear to have improved, credit continues to decline, contracting by around 8 per cent over 2009. Credit is declining not only to businesses but also to households, reflecting both tighter lending standards and reduced demand associated with deleveraging. While the pace of job losses has slowed markedly over recent quarters, US payrolls employment has continued to fall, with a cumulative decline over 2008 and 2009 of 7¼ million jobs, or more than 5 per cent.

Labour demand also remains weak in Europe. In the euro area, the unemployment rate reached 10 per cent in December for the first time since mid 1998; in the United Kingdom it stands at close to 8 per cent, although it has stabilised at that level over the past six months. Retail sales remain weak in the euro area, although exports and inventories are likely to have contributed to moderate growth in GDP in the December quarter. Output in the UK economy expanded by 0.1 per cent in the December quarter, after six successive contractions (Graph 9).

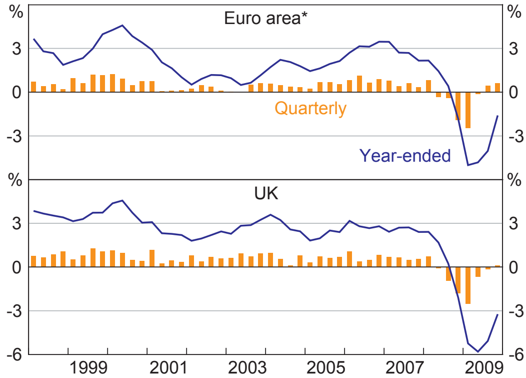
Like the rest of Asia, the Japanese economy has seen firm growth in exports and industrial production in recent quarters. However, machinery orders data suggest that firms' investment intentions remain weak, despite the level of business investment having fallen by over 25 per cent since early 2008, and a number of indicators of business conditions have weakened over recent months after earlier bouncing back. Similarly, consumer sentiment declined over the December quarter to retrace some of the improvement that had occurred earlier in 2009.

While the large advanced economies have seen significant upward revisions in growth forecasts for 2010, there are a number of factors that are likely to weigh on growth and contribute to more subdued recoveries in these countries than usually occurs after a large recession. Much of the recent strengthening seen in the pace of activity reflects the influence of temporary factors that are boosting output, namely the inventory cycle and the highly stimulatory fiscal and monetary policy settings. For the recovery in the advanced economies to strengthen further and be self-sustaining, a key requirement is that there is a pick-up in the pace of private final demand growth that is not reliant on ongoing policy stimulus. In this regard, consumer demand still remains weak in many advanced countries and may be vulnerable to the withdrawal of fiscal support measures (Graph 10). In the euro area, retail sales volumes continue to contract by around ¼–½ per cent per quarter, a pace little changed over the past two years, while in the United States the modest recovery in retail sales since mid 2009 has been underpinned by a large reduction in the amount of taxes paid and an increase in government transfers to households. In this environment, deciding the appropriate pace at which to withdraw the current very stimulatory monetary and fiscal policy settings represents a significant challenge for policy-makers in many advanced economies, especially those with high and rising public debt levels (Graph 11).

Commodity prices

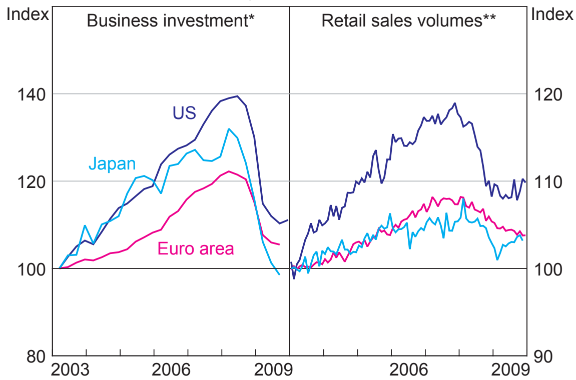
In line with the strong recovery in emerging Asia, commodity prices have continued to rise over the period since the November *Statement*, to be significantly above the levels prevailing in early to mid 2009 (Graph 12). Spot prices for bulk

Graph 9
Europe – GDP Growth



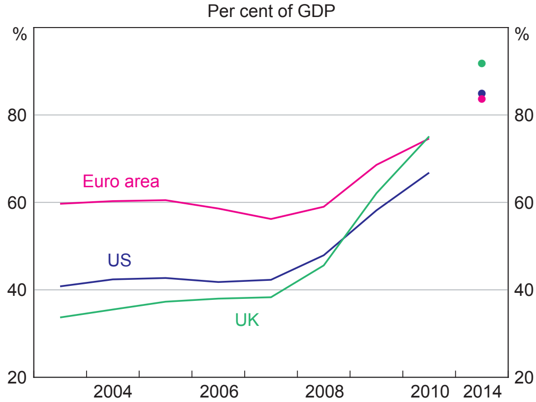
* Estimate for December quarter 2009
Sources: Consensus Economics; RBA; Thomson Reuters

Graph 10
Domestic Demand Indicators
March quarter 2003 = 100



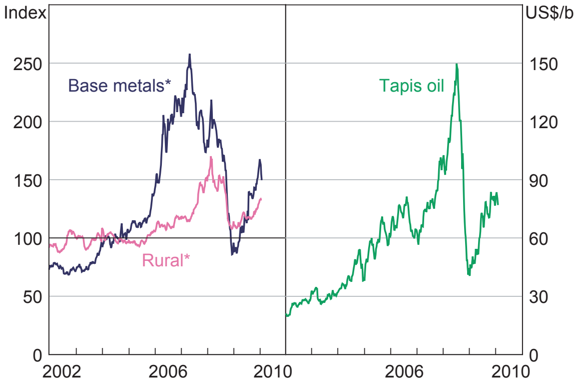
* For euro area, business investment includes public investment
** Retail sales measure for Japan is the Cabinet Office's synthetic consumption indicator
Source: Thomson Reuters

Graph 11
Net Public Debt
Per cent of GDP



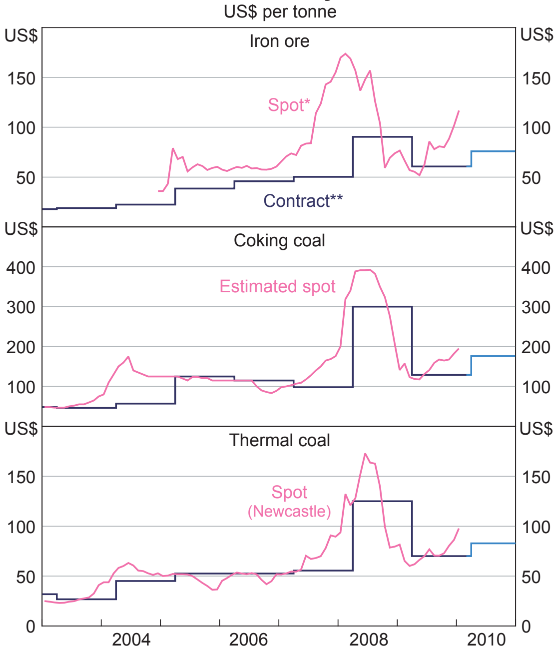
Source: IMF

Graph 12
Commodity Prices
Weekly



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

Graph 13
Bulk Commodity Prices
US$ per tonne



* Calculated using the spot import price in China less the spot freight rate from Australia to China
** Average of market analyst forecasts for 2010 contract
Sources: ABARE; AME Mineral Economics; Bloomberg; Citigroup; Consensus Economics; Macquarie Bank; RBA

commodities have shown particular strength, with iron ore prices up by around 40 per cent and coking and thermal coal prices up by around 20–30 per cent since November (Graph 13). Current spot prices represent substantial premiums over 2009/10 contract prices, and market analysts on average expect contract prices to settle between 20–40 per cent higher for 2010/11. Higher prices for bulk commodity exports would provide a substantial boost to Australia's terms of trade over the coming year.

Bulk commodity prices have been supported by robust demand from China, while demand from other traditional destinations such as Japan and Korea has also been recovering. Chinese end-user demand for steel products has remained solid, with spot steel prices 6 per cent higher since November and steel mills seeking to restock ahead of expected contract price increases. With major miners and ports operating at or near capacity, increased demand has underpinned a significant price response.

Base metals prices are also higher, due to strengthening industrial demand and various concerns over supply disruptions. Rural prices have increased, with price rises fairly broad-based across commodities. Sugar prices have risen particularly sharply, driven by concerns of a global sugar shortage. India, having been a sugar exporter in recent years, is expected to be a significant importer for the second year running in 2009/10, as production has been hampered by a weak monsoon. Oil prices have traded in a relatively wide range, and are currently a little lower than their levels at the time of the November *Statement*.

Box A

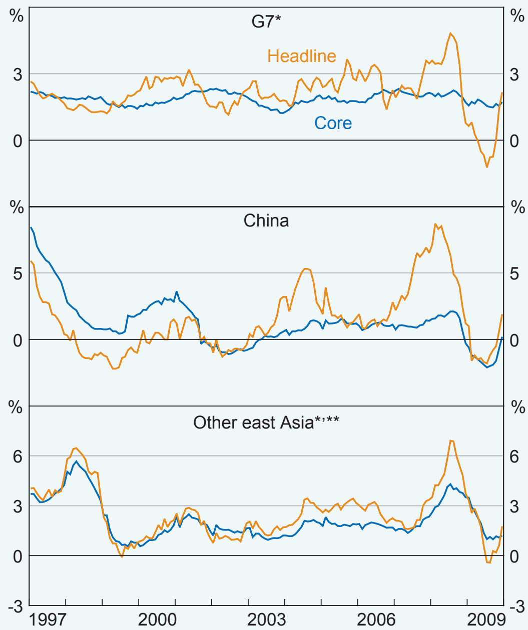
Global Developments in Inflation

Consumer price inflation has slowed considerably across the world through 2009. After peaking around September 2008, annual inflation turned negative in many countries around mid 2009 (Graph A1). In most cases, this was the first occasion that annual inflation has been negative in the post-war period. This sharp decline was driven by the global recession, and particularly its effects on oil and other commodity prices. While oil prices have since recovered – and headline inflation is again positive in most countries – they remain well below the levels seen prior to the onset of the global recession (Graph A2).

The effects of the global recession and the significant expansion of spare capacity in most economies can also be seen in measures of 'core' inflation, which typically exclude the effect of changes in oil and some food prices. Core inflation has declined across a wide range of countries since September 2008 (Graph A3). The extent of the decline has been most pronounced among the Asian economies, which had earlier experienced significant run-ups in core inflation; the median fall among a broad sample of emerging Asian economies has been around 2½ percentage points. The size of these declines reflects the higher responsiveness of inflation to output developments in many Asian economies. Price and wage setting arrangements in these economies are more flexible given the greater degree of informality in employment contracts and pricing.

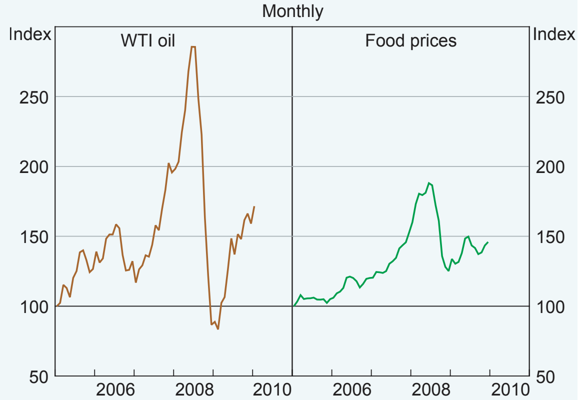
The extent of the moderation in core inflation among developed nations has been smaller, with a median decline of just over 1 percentage point. Some advanced economies that have had particularly large falls in output – for example, Ireland and

Graph A1
Consumer Price Inflation
Year-ended



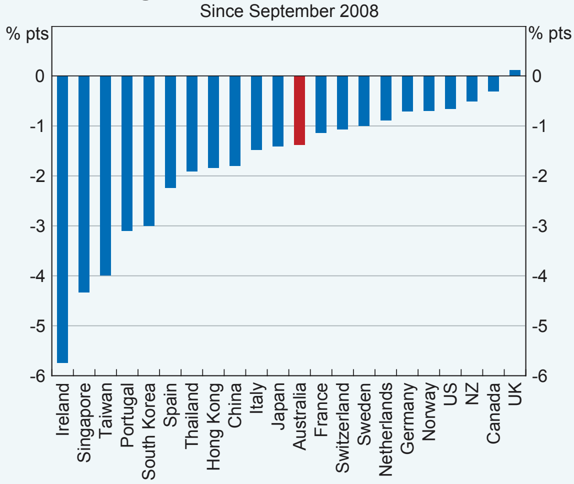
* Weighted by GDP at PPP exchange rates; excludes Japan
** Excludes Indonesia
Sources: CEIC; RBA; Thomson Reuters

Graph A2
Global Oil and Food Prices*
Monthly



* January 2005 = 100, US$ terms
Sources: Bloomberg; IMF

Graph A3
Change in Year-ended Core Inflation
Since September 2008



Sources: ABS; Central Statistics Office Ireland; RBA; Thomson Reuters

Spain – have also had larger-than-average declines in core inflation. However, other advanced economies have had relatively small declines in year-ended core inflation. This, in part, reflects lags in the response of inflation to changes in output, with the maximum effect typically estimated to occur after around one year;[1] hence there is stronger evidence of disinflation in rates calculated using only data for the past three or six months.

The relatively small moderation in inflation in some countries is also partly explained by significant currency depreciations in the early stages of the crisis. For example, the United Kingdom, Canada and New Zealand all saw trade-weighted depreciations of more than 15 per cent in late 2008 and early 2009. The effect of this on the prices of imported goods is most evident in the United Kingdom, whose currency has depreciated by around 25 per cent in trade-weighted terms since September 2008; the year-ended rate of change in core tradables prices is estimated to have risen to around 3 per cent recently, compared with an annual average of minus 1½ per cent during the past decade.

Traditional measures of core inflation have also been affected by special factors or government decisions in some countries. For example, in the United States a one-off rise in the price of tobacco (which increased by 30 per cent due to a 250 per cent rise in federal excise last April) has boosted the standard core inflation measure. Reflecting this, alternative measures of underlying inflation such as the trimmed mean and weighted median produced by the Federal Reserve Bank of Cleveland have declined more sharply than the standard core measure (falling by a little over 2 percentage points). In Canada and New Zealand, statistical measures of inflation have also fallen by more than the standard core measures.

As these temporary impacts fade, core inflation rates are likely to fall back further. Consistent with this, bond market prices suggest an expectation that inflation will ease further over the next two years in the United States, United Kingdom and Europe. Beyond that, however, there is considerable uncertainty about the medium-term outlook for inflation. More than 15 per cent of financial market participants recently surveyed by J.P. Morgan expect annual inflation to exceed 4 to 4½ per cent in the United States and United Kingdom over the medium term, with around three-quarters of these respondents citing large government deficits as the reason, while 10 per cent expect inflation to remain around 1 per cent or less, due to persistent economic weakness.

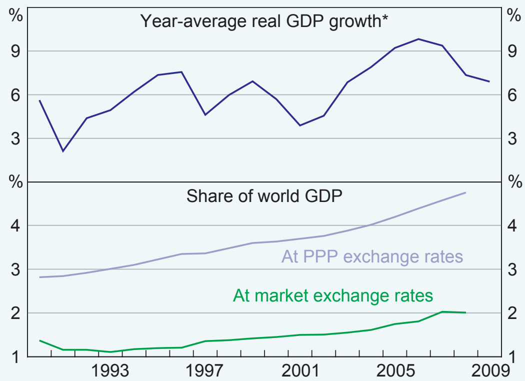
1 See, for example, Smets F and R Wouters (2004), 'Comparing Shocks and Frictions in US and Euro Area Business Cycles: A Bayesian DSGE Approach', European Central Bank Working Paper No 391.

Box B

The Growing Importance of the Indian Economy

Growth in the Indian economy has gradually strengthened over the past two decades, with annual real GDP growth averaging 6½ per cent since 1990 (Graph B1). Growth has been particularly strong since a drought-related slowdown in 2002, averaging around 8½ per cent. Reflecting a significant monetary easing as well as a relatively low exposure to global trade, growth in India slowed only modestly during the global financial crisis; India is estimated to have been one of the fastest growing economies in the world in 2009. While incomes have grown rapidly, they remain low, with per capita annual income at only just over US$1 000. As a consequence, while India accounts for close to one-fifth of the world's population, its share of global output remains relatively low, at 2 per cent when output is measured at market exchange rates and around 5 per cent on a purchasing power parity basis.

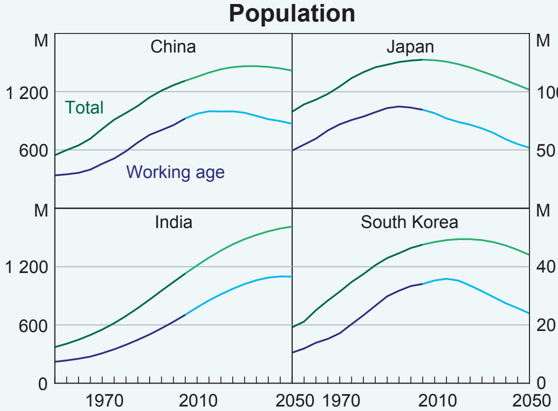
Graph B1
India



* RBA estimate for 2009
Sources: IMF; RBA

The Indian economy looks likely to continue to expand at a relatively rapid pace in coming decades and to become an increasingly important part of the world economy. Long-term population projections suggest that, notwithstanding a declining fertility rate, India's population will continue to grow rapidly through natural increase, and United Nations' estimates suggest it will surpass China as the world's most populous nation in around two decades (Graph B2). Further, economic growth in India is expected to continue to benefit from compositional change in its population structure; the working-age share of the population is projected to continue to increase over the next two decades, so India's potential labour force could grow even more rapidly than the anticipated increase in its total population. This contrasts with projected declines in the working-age share of the population not only in the major developed economies, but also in other Asian economies such as China and Korea. In addition to the boost from demographic factors, India's per capita income is likely to rise steadily as the composition of the labour force continues to shift away from subsistence farming towards the industrial and services sectors.

Graph B2
Population



Source: United Nations

The growing importance of India in the global economy has also been reflected in a rise in India's importance as a trading partner for Australia. Indian demand for Australia's exports has risen sharply, with particularly rapid growth over the past decade. This has seen India's share of Australia's total exports increase to around 6½ per cent – a four-fold increase in less than a decade (Graph B3). Growth has been rapid for exports of both goods and services.

Part of the increase in goods exports to India reflects gold exports, which have risen from negligible levels a decade ago to account for around two-fifths of total Australian gold exports in recent years. Much of these gold exports to India are 're-exports' – gold that has been imported from elsewhere for processing in Australia – and thus the value added of these exports is relatively low.

Graph B3
Australian Exports to India
Current prices

Source: ABS

Coal exports have also risen strongly over the past decade and accounted for over 40 per cent of Australia's total goods exports to India in 2008/09. Coal exports are likely to continue to grow over the next few years, as significant planned expansions in India's steelmaking capacity come online. Liquefied natural gas (LNG) is another likely source of future growth in Australia's goods exports to India. LNG production capacity in Australia and import capacity in India are both projected to increase significantly and long-term supply contracts have recently been agreed for the sale of Australian-produced LNG to Indian buyers (see 'Box D: Investment in the Resources Sector' in the November *Statement*).

International and Foreign Exchange Markets

Credit markets

Credit market conditions improved significantly over 2009, although concerns have emerged in some sovereign debt markets. Credit spreads are now generally well below crisis levels and many borrowing rates, in absolute terms, are around historically low levels. In money markets, spreads between LIBOR and the expected cash rate for most major currencies have been broadly stable since October 2009 (Graph 14). Reduced concerns regarding counterparty credit risk are also evident in falling credit default swap (CDS) premia. After peaking around the start of 2009, CDS premia on both investment-grade and riskier sub-investment-grade corporate debt have fallen, although they remain higher than they were pre-crisis.

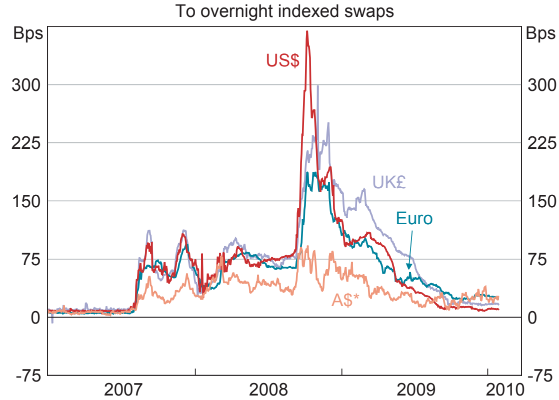
In the United States, non-financial corporate bond spreads for both highly and lower-rated ('junk') bonds have continued to narrow and are around their lowest levels since the beginning of 2008 (Graph 15). After increasing strongly in the first half of 2009, bond issuance by US non-financials has fallen back to around its pre-crisis average (Graph 16).

Bond issuance by US financial institutions remains subdued reflecting the expiry of the government-guarantee program in October 2009, slower balance sheet growth of financial corporates and a significant amount of issuance in early 2009. Bond issuance by European financial institutions rose strongly in January and is expected to remain high in the period ahead reflecting the fact that European banks have a higher-than-usual amount of debt to refinance in the next couple of years. Some banks in Europe and the United Kingdom have continued to issue under their respective government-guarantee schemes, although global government-guaranteed issuance remains low.

Graph 14

3-month LIBOR Spreads

To overnight indexed swaps



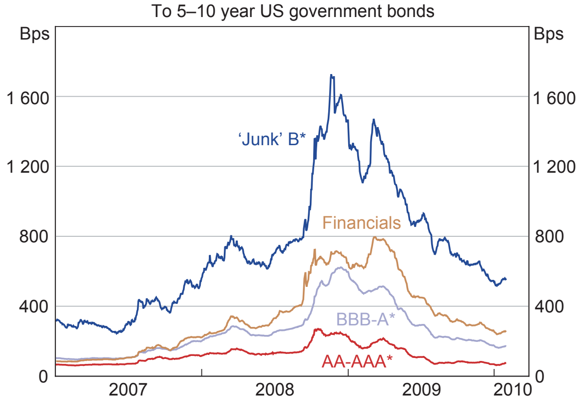
* Bank bills to overnight indexed swaps

Sources: Bloomberg; Thomson Reuters; Tullett Prebon (Australia) Pty Ltd

Graph 15

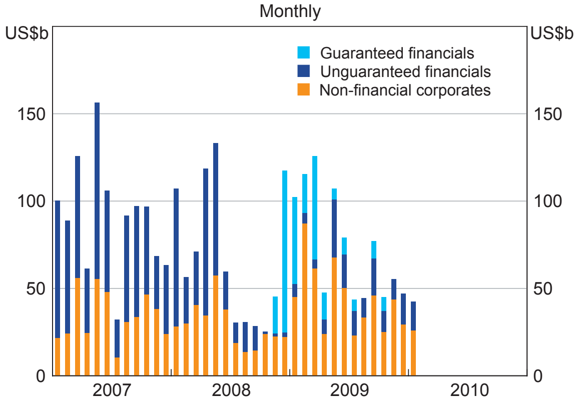
US Corporate Bond Spreads

To 5–10 year US government bonds



* Industrial corporates

Sources: Bloomberg; Merrill Lynch



Central bank policy

Policy interest rates in most advanced economies have remained at their lower bounds (Table 2). Consistent with the commitments by a number of these central banks – including the Fed, the Bank of Canada and Sveriges Riksbank – to keep policy rates low for some time, current financial market pricing anticipates that policy rates in most advanced economies will not begin to rise until the second half of this year, at the earliest. In contrast, the Bank of Israel and Norges Bank increased their policy rates further in December. In emerging markets, the People's Bank of China and the Reserve Bank of India increased their required reserves ratios for depository institutions, while central banks in Russia, Turkey and Hungary further reduced their policy interest rates in recent months.

With their policy rates at a lower bound, several central banks in advanced economies have continued to ease monetary policy through outright asset purchases. However, the rate of asset purchases has slowed in recent months as the programs approach their completion.

Table 2: Policy Rates

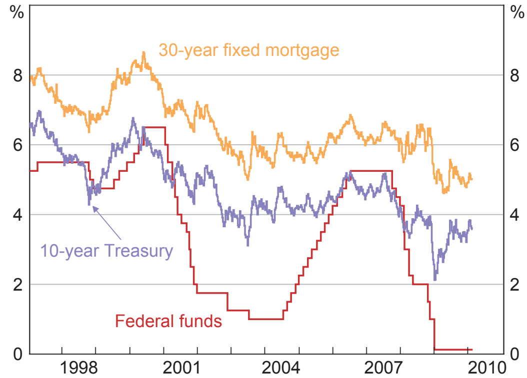
	Current level Per cent	Most recent change	
Euro area	1.00	↓	May 09
Japan	0.10	↓	Dec 08
United States	0.125	↓	Dec 08
Brazil	8.75	↓	Jul 09
Canada	0.25	↓	Apr 09
China	5.31	↓	Dec 08
India	4.75	↓	Apr 09
Indonesia	6.50	↓	Aug 09
Israel	1.25	↑	Dec 09
Malaysia	2.00	↓	Feb 09
Mexico	4.50	↓	Jul 09
New Zealand	2.50	↓	Apr 09
Norway	1.75	↑	Dec 09
Russia	8.75	↓	Dec 09
South Africa	7.00	↓	Aug 09
South Korea	2.00	↓	Feb 09
Sweden	0.25	↓	Jul 09
Switzerland	0.25	↓	Mar 09
Thailand	1.25	↓	Apr 09
Turkey	6.50	↓	Nov 09
United Kingdom	0.50	↓	Mar 09

Source: central banks

Graph 17

US Interest Rates

Weekly



Source: Bloomberg

In the United States, the Fed has continued to purchase agency mortgage-backed securities (MBS) and agency debt, after completing its program to purchase US$300 billion in US Treasury securities in October last year. The Fed still has approximately US$110 billion in purchases of agency securities remaining of an ultimate target of US$1 425 billion, with agency MBS accounting for most of the purchases. Recently, the rate at which these securities have been acquired has slowed to ensure that markets are not adversely affected when these programs come to their scheduled completion by the end of March. Reflecting the impact of these purchases, 30-year fixed mortgage rates are currently only a little above their trough despite the rise in Treasury yields (Graph 17).

The Bank of England (BoE) expanded its target for asset purchases by £25 billion to £200 billion at its November meeting and has recently reached this target on schedule, with the vast majority of purchases having been gilts. The European Central Bank (ECB) has purchased around €35 billion in euro-denominated covered bonds with an additional €25 billion of these securities to be purchased by the end of June this year. While purchases of these securities have provided ongoing support for issuance in the primary market, spreads in the secondary market have remained broadly unchanged in recent months. The Bank of Japan (BoJ) has continued to purchase Japanese government bonds and small amounts of stock in financial institutions. The Swiss National Bank (SNB) decided at its December meeting to cease outright purchases of private-sector bonds (but remains committed to preventing appreciation of the Swiss franc against the euro).

Demand for central bank liquidity facilities has also continued to recede, with ongoing improvements in financial markets prompting some central banks, including the Fed, ECB, BoJ and SNB, to end some of their facilities. Earlier this month, the Fed terminated its US-dollar swap facility with other central banks. At the same time, the Fed closed a number of other domestic liquidity facilities – including the Primary Dealer Credit Facility, the Term Securities Lending Facility and facilities aimed at supporting the functioning of commercial paper markets. In contrast, funds have continued to be sought through the Term Asset-backed Securities Loan Facility, with the facility recently supporting the first new commercial MBS issue since June 2008.

In line with the fall in demand for its liquidity facilities, the ECB has also begun to unwind some of these operations. It conducted its final 12-month refinancing operation in December and announced that it will end six-month refinancing operations in March. The Bank of Canada and Sveriges Riksbank have also taken steps to unwind some of their domestic liquidity facilities as conditions in financial markets have improved. In contrast, the BoJ announced at its unscheduled monetary policy meeting in December that it would temporarily provide ¥10 trillion (US$110 billion) in liquidity at the overnight rate in an attempt to lower longer-term money market rates.

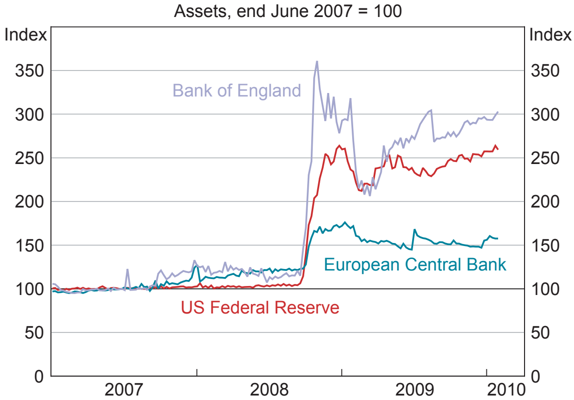
The Fed's balance sheet has expanded modestly in recent months, as the general fall in liquidity-providing facilities has been more than offset by the rise in securities held outright. However, since mid 2007 the Fed's balance sheet has increased by around 150 per cent. Over the same time period, the balance sheets of the BoE and ECB have increased by around 200 per cent and 50 per cent respectively (Graph 18).

In response to the large accumulation of reserves held by depository institutions resulting from the Fed's liquidity operations and outright asset purchases, the Fed has recently announced steps which could be used to reduce the aggregate quantity of excess reserves. At this stage the Fed has conducted a number of reverse repo operations designed to test the readiness of this tool, but they have been small enough to have no material impact on reserves. The Fed has also proposed the introduction of a term deposit facility and has stressed that neither of these developments represents a change in monetary policy stance.

Graph 18

Central Bank Balance Sheets

Assets, end June 2007 = 100



Source: Thomson Reuters

Government financial policy actions

The ongoing normalisation of credit markets has seen government financial policies in major economies maintain a focus on longer-term initiatives designed to support stability and improve regulatory oversight. Governments have, for the most part, continued to wind down emergency measures, and some governments are seeking to recover taxpayer losses associated with financial sector failures.

In the United States, financial reforms in draft legislation include creating a Financial Stability Council that will identify and increase the oversight and regulation of systemically important financial institutions, and establishing procedures for managing failing institutions to prevent the need for future government bailouts. These reforms would leave the Federal Deposit Insurance Corporation (FDIC) with resolution authority over systemically important institutions. Similarly, the European Council is seeking to implement a European Systemic Risk Board that will monitor and report on macro-prudential risks in the banking, insurance and securities markets.

The US draft legislation will also require all standardised over-the-counter (OTC) derivative swap transactions between dealers and major swap participants to be traded on an exchange or electronic platform and cleared by a central counterparty. Separately, major financial market participants agreed in mid January to expand central clearing for interest rate and credit derivatives, to broaden regulatory reporting on OTC derivatives transactions, and to improve risk management for derivatives transactions not cleared centrally.

Most large US financial institutions have redeemed preferred securities issued to the US Treasury under the Troubled Asset Relief Program (TARP) after raising more equity. The US Treasury extended the duration of the US$700 billion TARP to October 2010 and expects that no more than US$550 billion of this will be deployed. The US Treasury stated that it may also expand its commitment to the Fed's Term Asset-backed Securities Loan Facility.

Further losses of around US$20 billion at housing agency Fannie Mae in the third quarter resulted in additional capital injections of senior preferred stock from the US Treasury as part of the terms of its conservatorship, taking the total contribution to around US$60 billion. In contrast, the housing agency Freddie Mac, although reporting a third-quarter loss of US$5 billion, maintained a positive net worth, leaving its total funding from the US Treasury unchanged at around US$50 billion. The US Treasury has amended the terms of its support to the two housing agencies such that it may now provide unlimited capital injections over the next three years to ensure each agency maintains a positive net worth; previously the limit was US$200 billion per firm. Also, the US Treasury ended its purchases of MBS guaranteed by the agencies in December, after purchasing around US$220 billion of these securities to support the mortgage market.

The US Administration has proposed implementing a fee on the liabilities of large financial institutions for at least 10 years from 30 June in order to recoup losses under the TARP. It has also proposed measures restricting banks from owning, investing or sponsoring hedge funds, private equity funds or proprietary trading operations, while also extending the market-share cap on deposits to other non-deposit funding to limit industry concentration. The FDIC has also proposed to charge higher fees for deposit insurance for banks whose compensation plans encourage excessive risk-taking.

The UK Government announced a temporary 50 per cent levy on bonus payouts over a certain threshold by banks based in the United Kingdom on the basis that banks had avoided much larger losses as a result of the Government's bailout of the banking system. The French Government has announced similar plans.

The Basel Committee on Banking Supervision also proposed changes to improve the quality of banks' capital, strengthen capital requirements and set new standards for liquidity risk management. The changes are expected to be introduced by the end of 2012.

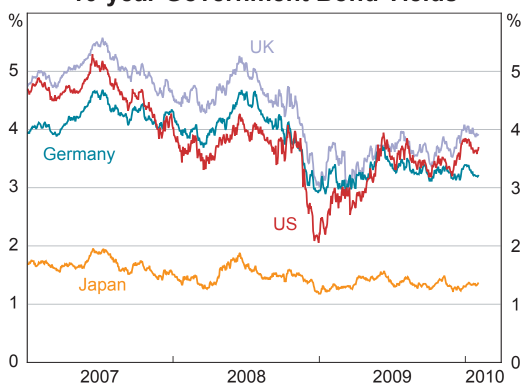
Sovereign debt markets

In the major economies, short-term government bond yields have generally remained within the low trading ranges seen since late 2008 as policy rates are expected to remain low for some time. Yields on short-term Japanese government bonds, however, have fallen to their lowest level in around five years.

Longer-term government bond yields in the United States recently rose toward the upper end of their trading range of the past year, reflecting better economic data, but have since partly retraced some of this increase (Graph 19). Longer-term bond yields in the United Kingdom have also risen, partly reflecting concern about rising domestic inflation. In contrast, longer-term bond yields in Germany have been relatively stable for at least the past six months, as they have in Japan, despite S&P downgrading the outlook for Japan to negative.

In Europe, spreads between sovereign debt issued by European Monetary Union member countries and the German Government have generally widened in recent months. Spreads on countries experiencing

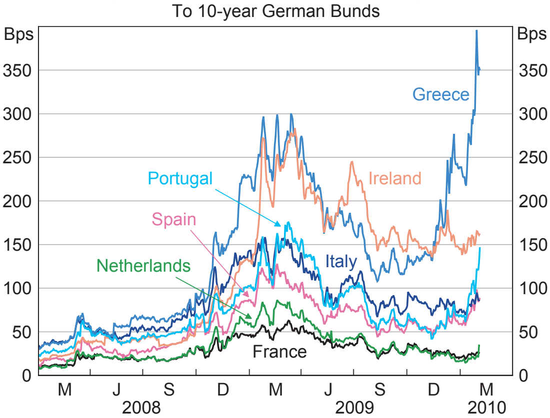
Graph 19
10-year Government Bond Yields



Source: Bloomberg

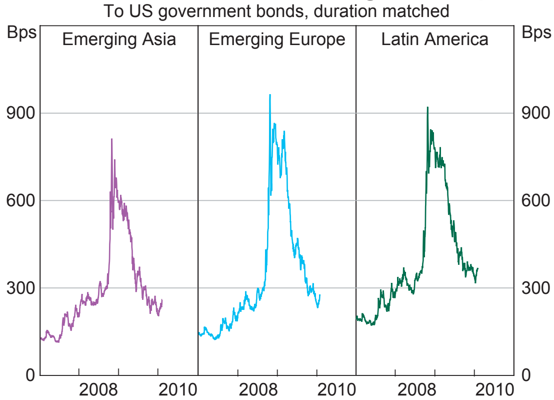
negative credit rating news have widened significantly (Graph 20). Notably, Greek government bond spreads have widened by around 210 basis points since early November. The three major credit rating agencies downgraded Greece's credit rating in December and have put a negative outlook on Greek government debt, indicating the possibility of further downgrades over the next two years if the government budget deficit is not reduced. S&P also placed Portugal and Spain on negative outlook citing deteriorating public finances. Iceland's credit rating was downgraded by Moody's and Fitch in response to political, economic and financial uncertainty with respect to its recovery from its severe financial crisis. The spread on Ireland's sovereign debt narrowed after the Government announced significant cuts to public spending in early December 2009.

Graph 20
European Government Bond Spreads
To 10-year German Bunds



Source: Bloomberg

Graph 21
US Dollar-denominated Sovereign Debt Spreads
To US government bonds, duration matched



Source: Thomson Reuters

Spreads of emerging market US dollar-denominated debt have generallly narrowed over the past three months, as emerging economies recover more quickly than the United States and other advanced economies, despite some credit concerns in Dubai, Mexico and Ukraine (Graph 21). In Dubai, some government-related entities sought to delay debt repayments, which raised concerns about a possible default and of contagion to other markets. In response, the credit ratings of a number of government-related entities were downgraded, although Abu Dhabi later provided financial support to Dubai. Fitch and S&P also downgraded Mexico's credit rating due to lower oil revenue, which comprises a large portion of government revenue, and Fitch downgraded Ukraine's sovereign credit rating in November after the IMF suspended funding when the Government introduced policies that are expected to result in a significant widening of Ukraine's budget deficit.

In contrast, Moody's upgraded the outlooks for China, Hong Kong and India to positive from stable, citing strong external positions. In Europe, Russia's outlook was upgraded by S&P and Fitch due to a more favourable economic and fiscal outlook. Turkey's rating was upgraded by Moody's and Fitch, reflecting the resilience of its economy to the financial crisis. Indonesia was upgraded by Fitch for similar reasons.

Equities

Major equity price indices continued to trend higher until late January, supported by broadly positive macroeconomic data and the repayment of TARP funds by several US financial institutions (Graph 22). They subsequently fell sharply, prompted by the US Administration's proposed restrictions on banks. Periods of heightened risk aversion on concerns surrounding the sovereign creditworthiness of Greece and Dubai have also weighed on equities at times. However, equity prices have recovered nearly half of the declines from their 2007 peaks.

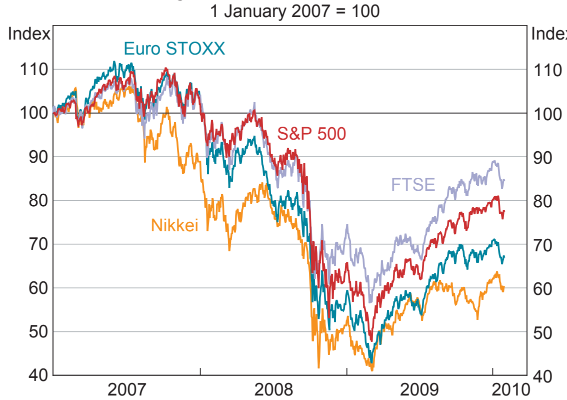
In the United States, further upward revisions to forecast earnings have generally kept pace with the increase in equity prices, resulting in the forward-looking price-to-earnings (P/E) ratio remaining around its long-run average (Graph 23). However, the ratio remains well above its recent trough in November 2008. Volatility continued to decline to be around its long-run average in mid January before spiking higher as equity prices fell sharply.

Fourth-quarter earnings reports from major US financial institutions continued to identify investment banking operations as the main source of profit (Graph 24). In contrast, retail operations continued to record losses or weak net income, reflecting further large provisions. As a result, banks whose operations are more heavily oriented toward investment banking, such as JPMorgan Chase and Goldman Sachs, have continued to post stronger results than banks focused on retail lending, such as Bank of America and Citigroup. However, some of the weakness in net income in the quarter, for the latter two banks in particular, reflects temporary costs associated with TARP repayments to the US Treasury.

Japanese equities have outperformed other major equity markets in recent months, after declining over most of the second half of 2009 (Table 3). Equity prices have risen by almost 15 per cent since late November – driven by a recovery in the stocks of exporters as the yen depreciated – to retrace their decline in the second half of 2009. Developments surrounding the bankruptcy of Japan Airlines led to considerable volatility in the company's stock price as well as the broader market; Japan Airlines' stock will be delisted on 20 February.

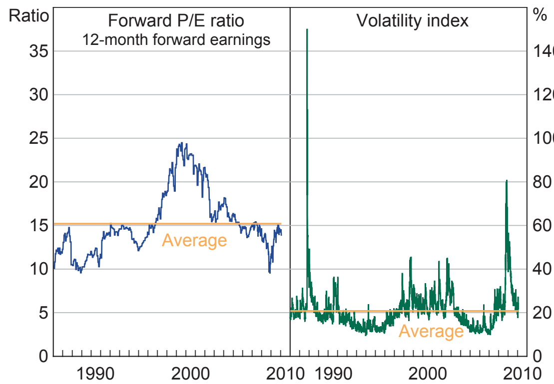
Emerging market equities have largely tracked movements in advanced-economy markets and commodity prices in recent months, with emerging

Graph 22
Major Share Price Indices
1 January 2007 = 100



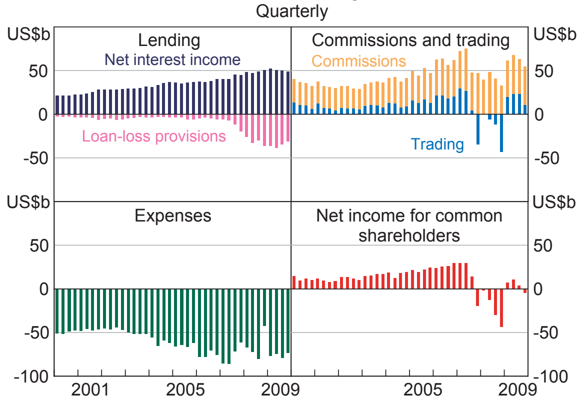
Source: Bloomberg

Graph 23
S&P 500



Sources: Bloomberg; Thomson Reuters

Graph 24
Net Income of US Major Banks*
Quarterly



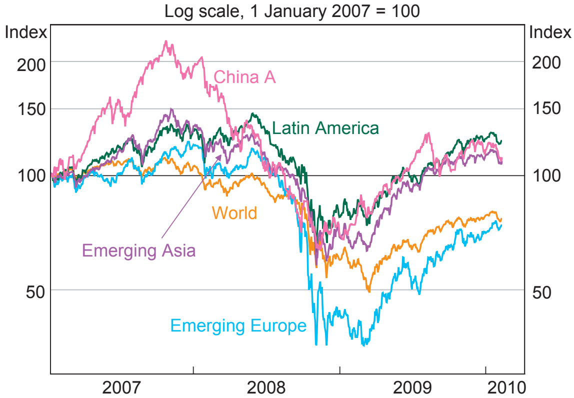
* Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase & Co., Morgan Stanley and Wells Fargo. Major acquisitions by these banks since 2007 are also included.
Sources: Bloomberg; RBA

Table 3: Changes in International Share Prices
Per cent

	Peak to recent trough	Since recent trough	Since previous *Statement*
United States			
– Dow Jones	–54	57	5
– S&P 500	–57	62	5
– NASDAQ	–56	73	7
Euro area			
– STOXX	–62	56	2
United Kingdom			
– FTSE	–48	50	3
Japan			
– Nikkei	–61	47	6
Canada			
– TSE 300	–50	51	3
China			
– China A	–72	76	-4
Australia			
– ASX 200	–54	48	2
MSCI indices			
– Emerging Asia	–61	88	1
– Latin America	–57	97	3
– Emerging Europe	–71	108	12
– World	**–56**	**56**	**4**

Source: Bloomberg

Graph 25
MSCI Share Price Indices
Log scale, 1 January 2007 = 100



Source: Bloomberg

European equities outperforming (Graph 25). An exception is Chinese equities, which have fallen in recent months as the announcement of measures to curb the rapid expansion in credit more than offset the effects of positive domestic economic data. Equity price indices for emerging economies have approximately doubled since their troughs in late 2008 and early 2009, and a number of Latin American equity markets are now back around, or above, their pre-crisis peaks.

Hedge funds

The recovery in equity markets has also been reflected in global hedge funds' returns, which were positive in the December quarter. Hedge funds recorded an average 3 per cent return in the December quarter and a small positive net inflow of investor funds, the first since 2008. Funds under management in the industry are now 20 per cent above the March quarter trough, although they remain considerably below the peak in mid 2008 (Graph 26).

Foreign exchange

Developments in foreign exchange markets have been broadly consistent with changes in general financial market sentiment. Overall, volatility in foreign exchange markets continues to be well below its peak recorded in late 2008 but above its long-run average.

The US dollar depreciated over most of 2009 but has appreciated in recent months in trade-weighted terms (Table 4). Positive US economic data releases, rising US Treasury yields relative to those for some other major economies, and rising risk aversion in late January have underpinned the US dollar. On a trade-weighted basis, the US dollar is currently around 12 per cent below its March 2009 peak (Graph 27).

The euro has depreciated against the US dollar over recent months after appreciating significantly from

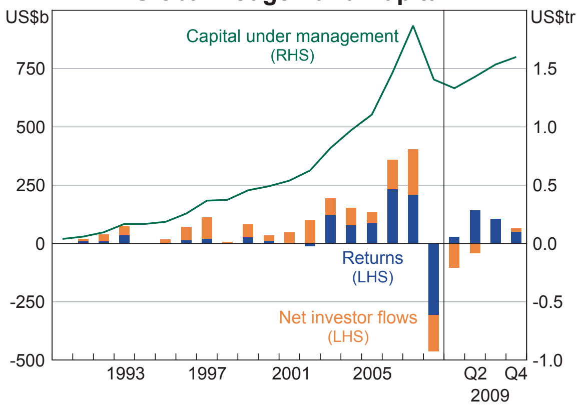
Table 4: Change in US Dollar against Other Currencies
Per cent

	Since previous *Statement*	Since recent peak (March 2009)
European euro	7	–9
Brazilian real	7	–23
Swiss franc	4	–9
UK pound sterling	4	–13
Swedish krona	3	–21
Australian dollar	3	–28
New Zealand dollar	2	–30
Singapore dollar	1	–9
Malaysian ringgit	0	–8
Japanese yen	0	–8
Chinese renminbi	0	0
Canadian dollar	0	–18
Thai baht	–1	–9
South African rand	–2	–29
New Taiwan dollar	–2	–8
South Korean won	–2	–26
Indonesian rupiah	–2	–23
Indian rupee	–2	–11
Mexican peso	–3	–17
Philippine peso	–3	–5
Majors TWI	3	–12
Broad TWI	2	–10

Sources: Bloomberg; Board of Governors of Federal Reserve System

Graph 26

Global Hedge Fund Capital

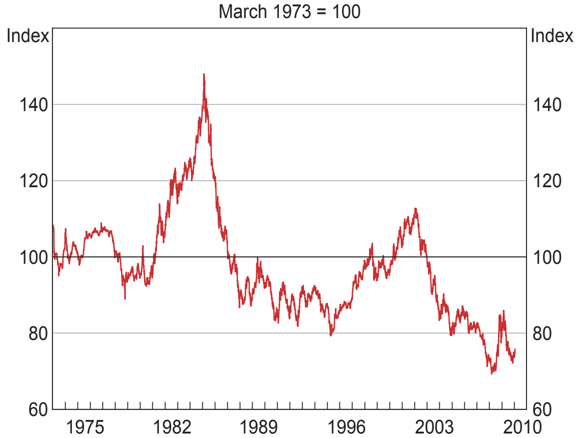


Source: Hedge Fund Research, Inc.

Graph 27

US Nominal TWI

March 1973 = 100

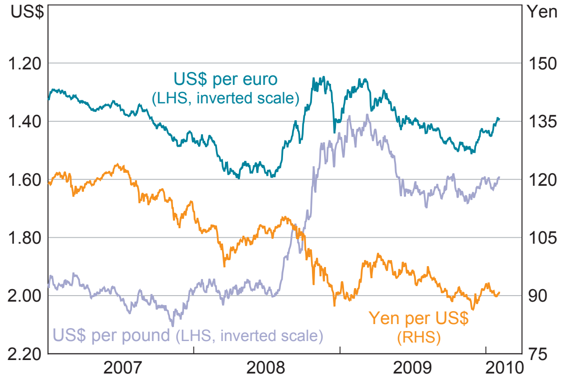


Source: Board of Governors of the Federal Reserve System early 2009 (Graph 28). Concerns over Greece's fiscal position and a pushing-out of market expectations of when the ECB will increase its policy rate contributed to the recent depreciation. The UK pound sterling has also depreciated against the US dollar over recent months, in part reflecting concerns regarding the level of UK government debt. Most commodity-related currencies – including the Australian dollar (see below), Canadian dollar, New Zealand dollar and South African rand – have moved broadly sideways against the US dollar in recent months (Graph 29). In contrast, the Brazilian real has depreciated by 7 per cent over this period. While these currencies remain below their most recent peaks reached in 2007 or 2008, they have appreciated significantly over the past year or so as commodity prices have rebounded strongly.

In emerging Asia, pressures on some currencies to appreciate eased in mid November after indications that a number of countries may impose restrictions on capital inflows. Nevertheless, many of these currencies have appreciated against the US dollar over recent months, in part because of the improved performance of the Chinese economy. In contrast, the Chinese renminbi has remained broadly unchanged against the US dollar, and as a result depreciated over the past three months against most other emerging Asian currencies and in trade-weighted terms (Graph 30).

Graph 28

US Dollar against Euro, Pound and Yen

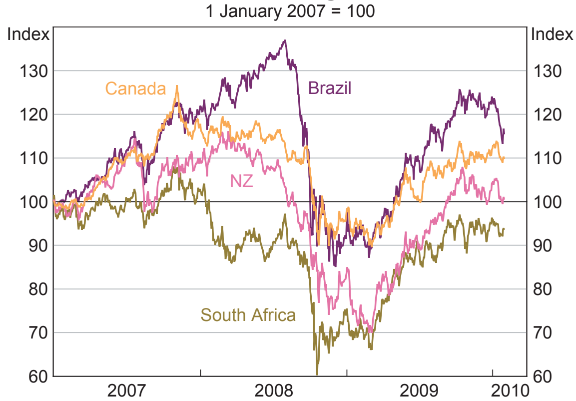


Source: Bloomberg

Graph 29

Selected Currencies against US Dollar

1 January 2007 = 100

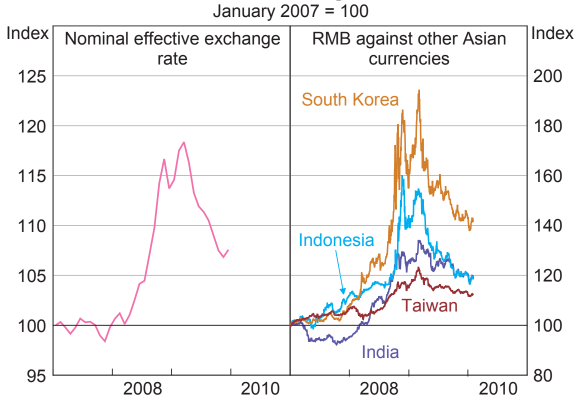


Source: Bloomberg

Graph 30

China – Exchange Rates

January 2007 = 100



Sources: BIS; Bloomberg

Table 5: Australian Dollar against Selected TWI Currencies
Percentage change

	Past year	Since previous *Statement*	Deviation from post-float average
Japanese yen	40	–2	–15
US dollar	37	–2	22
Chinese renminbi	37	–3	29
Thai baht	30	–3	24
Indian rupee	29	–5	54
Malaysian ringgit	29	–3	36
Singapore dollar	28	–1	0
European euro	27	4	–4
Swiss franc	25	2	–12
UK pound sterling	25	1	24
Canadian dollar	18	–3	1
South Korean won	14	–5	51
Indonesian rupiah	7	–5	123
South African rand	3	–5	51
New Zealand dollar	0	0	2
TWI	**29**	**–2**	**16**

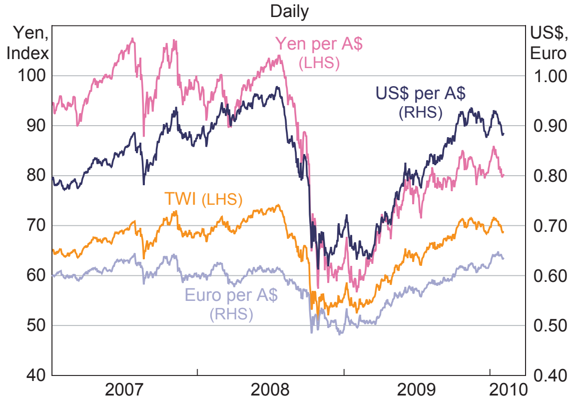
Sources: RBA; Thomson Reuters; WM/Reuters

Australian dollar

After appreciating steadily over most of 2009 to reach a 15-month high in mid November of 94 US cents, the Australian dollar has generally traded in a wide range between 88 and 93 US cents (Graph 31). On a trade-weighted basis the Australian dollar has appreciated by over 25 per cent since the trough in March 2009. It is well above its post-float average against the US dollar and Chinese renminbi but remains below average against the Japanese yen (Table 5). The appreciation has been underpinned by the improved outlook for global growth and commodity prices as well as the relative strength of the domestic economy and the associated widening in interest rate differentials.

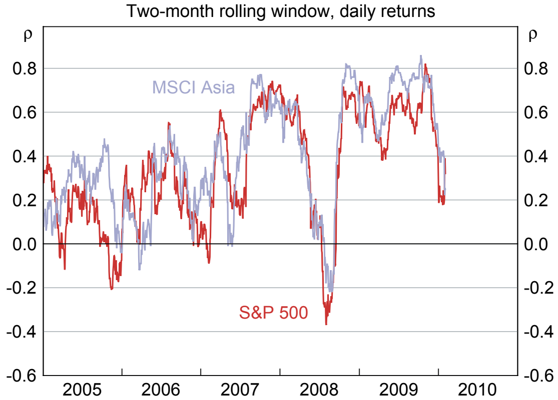
During 2009, movements in the Australian dollar were highly correlated with developments in global equity prices as shifting investor risk appetite was a

Graph 31
Australian Dollar
Daily



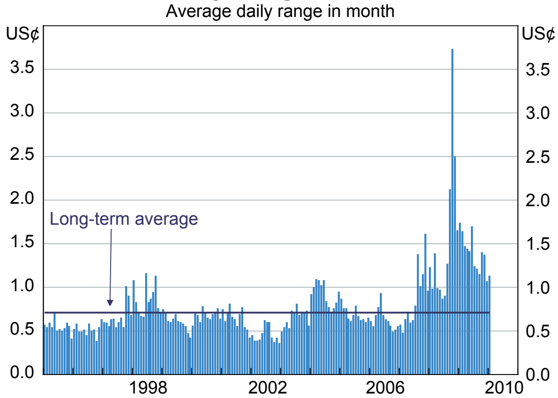
Sources: RBA; Thomson Reuters; WM/Reuters

Graph 32
Equity Indices and Australian Dollar Correlation
Two-month rolling window, daily returns



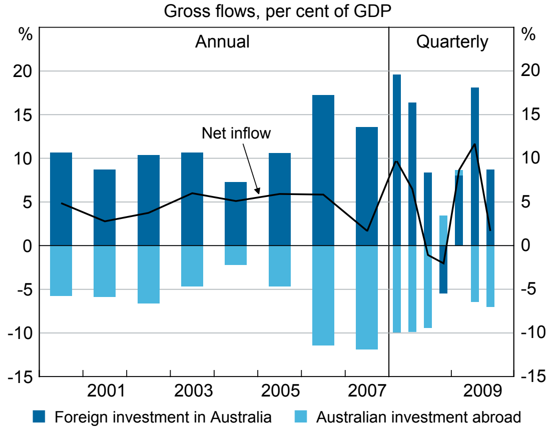
Sources: Bloomberg; Thomson Reuters

Graph 33
Intraday Range in A$/US$
Average daily range in month



Source: Bloomberg

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



Sources: ABS; RBA

common source of price movements. More recently, this correlation has fallen (Graph 32). Volatility in the exchange rate, as measured by the intraday range, is now well below the peaks seen in late 2008, although still above its long-run average (Graph 33).

Capital flows

Private capital flows have broadly returned to their pre-crisis configuration. Australian investors resumed investing in offshore markets in the June and September quarters of 2009 following two quarters of repatriating foreign investments (Graph 34). Foreign investment in Australia has also returned to pre-crisis levels, as the improvement in global market conditions in 2009 allowed Australian firms to raise offshore funding. However, the share of equity in net inflows is higher compared with the pre-crisis period, as corporations have sought to raise core capital and deleverage.

Box C

Foreign Currency Exposure and Hedging in Australia

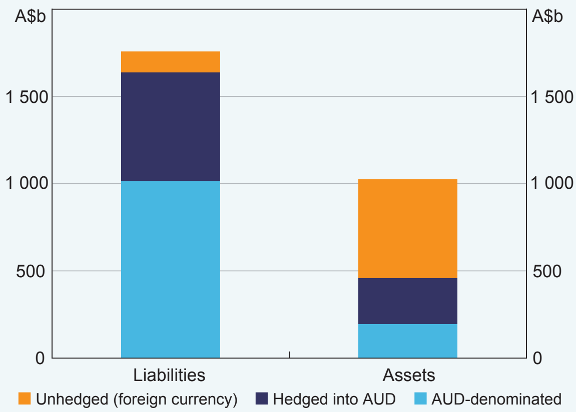
A recent survey by the Australian Bureau of Statistics, conducted on behalf of the Reserve Bank, confirms that Australian entities are well hedged against the risk of sharp movements in the exchange rate.[1] In particular the survey indicates that the foreign currency liabilities of the banking sector are almost entirely hedged against the risk of exchange rate movements using derivative instruments.

The survey collected information on the foreign currency exposures and hedging practices of resident entities. The implications of these exposures and hedging behaviour for the economy as a whole are best understood in the context of Australia's overall external position (Graph C1). Of Australian entities' $1.7 trillion in foreign liabilities, less than half are denominated in foreign currency. The majority of the liabilities that are denominated in foreign currency are hedged using derivative instruments, leaving only a small unhedged liability exposure. In contrast, the majority of Australian entities' $1 trillion in foreign assets are denominated in foreign currency and, as only about a third of these are hedged, the unhedged foreign currency asset position is relatively large. Thus, while Australian entities' foreign assets fall short of foreign liabilities by around $700 billion, the effective foreign *currency* assets of Australian entities exceed their foreign *currency* obligations by around $400 billion. One implication of this is that, in aggregate, the valuation effect of an exchange rate depreciation on Australia's external position is actually positive.

Graph C1

Currency Composition of Australia's External Position

As at 31 March 2009



Sources: ABS; RBA

The survey provides information on the distribution of foreign currency exposures and hedging across the main sectors of the economy. In line with the overall finding, the survey indicates that all sectors hedge their liability exposures more than their asset exposures (Graph C2). The banking sector accounts for the bulk of Australian entities' foreign currency liabilities. These exposures are almost entirely hedged back into Australian dollar obligations using derivative instruments – the hedge ratio for the banking sector's liabilities is around 95 per cent. Non-bank financial corporations and non-financial corporations also hold extensive derivative hedges against their foreign currency liabilities – with average hedge ratios of 70 per cent and 60 per cent respectively – although in aggregate these exposures are relatively small.

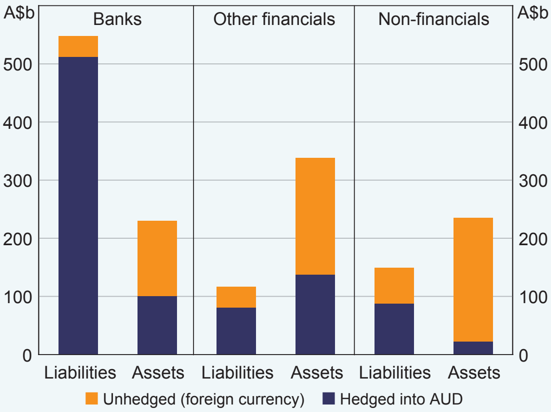
On the asset side, the non-bank financial sector holds the largest foreign currency asset exposure before hedging. These exposures primarily reflect superannuation funds' holdings of foreign asssets on behalf of Australian households. Around 40 per cent

1 For a full discussion of the results of the survey see D'Arcy P, M Shah Idil and T Davis (2009), 'Foreign Currency Exposure and Hedging in Australia', RBA *Bulletin*, December, pp 1–10.

Graph C2

Foreign Currency Exposure and Hedging

By sector and instrument



Sources: ABS; RBA

of the foreign currency exposure in these portfolios is hedged, leaving an unhedged exposure of around $200 billion. This exposure is likely to be deliberately held for diversification purposes and represents only a relatively small share – about 10 per cent – of the sector's total assets. Non-financial firms typically do not hedge their foreign currency assets and so have the largest foreign currency asset exposure after hedging. These assets represent about 10 per cent of non-financials' total assets and are mainly in the form of long-term foreign direct equity investments. Although in some cases these exposures are 'naturally hedged' with matching foreign currency liabilities, they are typically left unhedged for diversification reasons. The banking sector's foreign currency assets are hedged at around 50 per cent, meaning that it also has a small net foreign currency asset position after hedging.

The fact that Australian residents hedge a larger amount of foreign currency liabilities than assets means that, on balance, non-residents must be acting as counterparties to Australians hedging foreign currency liabilities. The survey data on derivative counterparties confirm that this is the case, with Australian residents holding a net long foreign currency position in derivative contracts with foreigners of just under $300 billion (Table C1). This represents Australian residents' net demand for hedging liability exposures after the netting of offsetting liability and asset exposures among residents. It also indicates that in addition to the Australian dollar exposure non-residents hold through direct holdings of Australian dollar assets, which amounts to $700 billion in total, they are willing to hold nearly half this amount again in Australian dollar exposure through the derivatives market. While this is significant in underpinning the market for Australian firms hedging the exchange rate risk on foreign borrowings, it is a relatively small exposure in the context of global investors' total portfolios.

Table C1: Residents' Gross Outstanding Foreign Exchange Derivative Positions

By counterparty, notional value, A$ billion, as at 31 March 2009[a]

Counterparty	Long foreign currency/short AUD positions	Short foreign currency/long AUD positions	Net positions
Resident	554	–554	0
Non-resident	991	–703	288
Total	**1 545**	**–1 257**	**288**

(a) Positive values represent derivative positions under which the holder will receive foreign currency in exchange for Australian dollars at a predetermined exchange rate (that is, a long foreign currency/short AUD position). Negative values represent derivative positions under which the holder will receive Australian dollars in exchange for foreign currency at a predetermined exchange rate (that is, a short foreign currency/long AUD position).

Source: ABS

Domestic Economic Conditions

The Australian economy has continued to perform better than had been expected, supported by stimulatory settings of monetary and fiscal policy, high population growth, strong trade links with Asia, and a sound financial system. Compared with the experience elsewhere around the world, the downturn in the Australian economy was relatively mild, with Australia one of only a few economies that did not record negative year-ended growth.

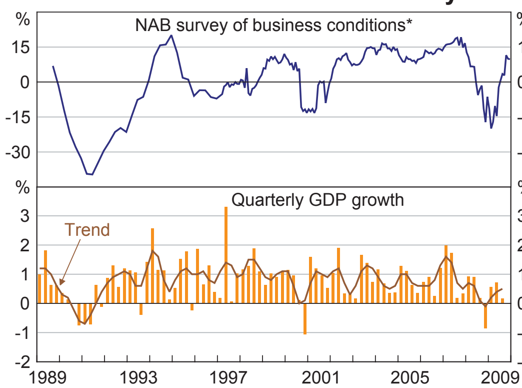
Estimates of GDP growth over the past year or so are subject to some uncertainty, given difficulties with the implementation of new statistical standards and the significant differences that remain between the various measures of GDP. Nevertheless, the September quarter national accounts suggest that GDP grew by around 1½ per cent over the first three quarters of 2009, after contracting in the December quarter 2008 (Graph 35, Table 6). Furthermore, a range of indicators, including employment, retail sales and various business surveys, suggest that the economy expanded at a solid pace in late 2009.

Household sector

Household spending was quite resilient through the second half of 2009, contrary to earlier expectations that it would weaken as the support to spending from the Government's cash handouts faded. A solid recovery in household wealth and much better than expected labour market conditions have been associated with a significant rise in consumer confidence (Graph 36). Household net worth is estimated to have risen by around 10 per cent over the second half of 2009, reflecting strong

Graph 35

Indicators of Economic Activity



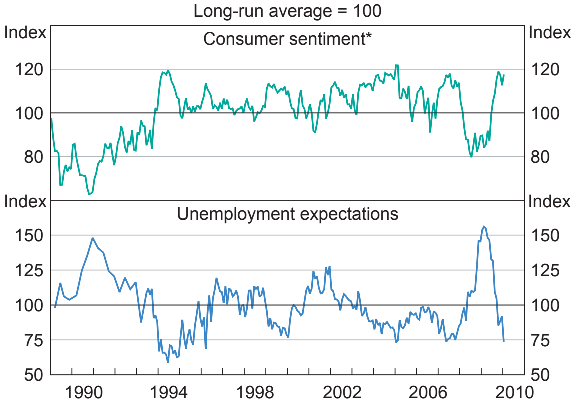
* Net balance; deviation from long-run average
Sources: ABS; NAB; RBA

Table 6: Demand and Output Growth
Per cent

	Three quarters to September quarter 2009
Domestic final demand	0.5
GNE	1.5
Net exports[(a)]	0.4
Statistical discrepancy[(a)]	–0.5
GDP	1.5
Non-farm GDP	1.5

(a) Contribution to GDP growth
Source: ABS

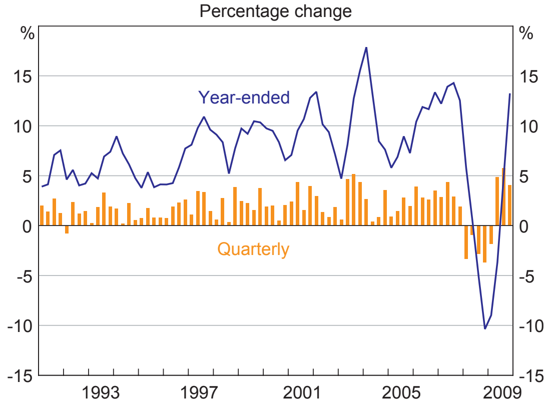
Graph 36
Household Sentiment Indicators
Long-run average = 100



* Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index

Sources: Melbourne Institute and Westpac; Roy Morgan Research

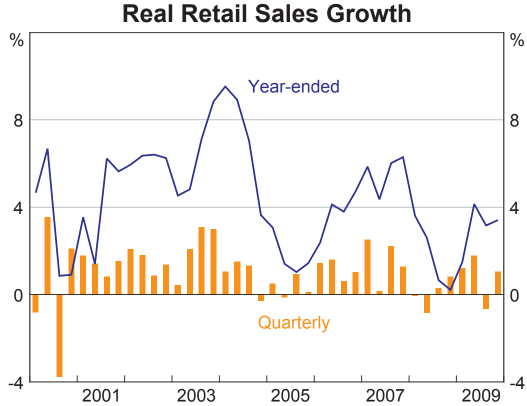
Graph 37
Household Net Worth*
Percentage change



* RBA estimate for December quarter 2009

Sources: ABS; RBA

Graph 38
Real Retail Sales Growth



Source: ABS

growth in both equity and dwelling prices, to be back around its peak in late 2007 (Graph 37).

The volume of retail sales increased by around 1 per cent in the December quarter to be 3½ per cent higher over the year (Graph 38). Spending on cafes and restaurants grew particularly strongly after having fallen sharply through 2008. In contrast, spending elsewhere in the retail sector has been softer, rising by 0.7 per cent in volume terms in the quarter, with a fall in the month of December. Sales of motor vehicles to households rose by 7 per cent in the quarter. Consumer sentiment increased in January, partly reversing the modest decline seen in the previous two months, to be again around an historically high level. The improvement in labour market conditions was reflected in the January surveys, with expectations of future unemployment falling sharply.

Real household disposable income (after interest payments) increased by 7 per cent over the year to the September quarter. Reduced interest payments by households made a significant contribution to growth over this period, with lower interest payments accounting for around 4 percentage points of the growth in disposable income. Many households took the opportunity to increase their saving and pay down debt: on average, households saved around 5½ per cent of their income over the year to the September quarter, compared with zero per cent in the prior year, and dissaving in the period from mid 2002 to mid 2005 (Graph 39). More recently, household disposable incomes are likely to have been supported by the improvements in the labour market.

Conditions in the housing sector have picked up quite strongly over the past year. A recovery in dwelling construction activity is now well under way and house prices have risen strongly, reflecting the temporary increase in first-home buyer grants, rapid population growth and below-average interest rates. Dwelling investment rose solidly in the September quarter, and should continue to increase in coming quarters. The increase in dwelling investment has been concentrated in detached houses, while forward indicators of apartment construction, including local government building approvals, have remained relatively weak (Graph 40). This is consistent with liaison reports that developers have found it difficult to access finance for large-scale property developments. In total, building approvals are estimated to have increased by around 40 per cent over 2009; it is possible there will be some upward revision to this estimate, consistent with the general pattern over the past few years, as loan approvals for new homes have increased considerably more than building approvals (Graph 41).

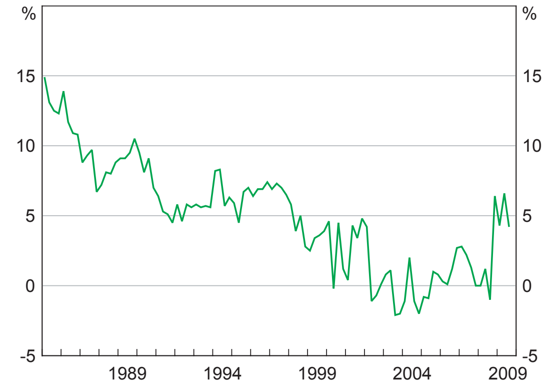
Over coming quarters, there will be an additional boost to dwelling investment from the almost 20 000 new homes to be built under the Federal Government's Social Housing Initiative, as well as from the temporary increase in grants paid under the Energy Efficient Homes Package for ceiling insulation and solar hot water systems.

Conditions have been quite buoyant in the established housing market, with capital city housing prices increasing by around 3–4 per cent in the December quarter and by around 10–12 per cent over the year (Table 7, Graph 42). There are some signs that the pace of growth eased through the quarter, particularly at the lower end of the market, although some seasonal weakness in the month of December clouds the interpretation of the data a little. Nationwide housing prices were around 8 per cent above the early-2008 peak. Sydney and Melbourne have experienced particularly sharp increases, although housing prices have also risen in the other capital cities. While growth was broad-based within cities earlier in 2009, growth in the second half of the year was strongest in the more expensive suburbs. In the lower-priced suburbs, dwelling prices levelled out in the December quarter, consistent with an easing in demand from first-home buyers. Housing prices in many regional areas also appear to have risen significantly after falling through 2008.

Graph 39

Household Saving Ratio*

Per cent of household disposable income



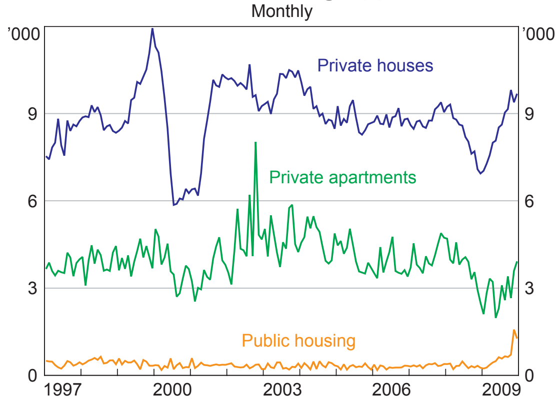
* Net of depreciation

Source: ABS

Graph 40

Residential Building Approvals

Monthly

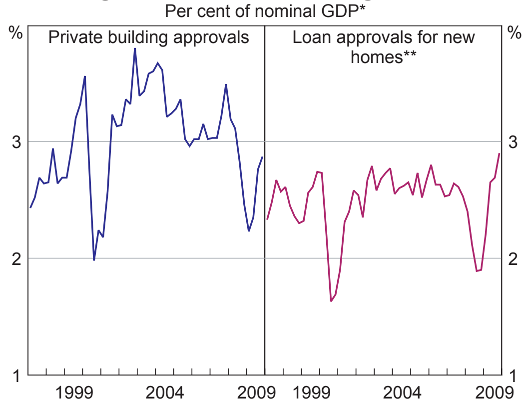


Source: ABS

Graph 41

Leading Indicators of Dwelling Investment

Per cent of nominal GDP*



* December quarter 2009 loan approvals are based on data for October and November. RBA estimate for December quarter 2009 GDP.

** Includes newly constructed dwellings and dwellings in the process of construction.

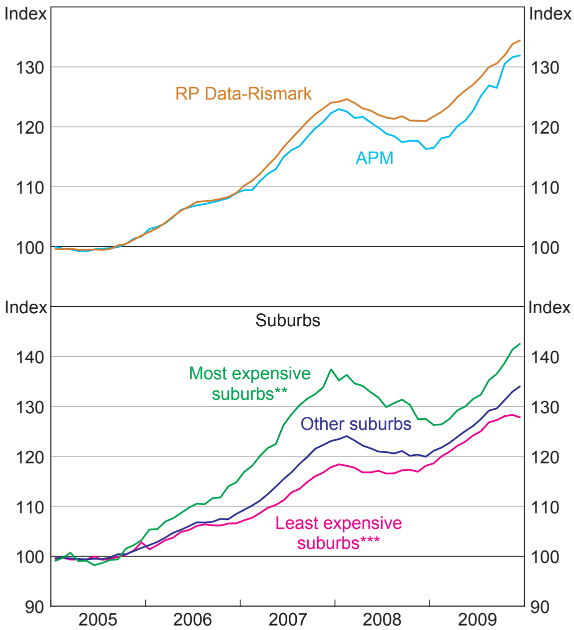
Sources: ABS; RBA

Table 7: National Housing Price Growth
Per cent

	September quarter 2009	December quarter 2009	Year to December quarter 2009	Peak-to-trough	Trough-to-latest
Capital cities					
ABS[(a)]	4.4	5.2	13.6	–5.5	14.5
APM	3.7	4.3	11.7	–3.6	11.8
RP Data-Rismark	2.8	2.8	10.2	–3.0	10.2
Regional areas					
APM	2.6	5.9	10.6	–4.8	10.6
RP Data-Rismark[(a)]	1.0	1.9	5.1	–3.8	5.1

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

Graph 42
Capital City Housing Prices*
2005 = 100



* Weighted average of houses and apartments in capital cities, seasonally adjusted by RBA
** Most expensive 20 per cent of suburbs
*** Least expensive 20 per cent of suburbs
Sources: APM; RBA; RP Data-Rismark

Business sector

Conditions in the business sector have strengthened over the past few quarters. The AIG and NAB business surveys generally report that trading conditions are firm, and capacity utilisation has risen noticeably to be back above longer-run average levels (see 'Box D: Recent Developments in Capacity Utilisation'). Although business investment fell by around 6 per cent over the year to the September quarter, this was a significantly smaller fall than experienced in most other countries and smaller than had been feared early in 2009. Survey measures of investment intentions have recovered somewhat from the very low levels recorded a year ago, but near-term investment intentions remain relatively soft. This suggests that for the moment many businesses remain cautious in their spending plans, despite a fairly optimistic general view about the future.

Over recent quarters, engineering construction activity has been sustained at an historically high level, supported by mining-related investment. Mining investment stood at 4¼ per cent of GDP in 2008/09, compared with a peak of around 3 per cent in the early 1980s mining boom and 2¾ per cent in the boom in the late 1960s and early 1970s (Graph 43), with large projects in the oil & gas, coal and iron ore sectors (Graph 44). The outlook for mining investment remains positive, with construction work on the Gorgon liquefied natural gas (LNG) project having started in the December quarter and a number of other significant projects currently in the early stages of development. More generally, the robust outlook for growth in China and other trading partners in Asia suggests that strong demand for Australian bulk commodities will continue to underpin a high level of engineering construction activity in the period ahead.

In contrast, private non-residential building activity has declined noticeably over the past year, in part due to difficult financing conditions faced by developers and an increase in vacancy rates in the office sector (Graph 45). The national CBD office vacancy rate has risen from a trough of 3.7 per cent in early 2008 to nearly 8 per cent in the December quarter, which is a little above the decade average. Capital values have also fallen significantly from their peak in late 2007, although there are signs of some improvement in conditions in the second half of 2009 with estimates suggesting capital values have stabilised.

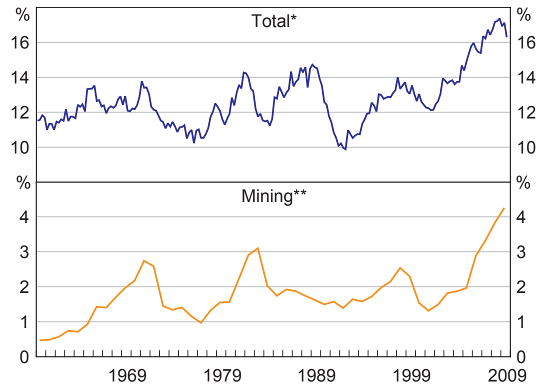
While non-residential approvals increased sharply in the second half of 2009, this was due to approvals associated with the Australian Government's education infrastructure package (Graph 46). Construction of educational facilities by both the private and public sectors increased by nearly 60 per cent in the September quarter as work on the $16 billion education infrastructure program started. Public-sector spending on engineering construction also increased strongly in the September quarter, mainly in the areas of transport infrastructure and utilities (Graph 47). In terms of the broader economy, the maximum effect of the overall fiscal stimulus package on the level of GDP is estimated to occur in early 2010, although the maximum effect on growth is estimated to have been in the June quarter 2009.

While machinery and equipment investment fell significantly around late 2008 and early 2009 – in line with the global slump in demand for manufactures – it appears to have risen sharply towards the end of 2009, partly reflecting a boost from the temporary tax deductions for new tangible assets. In particular,

Graph 43

Business Investment

Per cent of nominal GDP

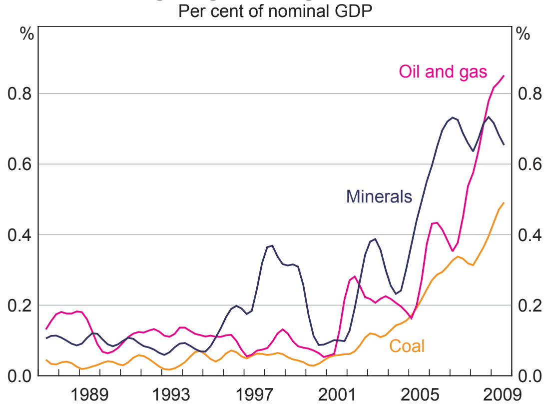


* Excludes livestock & orchards and second-hand asset transfers between the private and other sectors
** Financial year
Sources: ABS; RBA

Graph 44

Mining Engineering Work Done*

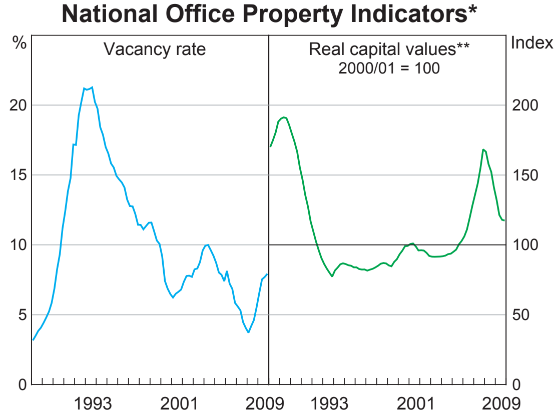
Per cent of nominal GDP



* 7-period Henderson trend
Sources: ABS; RBA

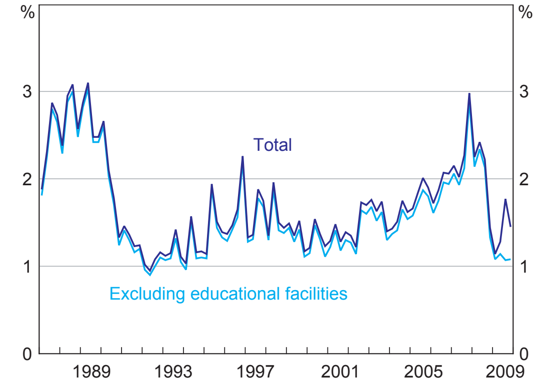
Graph 45

National Office Property Indicators*



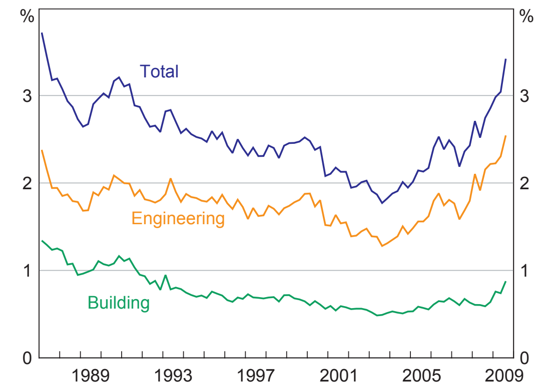
* Capital city CBDs (excluding Hobart)
** Deflated by trimmed mean CPI
Sources: Jones Lang LaSalle; Property Council of Australia; RBA

Graph 46
Private Non-residential Building Approvals
Per cent of nominal GDP*



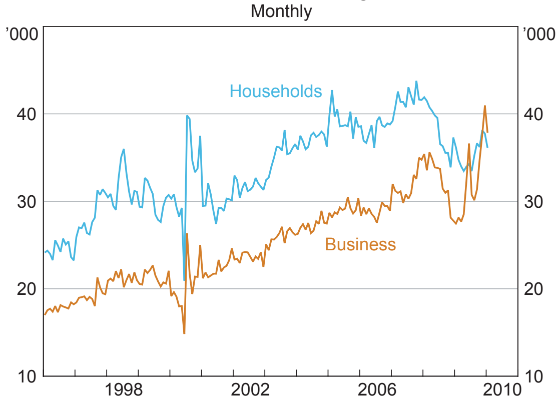
* RBA estimate for December quarter 2009 GDP
Sources: ABS; RBA

Graph 47
Public Construction Work Done
Per cent of nominal GDP



Source: ABS

Graph 48
Motor Vehicle Sales by Sector
Monthly

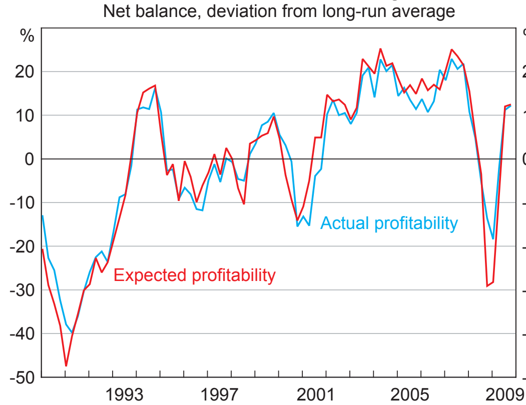


Sources: FCAI; RBA

motor vehicle sales to businesses increased by around 20 per cent in the December quarter, following a similar tax-incentive-related surge in the June quarter, although they have since eased (Graph 48).

Despite the improvement in business conditions, business credit fell over the second half of 2009 as many businesses sought to reduce leverage, partly by raising equity. While lending conditions remain tight, particularly in the commercial property sector, there is some evidence from liaison and business surveys suggesting that conditions for some borrowers have begun to ease. Firms have also been able to use internally generated funds to support investment and pay down debt, with business surveys suggesting that firms expect profit growth to continue, following a decline in profits in the first half of 2009 (Graph 49).

Graph 49
Business Profitability
Net balance, deviation from long-run average



Sources: NAB; RBA

Farm sector

The 2009 winter crop is estimated to have been slightly below the average non-drought harvest over the past decade and a little lower than earlier expectations, due to adverse weather conditions toward the end of the cropping season (Graph 50). For 2009/10 as a whole, farm output is expected to be broadly unchanged as a small rise in crop production is expected to be offset by lower expected production of livestock and related products, such as wool and dairy. Heavy rain across parts of the eastern states toward the end of December and in early February has helped to alleviate earlier concerns about the impact of the El Niño weather system, and boosted inflows to the northern part of the Murray-Darling basin, which have subsequently progressed down the river system. The NSW Government has recently started to release flows downstream of the Menindee Lakes, which are gradually reaching the Murray River.

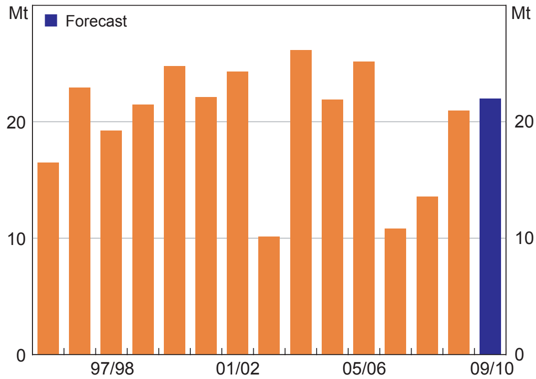
External sector

Export volumes are estimated to have risen solidly in the December quarter after falling by 2 per cent in the September quarter, to be up modestly over the year (Graph 51). This is a considerably stronger outcome than for almost all other major economies, where exports suffered large falls in late 2008 and early 2009.

In recent months, resource export volumes appear to have levelled out after a period of strong growth to mid 2009, particularly in the case of bulk commodities (Graph 52). This primarily reflects supply-side constraints, with port and rail facilities generally operating near capacity and maintenance occurring at LNG plants on the North West Shelf. Demand conditions for resource commodities remain strong, with Chinese imports of bulk commodities around record highs, and demand from other traditional trading partners continuing to improve. Demand for many resource commodities has recently been boosted by cold weather in many parts of the northern hemisphere, which has disrupted production there and boosted demand for energy commodities. Looking ahead, significant expansions over the next few years in production capacity and transport infrastructure for resource commodities are expected to result in substantial growth in Australia's resource export volumes.

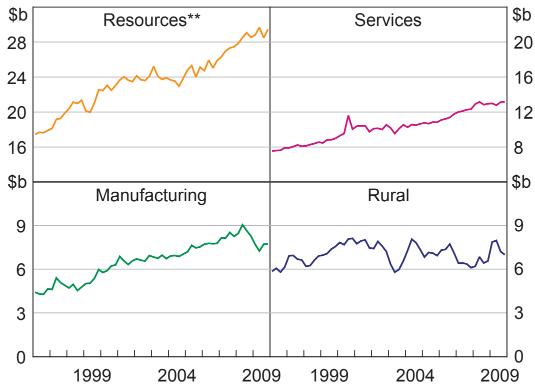
Manufactured exports have grown somewhat over recent quarters, largely due to higher motor vehicle exports, which look to have risen by nearly 50 per

Graph 50
Wheat Production



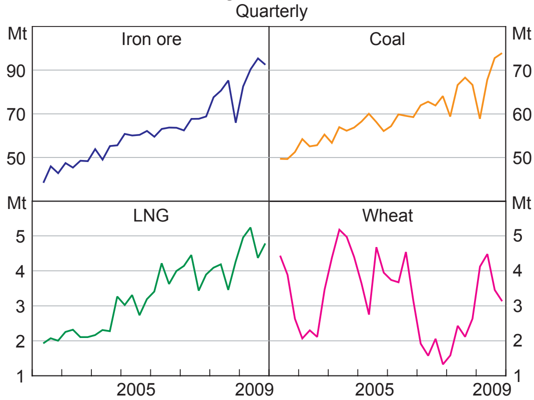
Source: ABARE

Graph 51
Export Volumes*
Quarterly



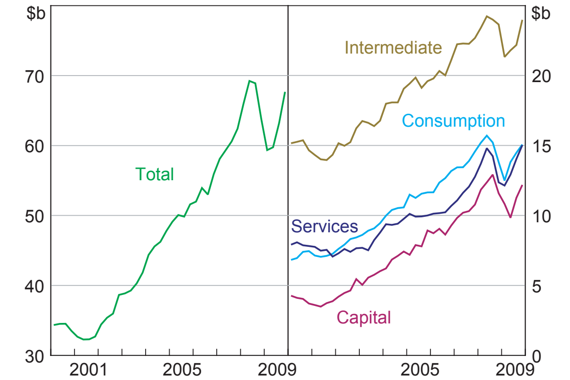
* RBA estimates for December quarter 2009
** Excludes RBA gold transactions
Sources: ABS; RBA

Graph 52
Commodity Export Volumes
Quarterly



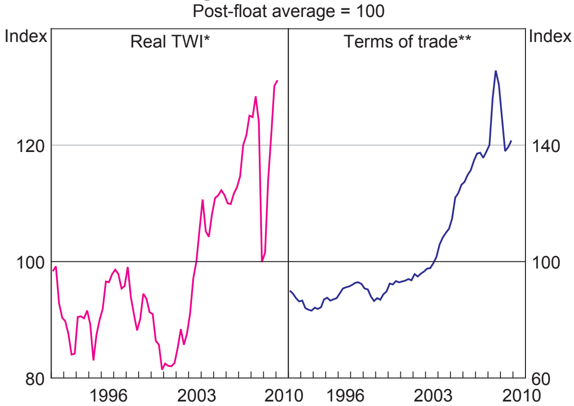
Sources: ABS; Government of Western Australia; RBA; Santos

Graph 53
Import Volumes*
Quarterly



* RBA estimates for December quarter 2009
Sources: ABS; RBA

Graph 54
Real Exchange Rate and Terms of Trade
Post-float average = 100



* March quarter 2010 observation assumes that nominal exchange rates on 3 February are maintained for the remainder of the quarter, and uses the latest core inflation rates
** RBA estimate for December quarter 2009
Sources: ABS; RBA; Thomson Reuters

cent over the past six months, but remain well below their previous peak. While manufactured exports are likely to be boosted by the global recovery, the appreciation of the Australian dollar will work in the opposite direction. The appreciation of the currency is also likely to weigh on service exports.

Import volumes have continued to rise, increasing by more than 10 per cent over the second half of the year (Graph 53). Imports have now reversed most of the nearly 15 per cent fall that occurred between mid 2008 and early 2009. This has reflected stronger domestic spending and some inventory restocking, as well as substitution toward imported goods as a result of the appreciation of the exchange rate. Imports of transport equipment have shown particular strength due to a rise in motor vehicle sales and dealer restocking, while imports of major capital items such as aircraft and large engineering components have also been strong. Service imports have also risen, particularly travel services, in line with strong growth in short-term resident departures.

The terms of trade are estimated to have risen moderately in the December quarter. Although they are around 15 per cent lower than the peak in the September quarter 2008, this is a smaller fall than was expected a year ago, and the terms of trade are currently around 60 per cent higher than the average for the 1984–2000 period. With significant price increases expected for coal and iron ore this year, the terms of trade are likely to strengthen further. These trends in commodity markets, together with a recovery in global investor sentiment, have contributed to a considerable appreciation since early 2009 of the exchange rate, which in real terms is now around its highest level in the post-float period (Graph 54).

Labour market

Conditions in the labour market have improved noticeably in recent months, and the labour market continues to perform better than had been expected. The number of people employed increased strongly in the December quarter, rising by 0.7 per cent after being largely unchanged over the previous year. Full-time employment accounted for around half of the increase in recent months, but is still well below its peak in mid 2008, while part-time employment continues to grow at a rapid pace (Graph 55). By state, the recovery in the labour market has been most pronounced in Victoria, which accounted for the bulk of the increase in aggregate employment over the second half of 2009.

Average hours worked by full-time and part-time employees also picked up in the December quarter.

This follows a significant decline in average hours worked during the downturn, when firms attempted to lower labour costs and save jobs. Reflecting both the recent strength in full-time employment and the pick-up in average hours worked, total hours worked in the economy increased by 1.0 per cent in the December quarter (Graph 56).

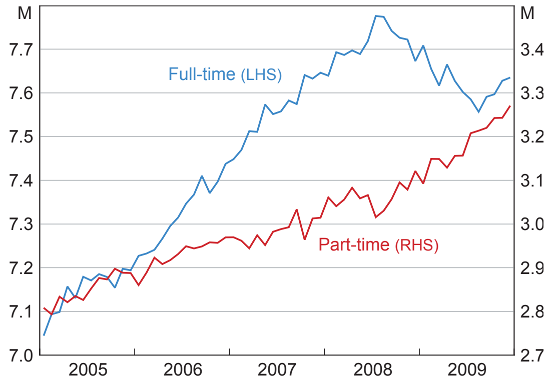
The unemployment rate declined to 5.5 per cent in December, having been at 5¾ per cent for much of the previous nine months. Broader measures of labour underutilisation, which take into account the reduction in hours worked during the recent downturn, point to a higher level of unused resources in the labour market than the unemployment rate, although this divergence is likely to narrow as labour market conditions improve and average working hours increase. Labour force growth has remained robust, driven by strong population growth, and the rising participation of older workers has contributed to a relatively high overall participation rate.

Forward-looking measures point to solid employment growth in coming quarters. Business survey measures of hiring intentions have rebounded in recent months, and are now at above-average levels (Graph 57). This is consistent with the Bank's liaison, which suggests that a greater proportion of firms are intending to increase employment over the coming year. The number of job advertisements has risen from its recent trough, although it remains well below the levels of early 2008. This improvement in labour market conditions is also being reflected in an improvement in consumers' expectations about unemployment over the next year.

Graph 55

Employment

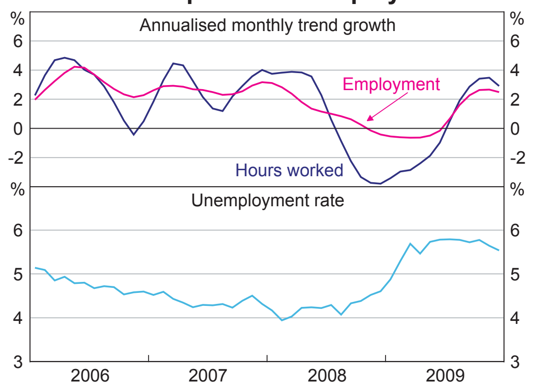
Number of persons



Source: ABS

Graph 56

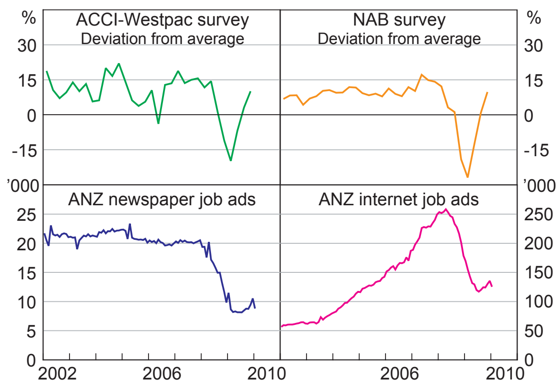
Labour Input and Unemployment



Sources: ABS; RBA

Graph 57

Labour Market Indicators



Sources: ACCI-Westpac; ANZ; NAB; RBA

Box D

Recent Developments in Capacity Utilisation

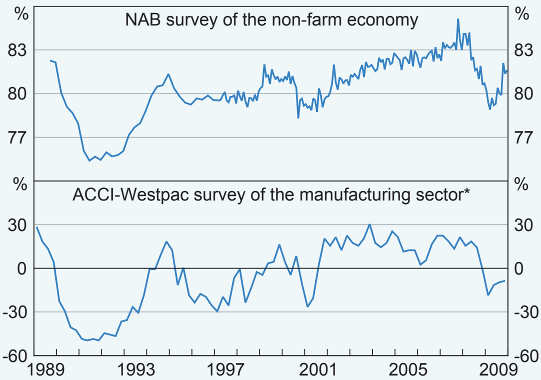
Judgments about the extent of spare capacity in the economy have an important bearing on the outlook for inflation. In general, if an economy has considerable underutilised capacity, inflationary pressure will be lower than if it is operating at a high level of capacity utilisation. The level of capacity utilisation also affects firms' investment and employment decisions, as firms operating close to full capacity are more likely to invest in additional capital and employ more workers, particularly if output prices and profitability are rising. While the amount of spare capacity in an economy is not directly observable, a number of business surveys publish aggregated measures of firm-level capacity utilisation, which are helpful for gauging the balance of supply and demand in the Australian economy (Graph D1).

Typically, these surveys ask businesses a question like 'at what level of output is your company currently operating?' The NAB survey also asks firms about the extent to which their output is being constrained by the availability of capital, labour and intermediate inputs. The responses suggest that the availability of labour is an important driver of overall trends in capacity utilisation while, perhaps surprisingly, premises and plant have tended to be a significantly less important factor over the past 15 years (Graph D2).

For much of the past decade, capacity utilisation – as measured by various business surveys – rose steadily, reaching unusually high levels. For example, in late 2007 the NAB measure was at its highest level in the two-decade history of the survey, with most industries experiencing high levels of capacity utilisation (Graph D1). Firms responded to this tight capacity by significantly increasing demand for labour and investment spending. Alternative measures of spare capacity in the economy, such as

Graph D1

Survey Measures of Capacity Utilisation

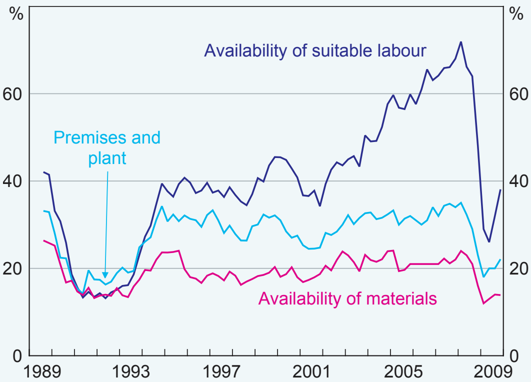


* Net balance; deviation from long-run average
Sources: ACCI-Westpac; NAB; RBA

Graph D2

Constraints on Output*

Per cent

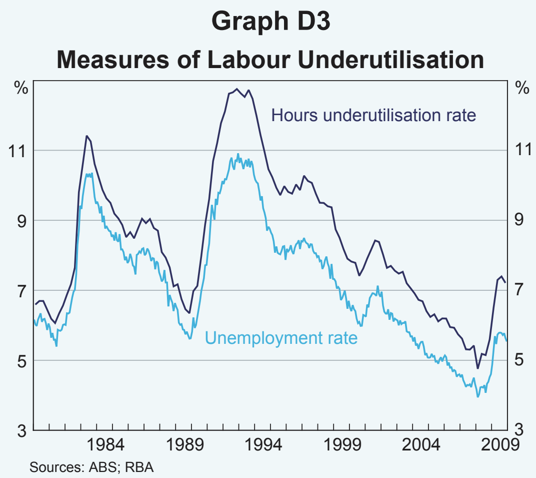


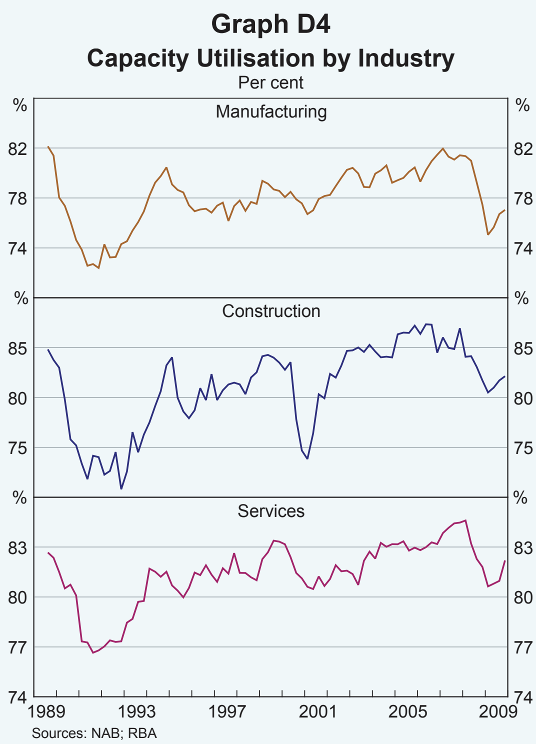
* Per cent of firms reporting a minor or significant constraint
Source: NAB

measures of labour underutilisation, also suggested a significant tightening in resource utilisation in the period to early 2008 (Graph D3).[1]

As economic activity slowed over 2008, capacity utilisation declined, with measures suggesting it fell modestly below its long-run average to be roughly in line with the levels recorded during the relatively mild 2000–01 downturn. While a particularly sharp fall was recorded for the manufacturing sector, consistent with the weakness in global demand for manufactured goods, utilisation in the construction and services sectors remained at relatively higher levels, reflecting the overall resilience of domestic demand (Graph D4).

From around mid 2009, measures of capacity utilisation began to recover, and are now back above long-run average levels. Initially, this was driven by a pick-up in the manufacturing and construction sectors, though a number of services sectors have also reported increased capacity utilisation in recent months. This is consistent with survey measures indicating that firms have stronger hiring and investment intentions, and with the improvement in business sentiment more generally. Overall, these measures suggest that the economy starts the cyclical upswing with considerably less spare capacity than earlier thought likely. ✠





1 The labour underutilisation rate accounts for both unemployed persons as well as those workers who would like to work more hours. A more detailed discussion can be found in the November 2004 *Statement*, 'Box B: Indicators of Labour Market Tightness', pp 35–36.

Domestic Financial Markets

Money markets and bond yields

The Board increased the cash rate target in December, to 3.75 per cent, and left it unchanged at the February meeting. Money market yields continue to reflect expectations of further tightening, though at a slightly slower pace than at the time of the previous *Statement*. The cash rate is expected to reach around 4½ per cent by the end of the year.

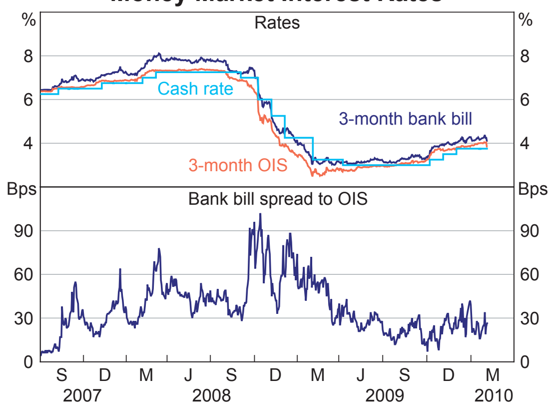
The spread between bank bill yields and the expected cash rate remains close to its level at the start of November, which is above its pre-crisis level but below the average during the financial turmoil (Graph 58). In December this spread was more volatile. This volatility appears to reflect some decline in the liquidity of the bill market, particularly around year-end, rather than any resurgence of concerns about bank counterparty risk.

In its market operations, the Bank has responded to changing demands for cash balances from commercial banks. Partly reflecting year-end pressures and higher demand for borrowing cash on a secured basis, the Bank allowed Exchange Settlement (ES) balances to rise temporarily in late December and early January. Aggregate ES balances have since fallen and are currently around $1½ billion.

Yields on 10-year Commonwealth Government Securities (CGS) have fallen by about 10 basis points over the past few months, with the spread to US Treasuries narrowing by about 30 basis points to 180 basis points (Graph 59). There have been larger falls in the yields on shorter-maturity CGS. Issuance of CGS slowed in recent months as the Australian

Graph 58

Money Market Interest Rates



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

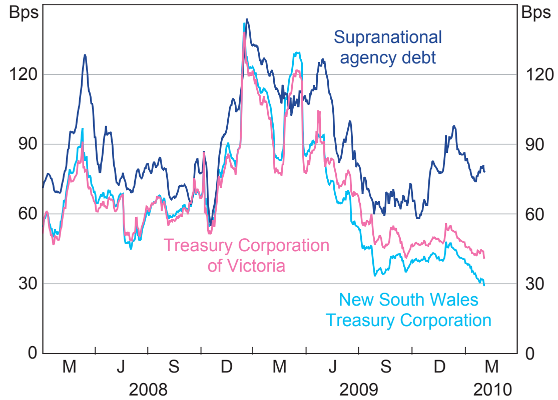
Graph 59

Australian Government Bond Yields

Source: RBA

Office of Financial Management (AOFM) did not conduct tenders over the year-end period. Nevertheless, total CGS outstanding has increased by around $11 billion since the last *Statement* to $121 billion. In early November, the Government's

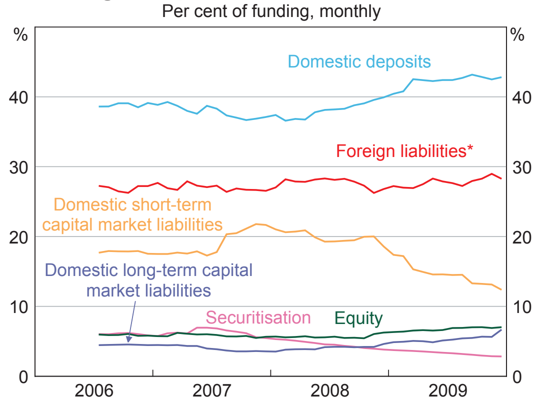
Graph 60
Spreads to 5-year CGS



Sources: RBA; Yieldbroker

Graph 61
Funding Composition of Banks in Australia

Per cent of funding, monthly

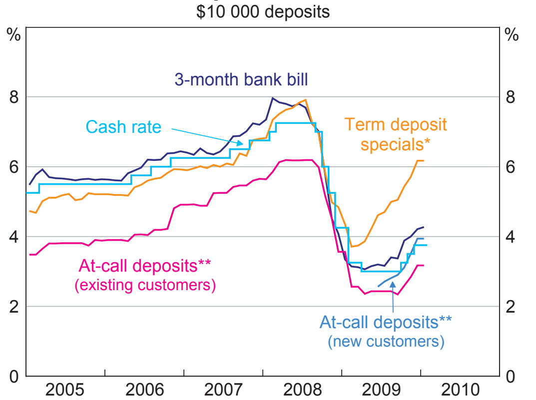


* Adjusted for movements in foreign exchange rates

Sources: APRA; RBA

Graph 62
Deposit Rates

$10 000 deposits



* Average of the specials rates for 1–12, 24-, 36- and 60-month terms at the major banks

** Average of online, bonus and cash management accounts at the major banks

Source: RBA

Mid-Year Economic and Fiscal Outlook revised down projected issuance in future years so that the outstanding stock is projected to peak at $270 billion, almost $50 billion less than previously anticipated.

Spreads at which state government bonds (semis) trade over CGS have narrowed slightly over the past few months, declining to around their previous lows of September 2009 (Graph 60). Semi issuance has been sizeable with one state that had previously used the Australian Government guarantee issuing without this, as it was cheaper to issue unguaranteed debt and there was good market access. At $4 billion, the bond was equal to the largest ever issued in Australia. Spreads on supranational debt remain around the elevated levels seen at the end of October, partly reflecting the strong issuance of Kangaroo bonds (bonds issued domestically by non-residents).

Financial intermediaries

There has been little change in the composition of banks' funding over recent months. The share of funding from deposits has remained at around 43 per cent in the December quarter after rising during 2008 and early 2009 (Graph 61). The shares of funding that come from domestic and foreign long-term capital market debt and equity have increased slightly over the quarter as banks continue to manage their balance sheets conservatively. Banks' use of short-term capital market debt has contracted further.

Competition among financial intermediaries for deposits remains intense, with the average rate on new at-call deposits (including online savings, bonus saver and cash management accounts) rising by over 80 basis points since end October, to be now higher than the cash rate (Graph 62). The average rate on the major banks' existing at-call deposits has risen by almost 60 basis points over the same period with the margin below the cash rate on these accounts the lowest it has been.

The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has risen by nearly 75 basis points since end October, and is up about 240 basis points since early 2009. For the past few months, the major banks have offered higher interest rates on 3- and 5-year term deposits than they pay on bonds of equivalent maturity, with this gap recently around 80 basis points for 3-year funds (Graph 63).

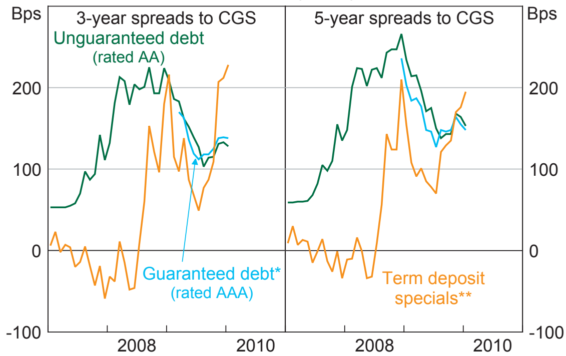
Australian banks issued $230 billion of bonds in 2009 – nearly double the issuance in 2008 and well above issuance in prior years (Graph 64). The very strong issuance last year predominantly reflected banks seeking to increase the duration of their wholesale funding liabilities as they shifted out of short-term debt. Australian banks have continued to lengthen the maturity of their liabilities by issuing longer-dated bonds. The average tenor of bonds issued recently is 4.8 years, up from 3.9 years a year ago.

Since the previous *Statement*, banks' bond issuance has amounted to around $58 billion, with the banks continuing to access a diverse range of markets and currencies. About 80 per cent of issuance has been offshore. Notwithstanding occasional issues of guaranteed bonds, the banks have increasingly issued unguaranteed bonds in recent months as investors have again become comfortable holding bank credit risk. Over the past few months, around two-thirds of newly-issued bank bonds have been unguaranteed, the highest share since the Australian Government Guarantee Scheme was introduced in October 2008 (Graph 65).

Unguaranteed issuance continues to be underpinned by the major banks for whom unguaranteed debt funding is generally cheaper than guaranteed debt. Nevertheless, there have been some guaranteed issues by major banks in recent months – notably in December – when it has been cost effective to do so and in response to reverse enquiries from investors. Secondary market spreads on guaranteed and unguaranteed bonds issued domestically by the major banks have narrowed a little since the previous *Statement*, and are well below their peak in early 2009 (Graph 66). Overall, yields on the major banks' bonds have fallen since the previous *Statement*.

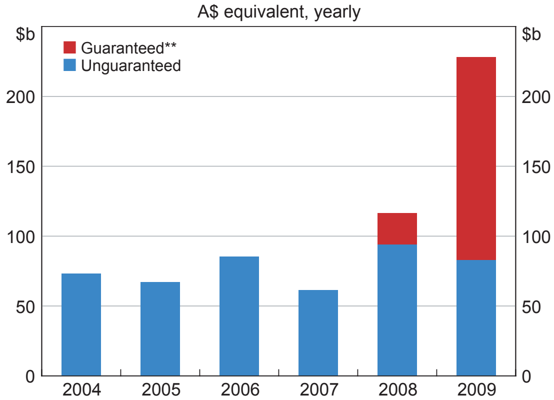
The cross-currency basis swap – which represents an additional funding cost for banks from hedging foreign currency bond issuance into Australian dollars – increased substantially over the final

Graph 63
Major Banks' Pricing of Term Deposits and Bonds
A$ debt, term deposit specials



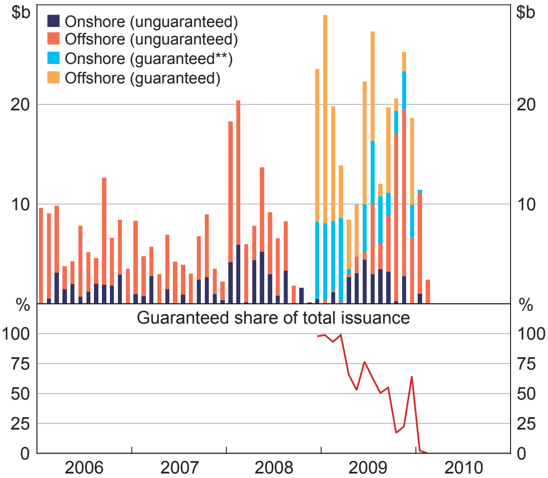
* Includes fee for guaranteed issues
** Prior to September 2008 it is the 24-month spread
Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

Graph 64
Banks' Bond Issuance*
A$ equivalent, yearly



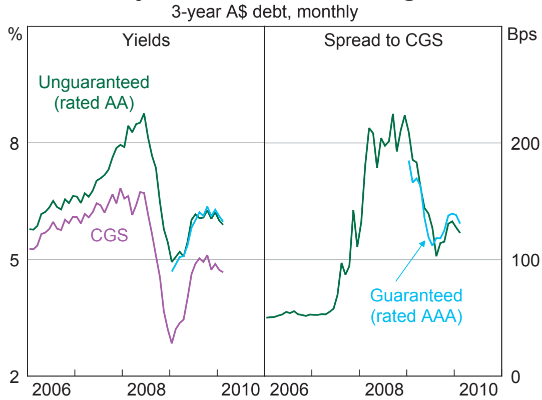
* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Includes A$3.25 billion of issuance guaranteed by the UK government
Source: RBA

Graph 65
Australian Banks' Bond Issuance*
A$ equivalent, monthly



* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Includes A$3.25 billion of issuance guaranteed by the UK government
Source: RBA

Graph 66
Major Banks' Bond Pricing*
3-year A$ debt, monthly



* Includes fee for guaranteed issues
Sources: RBA; UBS AG, Australia Branch

quarter of 2009. The cost of hedging 5-year US dollar issuance has increased by around 25 basis points since September 2009, to 45 basis points, with the cost of hedging bonds denominated in other currencies increasing by a similar amount (Graph 67). Market reports have attributed the pick-up in the cross-currency basis swap to an expected increase in Australian banks' bond issuance offshore, which would increase demand for this hedging instrument. However, the cross-currency swap market is relatively illiquid, with large irregular flows, and has exhibited large changes and reversals over the past couple of years. The elevated cross-currency basis swap has given Kangaroo issuers an incentive to tap the Australian market, with issuance picking up significantly in recent months. This Australian dollar issuance that non-resident issuers hedge into foreign currencies, in turn, puts downward pressure on the cross-currency basis swap.

Conditions in Australian securitisation markets have improved significantly over the past few months. Five residential mortgage-backed securities (RMBS) amounting to $5.3 billion have been issued since the previous *Statement* (Graph 68). Four of these deals, amounting to $4.8 billion, were issued without the AOFM as a cornerstone investor, including the first issue by a major bank since May 2007. These issues were met with strong demand from investors, including international investors, and tended to be upsized. Less than 10 per cent of issuance during the December quarter was purchased by the AOFM, down from around 80 per cent over the first half of 2009.

While issuance has picked up, this has not been large enough to offset the ongoing amortisation of principal (i.e. mortgage repayments) and so the stock of RMBS outstanding has continued to decline. The value of Australian RMBS outstanding is currently around $90 billion, almost 50 per cent below its peak in June 2007. RMBS outstanding offshore has declined by more than 60 per cent, because there has been no offshore issuance, while paper outstanding onshore has fallen by almost 30 per cent. The AOFM's holdings amount to around 8 per cent of all Australian RMBS outstanding, and 14 per cent of the domestic market.

The pick-up in investor demand for RMBS has also been reflected in declining spreads on deals issued without the AOFM as a cornerstone investor. The AAA-rated tranches of the most recently issued RMBS without the support of the AOFM priced at spreads of 130–135 basis points above BBSW, around 15 basis points below the spread on the first such deals in September. While RMBS spreads remain high by historical standards, recent issues were likely to have been profitable for the issuers.

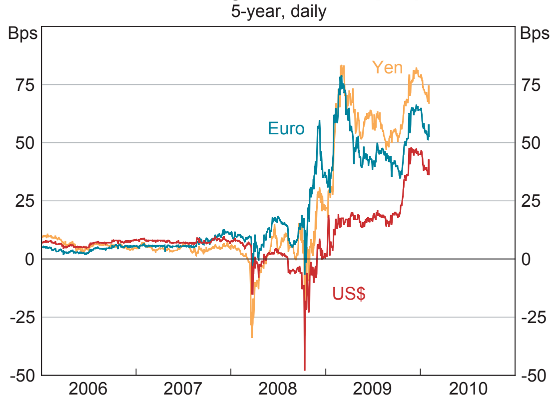
Spreads on AAA-rated RMBS tranches trading in the secondary market have, on average, narrowed over the past few months. Over the past year, there has been a substantial narrowing in the gap between secondary and primary market spreads, suggesting that the market has worked through much of the overhang of supply created by the portfolio liquidation of structured investment vehicles (SIVs). Prior to the financial crisis, these entities accounted for around one-third of the investor base.

Conditions in the Australian securitisation market continue to be supported by the relatively high quality of collateral underlying securities. Losses on Australian RMBS (after proceeds from property sales) remain low as a share of the stock outstanding, at 8 basis points per annum for prime and 150 basis points for non-conforming RMBS. Moreover, 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.

Conditions in short-term securitisation markets have also improved. While the amount of asset-backed commercial paper (ABCP) outstanding continues to fall, market participants report that they now have little difficulty rolling over paper, including at longer maturities. The decline in the stock of ABCP outstanding reflects the ongoing amortisation of existing loan pools (i.e. loan repayments) as well as some reduction in the supply of assets typically funded by ABCP (such as lending by mortgage originators). The improvement in conditions has been reflected in declining spreads. Since their peak, spreads on ABCP have fallen by around 20 basis points to be around the same level as in January 2008, at 45 basis points.

Graph 67

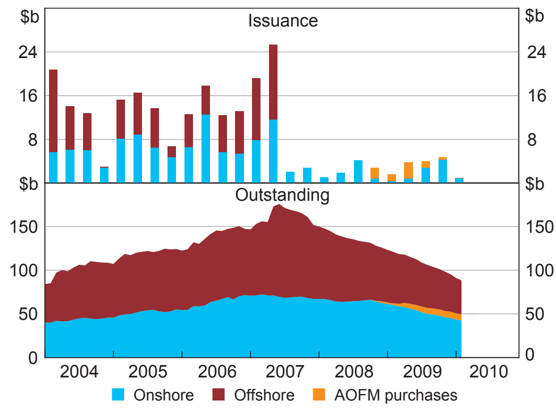
Cross-currency Basis Swap Spreads



Source: Bloomberg

Graph 68

Australian RMBS



Sources: Bloomberg; RBA; Standard & Poor's

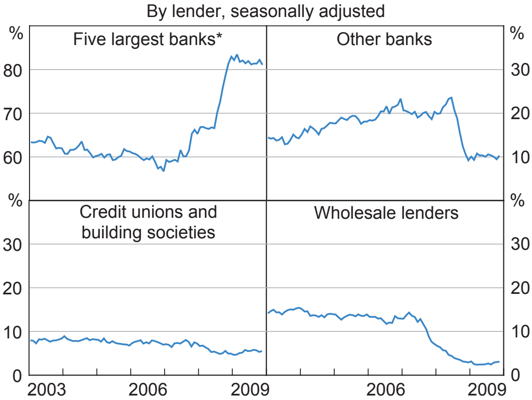
Household financing

On average, variable interest rates on prime full-doc loans (after discounts) have risen by about 60 basis points to 6.07 per cent since end October, though there was some variation across individual lenders (Table 8). For the major banks, the range of their standard indicator rates on housing loans has widened over the past two years, to 27 basis points. Previously, the rates charged had been very tightly clustered.

Graph 69

Share of Owner-occupier Loan Approvals

By lender, seasonally adjusted



* Includes Bankwest from December 2008

Sources: ABS; APRA

The major banks' interest rates on new 3-year and 5-year fixed-rate housing loans have risen by around 10 basis points since end October. With fixed rates currently around 1½–2 percentage points higher than variable rates, the share of owner-occupier loan approvals at fixed rates has declined further to 3 per cent.

Preliminary evidence suggests that the value of housing loan approvals experienced a sizeable fall in December, following declines in October and November. Loan approvals to first-home buyers have fallen since mid 2009 as mortgage rates have risen and the government incentives were wound back. Approvals to non-first-home buyer owner-occupiers also appear to have fallen recently, although investor approvals have continued to grow. The five largest banks' share of gross owner-occupier loan approvals stabilised during 2009 at about 82 per cent, up from 60 per cent before the onset of the financial market turbulence in mid 2007 (Graph 69). The market shares of the smaller banks, credit unions and building

Table 8: Intermediaries' Variable Lending Rates

Per cent

	Current level	Change since: End October	Change since: End April
	End January 2010	2009	2009
Cash rate	3.75	0.50	0.75
Housing loans			
Prime-full doc	6.07	0.61	0.88
Prime low doc	6.66	0.64	0.86
Personal loans	11.79	0.59	0.84
Small business			
Residentially secured			
Term loans	7.84	0.48	0.76
Overdraft	8.70	0.53	0.81
Average actual rate[(a)]	7.72	0.38	0.61
Large business			
Average actual rate, variable and bill funding[(a)]	6.04	0.57	0.98

(a) RBA estimate

Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA societies and wholesale lenders were little changed over 2009.

Housing credit growth has continued at a monthly average pace of 0.7 per cent in the December quarter (Graph 70). While owner-occupier housing credit has been the main driver of growth over the past year, lending to investors has started to pick up in recent months.

Financial institutions' rates on variable personal loans have risen by an average of 59 basis points since end October. Average variable rates on unsecured personal loans and margin loans have increased by 50–55 basis points, while rates on home equity loans and credit cards have risen by 60–65 basis points.

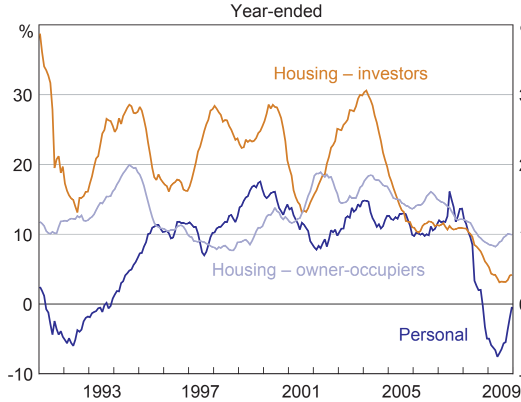
Personal credit, which is a small component of household credit, rose at a monthly average pace of 0.5 per cent during the December quarter. Within that, margin lending has remained broadly stable throughout 2009, having roughly halved during the previous year. More favourable conditions in equity markets meant that the incidence of margin calls remained low at less than one call per day per 1 000 clients during the December quarter, while borrowers' gearing levels were little changed.

Business financing

Since end October, the major banks have raised their variable indicator rates on small business lending by around 50 basis points, while indicator rates on 1–5 year fixed-rate facilities have fallen by 5–30 basis points.

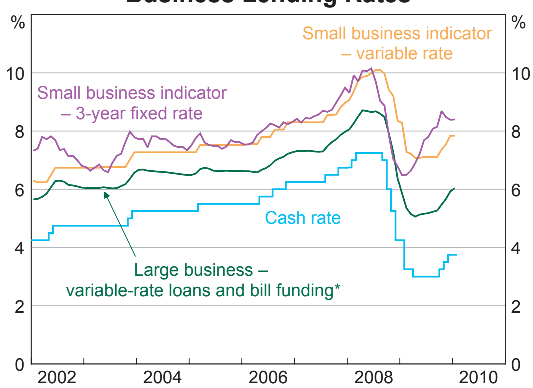
Variable interest rates on banks' outstanding large business loans (those greater than $2 million) are estimated to have increased by an average of 57 basis points since end October to 6.04 per cent (Graph 71). This reflects rising money market rates and a small increase in average risk margins as outstanding loans are gradually repriced at the current higher spreads. The average rate on new lending is estimated to have risen by about 40 basis points.

Graph 70
Household Credit Growth
Year-ended



Source: RBA

Graph 71
Business Lending Rates



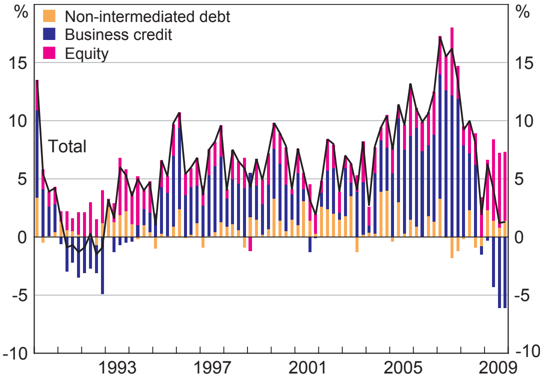
* RBA estimates
Sources: APRA; RBA

The changing composition of business external funding continued in the December quarter 2009, with declines in business credit offset by increases in non-intermediated debt (largely bond issuance) and new equity raisings (Graph 72). In large part, the decline in business credit over the past year reflects the repayment of bank loans by listed corporates, mostly funded by equity raisings, with companies reducing their leverage. Corporates that continued to raise debt funding during 2009 tended to do so in non-intermediated markets, rather than through banks.

Graph 72

Business External Funding

Net change as a share of GDP*, quarterly



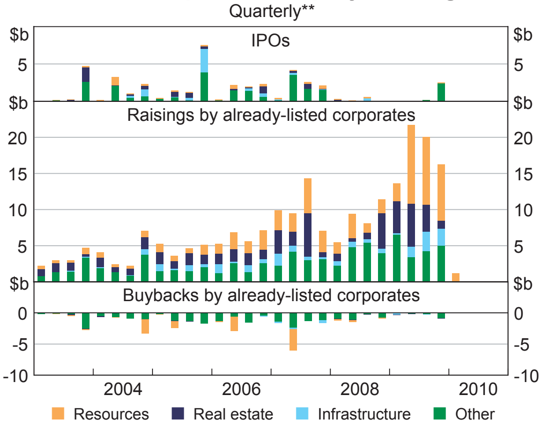
* RBA estimate for December quarter 2009 GDP

Sources: ABS; ASX; Austraclear Limited; RBA

Graph 73

Listed Corporates' Equity Raisings*

Quarterly**



* Excludes hybrid conversions which are a very small component of listed corporates' equity raisings (less than $0.5 billion per quarter)

** Data for March quarter 2010 estimated from company announcements

Sources: ASX; RBA

Over the December quarter, business credit fell at an annualised rate of 10.3 per cent, with the decline reasonably broadly based across industry sectors and evident for banks and non-bank lenders. The contraction in business credit over recent quarters has been more pronounced for large businesses than for small businesses.

Commercial loan approvals have been broadly steady throughout the year, following significant declines in 2008. There has been a pick-up in syndicated lending activity during the December quarter, with $23 billion of approvals to Australian businesses, substantially more than during each of the preceding four quarters. Much of the increase in syndicated lending has been attributable to capital expenditure and general corporate purposes, though refinancing continued to account for the largest share of lending.

Equity raisings remain the main source of business external funding, particularly for listed corporates. Already listed corporates (i.e. excluding IPOs) issued $15 billion of new equity during the December quarter, bringing issuance to a record $70 billion for 2009 (Graph 73). While companies are continuing to issue equity with the intention of retiring debt, an increasing number of companies have announced equity raisings to fund investment, including acquisitions. With the aggregate debt-to-equity ratio having declined by around 20 percentage points to around its long-run average of 65 per cent, it appears that many large listed companies may have completed their intended balance sheet adjustment.

Only a small number of listed corporates repurchased equity during 2009, with buybacks amounting to just $2 billion for the year – the smallest amount since 2002. Instead of using funds to repurchase equity, corporates have preferred to retain cash or retire debt given the uncertain outlook, though market reports suggest that buybacks are likely to pick up in the coming months. While IPO activity in 2009 was also relatively subdued, a couple of large companies listed on the ASX late in the year – the first IPOs of size for around 18 months – and some IPOs are currently in the pipeline.

Corporate bond issuance was solid in the December quarter with $6 billion raised. While the bulk of bonds were issued offshore by larger Australian entities, medium-sized real estate companies refinanced debt by issuing bonds into the domestic market. The broadening of issuers into the domestic market over recent months is another sign that investor risk aversion has eased from its extreme levels in early

2009. Consistent with this, spreads on corporate bonds have narrowed. BBB-rated corporate bonds are trading at around 300 basis points above CGS, 280 basis points below their peak in April 2009.

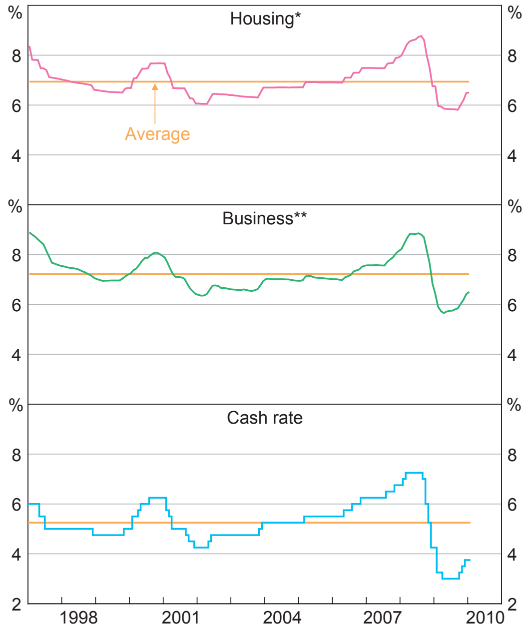
Aggregate credit

The average interest rates on all outstanding housing and business loans (variable and fixed) are estimated to have both increased by about 50 basis points since end October, to 6.50 per cent (Graph 74). For housing rates, this is about 45 basis points below its post-1997 average, though around the levels seen earlier in the decade. The rate for businesses has now risen by about 85 basis points since its early-2009 low, but is still about 70 basis points below its post-1997 average. Given the increases in banks' funding costs and lending spreads, both housing and business interest rates are closer to their historical averages than is the cash rate.

In aggregate, there was a small increase in total credit outstanding over the December quarter as the fall in business credit was more than offset by the growth in household credit. Over the year, total credit rose slightly (Table 9; Graph 75).

Graph 74

Average Interest Rates on Outstanding Lending



* RBA estimates prior to 2001
** RBA estimates
Sources: ABS; APRA; Perpetual; RBA

Table 9: Credit Aggregates
Average monthly growth, per cent

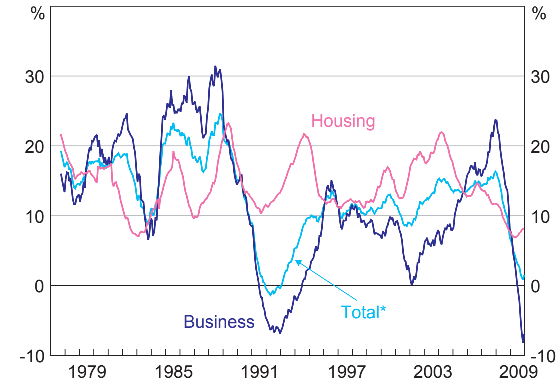
	March quarter 2009	June quarter 2009	September quarter 2009	December quarter 2009
Total credit	0.3	0.1	0.1	0.1
Household	0.5	0.5	0.6	0.7
– Owner-occupier housing	0.8	0.8	0.8	0.8
– Investor housing	0.2	0.2	0.4	0.5
– Personal	–0.4	–0.5	0.2	0.5
Business	0.0	–0.6	–0.9	–0.9

Source: RBA

Graph 75

Credit Growth

Year-ended



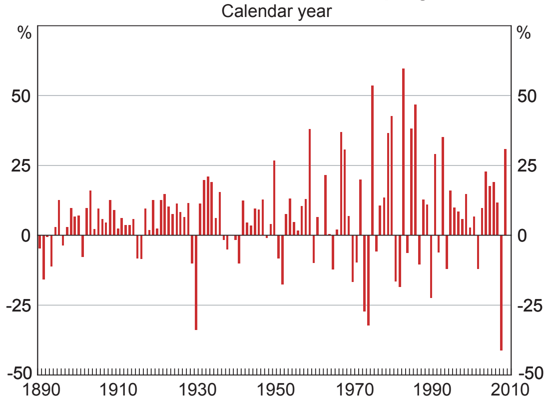
* Includes housing, personal and business credit

Source: RBA

Graph 76

Annual Return of Australian Equity Market*

Calendar year



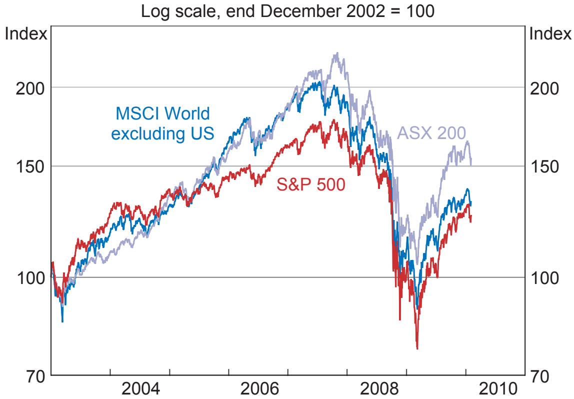
* 1890–1971 use December index averages

Sources: Global Financial Data; RBA; Thomson Reuters

Graph 77

Share Price Indices

Log scale, end December 2002 = 100



Sources: Bloomberg; Thomson Reuters

Equities

Over 2009, the ASX 200 increased by 31 per cent, its largest gain since 1993 (Graph 76). All sectors of the Australian share market recorded increases over the year.

Notwithstanding a 9 per cent fall in January, the ASX 200 is up slightly since the previous *Statement*. This is broadly in line with developments in share markets overseas (Graph 77). Resource stocks have risen on optimism about production volumes and higher commodity prices, though financials have been weighed down by uncertainties about the regulatory outlook in the United States. Share prices of other companies in the index have risen by around 3 per cent. The Australian share market remains around 30 per cent below its November 2007 peak and has seen little net change since September 2009.

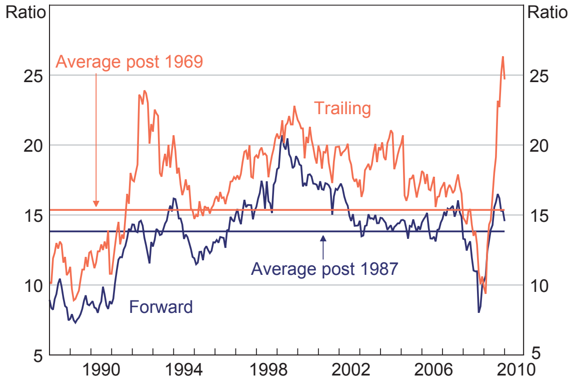
Due to the fall in profits reported by listed companies in 2008/09 and the pick-up in the share market, the Australian trailing P/E ratio has risen sharply over the past year to stand at around 25 (Graph 78). While the trailing P/E is currently well above its historical average, this ratio tends to rise around the end of recessions as share prices incorporate the expected improvement in earnings. Incorporating these expectations, the forward P/E ratio – which is based on earnings forecasts for the next 12 months – is currently a little above its long-run average but not particularly high by historical standards.

The dividend yield for the Australian share market is around its long-run historical average. Since its peak in early 2009, the Australian dividend yield has nearly halved to 4 per cent, with around 45 per cent of this fall due to firms cutting dividends in order to retain cash.

Reflecting the decline in uncertainty about the economic outlook and improving financial conditions, there has been a recent pick-up in M&A deals announced by listed entities. Deals amounting to $28 billion were announced during the December quarter 2009 – one of the larger quarterly amounts since 2000. Recently announced deals are being mostly funded by equity and companies' high levels of cash holdings rather than debt.

Graph 78

Australian P/E Ratios



Sources: MSCI; RBA; Thomson Reuters

Price and Wage Developments

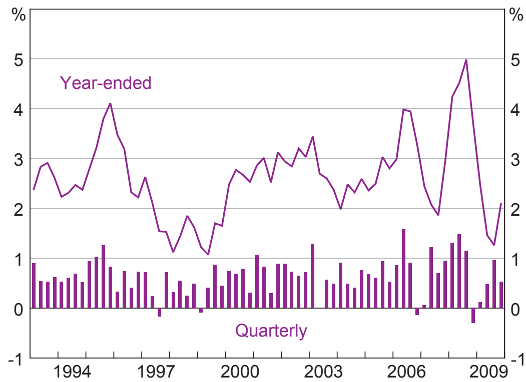
Recent developments in inflation

Recent inflation data indicate that price pressures continue to moderate in line with the Bank's expectations and the easing seen in capacity pressures. Wage growth has slowed, and the prices of many imported items have recently fallen due to the appreciation of the exchange rate. Further moderation in year-ended underlying inflation is expected in coming quarters.

The consumer price index (CPI) increased by 0.5 per cent in the December quarter, to be 2.1 per cent higher over the year (Table 10, Graph 79). The main contributors to the quarterly increase were a large rise in fruit prices – reflecting weather-related supply shortages – and an increase in the price of domestic holiday travel. These were partly offset by significant declines in the prices of automotive fuel and audio, visual & computing (AVC) equipment.

Graph 79

Consumer Price Inflation*



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

Sources: ABS; RBA

Table 10: Measures of Consumer Price Inflation

Per cent

	Quarterly		Year-ended	
	September quarter 2009	December quarter 2009	September quarter 2009	December quarter 2009
CPI	1.0	0.5	1.3	2.1
– Tradables	0.2	0.1	-0.5	1.4
– Tradables (ex food & fuel)	0.3	-0.3	2.1	2.0
– Non-tradables	1.5	0.8	2.3	2.6
Selected underlying measures				
Weighted median	0.8	0.7	3.7	3.6
Trimmed mean	0.8	0.6	3.2	3.2
CPI ex volatile items[(a)] and deposit & loan facilities	0.9	0.5	3.5	3.4

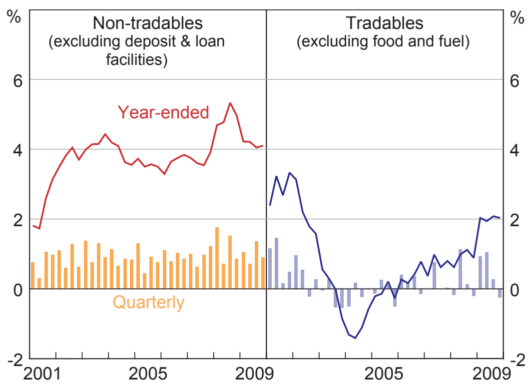
(a) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

Tradables prices (excluding food & fuel) fell by 0.3 per cent in the quarter, reflecting lower prices for AVC equipment, pharmaceuticals and major household appliances (Graph 80). The year-ended rate of tradables inflation was around 2 per cent. This primarily reflected strong outcomes over the first half of 2009, after the sharp depreciation of the exchange rate in late 2008 fed into the price of most tradable goods. With the exchange rate having appreciated significantly since early 2009, tradables prices fell in the December quarter and inflation for this category is expected to remain subdued over coming quarters. The reduction on 1 January in the tariff rates charged on motor vehicles & parts and textile, clothing & footwear products is likely to add to the downward pressure on tradables price inflation.

Graph 80

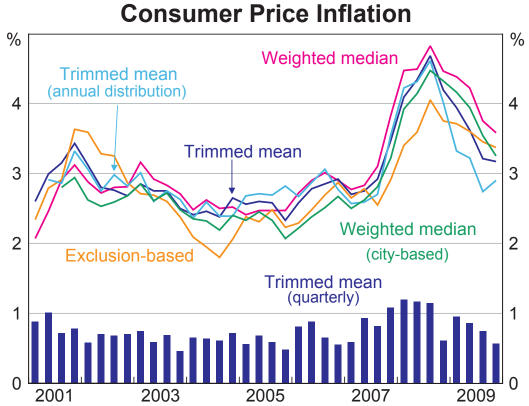
Consumer Price Inflation



Sources: ABS; RBA

Graph 81

Consumer Price Inflation



Sources: ABS; RBA

Non-tradables inflation (excluding deposit & loan facilities) was 0.9 per cent in the December quarter and 4.1 per cent in year-ended terms. The current year-ended pace of non-tradables inflation is 1¼ percentage points below the September 2008 peak, reflecting a relatively broad-based easing in inflation pressures. Nevertheless, non-tradables inflation remains ¾ percentage points higher than its average rate over the inflation targeting period. This reflects particular strength in utilities inflation and in rents, notwithstanding some recent slowing in the latter.

CPI inflation can, at times, be heavily influenced by movements in particular prices that are not representative of the broader trend in inflation. In 2009, year-ended CPI inflation was held down by the large falls in the ABS estimate of deposit & loan facilities prices and to a lesser extent by falls in automotive fuel prices. Given the influence that particular items can have on CPI inflation, RBA staff monitor a range of measures of underlying inflation, as well as attempting more broadly to understand the various factors driving the CPI at any point in time. Measures of underlying inflation include some that exclude particular items – such as automotive fuel, fruit & vegetables and deposit & loan facilities prices – and various trimmed mean and weighted median measures (Graph 81).[1] As has been noted previously, typically these measures will provide a range of estimates and there can be no single measure of underlying inflation that is best at all times.[2]

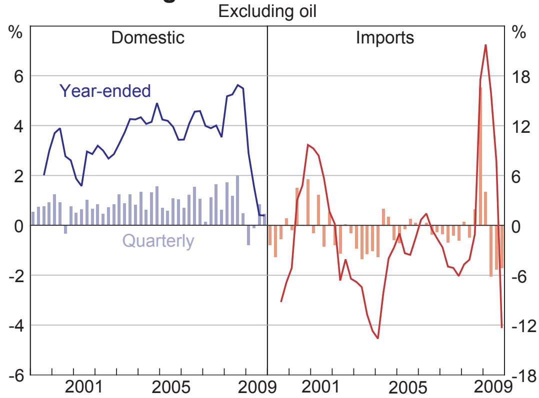
1 The exclusion-based series is the CPI excluding fruit, vegetables, automotive fuel and deposit & loan facilities. The weighted median (city-based) series is calculated using disaggregated quarterly price change data for each CPI item in each of the eight capital cities, rather than using national average data (i.e. it is based on 720 price changes rather than the 90 national price changes). The trimmed mean (annual distribution) series is the average annual inflation rate after trimming the 15 per cent (by weight) of items with the highest and lowest year-ended inflation rates (rather than calculating trimmed mean inflation using the quarterly price changes of items and then cumulating these quarterly rates to an annual rate).

2 For further discussion on a range of measures, see 'Box D: Underlying Inflation', May 2002 *Statement*, 'Box D: Measures of Underlying Inflation', August 2005 *Statement*, and Brischetto A and A Richards (2006), 'The Performance of Trimmed Mean Measures of Underlying Inflation', RBA Research Discussion Paper No 2006–10.

Overall, the range of measures monitored by the Bank suggests that year-ended underlying inflation was around 3¼ per cent in the December quarter, down from a peak of just over 4½ per cent in the year to September 2008. In quarterly terms, underlying inflation was 0.6 per cent in the December quarter, a step-down from around 0.8 per cent in the previous two quarters, and significantly below the peak quarterly rates of around 1¼ per cent recorded in the first three quarters of 2008. These recent outcomes have been in line with the Bank's expectations that the slowing in the economy from mid 2008 and easing in capacity pressures would be reflected in a gradual decline in underlying inflation.

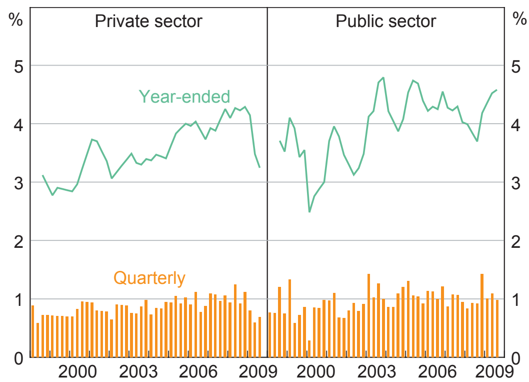
The moderation in inflation is also apparent in producer prices. Preliminary-stage producer prices (excluding oil) fell by 0.9 per cent in the December quarter – the fourth consecutive fall – to be 8.1 per cent lower over the year. Final stage prices (excluding oil) also remained weak, falling by 1.4 per cent over 2009, which is the lowest outcome in the 10-year history of the series. Import prices at each stage of production again fell sharply in the quarter, reflecting the appreciation of the exchange rate. Domestic price pressures were subdued, although prices at the final stage have firmed a little in recent quarters following weakness earlier in the year (Graph 82).

Graph 82
Final Stage Producer Price Inflation
Excluding oil



Sources: ABS; RBA

Graph 83
Wage Price Index Growth



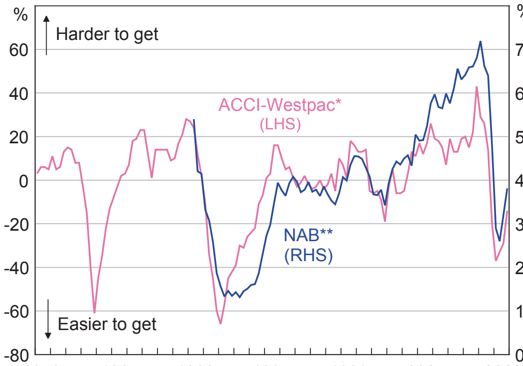
Source: ABS

Labour costs

The moderation in wage growth over the first half of 2009 continued into the September quarter, with private-sector wages growing at a below-trend pace. More timely information from business surveys and liaison suggests that wage growth remained moderate in the December quarter, although the recent improvement in labour market conditions may contribute to higher wage growth over 2010.

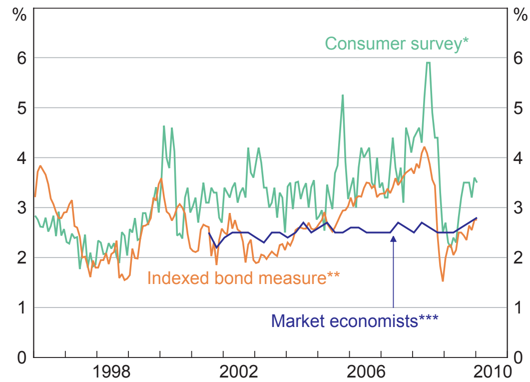
The wage price index (WPI) increased by 0.7 per cent in the September quarter, another below-average outcome, following growth of 0.8 per cent in the previous two quarters. In year-ended terms, WPI growth eased for the third consecutive quarter to 3.6 per cent. The moderation was driven by slower growth in private-sector wages, which eased to 3.2 per cent over the year to September, the slowest pace since 2002 (Graph 83). The easing was broad-based across industries, and bonus payments have grown at a slower pace than base wages. Growth in public-sector wages remained around its decade average in quarterly terms and has shown no sign of moderating. Other measures – such as average earnings per employee from the national accounts, ordinary time earnings and new federal enterprise bargaining agreements – also recorded further moderation in wage growth in the September quarter.

Graph 84
Difficulty Finding Suitable Labour



* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

Graph 85
Indicators of Inflation Expectations



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

Business surveys point to some increase in the rate of growth of labour costs in coming quarters, albeit from low levels, although there is little to suggest that firms are having difficulty obtaining suitable labour (Graph 84). The Bank's liaison suggests that the proportion of firms expecting to increase wages over the next 12 months has increased from the low levels seen earlier this year, although not to pre-downturn levels.

Inflation expectations

Forecasts by market economists indicate that inflation is expected to remain consistent with the medium-term inflation target. The median forecast for inflation in 2010 remains in the lower part of the target range, while the forecast for 2011 has increased (Table 11, Graph 85). Medium-term expectations inferred from bond prices have risen slightly recently, to be around 2¾ per cent. The Melbourne Institute's measure of consumer inflation expectations has been around 3½ per cent since mid 2009, which is modestly above its average level over the inflation targeting period. Business survey measures of expected selling prices remain subdued, despite picking up a little recently.

Table 11: Median Inflation Expectations
Per cent

	Year to December 2010			Year to December 2011	
	August 2009	November 2009	February 2010	November 2009	February 2010
Market economists[(a)]	2.4	2.2	2.3	2.7	2.9
Union officials[(b)]	2.5	2.6	3.0	–	3.0

(a) RBA survey
(b) Workplace Research Centre

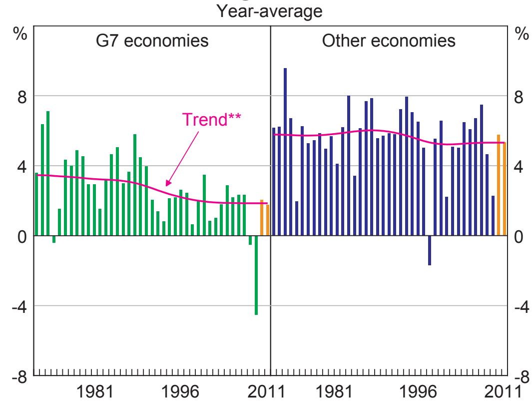
Economic Outlook

The international economy

The outlook for the world economy has improved since the November *Statement*, although some of the risks to global growth (in both directions) have come more clearly into focus over recent months. Overall, global output is now expected to grow by around 4 per cent in year-average terms in both 2010 and 2011. These forecasts are a little stronger for both years than expected three months ago and, if achieved, would be around the average rate of global growth over the past decade or so. However, by historical standards this would still represent a relatively modest recovery given the scale of the downturn in activity in 2008 and 2009 and the significant degree of spare capacity in many economies. Growth is projected to be around trend over the forecast period both in China and most other emerging economies, and in the advanced economies (Graph 86). The risks to these forecasts are discussed below.

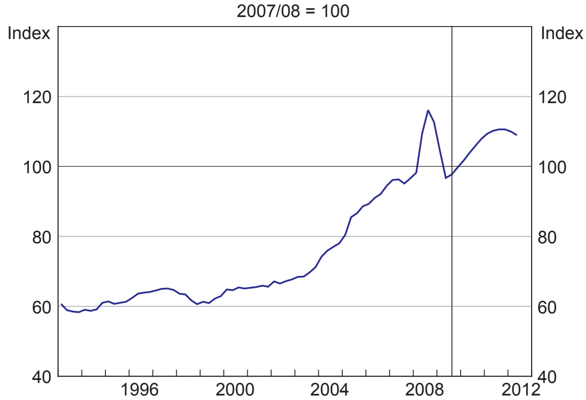
Australia's terms of trade are forecast to increase over the coming year, reflecting higher prices for Australia's commodity exports and subdued growth in the prices of manufactured imports (Graph 87). Consistent with the improved outlook for the world economy, spot prices for a range of commodities have risen further over recent months. Contract prices for coal and iron ore are expected to increase strongly, supported by the increase in demand from China, as well as the ongoing recovery in demand from more traditional trading partners including Japan and Korea.

Graph 86
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; IMF; RBA; Thomson Reuters

Graph 87
Terms of Trade
2007/08 = 100



Sources: ABS; RBA

Domestic activity

As discussed in earlier chapters, conditions in the domestic economy have been somewhat stronger than was expected in mid 2009. The economy has benefited from the rebound in growth in Asia, the significant stimulus delivered by fiscal and monetary policies and strong population growth. Despite the fading of the effects of the fiscal payments to households, consumption has continued to grow, supported by growth in household wealth and the resilience of the labour market. Business conditions and capacity utilisation have both risen over recent months, while business investment has only fallen modestly and is expected to strengthen over the forecast period, driven by developments in the resources sector.

The central forecasts are summarised in Table 12. In year-ended terms, growth is forecast to be 3¼–3½ per cent from late 2010 out to the end of the forecast period in mid 2012. In year-average terms, GDP is forecast to grow by 2 per cent in 2009/10 and 3½ per cent in 2010/11 and 2011/12. The forecasts are based on the technical assumption of a rise in the cash rate over the forecast period, with the assumed path broadly consistent with market expectations as the *Statement* was finalised. As noted in the August *Statement*, this technical assumption for the cash rate should in no way be viewed as a commitment by the Board to any particular path for policy. The exchange rate is assumed to remain constant over the forecast period after having appreciated strongly over the second half of 2009, reflecting the improved outlook for the domestic economy and the resources sector.

The solid growth in the economy through most of the forecast period is expected to absorb some of the spare capacity generated during the period of below-average growth in 2008 and 2009. Public demand is expected to make a significant contribution to growth in the early part of the forecast period, reflecting spending on education, health, public housing, communications and transport infrastructure. However, the maximum effect of the full package of fiscal stimulus measures (including the payments to households) on the growth rate of output is estimated to have already passed, although the level of output is still being boosted.

As the stimulus fades, private demand will become a more important driver of growth, reflecting solid household spending and strong business investment. Dwelling investment is also expected to grow strongly through 2010, reflecting the pick-up in demand for housing, particularly from first-home buyers. Mining investment is expected to increase further from its already very high level, reflecting the strong recovery in commodity prices, improved investor sentiment, the recent commencement of the Gorgon LNG project and a pipeline of other significant projects. Resource exports are expected to grow strongly, reflecting capacity increases resulting from the high level of mining investment over recent years. However, growth outside of the mining sector is expected to be only modest, reflecting the reallocation of productive resources within the economy. This is partly due to the high level of the real exchange rate, which has reduced the

Table 12: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	June 2009	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012
GDP growth	0.6	2	2½	3¼	3½	3½	3½
Non-farm GDP growth	0.6	2¼	2½	3¼	3½	3½	3½
CPI inflation	1.5	2.1	3	2½	2½	2¾	2¾
Underlying inflation	3¾	3¼	2½	2½	2½	2¾	2¾

(a) Actual GDP data for June 2009 and actual inflation data to Dec 2009. For the forecast period, technical assumptions include A$ at US$0.88, TWI at 69, WTI crude oil price at US$85 per barrel and Tapis crude oil price at US$88 per barrel.
Sources: ABS; RBA

international competitiveness of import-competing and exporting sectors, including the manufacturing and tourism sectors.

As noted in the 'Domestic Economic Conditions' chapter, recent labour market outcomes have been stronger than had been expected three to six months ago. The unemployment rate is now forecast to decline modestly over the period to mid 2012. In the near term, it is likely that growth in labour demand will be reflected in hours worked recovering at a faster pace than the number of employees, given that much of the downturn in the labour market occurred through reduced working hours rather than redundancies.

Inflation

Underlying inflation has slowed noticeably in year-ended terms from its peak in September 2008, to around 3¼ per cent over 2009. The quarterly outcome for underlying inflation in the December quarter was a step-down from the rates recorded earlier in the year and was well below the peak rates seen in 2008.

This decline in quarterly inflation rates reflects the significant easing in wage growth and capacity pressures over 2009, as well as the substantial appreciation of the exchange rate. Given the lags, these factors are expected to contain inflation for some time. Year-ended underlying inflation is expected to be around or below 3 per cent in the March quarter and to fall to around or slightly below 2½ per cent in late 2010 and early 2011. Underlying inflation will probably then pick up a little towards the end of the forecast period, reflecting both a pick-up in wage growth from low levels as the labour market tightens and higher levels of capacity utilisation in the economy. The dampening influence on inflation of the appreciation is also likely to wane through the forecast period. Overall, the central forecast is a small upward revision relative to the expectation in November, reflecting the recent strengthening in the labour market and hence the outlook for wage growth, and also the stronger outlook for demand in the economy.

In contrast to underlying inflation, year-ended CPI inflation has been around or below 2 per cent for the past three quarters, largely due to sharp declines in the volatile automotive fuel and deposit & loan facilities prices in 2008/09. By late 2010 it is expected to be moving broadly in line with the forecast for underlying inflation. Within the CPI, there are a few items that are expected to contribute significantly to inflation. Rent inflation is expected to be firm, and large increases in some utilities prices are scheduled. In addition, based on historical behaviour of the deposit & loans category, the recent and assumed increases in the cash rate could be expected to add temporarily to the measured CPI increase.

Risks

As always, there are uncertainties around the forecasts. One issue is whether the stronger-than-expected performance of the economy over the past few quarters is largely accounted for by a bring-forward of spending. If so, underlying growth would be soft into 2010 as the effects of the temporary fiscal stimulus fade. On the other hand, the peak effect of the cash payments component of the fiscal stimulus passed some time ago, and household consumption is likely now being supported by the firmer labour market and increases in household net worth. Moreover, the improvement in the outlook in the resources sector is clearly not due to temporary policy factors.

Overall, risks around the central forecasts appear to be fairly balanced. Perhaps the most likely scenario in which growth and inflation are both significantly higher than expected is one in which confidence continues to build on the back of a further pick-up in commodity prices and there is a larger increase in investment in the resources sector than currently expected. In this scenario, non-residential construction might also pick up more quickly than is currently expected as credit constraints ease. If this were to occur, capacity constraints, particularly in the construction sector, would be likely to emerge and wage growth would be likely to accelerate more quickly than currently expected. The result would be higher inflation.

The most likely scenario in which growth turns out to be much weaker than the central forecast involves a significantly slower recovery in the world economy than currently expected. The dynamics of the inventory cycle are generating much of the initial recovery in the advanced economies, as expected, but private demand will have to pick up for sustained growth. Moreover, many of these economies face significant fiscal challenges: early steps to rein in budget deficits could limit growth in the short term at a time when there is already significant excess capacity, while the failure to take credible steps in this direction could also limit growth by undermining confidence and forcing up borrowing costs. There is also a risk that uncertainty about the future shape of the financial system could further reduce banks' willingness to lend and that this could restrain growth.