2. International and Foreign Exchange Markets

The US election result has led financial markets to reassess the economic and policy landscape. Market participants expect some degree of corporate tax reduction, deregulation and increased fiscal expenditure in the United States, although there remains considerable uncertainty around what form these policies will take. The US election result came amid an improving outlook for global growth and inflation that has been building since mid 2016. As a result, bond yields in developed markets have risen substantially in recent months, share prices are higher, particularly for financial institutions, the US dollar has appreciated and the expected stance of the major central banks' monetary policies has become less accommodative. The US election result weighed on most emerging markets; the asset markets of countries with significant US dollar liabilities or trade exposures to the United States have generally underperformed and their currencies have generally depreciated. Despite the significant changes in global financial market prices, the adjustments have been orderly and measures of market volatility remain low.

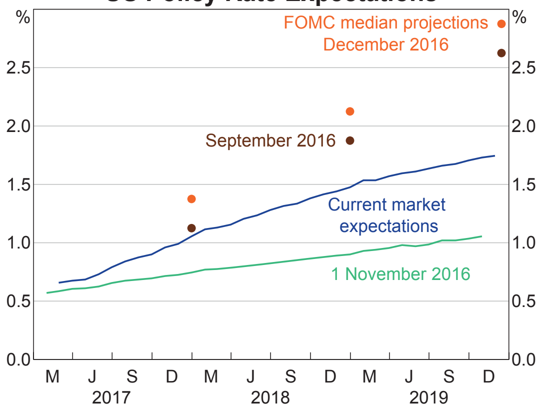
Central Bank Policy

Monetary policy remains very accommodative. The European Central Bank (ECB) and Bank of Japan (BoJ) have kept interest rates at extremely low levels and the Bank of England (BoE) cut interest rates further in August 2016. While the US Federal Reserve recently raised interest rates, its policy rate is lower than had been expected at the beginning of 2016. Many central banks also continue to purchase large quantities of assets. However, expectations for central bank stimulus have been scaled back somewhat since mid 2016 as the outlook for growth and inflation has improved.

The US Federal Open Market Committee (FOMC) voted in December to raise its target range for the federal funds rate by 25 basis points to 0.5–0.75 per cent, citing realised and expected labour market tightening, as well as an increase in inflation. At the same time, FOMC members revised up their projections for the pace of future rate increases, with a median projection of 75 basis points of rate increases in 2017. The market's expected path for interest rates has also steepened, although the implied pace of tightening remains slower than that projected by FOMC members (Graph 2.1). FOMC members have since stated that, with the economy near full employment and inflation moving towards target, expansionary fiscal policy may result in a faster pace of interest rate increases. Some FOMC members have suggested that a reduction of the Federal Reserve's balance sheet may be brought forward as well.

In December, the ECB extended its asset purchase program from March 2017 until the end of 2017 – which was a little longer than had been expected – noting that core inflation lacked a convincing upward trend. But the ECB also reduced the extent of monthly purchases from €80 billion to €60 billion, noting that the longer term of the program, relative to expectations, would be more effective in maintaining a longer-lasting transmission of

Graph 2.1
US Policy Rate Expectations



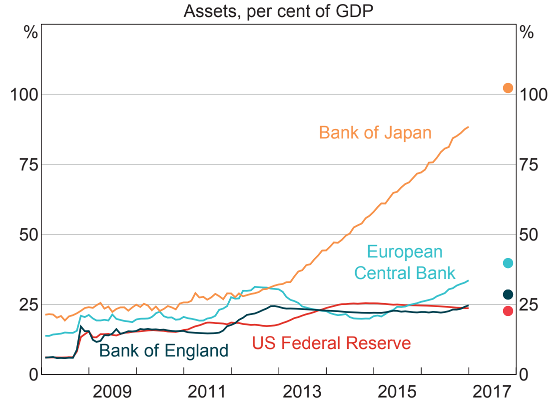
Sources: Bloomberg; Board of Governors of the Federal Reserve System

The BoJ has left monetary policy unchanged since instituting its yield curve control policy in September 2016. The overnight interest rate is –10 basis points, the target yield on 10-year government bonds is around zero and asset purchases are continuing at broadly the same pace as before (Graph 2.2). The BoJ has noted that the Japanese economy has continued to recover, and it expects inflation to pick up. Market expectations for further cuts to the overnight interest rate have been unwound in recent months, although the BoJ has reiterated that it is prepared to ease further should that be necessary to meet its inflation target.

the ECB's stimulus measures, notwithstanding the slower accumulation of assets. To ensure the continued smooth implementation of its program, the ECB also made technical changes to the program, reducing the minimum maturity for bond purchases from two years to one year, and removing its restriction on purchasing bonds with yields below the deposit rate (currently –0.40 per cent). The ECB continues to operate its bank lending schemes to support monetary policy pass-through and credit growth. The total stock of its longer-term refinancing operations grew by around €90 billion in 2016, to €560 billion (about 5 per cent of GDP).

Although the BoE was widely expected to ease policy further following its initial response to the UK referendum result, stronger-than-expected economic data and a stronger outlook for inflation have resulted in the BoE leaving interest rates unchanged and noting that it might now move policy in either direction. The BoE expects inflation to pick up and overshoot the inflation target temporarily, as the recent depreciation in the pound passes through to consumer prices. It has stated that it is prepared to tolerate some overshoot, but that this tolerance is limited, particularly if the resulting increase in inflation affects expectations for ongoing inflation.

Graph 2.2
Central Bank Balance Sheets*
Assets, per cent of GDP



* Dots are RBA projections for end 2017 based on central bank communications

Sources: Central banks; IMF; RBA; Thomson Reuters

Some other advanced economy central banks have eased policy in recent months in response to subdued domestic inflation (Table 2.1). The Reserve Bank of New Zealand lowered its policy rate by 25 basis points to 1.75 per cent at its November meeting, but noted that it now sees the current level of interest rates as sufficiently low to return inflation to the middle of its target band. The Swedish Riksbank announced an extension of its asset purchase program at its December meeting, noting downside risks to inflation after some recent weaker-than-expected economic data.

Table 2.1: Monetary Policy

	Policy rate Per cent		Most recent change
Euro area[(a)]	–0.40	↓	Mar 16
Japan[(a)]	–0.10	↓	Jan 16
United States[(b)]	0.625	↑	Dec 16
Australia	1.50	↓	Aug 16
Brazil	13.00	↓	Jan 17
Canada	0.50	↓	Jul 15
Chile	3.25	↓	Jan 17
India	6.25	↓	Oct 16
Indonesia	4.75	↓	Oct 16
Israel	0.10	↓	Feb 15
Malaysia	3.00	↓	July 16
Mexico	5.75	↑	Dec 16
New Zealand	1.75	↓	Nov 16
Norway	0.50	↓	Mar 16
Russia	10.00	↓	Sep 16
South Africa	7.00	↑	Mar 16
South Korea	1.25	↓	Jun 16
Sweden	–0.50	↓	Feb 16
Switzerland[(b)]	–0.75	↓	Jan 15
Thailand	1.50	↓	Apr 15
Turkey	8.00	↑	Nov 16
United Kingdom	0.25	↓	Aug 16

(a) Marginal rate paid on deposits at the central bank
(b) Midpoint of target range
Sources: Central banks; RBA; Thomson Reuters

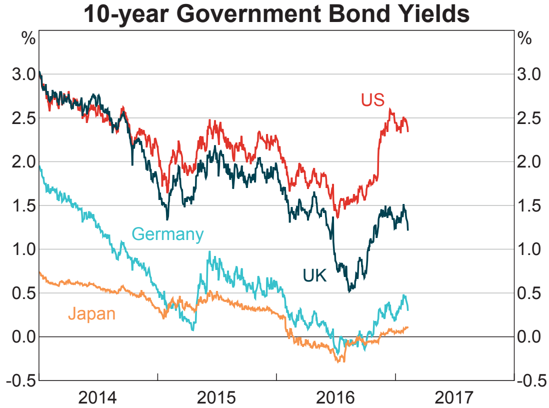
A number of emerging market central banks have also recently adjusted policy settings, many in response to significant currency and asset price moves following the US election. The central banks of Mexico and Turkey increased their policy rates by 100 basis points and 50 basis points, respectively, citing the need to manage inflation expectations following large depreciations of their currencies. Several other central banks intervened in foreign exchange markets (see Foreign Exchange) and both Bank Indonesia and the Bank of Korea intervened in domestic government bond markets following sharp moves in yields. In contrast, the central bank of Brazil decreased its policy rate by 100 basis points due to weak domestic growth and noted that further reductions in the policy rate are likely to be necessary.

In China, the level and volatility of interbank interest rates has remained elevated in recent months. In addition, the People's Bank of China (PBC) increased the interest rates it charges on its main liquidity operations by 10 basis points. The PBC has allowed money market conditions to tighten recently due to concerns about leverage and higher inflation.

Sovereign Debt Markets

Major market sovereign bond yields have increased significantly from their mid-2016 lows as the outlook for growth has improved and concerns about disinflationary pressures have eased (Graph 2.3). The rise in yields has been most pronounced in the United States, where 10-year Treasury yields are around 100 basis points higher than their mid-2016 levels. Around half of this increase has occurred since the US election, due to expectations for fiscal stimulus and less monetary stimulus. In addition, around half of the rise in yields has been attributable to an increase in market-based measures of

Graph 2.3
10-year Government Bond Yields



Source: Bloomberg

inflation compensation, some of which reflects increased compensation for uncertainty about future inflation. Nonetheless, nominal Treasury yields remain at low levels relative to history. This partly reflects the continued low level of the term premium – the additional compensation investors require for holding long-term bonds – which, despite having risen recently, is currently estimated to be around zero.

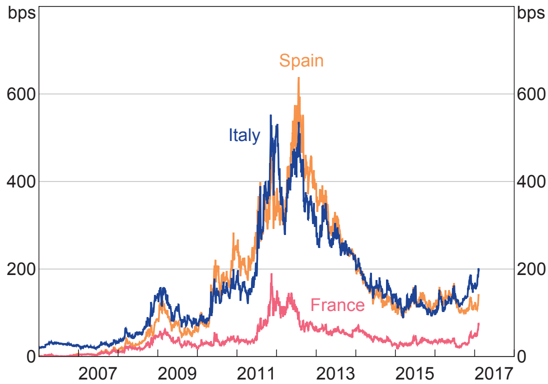
Signs of a firming economic recovery and rising headline inflation have also been evident in the euro area, though to a lesser extent than in the United States, and have contributed to a 50 basis point rise in German Bund yields since mid 2016. The ECB's December decision to adjust the parameters of its asset purchase program, allowing for the purchase of shorter-dated and lower-yielding securities, has contributed to a modest steepening of the German sovereign yield curve.

In the United Kingdom, yields on 10-year gilts have risen by around 70 basis points from their August trough, partly because economic data in the months following the UK referendum have been stronger than expected, which has caused the BoE to remove its easing bias. Market-based measures of inflation compensation have increased since August, following a significant depreciation of the UK pound because expectations of a 'hard' exit from the European Union have risen. Prime Minister May has pledged to begin the formal process of withdrawing from the European Union by the end of March.

In Japan, 10-year government bond yields have remained close to zero per cent. This is despite the rise in other major market sovereign bond yields and is consistent with the BoJ's policy of yield curve control.

Spreads on euro area government bonds have generally risen relative to German Bunds since mid 2016 amid the increasing popularity of euro-sceptic political parties in a number of European countries (Graph 2.4). In early December, Italians rejected reforms that would have reduced the powers of the Senate and regional governments, which led to the resignation of Prime Minister Renzi. In the coming months, it is likely that political developments will continue to have an important influence on European government bond yields ahead of national elections in the Netherlands (March), France (May), Germany (September) and Italy (due by May 2018).

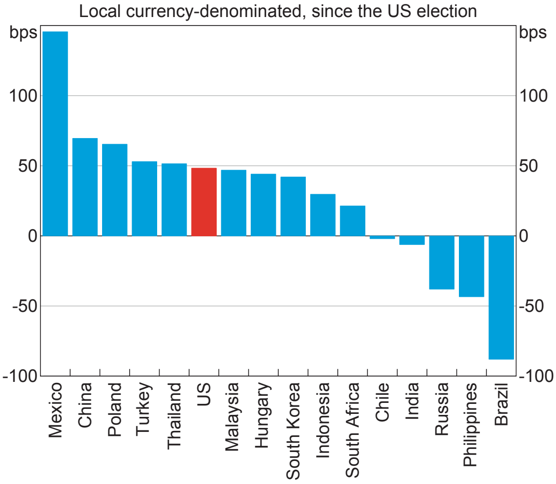
Graph 2.4
Euro Area 10-year Government Bond Spreads
To German Bunds



Source: Bloomberg

In emerging markets, yields on local currency-denominated sovereign bonds have generally risen since the US election (Graph 2.5). The largest rise in yields has occurred in Mexico, reflecting its trade linkages with the United States and is consistent with increases in the Bank of Mexico's policy rate and expectations of higher inflation owing to the depreciation of the Mexican peso. In China, the rise in yields partly reflects stronger Chinese economic activity and inflation data, and higher short-term interbank interest rates. One exception has been in India, where local-currency government bond yields have declined since the government announced that the country's two highest

Graph 2.5
Change in 10-year Government Bond Yields
Local currency-denominated, since the US election



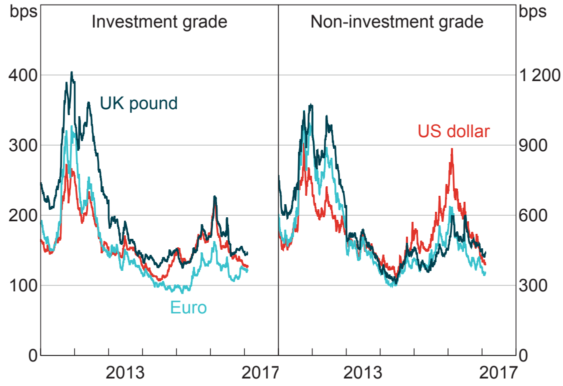
Source: Bloomberg

denomination banknotes would cease to be legal tender.

Credit Markets

Spreads on corporate bonds in advanced economies have narrowed significantly since early 2016, supported by better-than-expected economic data and higher commodity prices, which in turn have supported expectations of better debt serviceability, particularly for resource-related companies (Graph 2.6). In the United States, the US election has given extra impetus to this narrowing as expectations of corporate tax reform, deregulation and increased fiscal expenditure have all supported the outlook for corporate profitability. In the euro area and the United Kingdom, ongoing central bank purchases have also supported corporate bond markets. The positive sentiment towards credit markets has generally extended to emerging market corporate bond spreads, which have narrowed since early 2016 despite a period of widening following the US election.

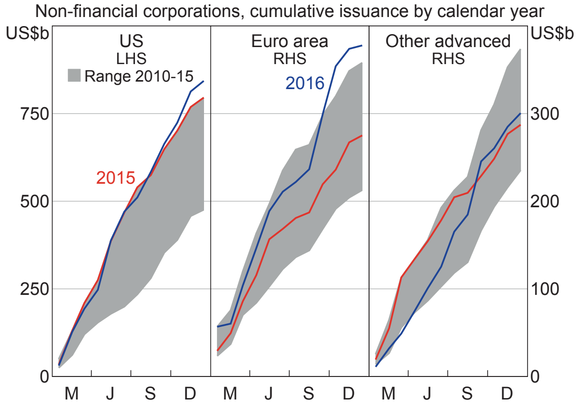
Graph 2.6
Corporate Bond Spreads
To equivalent government bonds



Sources: Bank of America Merrill Lynch; Bloomberg; RBA; Thomson Reuters

Corporate bond issuance was strong in advanced economies over 2016 as firms took advantage of low interest rates to reduce their debt costs and to finance mergers and acquisitions (Graph 2.7). In addition, a rise in the premium earned from swapping US dollars into other currencies (see below) has led to an increase in the issuance of US dollar-denominated bonds by non-US domiciled firms. Bond issuance has also been strong in 2017 to date reflecting narrow spreads and low market volatility. Bond issuance by emerging market corporations increased in the second half of 2016 after a slow start to the year.

Graph 2.7
Corporate Bond Issuance
Non-financial corporations, cumulative issuance by calendar year

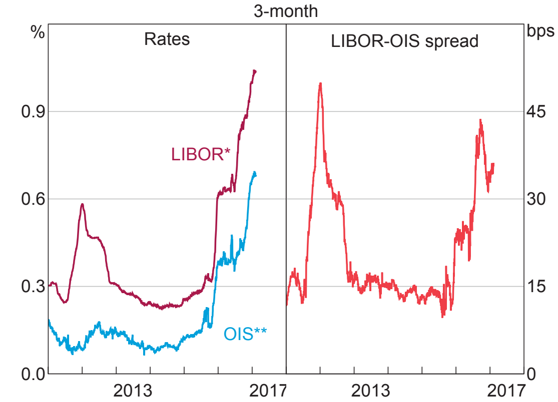


Sources: Dealogic; RBA

Short-term bank funding costs in US dollar markets have risen over recent months due to an increase in the US Federal Reserve's policy rate (Graph 2.8). In addition, the spread to overnight index swaps remains elevated, having widened ahead of the implementation of reforms to US money market funds in mid October. As a result of these reforms, the value of assets under management (AuM) of prime money market funds (those that lend to banks) has fallen by more than US$1 trillion since October 2015, while the AuM of government-only funds has risen by a similar amount. The costs for holders of both yen and euro to borrow US dollars in the foreign exchange swap market – the cross-currency basis – remains high (Graph 2.9). However, abstracting from volatility around year end, the basis has narrowed over the past few months, partly because Japanese residents have reduced their purchases of US fixed-income securities amid the sharp rise in bond market yields. European repo rates fell sharply around year end due to a decline in the supply of high-quality collateral, which reflects: banks' increased holdings of high-quality liquid assets; increased ECB holdings of securities due to its purchase program; and the increased demand for collateral by central counterparties.

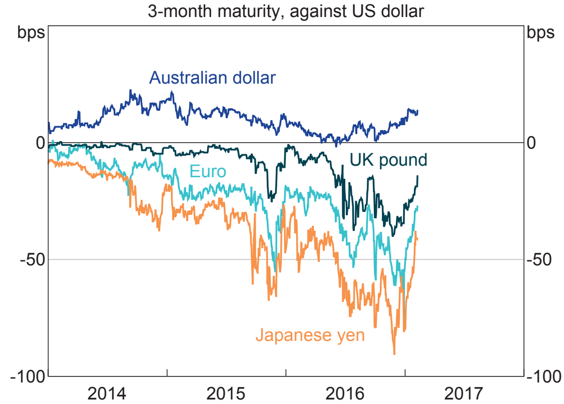
Investor sentiment towards the Chinese corporate bond market has deteriorated over recent months, resulting in a widening of spreads (Graph 2.10). A number of factors have contributed to this deterioration, including: tighter liquidity conditions; new regulations, which may increase capital requirements for banks' wealth management products (which invest a significant portion of their funds in corporate bonds); a rise in corporate bond defaults, albeit from a low level; and a technical default by a securities company following internal fraud. The combination of higher corporate bond spreads and higher sovereign

Graph 2.8
US Money Markets
3-month



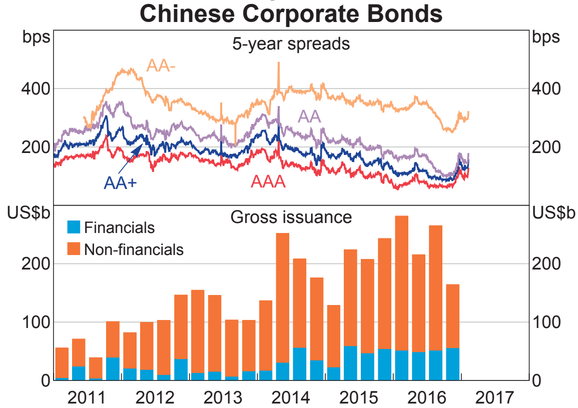
* London interbank offered rate
** Overnight index swap
Source: Bloomberg

Graph 2.9
Cross-currency Basis
3-month maturity, against US dollar



Source: Bloomberg

Graph 2.10
Chinese Corporate Bonds

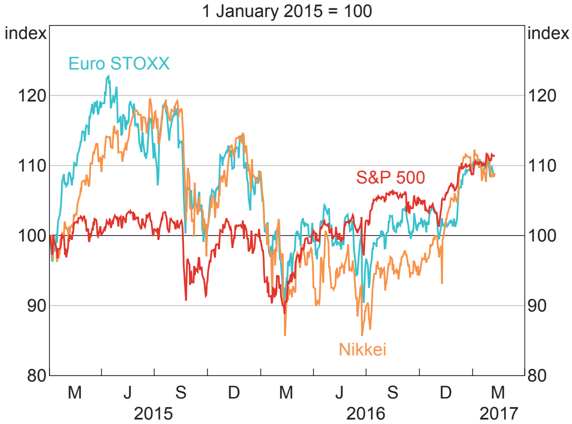


Sources: Bloomberg; CEIC Data; Dealogic; RBA yields has resulted in a sharp increase in corporate borrowing costs. As a result, a number of planned corporate bond issues have been cancelled or delayed, and gross and net bond issuance by Chinese corporations decreased in the December quarter.

Equities

Global equity markets rallied strongly over the final weeks of 2016 as the US election result generated considerable investor optimism around the outlook for corporate earnings (Graph 2.11). Market participants have focused on three potential areas of change under the new US administration: a reduction in the US corporate tax rate; deregulation; and a fiscal boost from higher infrastructure spending.

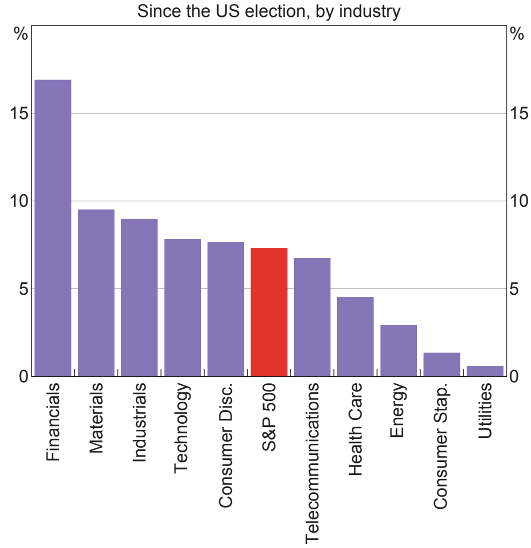
Graph 2.11
Major Share Price Indices
1 January 2015 = 100



Source: Bloomberg

In the United States, the financial sector has experienced the largest increase in share prices, supported by the prospect of less regulation and higher net interest income from rising bond yields (Graph 2.12). Bank earnings for the December quarter were also boosted by a rise in financial market trading revenue due to an increase in client activity around the US election, lower loss provisions for real estate and energy

Graph 2.12
Change in US Share Prices
Since the US election, by industry



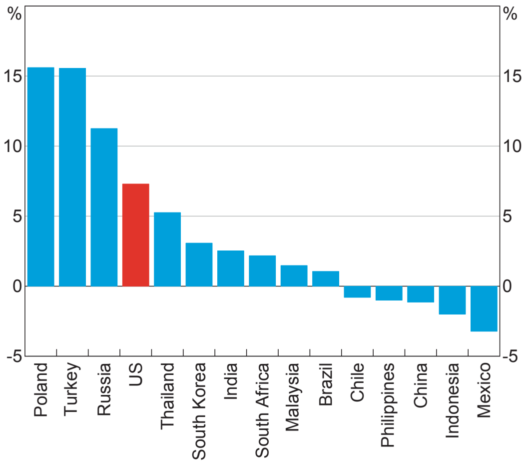
Source: Bloomberg

sector loans, and lower legal expenses. The prospect of reduced regulation and increased infrastructure spending has supported a number of other sectors. This rise in share prices has resulted in valuation measures returning to their post-financial crisis highs.

European and Japanese share prices have also risen sharply following the US election result, recovering to their early 2016 levels. In Japan, the rise in share prices has been underpinned by a depreciation of the yen and a corresponding rise in corporate earnings. The recovery in Europe has been, in part, supported by better-than-expected economic data. As in the United States, bank share prices in Europe and Japan have outperformed the broader market indices, largely reversing their significant underperformance of the first half of 2016, in part due to the favourable market conditions outlined above, and in part due to an easing of concerns around the capital positions of some European banks.

Emerging market share prices initially declined following the US election on concerns that protectionist trade policies and higher US dollar-denominated borrowing costs would adversely affect earnings, and many markets experienced a short period of sizeable capital outflows (Graph 2.13). However, the price declines in most markets have subsequently reversed and these capital outflows have ceased, in part aided by the ongoing recovery in commodity prices.

Graph 2.13
Change in Emerging Market Share Prices
Since the US election



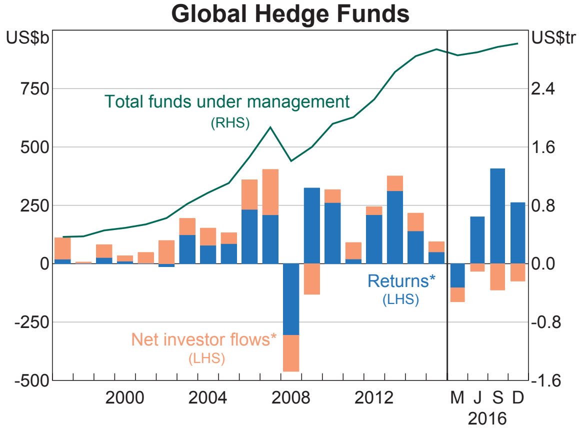
Source: Bloomberg

Chinese share prices have declined over the past few months, partly reflecting concerns that US trade policy may become more protectionist. Nonetheless, share prices are around 20 per cent higher since their trough in late January 2016, owing to better-than-expected economic data and an improving corporate earnings outlook. Equity trading links between mainland China and Hong Kong were strengthened in December with the opening of the Shenzhen-Hong Kong Stock Connect scheme, which largely replicates the existing Shanghai-Hong Kong Stock Connect scheme.

Hedge Funds

Global hedge funds recorded an asset-weighted return on investment of 2.4 per cent over the December quarter, outperforming a balanced portfolio of sovereign bonds and global equities (Graph 2.14). Investors continued to make net withdrawals from hedge funds for the fifth consecutive quarter; net redemptions for 2016 totalled US$70 billion. However, combined with positive investment returns, AuM rose by 1.6 per cent over the December quarter to US$3.0 trillion.

Graph 2.14
Global Hedge Funds



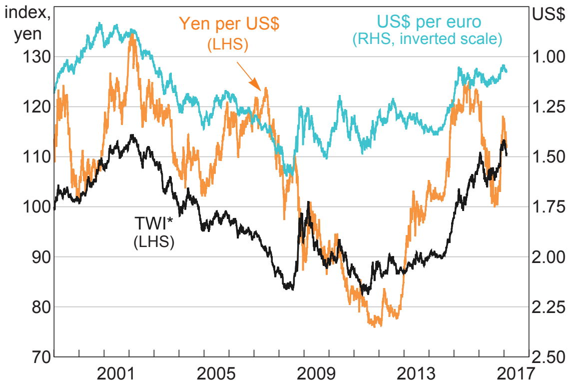
* Annualised for 2016 data
Sources: Hedge Fund Research, Inc.; RBA

Foreign Exchange

The potential policy implications of the US election result and evolving expectations about monetary policy in the major economies have also been the key drivers of foreign exchange markets over recent months. Despite significant moves in some currency pairs as investors assessed the implications of the US election for US fiscal policy and international trade, foreign exchange markets have generally functioned in an orderly manner. Observed and forward-looking measures of volatility in most developed market currency pairs remain around their long-run averages.

The US dollar appreciated against most currencies following the US election in November 2016, although it has since retraced some of that appreciation, reflecting uncertainty about actual US fiscal and trade policy implementation. The US dollar's (net) appreciation since the election has been part of a more general upward trend observed in recent years and largely reverses the depreciation of the currency in early 2016 (Table 2.2). On a trade-weighted (TWI) basis, the currency is around its highest level since 2002 (Graph 2.15). Taking into account relative price differentials between trading partners, the US dollar is also at a high level on a real trade-weighted basis (Graph 2.16).

Graph 2.15
US Dollar



* 1 January 1999 = 100
Sources: Bloomberg; Board of Governors of the Federal Reserve System

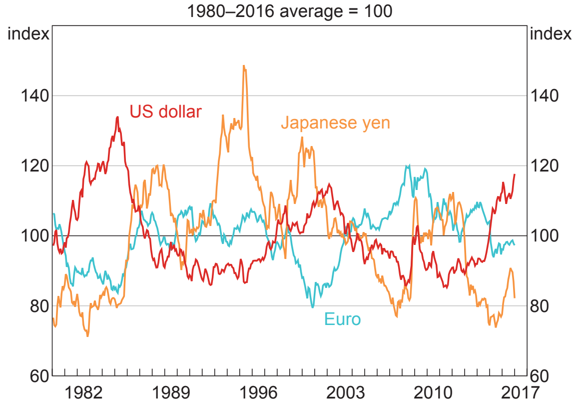
The Japanese yen depreciated markedly after the US election result, in part because of a widening of the yield differential between US and Japanese bonds (see Sovereign Debt Markets). However, since the beginning of last year, the yen has appreciated against the US dollar and on a trade-weighted basis. In contrast, the euro only depreciated slightly against the US dollar following the US election and has been little changed on a trade-weighted basis since the beginning of 2016. The euro remains around its average level on a real trade-weighted basis since the introduction of the single currency in 1999.

Table 2.2: Changes in the US Dollar against Selected Currencies
Per cent

	Over 2016	2017 to date
Philippine peso	6	1
Malaysian ringgit	5	–1
Indonesian rupiah	–2	–1
Chinese renminbi	7	–1
Mexican peso	21	–1
UK pound sterling	19	–1
Indian rupee	3	–1
European euro	3	–2
Singapore dollar	2	–2
Canadian dollar	–3	–2
Thai baht	–1	–2
Swiss franc	2	–2
Swedish krona	8	–3
Russian rouble	–14	–4
New Taiwan dollar	–1	–4
Japanese yen	–3	–4
Brazilian real	–18	–4
New Zealand dollar	–1	–5
South Korean won	3	–5
Australian dollar	1	–6
Trade-weighted index	**4**	**–2**

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

Graph 2.16
Real Trade-weighted Indices*
1980–2016 average = 100



* BIS narrow real exchange rate indices
Sources: BIS; RBA

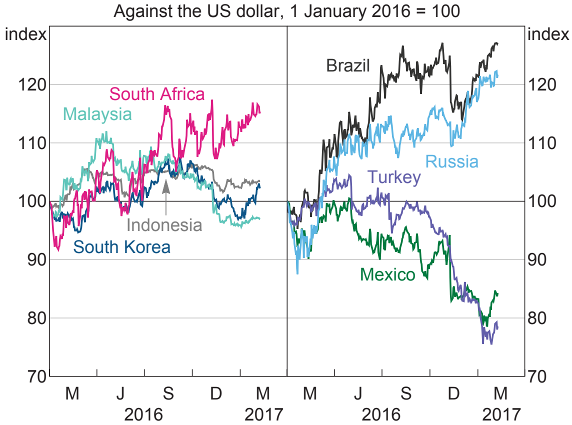
Evolving market expectations regarding the nature of the exit of the United Kingdom from the European Union have continued to be the main driver of the UK pound. The currency has fluctuated in a wide range against the US dollar in recent months, although it remains around its lowest level against the US dollar since 1985.

Most emerging market currencies depreciated significantly against the US dollar following the outcome of the US election (Graph 2.17). The depreciation of the Mexican peso was particularly pronounced, reflecting the country's vulnerability to potential changes in US trade policy. A number of emerging market central banks, including those of Indonesia and Malaysia, intervened in foreign exchange markets to moderate volatility and provide liquidity following the US election. The Bank of Mexico also intervened in early January, the first such intervention since February 2016. The central bank of Turkey has undertaken measures to increase US dollar liquidity in the market in recent months. This followed sustained depreciation pressure on the Turkish lira – partly due to domestic political developments – and the currency reached a historic low. The foreign currency reserves of most emerging market economies have declined a little since the end of September 2016 (Table 2.3).

Notwithstanding the downward pressure on a range of emerging market currencies following the US election, the currencies of commodity exporters have been supported by an increase in commodity prices (oil prices in particular) since late November 2016. Notably, the Russian rouble and Brazilian real have appreciated against the US dollar over the past few months, to be around 20–25 per cent higher since the beginning of 2016.

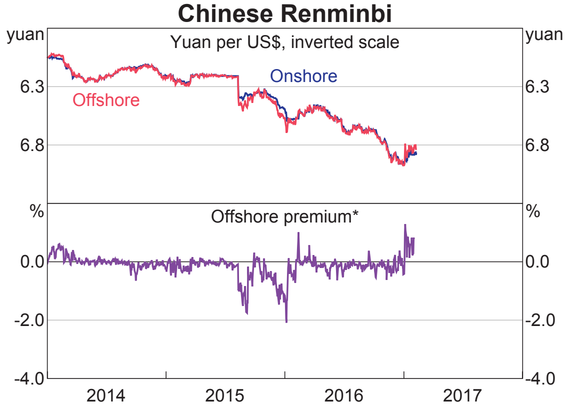
The Chinese renminbi (RMB) has depreciated by 6 per cent against the US dollar since its recent peak in early 2016 (Graph 2.18). This reflects the broad-based US dollar appreciation over that period and has occurred alongside continued net private capital outflows from China. These outflows appear to be associated with market expectations for further RMB depreciation against the US dollar. Notwithstanding this, the RMB has appreciated in 2017 to date. A larger appreciation has occurred in the smaller offshore market than the onshore market, following reported intervention by the PBC that had the effect of increasing offshore interbank borrowing costs. There have been periodic short-term spikes in

Graph 2.17
Asian and Emerging Market Currencies
Against the US dollar, 1 January 2016 = 100



Source: Bloomberg

Graph 2.18
Chinese Renminbi



* Negative spread indicates that one US dollar buys more yuan in the offshore market than the onshore market
Sources: Bloomberg; RBA

Table 2.3: Gross Foreign Currency Reserves[(a)]

	Percentage change: End December 2015 to latest	Percentage change: End September 2016 to latest	Level US$ equivalent (billions)
China	–10	–5	2 998
Saudi Arabia	–13	–3	527
Taiwan[(b)]	2	0	437
Hong Kong	9	7	379
South Korea	1	–1	364
Brazil	2	–1	355
India	3	–2	339
Russia	3	–1	318
Singapore	2	0	250
Mexico	0	–2	168
Thailand	10	-4	164
Indonesia	11	2	111
Turkey	0	–7	91
Malaysia	1	–2	88

(a) Data to end December for Mexico, Saudi Arabia, and Thailand; to 27 January for India and Turkey; and to end January for Brazil, China, Hong Kong, Indonesia, Malaysia, Russia, Singapore, South Korea and Taiwan
(b) Foreign exchange reserves (includes foreign currency and other reserve assets)
Sources: Bloomberg; CEIC Data; central banks; IMF; RBA

such costs since early 2015 that appear to reflect intervention by the PBC to support the currency. This intervention and expectations for longer-term RMB depreciation have led to the value of RMB deposits in Hong Kong falling by around 35 per cent over the year to December 2016.

In contrast to the depreciation against the US dollar, the RMB has been broadly flat on a trade-weighted basis since mid 2016, consistent with the Chinese authorities' commitment to keep the RMB relatively stable on a trade-weighted basis. The basket of currencies that make up the China Foreign Exchange Trade System (CFETS) trade-weighted index for 2017 has 11 more currencies than the basket for 2016. The new CFETS trade-weighted index would have closely tracked last year's index, but is more representative of China's trade shares and accounts for 70 per cent of its merchandise trade. The additional currencies – which include the South Korean won (with a weight of 11 per cent) – have a combined weight of 21 per cent of the index, and the new weights of the euro (16 per cent) and US dollar (22 per cent) are each around 5 percentage points lower than in the previous year.

The value of the PBC's foreign currency reserves has fallen by around US$200 billion since mid 2016, to around US$3 trillion, following a period of relative stability over much of the first half of 2016. The decline partly reflects an increase in net private capital outflows over the second half of 2016 as well as valuation effects. The Chinese authorities have recently introduced a number of measures to allow them to scrutinise capital outflows more closely with the aim of enforcing capital controls more effectively.

Australian Dollar

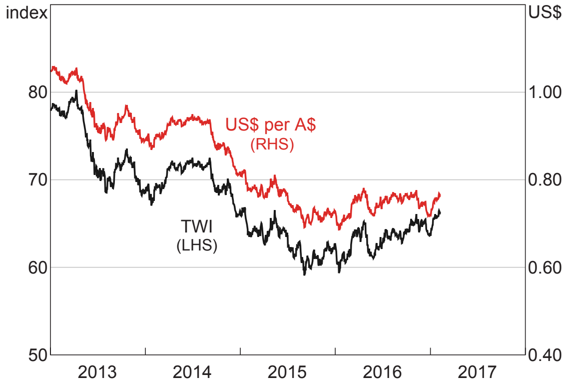
The Australian dollar has been broadly unchanged since the US election, with the downward pressure associated with the narrowing in the interest rate differential between Australian and US sovereign bonds offset by support from the increase in commodity prices over this period. Since its trough in January 2016, the Australian dollar has appreciated by more than 10 per cent against the US dollar and on a trade-weighted basis, alongside a significant increase in commodity prices (Table 2.4; Graph 2.19). The real trade-weighted index has tracked the nominal index closely and is also noticeably higher over that period.

Table 2.4: Changes in the Australian Dollar against Selected Currencies
Per cent

	Over 2016	2017 to date
US dollar	–1	6
Malaysian ringgit	3	5
Indonesian rupiah	–3	5
Chinese renminbi	6	5
UK pound sterling	18	5
Indian rupee	1	5
European euro	2	4
Singapore dollar	1	4
Canadian dollar	–4	4
South African rand	–12	4
Thai baht	–2	4
Swiss franc	1	3
Japanese yen	–4	2
New Zealand dollar	–3	1
South Korean won	1	1
Trade-weighted index	**2**	**4**

Sources: Bloomberg; RBA

Graph 2.19
Australian Dollar



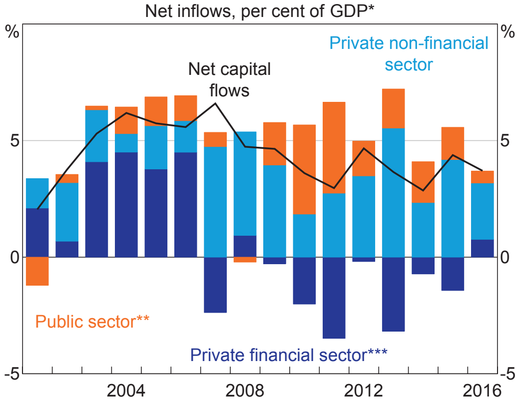
Sources: Bloomberg; RBA

Capital Flows

Net capital inflows to the Australian economy were equivalent to around 4 per cent of GDP over the first three quarters of 2016, slightly lower than the average of net capital inflows over the past 15 years (Graph 2.20). Consistent with the pattern of capital flows observed since 2007, recent net capital inflows have largely reflected flows to the private non-financial sector, most of which were directed to the mining sector. Initially, net inflows to the mining sector – the majority of which is foreign owned – largely reflected inflows from retained earnings during a period when profitability in the mining sector was especially strong.[1] However, since 2011–12, inflows appear to have mostly reflected transfers from offshore affiliates. This is consistent with liquefied natural gas projects comprising a larger share of resource investment during this period than previously. These projects have typically involved new joint ventures where the majority of participants are foreign entities, and are likely to have limited existing domestic operations with which to fund investment through retained

1 For a discussion of net capital inflows to the mining sector in the preceding period, see RBA (2011), 'Box B: The Mining Sector and External Account', *Statement of Monetary Policy*, November, pp 42–44.

Graph 2.20
Australian Capital Flows
Net inflows, per cent of GDP*

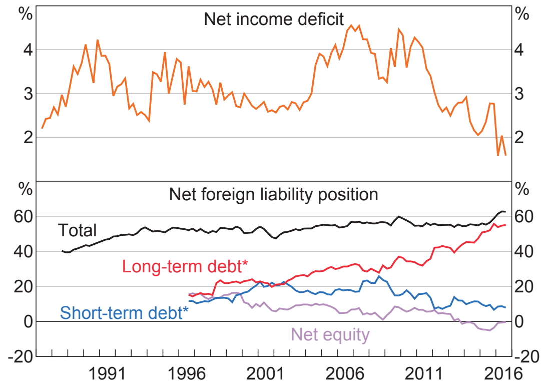


* 2016 excludes December quarter
** Excludes official reserves and other RBA flows
*** Adjusted for US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

earnings. Net capital flows associated with the financial sector remain modest.

Consistent with below-average capital inflows, Australia's current account deficit has also been smaller than average in recent years. This has partly reflected a longer-term decline in the net income deficit – which largely comprises payments made on Australia's net foreign liabilities – to historically low levels (Graph 2.21).

Graph 2.21
Net Foreign Payments and Position
Per cent of GDP



* Short-term includes debt with a residual maturity of one year or less; long-term includes all other debt
Sources: ABS; RBA

In the past few years, the decline in the net income deficit was mainly the result of higher receipts from foreign equity assets owned by Australian entities. Australia's net foreign liability position increased to a little over 63 per cent of GDP at the end of the September quarter, with recent fluctuations driven by asset price and foreign exchange valuation effects. Notwithstanding this increase, Australia still maintains a net foreign currency asset position. ✠