Statement on Monetary Policy

MAY 2010

Reserve Bank

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Statement on Monetary Policy Enquiries

Information Department
Tel: (612) 9551 9830
Facsimile: (612) 9551 8033
E-mail: rbainfo@rba.gov.au

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Statement on Monetary Policy

Conditions in the global economy have generally continued to improve. Forecasts for growth have been revised up again recently, with global GDP now expected to grow at trend pace, or a little above, in 2010. While the recovery is most advanced in Asia and in some other emerging economies, there are also signs that the pick-up in North America has become more broad based recently. The main area of weakness continues to be Europe, with concerns about the fiscal situation in a number of countries, particularly Greece, increasing significantly over the past month.

With the recovery at different stages in different parts of the world, the nature of the challenges varies across regions. In the advanced economies, the recovery is still dependent on accommodative fiscal and monetary policies and there are very high levels of excess capacity that will remain for some time. Credit conditions also remain tight and core inflation is still trending lower. While in most countries the data over the past six months have been better than was expected a year ago, significant fiscal challenges lie ahead that are weighing on medium-term growth prospects.

In contrast, Asia has had a V-shaped recovery, with growth in China particularly strong. Unemployment rates in the region are coming down, spare capacity is more limited, housing markets are buoyant and financial systems are not impaired. The process of withdrawing the considerable policy stimulus that was put in place during the depths of the global downturn has now commenced in several countries, and further steps could be expected over the period ahead to prevent inflationary pressures building further.

The strong recovery in Asia has underpinned substantial rises in the prices of Australia's main commodity exports. In particular, prices for iron ore and coking coal have increased sharply over recent months, reflecting strong growth in steel production in China and elsewhere in Asia. As a result, Australia's terms of trade are likely to increase substantially this year to reach the very high levels of two years ago, providing a significant boost to incomes.

In financial markets, conditions have generally been more settled than was the case last year, although concerns about the Greek Government's public finances have weighed on market sentiment. Yields on Greek debt have increased sharply, and the yields on the debt of several other European governments have also increased markedly. Outside of Europe, the impact has been more limited. Credit spreads in most markets have been little affected, although both equity markets and government bond yields in the major countries have declined recently. More generally, credit markets are working more smoothly than was the case last year, with most central banks having wound back emergency support measures. Notwithstanding this, credit growth remains very weak in the major economies, reflecting a combination of both demand and supply factors. Business investment is at very low levels in most of these economies and many banks remain cautious in their lending decisions. Banking sector profitability has however picked up recently, primarily due to investment banking activities.

Economic conditions in Australia continue to improve from the relatively mild downturn a year or so ago. The recovery has been supported by stimulatory settings of both monetary and fiscal policy, strong growth in Asia, the stability of the financial system and a high rate of population growth. Through the global downturn, Australia's exports held up much better than those from most countries, and investment remained at a high level.

Both consumer and business confidence in Australia are high, although one legacy of the global downturn is a more cautious approach to spending than was previously the case. The household saving rate is higher than it was in earlier years and retail spending has recently been soft, after increasing strongly in late 2008 and early 2009 partly as a result of the Government's payments to households. Outside of the resources sector, businesses' investment plans remain relatively subdued, although they have strengthened a little recently. Over the past year, business credit outstanding has also fallen as many businesses sought to reduce their debt levels. This process of deleveraging, however, looks like it has come to an end, with business credit unchanged over the past three months. Credit conditions have also begun to ease for some borrowers.

Reflecting the high level of commodity prices over recent years, mining investment has been at record levels as a share of GDP and further increases are expected, with very large projects in the LNG, iron ore and coal sectors. This pick-up in investment will support growth in the Australian economy at a time when the boost from the earlier expansionary policy settings is diminishing. It will also expand the supply capacity of the economy, with growth in resource exports likely to pick up further over coming years.

The housing market in Australia also remains buoyant, with auction clearance rates high and nationwide measures of housing prices rising at a double-digit rate over the past year. The housing construction cycle remains in an upswing, although given continuing high rates of population growth, further expansion of the supply side is likely to be required over the period ahead. In contrast to housing prices, there has been a steady decline in the value and number of housing loan approvals over the past six months, although overall housing credit continues to grow at a solid rate, with households making smaller excess principal repayments than was the case last year when interest rates were lower. While the number of first-time buyers has declined following the earlier rise associated with the temporary boost to the first-home owner grant, demand from investors has picked up, especially in Victoria where the property market has been strongest.

With the Australian economy having performed better than expected, employment has grown strongly over the past six months or so and the unemployment rate has declined by around ½ percentage point from its peak of 5¾ per cent. The recovery in the labour market is evident across a range of industries, although it is most apparent in a number of service industries. Reflecting the weaker demand for labour during the slowdown, wage growth in the private sector slowed significantly over the course of 2009 to its slowest rate in many years, although growth in public-sector wages has remained firm. More recently, despite some tightening of the labour market, business surveys and the Bank's liaison suggest that the rate of wage growth remains below average.

Recent data on prices continue to show a moderation in underlying inflation in year-ended terms, reflecting the earlier weaker demand conditions and the appreciation of the exchange rate. Underlying inflation has now fallen by a little over 1½ percentage points from its peak in September 2008 and for the year to March was around 3 per cent. Inflation as measured by the Consumer Price Index was also around 3 per cent over the year to March.

Although inflation has moderated, the extent of the moderation now looks as though it will not be as large as previously thought. Recently, there have been significant price declines for many imported goods, reflecting the exchange rate appreciation,

tariff cuts and heavy discounting by retailers. But there have also been reasonably widespread price increases for a range of services. Growth in rents remains firm and the prices of utilities have increased significantly, partly to help fund expansions of capacity.

Looking forward, the central forecast is for GDP to grow by around 3¼ per cent over 2010, a similar outcome to that expected three months ago. Growth in public demand is expected to slow as fiscal measures run their course, with this being offset by a pick-up in private-sector demand. Beyond this year, growth is expected to increase to be in the 3¾–4 per cent range, with investment strengthening further. This outlook is underpinned by the positive prospects for the resources sector – including a substantial increase in the terms of trade – with the resources-related parts of the economy expected to record stronger growth than other sectors. This central forecast also assumes that a greater share of the boost to national income arising from the higher commodity prices will be saved than was the case in the boom in the second half of the 2000s.

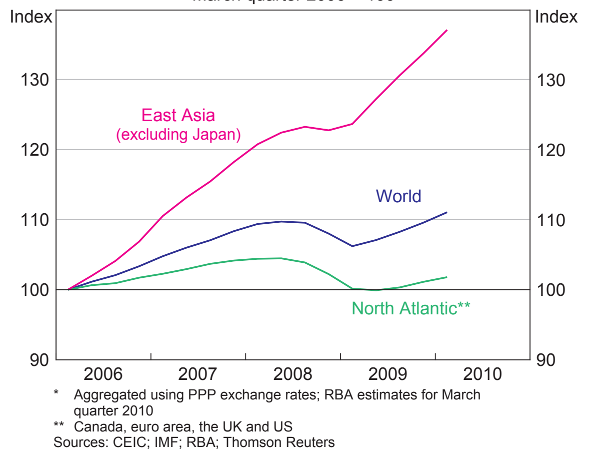
Some further moderation in the year-ended rate of underlying inflation is still expected in the near term. However, given the relatively limited amount of spare capacity and the current price pressures that exist for services and utilities, the trough in inflation later this year now looks likely to be in the top half of the target band, rather than in the middle of the band as previously forecast. A gradual rise in inflation is then expected, as capacity utilisation gradually increases and the effect of the earlier appreciation on the prices of imported goods diminishes.

As usual, these forecasts are subject to a range of risks. Global growth could continue to surprise on the upside and the expansionary impact of the terms of trade could be greater than currently anticipated, particularly if the prospect of future income gains leads to an upgrading of current spending plans. On the downside, a marked slowing in the pace of growth in Asia could have a significant impact on the Australian economy, in particular changing the outlook for commodity prices and the resources sector. It is also possible that the fiscal problems in Europe could intensify, prompting a retreat from risk-taking by investors and a sharp slowing in the world economy, although, to date, the impact has been largely confined to Europe.

In October last year, with the risk of serious economic weakness in Australia having passed, the Board began a process of lessening the monetary stimulus that was put in place when the outlook appeared much weaker. At each of its past three meetings, the Board has increased the cash rate by 25 basis points to 4.5 per cent currently, bringing the total increase since October to 1½ percentage points. Although the cash rate remains below its medium-term average, variable lending rates are now around their average levels, as market developments have pushed up most interest rates relative to the cash rate. The Board will continue to assess prospects for demand and inflation and set monetary policy as needed to achieve an average inflation rate of 2–3 per cent over time. ✠

International Economic Developments

The global economy is continuing to recover following the sharp contraction recorded in late 2008 and early 2009, although the extent of the recovery varies considerably across regions. Available data suggest that growth was firm in most regions in the March quarter – the major exception being the euro area – taking world output back above its previous peak in mid 2008 (Graph 1). The recovery in Asia has been particularly strong, and growth has also picked up noticeably in a range of other emerging economies. In contrast, the recovery is much less advanced in the major North Atlantic economies, with aggregate output for these countries still nearly 3 per cent below its previous peak. Conditions remain particularly subdued in Europe. This partly reflects a later turn in the inventory cycle than in east Asia and the United States, although domestic demand also remains weak and there are only tentative signs of the turnaround in private consumption and investment required for recovery to become self-sustaining.

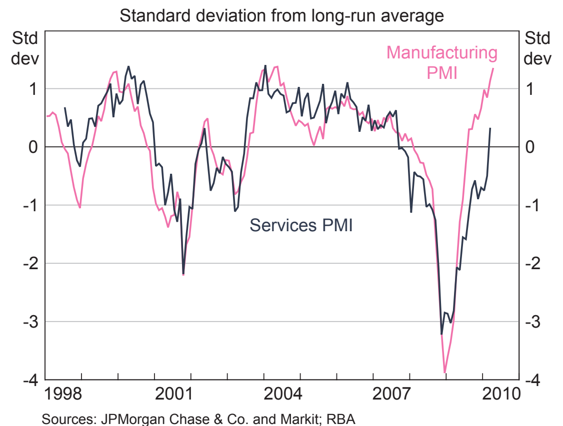


* Aggregated using PPP exchange rates; RBA estimates for March quarter 2010

** Canada, euro area, the UK and US

Sources: CEIC; IMF; RBA; Thomson Reuters

Reflecting the general improvement in global conditions, indicators of business conditions and aggregate demand have picked up over recent months. Globally, both the manufacturing and services PMIs have recently risen further, to above-average levels (Graph 2). Consistent with these developments, private sector and official forecasts for the world economy have generally been revised upwards since the February *Statement*, although the pace of revision has moderated from that seen in the second half of 2009 and early 2010. The IMF now forecasts world output to expand by around 4¼ per cent in 2010, 0.3 percentage points stronger than it expected in January, with a similar expansion in 2011 (Table 1).



Sources: JPMorgan Chase & Co. and Markit; RBA

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

	2008	2009	2010	2011
			IMF forecasts[(b)]	
United States	0.4	–2.4	3.1	2.6
Euro area	0.6	–4.1	1.0	1.5
Japan	–1.2	–5.2	1.9	2.0
China	9.6	8.7	10.0	9.9
Other east Asia[(c)]	2.8	0.0	5.3	5.2
India	7.3	5.7	8.8	8.4
World	**3.0**	**–0.6**	**4.2**	**4.3**
Australia's trading partners[(d)]	2.7	–0.1	4.9	4.9

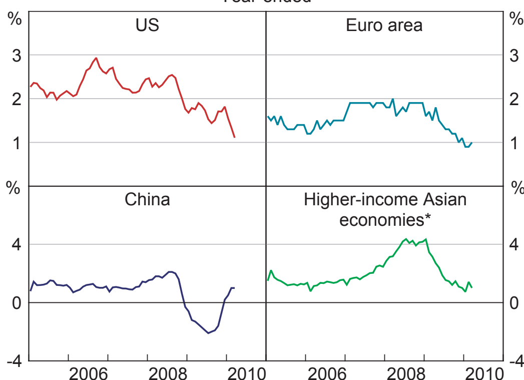
(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Forecasts from the April *World Economic Outlook*
(c) Weighted using GDP at market exchange rates
(d) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Reuters

In many east Asian economies (excluding Japan), where activity and demand have recovered most strongly, year-ended core inflation has stabilised or increased (Graph 3). In contrast, core inflation continues to drift lower in the euro area and the United States, where spare capacity is substantial, private demand is well below earlier levels and consumer sentiment remains weak.

Momentum in the Chinese economy remains strong and has shown few signs of slowing recently. GDP is estimated to have grown by around 3 per cent in the March quarter and by 12 per cent over the year (Graph 4). Monthly indicators suggest that recent growth in activity has been broad-based. Retail and car sales data suggest that consumption spending grew solidly in the early part of 2010 (Graph 5). Nominal urban fixed-asset investment increased by more than 10 per cent in the March quarter, after falling in the December quarter. The renewed strength in investment is evident in the manufacturing and real estate sectors. Infrastructure spending was also robust, reflecting ongoing effects of the fiscal stimulus. Chinese export volumes are estimated to have grown by 7 per cent in the March quarter and now exceed their peak in mid 2008. Exports to all major destinations have increased, driven primarily by exports of machinery and electrical equipment. Import volumes rose by around 4 per cent in the March quarter, with the value of imports rising by 11½ per cent, mainly due to higher commodity prices. As a result, in March China recorded its first monthly trade deficit since 2004, with the trade surplus for the quarter falling to 2 per cent of GDP.

Consistent with ongoing strong growth, inflation is rising in China, albeit from a low level. Consumer prices rose by 2.4 per cent over the year to March and

Graph 3
Core Consumer Price Inflation
Year-ended

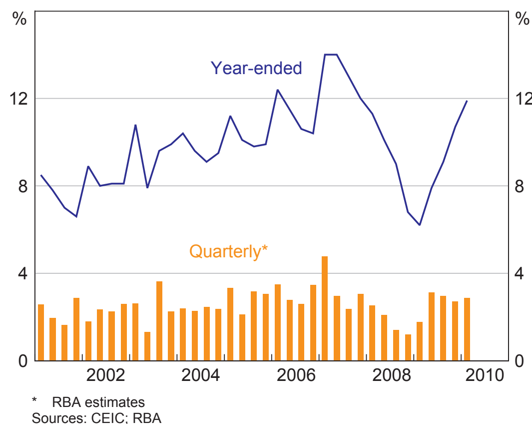


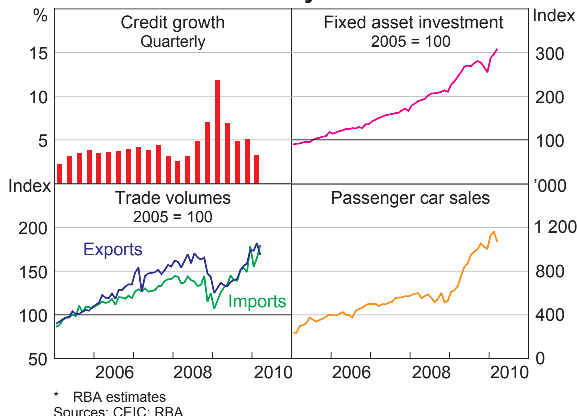
* Hong Kong, Singapore, South Korea and Taiwan
Sources: CEIC; RBA; Thomson Reuters

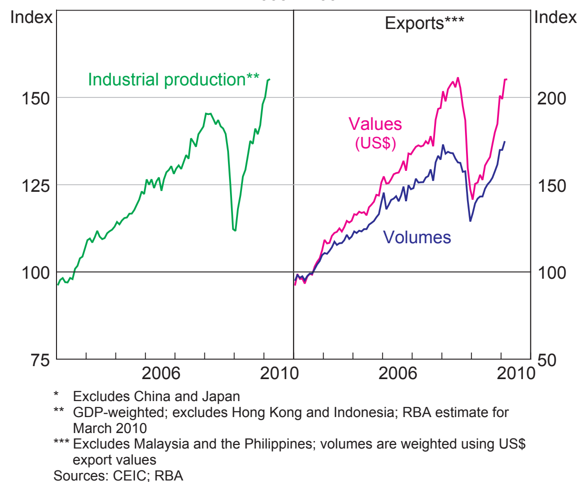
producer prices have accelerated in recent months, suggesting increased upstream price pressures. Official data indicate that nationwide property prices rose by around 12 per cent over the year to March – the fastest rate in at least five years – with significantly larger increases in some regions. In response to these developments, the Chinese authorities have taken a range of steps to cool the property market, including increasing the minimum deposit required by investors and repeat home buyers and by those purchasing larger apartments. The State Council has also required banks to increase mortgage rates on lending to people purchasing a second property.

Since the February *Statement*, data for other east Asian economies (excluding Japan) have also been positive, suggesting these economies carried considerable momentum into early 2010. Malaysia and Thailand reported December quarter growth of more than 3 per cent, and Taiwan of more than 4 per cent, while preliminary estimates for Korea and Singapore suggest March quarter growth of 1¾ per cent and 7¼ per cent respectively. These robust quarterly outcomes have been driven by broad-based strength in industrial production and exports (Graph 6).

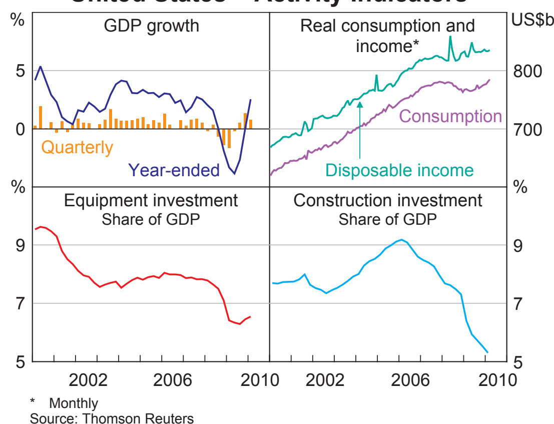
Rebounding production has generated corresponding improvements in labour demand across most countries in the region, and a tightening of capacity more generally. Consistent with this, consumer price inflation has picked up somewhat in a number of economies. Asset prices, particularly house prices, have also risen sharply in several countries over the past year, after earlier falls. Policy-makers in some economies have begun to take steps towards normalising financial conditions through a range of channels, including: increasing policy rates (Malaysia); tightening of macroprudential regulations, particularly in relation to mortgage lending (all of the higher-income Asian economies); and nominal exchange rate appreciation (Singapore).







Graph 7



* Monthly
Source: Thomson Reuters

Conditions remain healthy in the Indian economy, although year-ended growth in real GDP slowed to 6 per cent in the December quarter due to the effects of an unusually dry summer monsoon. A range of information suggests that economic activity in early 2010 has been robust, with industrial production, the services PMI and external trade pointing to solid growth in the non-farm economy and agricultural output expected to have stabilised in the March quarter. Wholesale price inflation has continued to rise, to around 10 per cent over the year to March. Citing growing concern about inflation developments, the Reserve Bank of India raised its policy interest rates by 25 basis points in both March and April. In addition, the cash reserve ratio was increased by 25 basis points in April, after increases totalling 75 basis points earlier this year.

In the advanced economies, activity continues to recover, although output remains well below earlier levels and medium-term prospects are clouded by significant structural challenges. One of these is reversing the substantial decline in national net saving in many countries, with net saving having turned negative in the United States and Japan for the first time in many decades primarily reflecting developments in government budget positions. The need for national saving to increase over coming years is likely to weigh on demand growth in many developed economies.

In the United States, recent data suggest that the significant monetary and fiscal stimulus has now helped to generate an expansion in private final demand. Consumption and equipment investment are growing, with output growth less dependent upon the inventory cycle. GDP expanded by 0.8 per cent in the March quarter, following growth of 1.4 per cent in the December quarter, to leave output 1¼ per cent below its peak in the June quarter 2008 (Graph 7). Household consumption recorded a third solid quarterly rise, although real personal disposable income remained unchanged in the face of ongoing slow wage growth and only a limited recovery in labour demand (as measured by aggregate hours worked, which increased by 0.4 per cent in the March quarter). Machinery & equipment investment also rose solidly for a second quarter, with core capital goods orders suggesting further growth is in prospect.

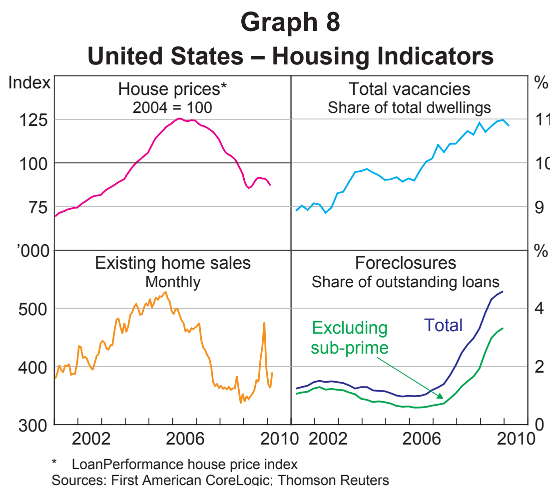
In contrast, construction investment (both residential and non-residential) remains depressed, declining in the March quarter to a new low of only 5¼ per cent of nominal GDP, down around one-third from the average share seen over recent decades. The commercial real estate market remains weak, with commercial property prices down by more than 40 per cent from their early 2008 peak and delinquency rates on commercial property lending continuing to rise. In the housing market, after increasing modestly through mid 2009, measures of house prices have broadly tracked sideways since September, while new and existing home sales are only slightly above their earlier troughs (Graph 8). New home starts remain depressed, the vacancy rate is still elevated, and the stock of foreclosed homes rose further in the December quarter, albeit more slowly than in the two previous quarters.

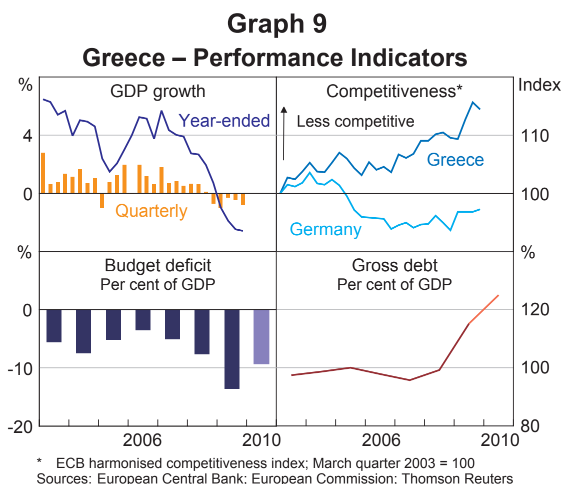
Weakness in construction spending, both residential and non-residential, also continues to constrain activity in Europe, where the recovery to date remains

least advanced. In the December quarter, a faltering in the pace of expansion in Germany and Italy saw the euro area record no growth, with consumption and investment declining further. Overall, available data suggest little if any growth in the euro area in the March quarter, although recent data on euro area industrial production suggest some recovery in the manufacturing sector in early 2010. In the United Kingdom, December quarter growth was revised up by 0.3 percentage points from the preliminary estimate, to 0.4 per cent, while output is estimated to have expanded by a further 0.2 per cent in the March quarter, underpinned by growth in manufacturing and in business services & finance.

Concerns over fiscal sustainability in Greece (and to a lesser degree Portugal, Ireland and Spain) continue to weigh on confidence across Europe. As discussed further in the 'International and Foreign Exchange Markets' chapter, investor concerns about the Greek Government's deficit and debt levels remain high despite announcements of emergency lending support from the euro area and IMF (Graph 9). Greece's debt servicing ability is being impaired by ongoing declines in output, with limited prospect of a strong recovery in growth given its loss of competitiveness over many years compared with other euro area economies (and inability to restore international competitiveness through currency devaluation while remaining within the euro area).

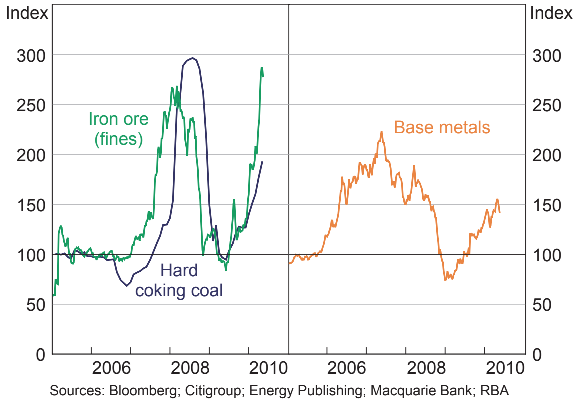
In Japan, the strong December quarter GDP outcome and the recovery over recent months in consumer confidence and business surveys (such as the Economy Watchers and Shoko Chukin surveys) have eased earlier fears about the durability of the recovery. Export volumes continue to grow strongly, and have now recovered nearly two-thirds of their decline, while the pace of industrial production growth has been solid (although it may be beginning to moderate, with production little changed over February and March following almost a year of rapid monthly increases).

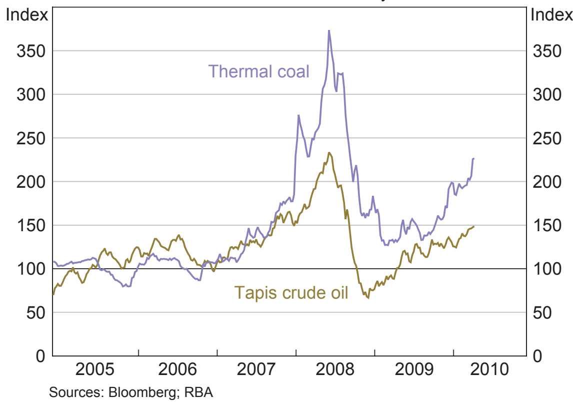




Commodity Prices

Commodity prices have continued to rise in recent months, supported by increased global industrial production and the relative strength of the recovery in Asia. The RBA's index of commodity prices has risen by around 25 per cent since the February *Statement* (in SDR terms), to be nearly 45 per cent above its trough in mid 2009. The increases in commodity prices are feeding through into a significant increase in the terms of trade and nominal incomes, as discussed further in the 'Economic Outlook' chapter.





Contract prices for bulk resource commodities have settled well above 2009/10 benchmarks, and much higher than was expected a few months ago. These settlements have seen a significant shift in the pricing regime for iron ore and coking coal, away from annually negotiated benchmarks toward more frequent resetting of prices. It appears that the new arrangements will result in quarterly contract prices that broadly follow spot market prices. While there is some uncertainty, for the June quarter, Australian producers look to have negotiated increases (relative to the previous annual contracts) of around 100 per cent for iron ore fines, and between 55 per cent and 100 per cent for various grades of coking coal. Since these quarterly agreements were reached, spot prices for iron ore and coking coal have continued to rise to be around 40 per cent and 25 per cent above the estimated new prices (Graph 10). A more detailed discussion of the recovery in iron ore and coking coal prices is provided in 'Box A: The Boom in the Prices of Steel-making Commodities'.

The recovery in industrial activity and improved sentiment about the global economic outlook have also supported base metals prices. The RBA index of base metals prices has risen by around 10 per cent since the time of the February *Statement*, to be 80 per cent higher than its December 2008 low. A rebound in stainless steel production has driven a particularly large rise in the price of nickel, which is more than 30 per cent higher since the start of the year.

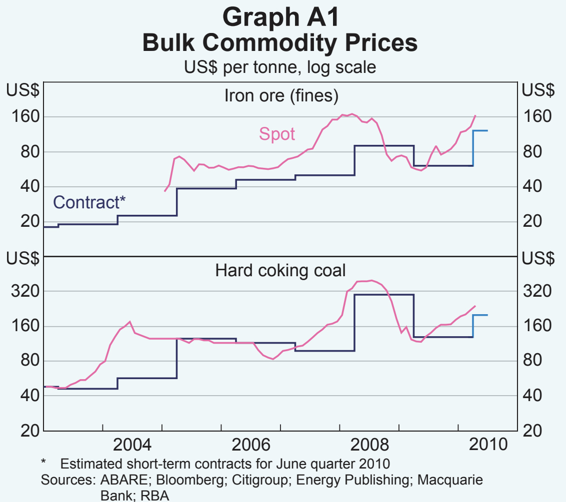
Prices of energy commodities have also risen strongly since the February *Statement*. Spot prices for thermal coal have strengthened, owing to strong demand from China as drought conditions in the country's south have restricted hydro power generation, and contract prices for 2010/11 have been settled between 36 and 40 per cent above last year's benchmark (Graph 11). Oil prices have risen to around their highest level since October 2008.

Rural commodity prices are broadly unchanged since the February *Statement*. Wheat prices have risen slightly, although they remain at low levels owing to ample global supply, while sugar prices have fallen by more than one-third from their January peak on expectations of improved supply over the coming year.

Box A

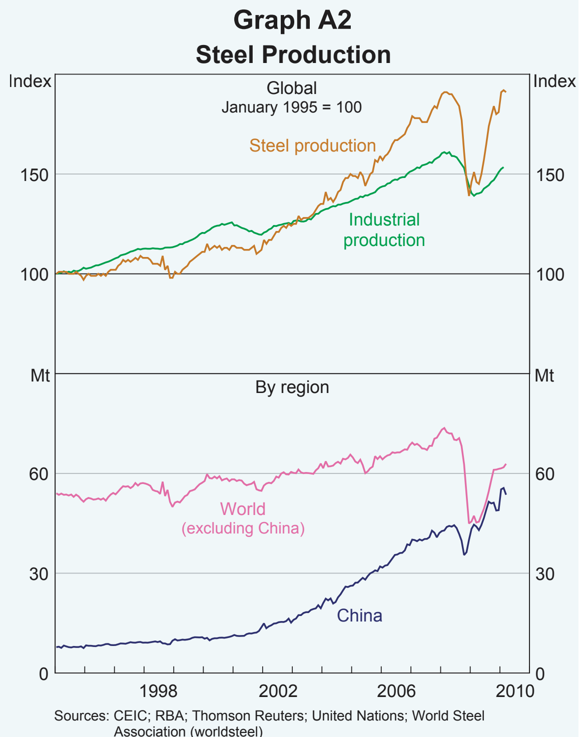
The Boom in the Prices of Steel-making Commodities

The global economic recovery has resulted in a significant tightening in the markets for iron ore and coking coal – the main raw materials used in steel-making. Since the start of the year, spot prices for iron ore and coking coal have risen by nearly 70 per cent and 35 per cent respectively (in USD terms), to be two to three times their troughs in mid 2009 (Graph A1). In line with higher spot prices, Australian exporters have negotiated substantial increases in contract prices, with iron ore contract prices expected to reach record levels in the June quarter.



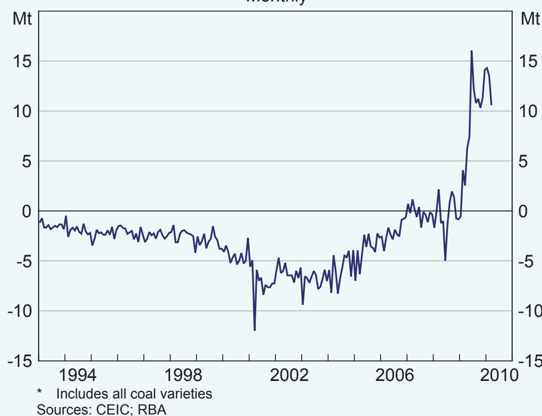
* Estimated short-term contracts for June quarter 2010
Sources: ABARE; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

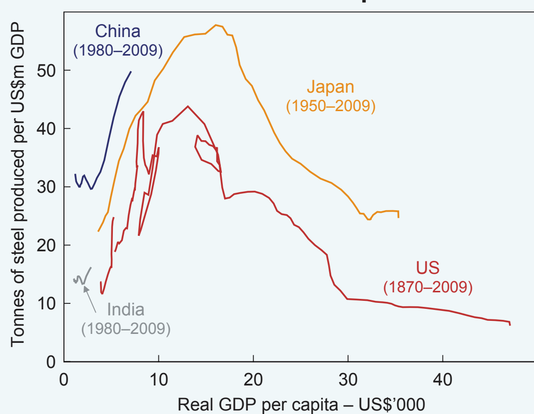
The recent surge in prices has been underpinned by a sharp rebound in global steel production which is now back to around its pre-crisis peak and has experienced a stronger recovery than global industrial production (Graph A2). The Chinese steel industry saw only a brief slowdown in late 2008 and has since grown strongly, with production now 20 per cent higher than at the outset of the global economic downturn. Steel industries in other countries had more severe downturns and have only begun to restart idled capacity more recently. Demand for steel in China has been boosted in part by fiscal measures, including investment in major infrastructure projects and a reduction in sales tax on some motor vehicles, leading to a surge in motor vehicle production and consumption.



Sources: CEIC; RBA; Thomson Reuters; United Nations; World Steel Association (worldsteel)

As steel-making has recovered, global supplies of iron ore and coking coal have become increasingly stretched. Australia and other major exporters have seen a return to near full capacity, and vessel congestion off major ports has begun to rise. Within China, domestic coal supplies have lagged demand growth, owing to consolidation of the coal industry and a lack of the better quality coals that are needed by newer steel mills. This has contributed to China





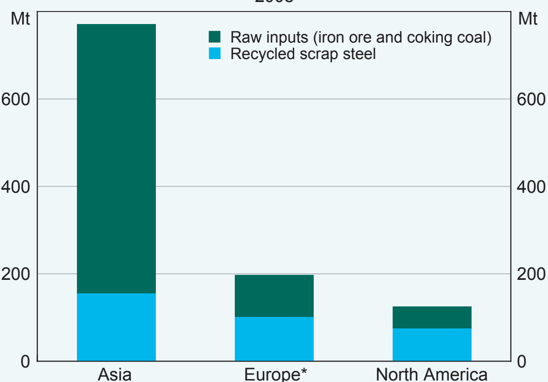
becoming a significant net importer of coal, after having been a net exporter for many years (Graph A3). Chinese iron ore production, which is characterised by low ore grades and high production costs, has also not been able to alleviate demand pressures.

China's demand for steel has been rising steadily for a number of years, reflecting its stage of economic development and the growth model that it has pursued. Rapid industrialisation and urbanisation are driving high levels of investment in fixed capital, such as infrastructure and buildings, and an export-oriented growth model has contributed to the development of a large manufacturing sector. As a result, China's economy exhibits a high level of 'steel intensity' – for an equivalent amount of real economic output, China uses around nine times as much crude steel as the United States. High levels of steel intensity have been typical in the past among economies at a similar stage of development (Graph A4). For example, periods of industrialisation in the United States in the late 1800s and early 1900s and Japan in the 1960s also saw rapid growth in steel production to build their capital stock, which in turn boosted labour productivity and real incomes. In contrast, steel intensity has remained at very low levels in other developing economies such as India, and there is considerable scope for increased use of steel as incomes rise.

China's appetite for steel has translated into demand for raw materials, as a relatively small proportion of its steel production is fed by recycled scrap (Graph A5). In 2008, around 10 per cent of Chinese steel and 20 per cent of total Asian steel was produced from scrap steel. This is in contrast with steel industries in developed economies such as the United States and Europe where between half and two-thirds of steel is produced from scrap, and there is a higher prevalence of electric arc furnace technology.

While the surge in iron ore and coal prices will provide a large boost to Australian incomes, it will also act

as an important signal to producers and users of these commodities. High prices create an incentive for producers to expand supply, encouraging exploration and investment in new capacity. Reflecting this, a large number of new mining projects are progressing around the world. In Australia alone, coking coal and iron ore export capacity are expected to increase by more than 10 per cent annually for the next few years. Among importers, high prices encourage substitution away from steel-intensive activities and reduce real incomes, acting to moderate growth in demand. ✠



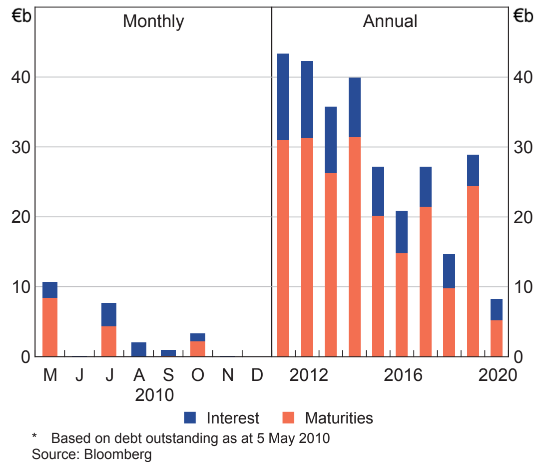
International and Foreign Exchange Markets

Sovereign Debt Markets

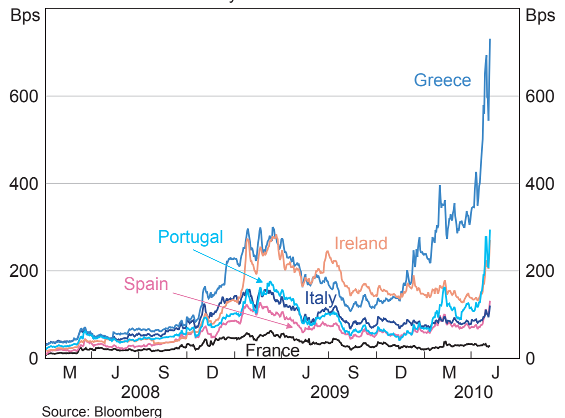
Concerns about the Greek Government's public finances have been at the forefront of developments in financial markets this year. Greece has a large funding requirement, reflecting both its sizeable budget deficit (13½ per cent of GDP in 2009 and likely to be at least 8 per cent of GDP in 2010) and the need to refinance large volumes of maturing debt (outstanding debt at end 2009 was 115 per cent of GDP) (Graph 12). During April, Greece's credit rating was downgraded by all three rating agencies; S&P downgraded Greece in late April to below investment grade. All rating agencies have Greece under review for a further downgrade. Several Greek banks also had their credit ratings downgraded because of the poor economic outlook and their large holdings of Greek government debt.

In early May, the Greek Government agreed to the terms of financial support from other euro area countries and the IMF. Under the three-year program, €80 billion in bilateral loans will be provided by euro area countries and €30 billion by the IMF; up to €30 billion will be provided in 2010 by euro area countries at interest rates reportedly around 5 per cent, which is well below recent market rates for Greek government debt (see below). The Greek Government aims to reduce its budget deficit to 3 per cent of GDP by 2014 by reducing government spending and increasing revenue.

The concerns about Greece saw spreads between yields on Greek and German sovereign debt widen to be the highest of any euro area country since the European Monetary Union was formed in 1999 (Graph 13). With the caveat that the market has become very illiquid and pricing is at best indicative, in early May the yields on 2-year and 10-year Greek bonds were around 15 per cent and 10 per cent, respectively.



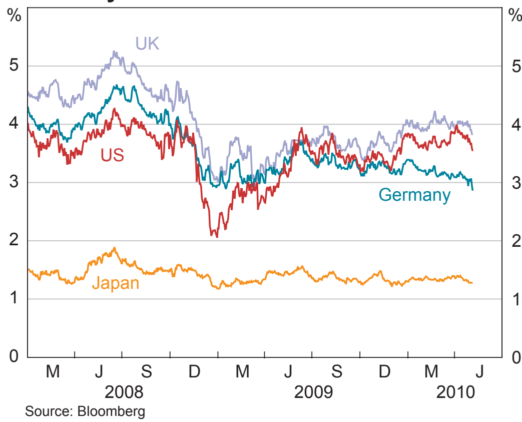
* Based on debt outstanding as at 5 May 2010
Source: Bloomberg



Source: Bloomberg

Graph 14

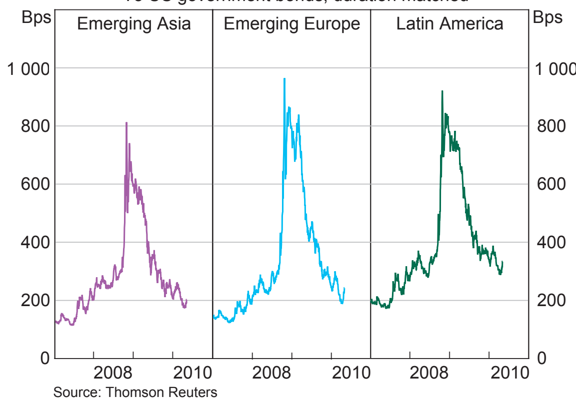
10-year Government Bond Yields



Graph 15

US Dollar-denominated Sovereign Debt Spreads

To US government bonds, duration matched



Sovereign bond spreads for several other euro area countries with large budget deficits have also widened recently. Fitch and S&P downgraded Portugal's credit rating in recent months, citing increased medium-term fiscal challenges. Subsequently, the Government brought forward additional measures to cut its budget deficit in 2010. In late April, S&P also downgraded Spain's credit rating. In addition, Ireland's budget deficit for 2009 was revised higher by 2½ percentage points.

Longer-term bond yields in the United States and United Kingdom had risen in recent months to the top of their trading range over the past year, reflecting in part the better macroeconomic outlook (Graph 14). Recently, however, yields in major bond markets have fallen, reflecting safe-haven demand due to concerns over sovereign credit risk in some euro area countries. Short-term government bond yields in the major economies have remained low as policy rates are expected to remain low for some time.

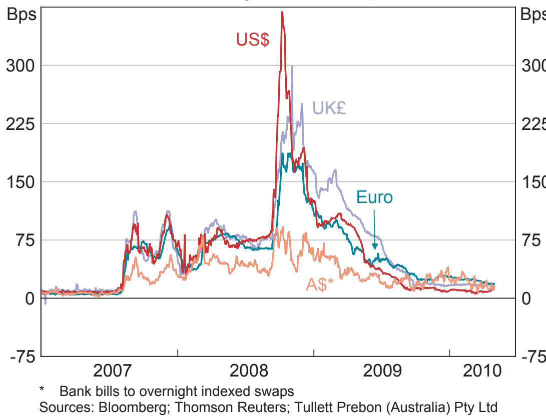
Spreads of emerging market debt have only been modestly affected by the concerns about some euro area countries and have narrowed considerably over the past year or so as these economies have improved (Graph 15). Spreads are now similar to, or lower than, those prevailing prior to the collapse of Lehman Brothers in September 2008 and are well below their decade average. In mid April, Argentina announced a debt restructuring plan for around US$20 billion of bonds outstanding from the Government's 2001 debt default.

In emerging Asia, Moody's upgraded South Korea's credit rating from the equivalent of A to A+, citing its ongoing resilience to the financial crisis. S&P revised India's credit rating outlook from negative to stable citing its fiscal consolidation. A number of emerging European countries also had their credit outlooks raised.

Credit Markets

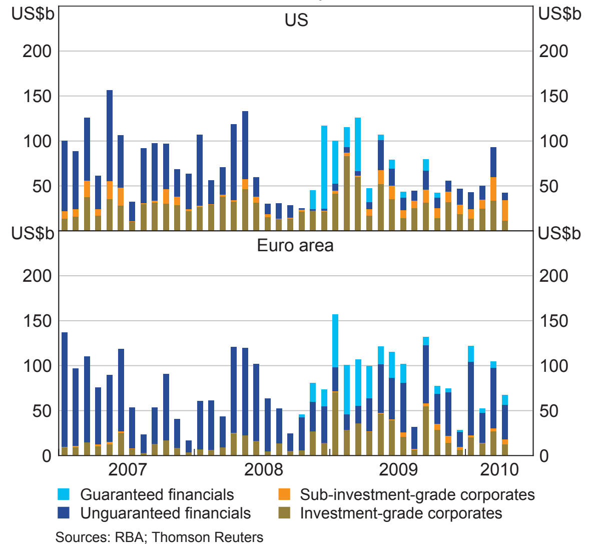
In money markets, spreads between LIBOR and the expected cash rate (a measure of bank risk) have remained broadly stable since mid to late 2009 (Graph 16). Conditions in other credit markets have generally improved further in recent months, despite having experienced some repercussions from the deterioration in several euro area sovereign debt markets. Reflecting the improvement in global economic conditions, the global corporate speculative-grade default rate has declined from its peak in December 2009.

Graph 16
3-month LIBOR Spreads
To overnight indexed swaps



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

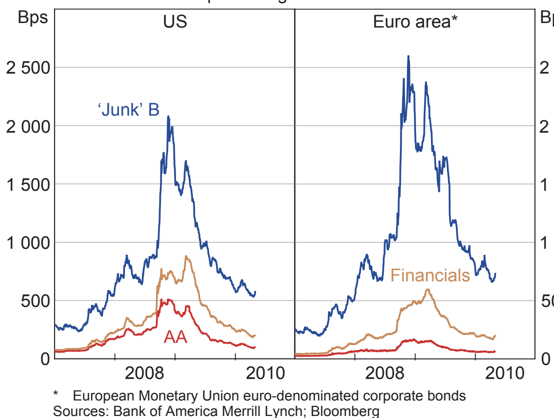
Graph 18
Corporate Bond Issuance
Monthly



Sources: RBA; Thomson Reuters

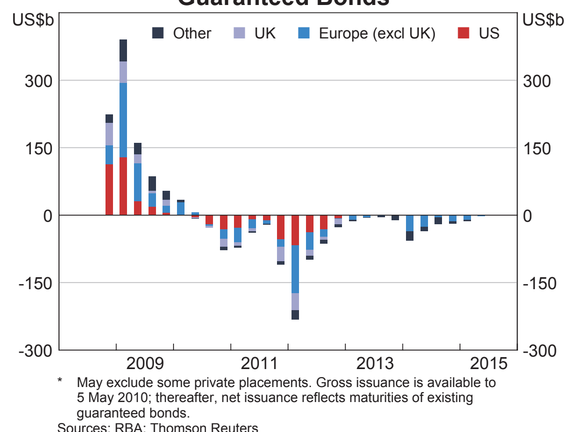
Although corporate bond spreads in the United States and euro area have widened slightly in recent weeks, they remain around low levels (Graph 17). Bond issuance by US non-financial corporates, including by those rated below investment grade, has strengthened a little in recent months, although issuance by non-financial corporates in the euro area has moderated after being strong in 2009 (Graph 18). In recent months, bond issuance by financial institutions has been around its average of recent years in the euro area but below average in the United States. Some Irish, French and Spanish financial institutions continue to issue government-guaranteed bonds, although aggregate issuance has continued to decline (Graph 19). The aggregate stock of government-guaranteed bonds in the United States, United Kingdom and Europe is likely to begin falling this year as bonds start to mature, although the majority of government-guaranteed bonds will mature in 2011 and 2012.

Graph 17
Corporate Bond Spreads
To equivalent government bonds



* European Monetary Union euro-denominated corporate bonds
Sources: Bank of America Merrill Lynch; Bloomberg

Graph 19
Net Issuance of Government Guaranteed Bonds*

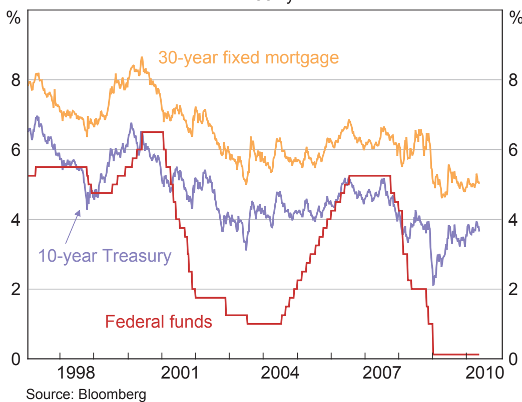


* May exclude some private placements. Gross issuance is available to 5 May 2010; thereafter, net issuance reflects maturities of existing guaranteed bonds.
Sources: RBA; Thomson Reuters

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	9.50	↑	Apr 10
Canada	0.25	↓	Apr 09
China	5.31	↓	Dec 08
India	5.25	↑	Apr 10
Indonesia	6.50	↓	Aug 09
Israel	1.50	↑	Mar 10
Malaysia	2.25	↑	Mar 10
Mexico	4.50	↓	Jul 09
New Zealand	2.50	↓	Apr 09
Norway	2.00	↑	May 10
Russia	8.00	↓	Apr 10
South Africa	6.50	↓	Mar 10
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

Sources: central banks



Central Bank Policy

Central banks in most advanced economies have kept their policy rates unchanged at low levels (Table 2). Financial markets continue to expect that the major central banks will not raise rates until at least the end of the year, with the exception of the Bank of Canada which is expected to tighten policy in coming months.

Monetary policy has been more of a mixed picture outside the major advanced economies. A number of Asian central banks (China, India, Malaysia and Singapore) have tightened monetary policy in recent months as the economic outlook has improved and/or as inflation has risen. The Bank of Israel raised its policy rate by 25 basis points in March, taking its cumulative tightening to 100 basis points since August 2009. The Central Bank of Brazil increased its policy rate by 75 basis points in April. The Central Bank of Norway increased its policy rate by 25 basis points in May. In contrast, several central banks in emerging Europe have further reduced their policy rates. The South African Reserve Bank also lowered its policy rate by a further 50 basis points in March.

In the United States, the Fed has completed its asset purchases designed to ease monetary policy and support the US mortgage market. Final purchases of agency mortgage-backed securities and agency debt occurred in March. Spreads on these securities to US Treasuries as well as 30-year fixed mortgage rates have remained relatively low following the completion of asset purchases (Graph 20).

The European Central Bank (ECB) has purchased more than four-fifths of its target of €60 billion of covered bonds, which will be completed by end June 2010. The Bank of England has maintained the stock of financial assets it purchased at £200 billion since reaching this target in early 2010.

Most central banks have closed the majority of their temporary liquidity facilities, reflecting falling

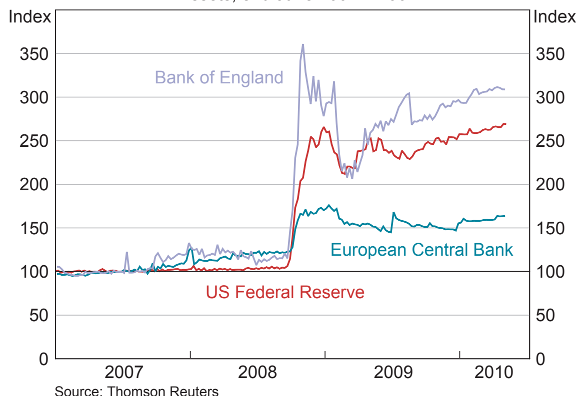
demand in line with the improvements in credit market conditions. In the United States, the sole remaining facility, the Term Asset-backed Securities Loan Facility, which aims to support issuance of commercial mortgage-backed securities, will end by 30 June. The Fed also increased the interest rate (the 'discount rate') it charges on emergency loans to banks by 25 basis points to 0.75 per cent in February and reduced the term of such loans to overnight. The Fed emphasised that this was not a tightening of monetary policy but rather a normalisation of its liquidity operations.

In March, the ECB announced that it will keep the minimum allowable rating on collateral accepted for its market operations at investment grade (BBB– or equivalent), rather than reverting to A– at the end of 2010 as previously anticipated. Subsequently, the ECB suspended the application of the minimum credit rating threshold to Greek government debt used as collateral. The ECB has also announced other changes to the collateral framework for its market operations: from 1 January 2011 higher haircuts will be imposed on certain private-sector securities while some other securities, including those not denominated in euros, will cease to be eligible collateral.

The Bank of Japan announced at its March policy meeting that it will double, to ¥20 trillion, the amount of liquidity provided at the policy rate through its 3-month loan operations, with a view to lowering longer-term money market interest rates.

Consistent with the scaling-back or completion of asset purchases and liquidity facilities, central bank balance sheets are close to peaking (Graph 21).

Graph 21
Central Bank Balance Sheets



Source: Thomson Reuters

Government Financial Policy

In the United States, negotiations over financial reform legislation are close to resolution. Key proposals contained in the current draft legislation include: new capital and leverage requirements for financial institutions; the ability to break up large companies if they pose a threat to financial stability; a study of the feasibility of the proposed 'Volcker rule' restricting banks' proprietary trading activities; greater use of centralised clearing and exchange trading for derivatives currently traded over the counter; and the creation of a new consumer protection agency. In April, the Securities and Exchange Commission also proposed new rules for issuing asset-backed securities, aimed at providing better protection for investors.

The US Treasury continues to unwind its assistance to financial institutions under the Troubled Asset Relief Program (TARP). Over 70 per cent of the banking-sector support programs have been repaid, and the US Treasury ultimately expects to earn a profit on these investments. However, reflecting the large losses expected from assistance to insurer American International Group and the auto industry, as well as the cost of the housing affordability program, the Congressional Budget Office estimates that the total cost of the TARP will be more than US$100 billion in present value terms. The US Treasury also announced

it will sell its 27 per cent stake in Citigroup during 2010, subject to market conditions. At current market prices, the Government's profit on these shares would be around US$7 billion.

The housing finance agency Freddie Mac reported further losses in the March quarter, resulting in a request for an additional capital injection of more than US$10 billion from the US Treasury as part of the terms of its conservatorship. This would take the total contribution from the US Treasury to more than US$60 billion. Fannie Mae's total funding from the US Treasury at the end of 2009 was around US$75 billion.

The IMF has approved measures to ensure that it has adequate resources to lend to member countries through its crisis prevention and resolution measures. The Executive Board approved a significant expansion of the IMF's New Arrangements to Borrow – where participants commit resources to IMF lending when needed to supplement the IMF's regular quota resources – from around US$50 billion to almost US$600 billion.

The IMF has also discussed two proposals in which additional taxes on the financial system might be levied: a Financial Stability Contribution that would be predominantly based on specific liabilities of financial institutions; and a Financial Activities Tax that would be levied on the remuneration and 'excess' profits of financial institutions. Responses to these proposals have been mixed, with many countries not seeing a need for a special tax on their financial institutions.

A number of governments and regulators have proposed banning 'naked' credit default swap (CDS) transactions referencing sovereign debt where the protection buyer does not own the underlying asset. Activity in the sovereign CDS market, however, is much smaller than the underlying market for government bonds (Table 3).

Ireland's National Asset Management Agency, set up to buy non-performing loans, began its first loan purchases in March. Loans with a nominal value of €16 billion are being purchased at an average discount of nearly 50 per cent. In total, €81 billion of loans (6 per cent of credit institutions' assets) are expected to be purchased by end 2010. Several institutions will be required to raise capital to offset the effects of the loan write-downs.

Table 3: Selected Sovereign Credit Default Swaps

April 2010

		Outstandings (US$ billion)		
	S&P credit rating	Gross CDS contracts	Net CDS contracts	Government debt[(a)]
Italy	A+	224	25	1 892
Spain	AA	105	14	614
Greece	BB+	79	8	377
Germany	AAA	71	14	1 341
Portugal	A–	62	9	149
France	AAA	55	10	1 517
Ireland	AA	35	5	115
United States	AAA	13	2	8 430
Australia	AAA	7	1	124

(a) Central government; May 2010

Sources: Bloomberg; Depository Trust & Clearing Corporation; RBA; S&P; US Treasury

Table 4: Changes in International Share Prices

Per cent

	2007/08 peak to recent trough	Since recent trough	2007/08 peak to current	Since previous *Statement*
United States				
– Dow Jones	–54	66	–23	6
– S&P 500	–57	72	–26	6
– NASDAQ	–56	89	–16	10
Euro area				
– STOXX	–62	51	–42	–3
United Kingdom				
– FTSE	–48	52	–21	2
Japan				
– Nikkei	–61	57	–39	6
Canada				
– TSE 300	–50	57	–21	4
China				
– China A	–72	67	–53	–5
Australia				
– ASX 200	–54	49	–32	1
MSCI indices				
– Emerging Asia	–61	93	–25	3
– Latin America	–57	92	–17	–3
– Emerging Europe	–71	105	–41	–1
– World	**–56**	**63**	**–28**	**4**

Source: Bloomberg

Equities

Global equity prices reached a 19-month high in mid April, supported by generally better-than-expected earnings reports for the March quarter and steady improvements in the global economic outlook (Table 4, Graph 22). However, recent developments in the euro area have resulted in global equity prices falling by around 5 per cent and European equity prices by around 10 per cent. Global equity prices remain well below their peak in October 2007.

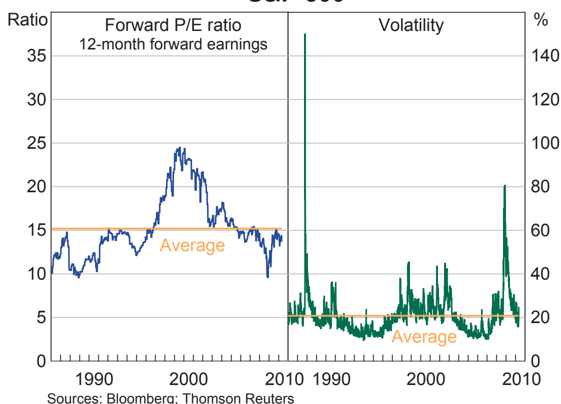
In the United States, first-quarter earnings reports from major US financial institutions continued to show investment banking and trading operations, particularly fixed-income activities, as the main sources of profit. Net income from retail operations was a little higher as loan-loss provisions, which peaked in mid 2009, declined further due to reported

Graph 22
MSCI Global Share Price Indices

Source: Bloomberg

improvements in credit quality. While US financial institutions' earnings have improved significantly, they remain below their pre-crisis levels. Reported profits of non-financial companies also improved in the March quarter compared with a year earlier.

Equity prices have not increased at the same rate as expected earnings with the result that the forward-looking price-to-earnings (P/E) ratio has fallen to be slightly below its long-run average (Graph 23). Volatility in the US equity market has recently increased to be slightly above its long-run average.



Equity prices in most emerging economies have broadly tracked those in advanced economies this year, with the notable exception of China where uncertainty surrounding the pace of policy tightening and the effect of measures implemented by authorities to cool property market activity have weighed on equity prices.

Hedge Funds

The continuing improvement in financial markets has been reflected in global hedge funds' returns, which averaged 3 per cent in the March quarter and 23 per cent over the year. Hedge funds as a group have recovered the sharp losses suffered in 2008, with unit values now around levels seen before the financial crisis. Despite this recovery in returns, funds under management in the industry are still 14 per cent below the peak in mid 2008, reflecting large redemptions during the crisis.

Foreign Exchange

Developments in major foreign exchange markets have primarily been driven by the sovereign debt concerns in Europe, while emerging Asian and South American currencies have generally appreciated in line with the relative strength of economic recovery in these regions. With the exception of heightened volatility in the euro, foreign exchange markets have been relatively stable in recent months with volatility around its long-run average and well below the peaks recorded in 2008.

In trade-weighted terms, the US dollar has appreciated since the previous *Statement*, and at the end of April was around 12 per cent above the record lows in March 2008 and around 10 per cent below its peak in March 2009 (Graph 24, Table 5).

The dollar has appreciated against the other major currencies, owing largely to the response of investors to the sovereign debt problems in the euro area, but has depreciated against emerging market and commodity currencies, which have been buoyed by the strengthening global recovery and capital inflows.

Concerns over the fiscal position of a number of euro area countries, particularly Greece but also Ireland, Spain and Portugal, have seen the euro depreciate by around 15 per cent against the US dollar since late 2009 (Graph 25). Despite this, the euro remains over 10 per cent above its long-run average in effective terms. The UK pound sterling has continued to depreciate, affected by economic and political uncertainty in the country. In effective terms the UK pound sterling remains around its lowest level for at least 30 years. The Swiss National Bank has continued to intervene at times to constrain appreciation of the Swiss franc against the euro.

Despite market discussion of a possible revaluation of the Chinese renminbi, the current peg to the US dollar, in place since July 2008, remains unchanged. The non-deliverable forward market suggests that market participants have expected an upward revaluation of the renminbi relative to the US dollar since late last year. Although Premier Wen cautioned that the currency will remain basically stable in the near term, Chinese President Hu stated recently that China will move towards a floating exchange rate regime. In effective terms the Chinese exchange rate has appreciated from the start of 2010. It is around 8 per cent below its peak in February 2009, but remains around 20 per cent above its trough in 2005 (Graph 26).

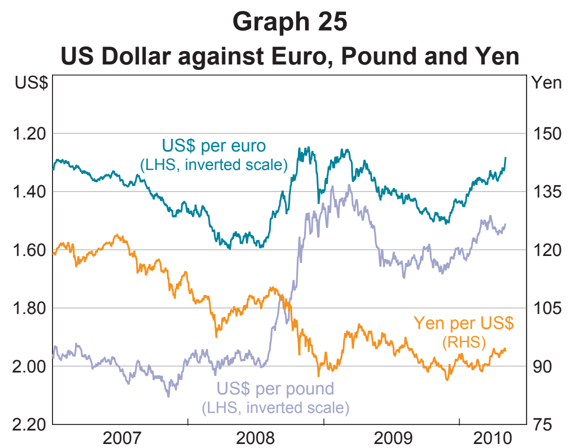
Table 5: US Dollar against Other Currencies

Percentage change

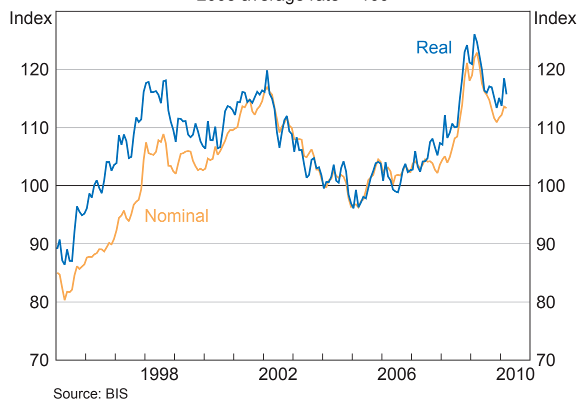
	Past year	Since previous *Statement*
European euro	4	8
Chinese renminbi	0	0
UK pound sterling	0	5
Swiss franc	–1	6
Mexican peso	–4	–2
Swedish krona	–5	4
New Taiwan dollar	–5	–1
Japanese yen	–5	3
Singapore dollar	–6	–1
Philippine peso	–6	–3
Thai baht	–8	–2
Malaysian ringgit	–8	–5
Indian rupee	–9	–2
South African rand	–9	2
South Korean won	–10	0
Indonesian rupiah	–11	0
Canadian dollar	–12	–3
Brazilian real	–16	–2
Australian dollar	–18	–3
New Zealand dollar	–19	–2
Majors TWI	**–3**	**3**
Broad TWI	**–3**	**1**

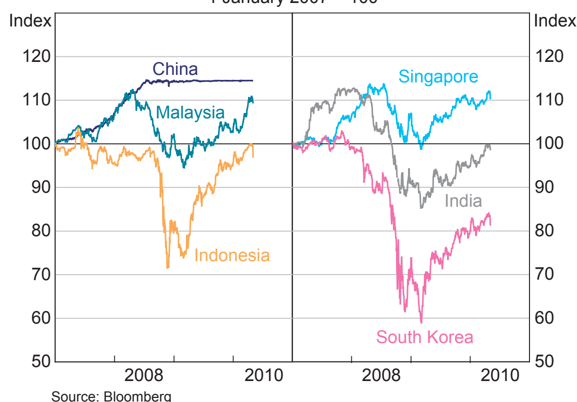
Sources: Bloomberg; Board of Governors of the Federal Reserve System

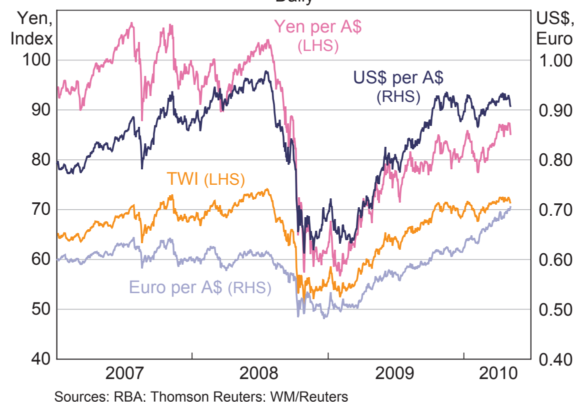
Graph 25
US Dollar against Euro, Pound and Yen



Source: Bloomberg







Other emerging Asian currencies have generally appreciated against the US dollar since the beginning of the year, consistent with strong capital inflows and the strength of the recovery in the region (Graph 27). The Malaysian ringgit has experienced a particularly strong appreciation in response to strong trade data and higher domestic interest rates. Most currencies in the region with flexible exchange rates appreciated following the decision by the Monetary Authority of Singapore to raise the target band for the Singapore dollar and to allow the currency to gradually appreciate. In early May, however, most emerging Asian currencies depreciated in response to sovereign debt concerns in some euro area countries.

Australian Dollar

The Australian dollar has appreciated against most major currencies in recent months, reflecting the general strength in commodity prices and associated strength of the domestic economy (Graph 28, Table 6). On a trade-weighted basis the Australian dollar has appreciated by over 35 per cent since the trough in February 2009 and is just 4 per cent below the post-float high achieved in July 2008. It has reached a new high against the euro of over 70 euro cents and a decade high against the NZ dollar. Intraday volatility in the Australian dollar has declined sharply in recent months to its lowest level since mid 2007.

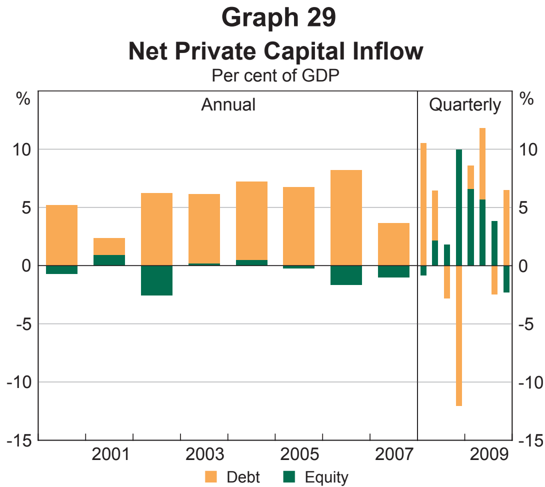
Table 6: Australian Dollar against Selected TWI Currencies
Percentage change

	Past year	Since previous *Statement*	Deviation from post-float average
European euro	26	11	7
UK pound sterling	21	8	34
Chinese renminbi	21	3	32
US dollar	21	3	25
Swiss franc	20	8	–5
Japanese yen	16	6	–10
Singapore dollar	15	1	1
Thai baht	12	1	24
South African rand	11	4	54
Malaysian ringgit	11	–3	31
Indian rupee	10	0	52
South Korean won	10	2	51
Indonesian rupiah	8	3	124
Canadian dollar	7	0	0
New Zealand dollar	–1	1	3
TWI	**16**	**4**	**20**

Sources: Bloomberg; RBA; Thomson Reuters; WM/Reuters

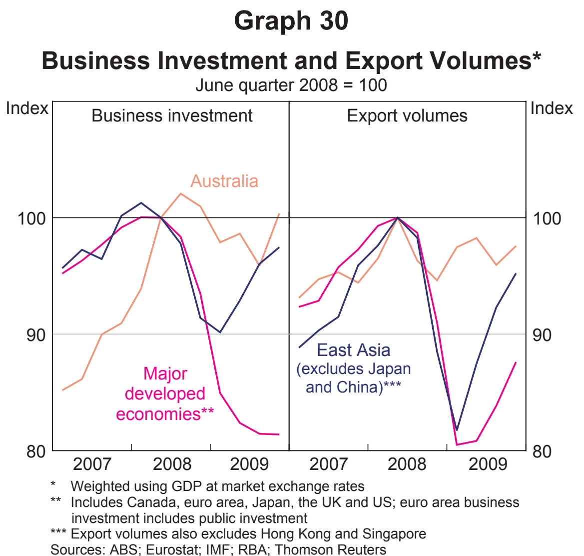
Capital Flows

Private capital flows have largely returned to their pre-crisis configuration. Official data to the end of 2009 show that, following a short period of repatriation flows during the crisis, both foreign investment in Australia and Australian investment abroad have returned to levels similar to those seen prior to the crisis (Graph 29). Net equity inflows, which rose sharply following the crisis, reflecting repatriations and domestic equity raisings, have declined recently, while strong offshore debt financing by banks and other corporates has seen a recovery in net debt inflows.



Domestic Economic Conditions

The Australian economy continues to recover from what turned out to be a relatively mild downturn. Over the past 18 months or so, activity has been supported by stimulatory settings of fiscal and monetary policy, high population growth, strong trade links with Asia and a sound financial system. Compared with the experience elsewhere in the developed world, business investment is at high levels and exports held up well through the financial crisis (Graph 30). Over 2009, GDP is estimated to have increased by 2.7 per cent (Table 7), a considerably stronger outcome than expected a year ago, with the result that the economy starts this expansion with less spare capacity than earlier thought likely.



A range of indicators suggests that the expansion has continued into 2010, although as is typical, conditions vary across sectors of the economy. Surveys indicate high levels of confidence in the future of the economy, although there appears to be a degree of caution in the spending plans of

Table 7: Demand and Output Growth
Per cent

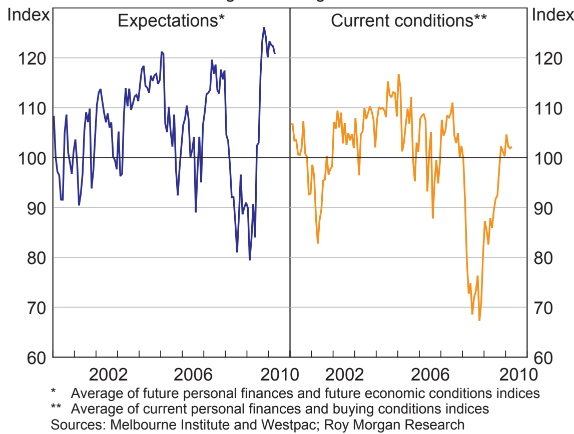
	December quarter 2009	Year to December quarter 2009
Domestic final demand	2.0	3.3
– Private demand	1.5	2.1
– Public demand	3.8	7.7
GNE	2.1	4.5
Net exports[(a)]	–1.3	–0.5
Statistical discrepancy[(a)]	0.0	–1.4
GDP	0.9	2.7

(a) Contribution to GDP growth
Source: ABS

Graph 31

Consumer Sentiment

Long-run average = 100



* Average of future personal finances and future economic conditions indices

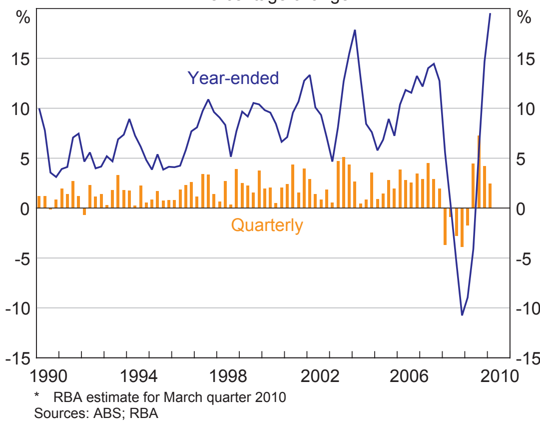
** Average of current personal finances and buying conditions indices

Sources: Melbourne Institute and Westpac; Roy Morgan Research

Graph 32

Household Net Worth*

Percentage change



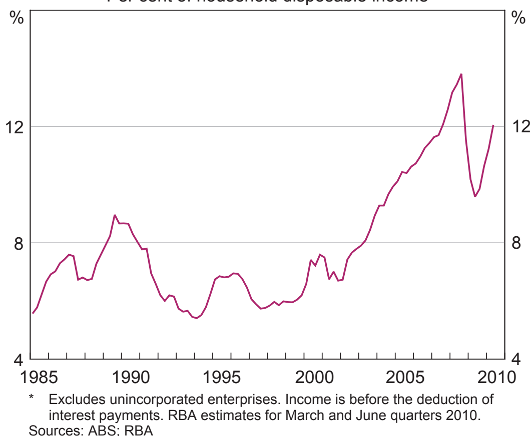
* RBA estimate for March quarter 2010

Sources: ABS; RBA

Graph 33

Household Interest Payments*

Per cent of household disposable income



* Excludes unincorporated enterprises. Income is before the deduction of interest payments. RBA estimates for March and June quarters 2010.

Sources: ABS; RBA

consumers and of businesses outside of the mining sector. The effect of the fiscal measures on activity is declining, with private demand expected to strengthen over the period ahead. The outlook for the resources sector is very positive, with rises in commodity prices and the terms of trade boosting domestic incomes and underpinning a further increase in mining investment.

Household Sector

Households appear to be quite optimistic about the future, and particularly the outlook for the economy (Graph 31). This is consistent with recent increases in wealth and solid employment growth. Household net worth is estimated to be around 20 per cent higher than its trough in March 2009, driven by solid growth in equity and property prices (Graph 32). While households are confident about the future, this appears to have had only a limited effect on spending recently. This apparent caution is reflected in consumers' survey responses about current conditions, which remain close to their long-run average.

The increase in mortgage rates to more normal levels over the past half year is resulting in a significant increase in household interest payments (Graph 33). Based on the current level of mortgage rates, the ratio of interest payments to household disposable income is estimated to have increased by 2½ percentage points since mid 2009, although it remains below its peak of 13.8 per cent in September 2008.

The volume of retail sales increased by 0.1 per cent in the March quarter to be 2 per cent higher over the year (Graph 34). The recent modest growth is likely to partly reflect the unwinding of the effects of the stimulus payments, which prompted some households to bring forward the purchase of durable goods into the first half of 2009 (Graph 35). A similar pattern can be seen in the number of overseas trips taken by residents, which rose sharply in mid 2009 in response to low airfares and the appreciation of the exchange rate. In contrast, some other components of consumption have grown relatively strongly over

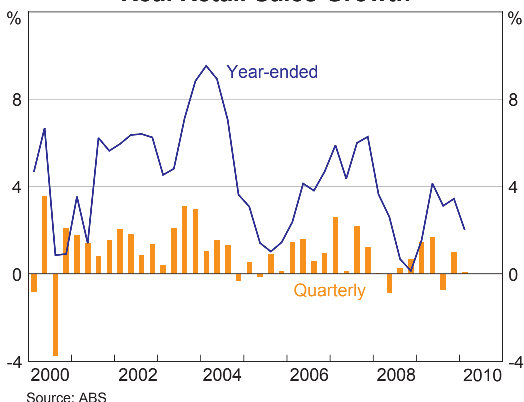
the past year after weakness in 2008, particularly cafes and restaurants and purchases of motor vehicles.

The recovery in dwelling construction activity continues, with total building approvals in March around their highest level since 2003. After rising by close to 50 per cent over 2009, the number of private house building approvals has flattened out in recent months, partly reflecting the reduction in government grants to first-home buyers and the gradual removal of the earlier monetary stimulus (Graph 36). In contrast, private apartment approvals appear to be gradually picking up from their earlier very low levels. The increase has been concentrated in low-rise developments where business liaison is pointing to some improvement in access to construction finance, while high-rise apartment approvals remain weak (Graph 37). There is also a boost to dwelling investment from the almost 20 000 new homes being built under the Federal Government's Social Housing Initiative.

Housing prices have risen strongly over the past year or so, reflecting both supply- and demand-side factors. Over the past 15 months, capital city housing prices have risen by an average of around 1 per cent a month, to be 15 per cent above their trough in late 2008 (Graphs 38 and 39, Table 8). In the first three months of this year, the pace of growth was particularly strong in Melbourne and Sydney, though it tended to ease in the other capital cities, especially in Perth and Brisbane. Consistent with these trends,

Graph 34

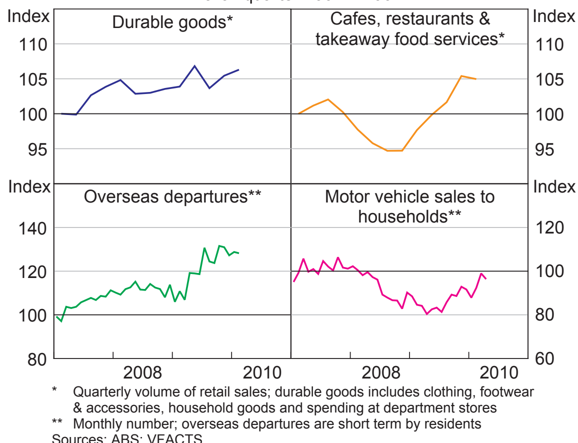
Real Retail Sales Growth



Graph 35

Consumption Indicators

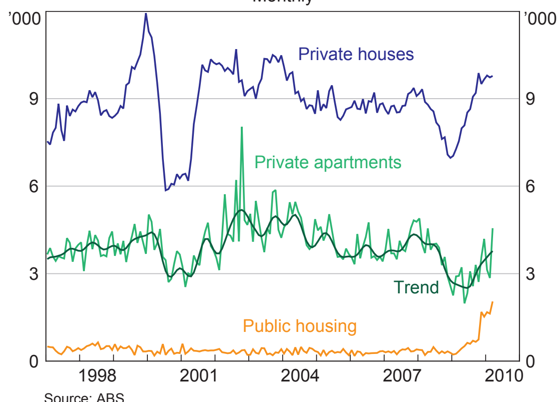
March quarter 2007 = 100



Graph 36

Residential Building Approvals

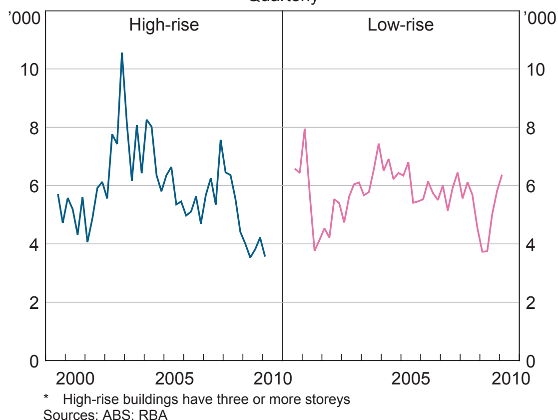
Monthly



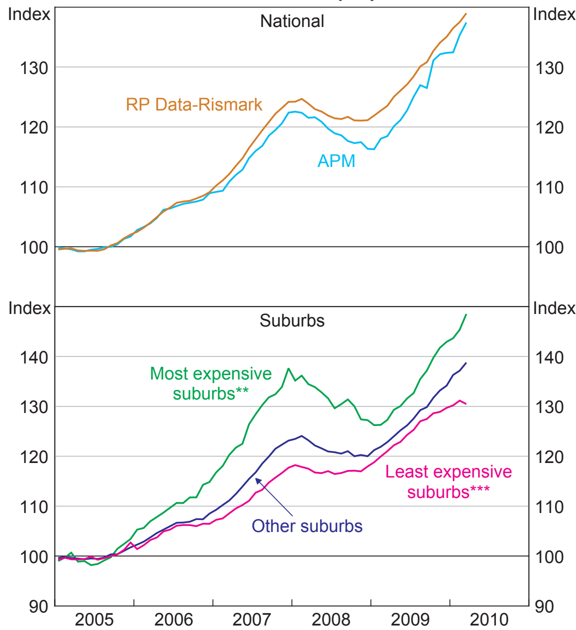
Graph 37

Private Apartment Building Approvals*

Quarterly

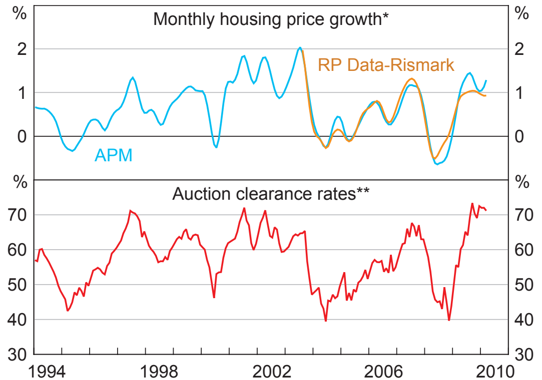


Graph 38
Capital City Housing Prices*
2005 = 100, seasonally adjusted



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

Graph 39
Housing Market Indicators



* Capital cities; 13-period Henderson trend
** Dwelling stock-weighted nationwide measure
Sources: APM; RBA; REIV; RP Data-Rismark

auction clearance rates – which are a timely indicator of housing market conditions – have been around historically high levels since late last year, particularly in Melbourne, Sydney and Canberra.

The rise in housing prices reflects a number of fundamental factors including the improved outlook for economic growth and the strong rate of population growth as well as supply-side problems, which have constrained home-building in recent years. Traditionally, the rate of home-building has exceeded the rate of population growth. However, over the past year, the population growth rate of a little over 2 per cent has been well in excess of the 1.4 per cent growth in the number of dwellings

Table 8: National Housing Price Growth
Per cent

	December quarter 2009	March quarter 2010	Year to March quarter 2010	Trough-to-latest
Capital cities				
ABS[(a)]	5.1	4.8	20.0	20.0
APM	4.9	2.9	15.7	15.7
RP Data-Rismark	2.9	3.6	12.6	14.5
Regional areas				
APM	4.2	1.1	11.0	11.6
RP Data-Rismark[(a)]	2.3	0.6	6.3	6.7

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

(Graph 40). This reversal is evident across all mainland states.

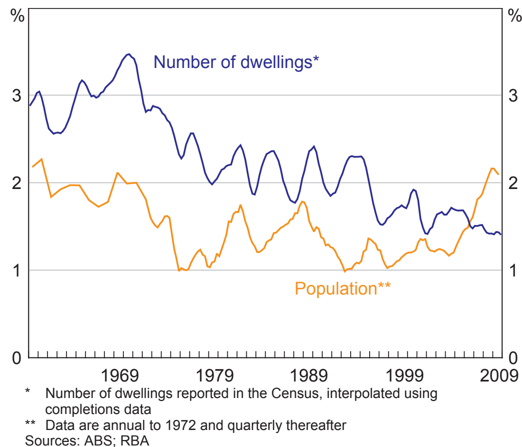
Growth in housing prices has been apparent for both houses and apartments, both within and outside the major capitals, and across both more- and less-expensive suburbs in the capital cities. Following a modest decline in nationwide dwelling prices in 2008, the pick-up in dwelling prices was initially strongest in the least-expensive suburbs, which may have been most sensitive to low mortgage rates and the increase in grants for first-home buyers (Graph 38). The rise in dwelling prices has been strongest in Victoria, where state government supplements to first-home buyer grants, which continue to apply, have been among the largest (Graph 41).

The continuing buoyancy in the established housing market has been somewhat at odds with recent developments in housing finance, which has traditionally been a good indicator of housing market conditions. Housing loan approvals have declined by around 15 per cent since their peak in September last year. This divergence might be partly explained by shifts in the composition of transactions in the housing market. For example, with the recent easing of first-home buyer demand there has been a large decline in turnover in lower-priced suburbs. This may help explain the fall in loan approvals as first-home buyers are more likely than other buyers to use debt to purchase dwellings: household surveys indicate that around 90 per cent of purchases by first-home buyers involve a mortgage, while for repeat buyers only around 65 per cent of housing sales involve a mortgage. Overall, the divergence between aggregate nationwide loan approvals and housing prices remains something of a puzzle, although the developments in housing finance across the states appear to be broadly consistent with developments in prices, with loan approvals strongest in Victoria, which has also had the strongest housing market (Graph 42).

Graph 40

Dwelling and Population Growth

Year-ended



* Number of dwellings reported in the Census, interpolated using completions data

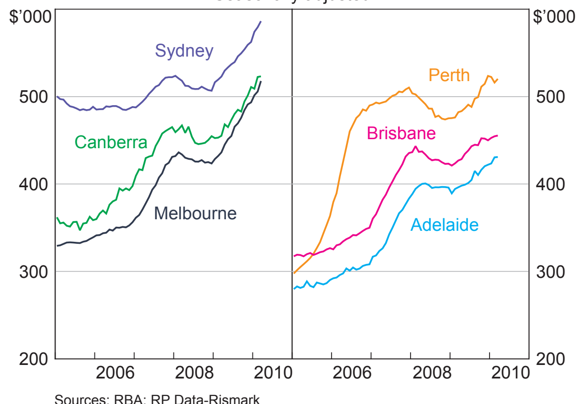
** Data are annual to 1972 and quarterly thereafter

Sources: ABS; RBA

Graph 41

Capital City Housing Prices

Seasonally adjusted



Sources: RBA; RP Data-Rismark

Graph 42

Housing Loan Approvals by State

January 2005 = 100

* Net of refinancing

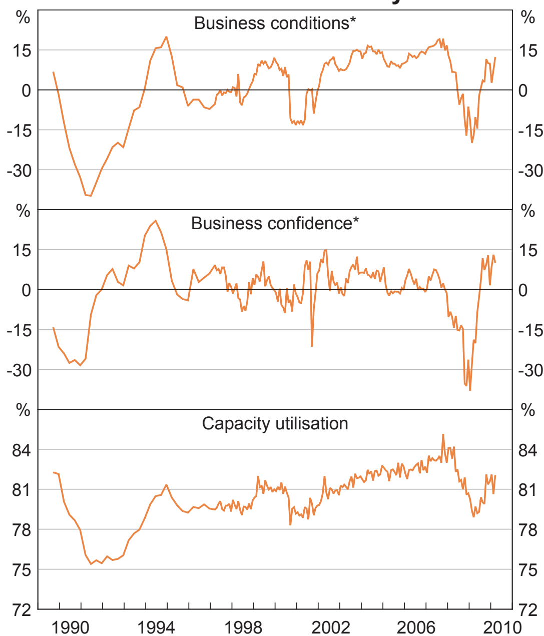
** Excludes investor approvals for new construction and by 'others'

Sources: ABS; RBA

Business Sector

Surveys report that conditions and confidence in the business sector remain above long-run average levels after rising strongly through 2009, while measures of capacity utilisation are around average levels (Graph 43). These patterns are reasonably consistent across sectors, although confidence in the mining sector is particularly high. Business profits recovered in late 2009 and the very large increases in bulk commodity contract prices will provide a boost to profits over coming quarters.

While firms have a fairly optimistic view of the future, outside of the mining sector they remain cautious in their spending plans. There was strong growth in business investment in the December quarter, but this was partly in response to the temporary tax concessions for new tangible assets. In particular, sales of motor vehicles to businesses, which typically comprise around one-quarter of machinery and equipment investment, rose strongly in the December quarter, but have since eased to be 4 per cent lower in the four months to April.



The outlook for mining-sector investment has strengthened over the past year, underpinned by further large increases in bulk commodity prices and an expectation that demand for raw materials from China and other emerging economies will grow solidly in the medium term. Mining investment is at a historically high level, well above the peaks of previous mining booms in the early 1980s and the late 1960s and early 1970s, supported by large projects in the oil and gas, coal and minerals sectors (Graph 44). Construction work on the $43 billion Gorgon liquefied natural gas (LNG) project commenced in the December quarter and there are a number of other significant projects currently in the advanced stages of planning, including additional LNG projects on the North-West Shelf off the coast of Western Australia and coal-seam methane projects in Queensland. There are also a number of large iron-ore projects being developed in the Pilbara and other areas of Western Australia, and coal supply expansions in the Bowen Basin in Queensland and the Hunter Valley in New South Wales. This large pipeline of work is expected to result in a further substantial increase in mining investment over coming years.

In contrast to the mining sector, commercial property development remains weak, with the value of private non-residential building approvals (excluding educational facilities) at around its lowest level as a share of the economy since the early 1990s (Graph 45). This has reflected both weak demand for office and industrial property, with vacancy rates rising over the past year, and a reduction in the supply of credit to many property developers (Graph 46). Over recent months, however, office and industrial property capital values and rents have stabilised as the economy has improved. While commercial property construction remains weak, overall non-residential building activity is being supported by public spending on educational

facilities. Construction of educational facilities by both the public and private sectors rose strongly in the second half of 2009, although it is expected to subtract from growth over 2010 as projects are completed.

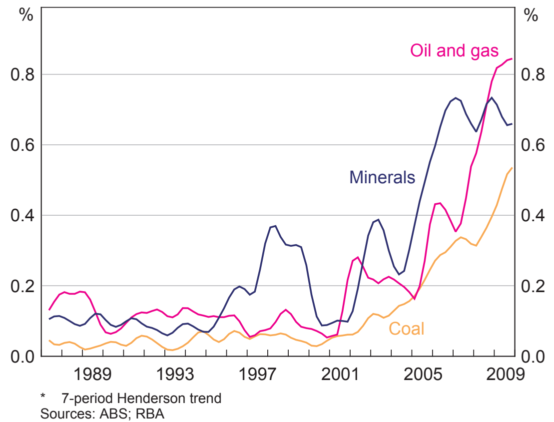
The business sector as a whole is in a generally sound financial position, as reflected in reduced gearing ratios (see 'Box B: Listed Corporates' Gearing Ratios') and a low level of corporate insolvencies. Business borrowing has fallen sharply over the past year, largely due to a significant deleveraging of balance sheets and tighter lending standards. There are, however, signs this process is coming to an end, with business credit stable in the March quarter, and liaison with businesses indicating the availability of credit has improved somewhat in recent months (see also the 'Domestic Financial Markets' chapter).

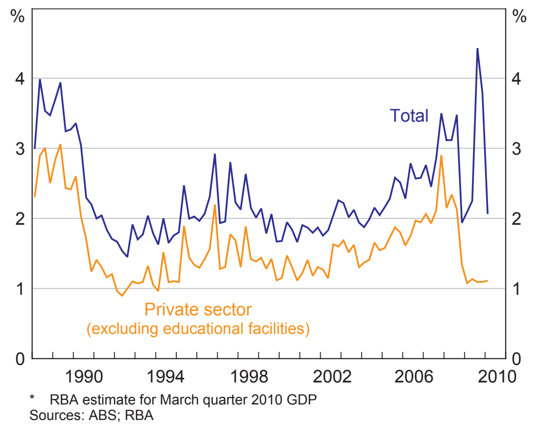
Farm Sector

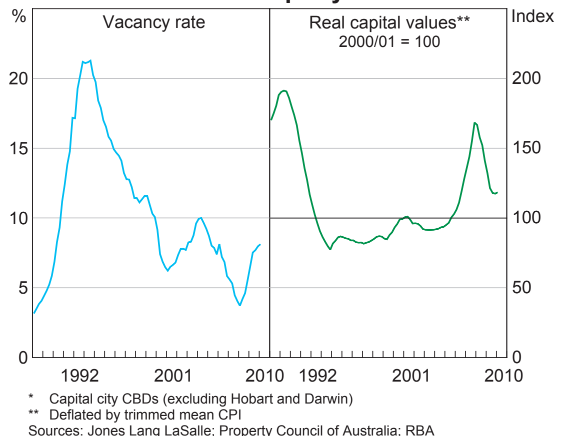
Farm production is expected to have increased slightly in 2009/10, with an increase in the wheat crop partly offset by a decline in dairy and wool production. The outlook for the period ahead appears largely favourable. Eastern cropping regions have received above-average rainfall in recent months as the El Niño weather pattern seen over the summer has abated, which has raised soil moisture levels and should support winter crop plantings. Floodwaters in late 2009 and February/March 2010 have boosted inflows to the Murray-Darling basin, which are now around historical averages for this time of year, improving water availability for irrigated crops.

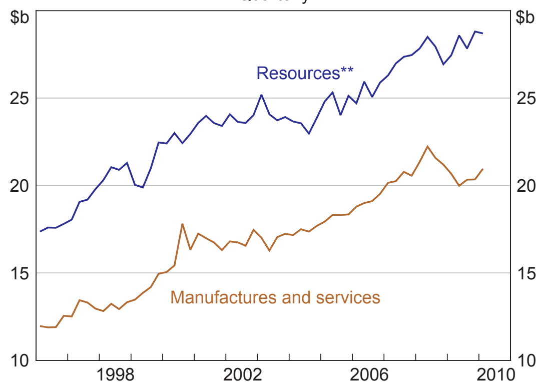
External Sector

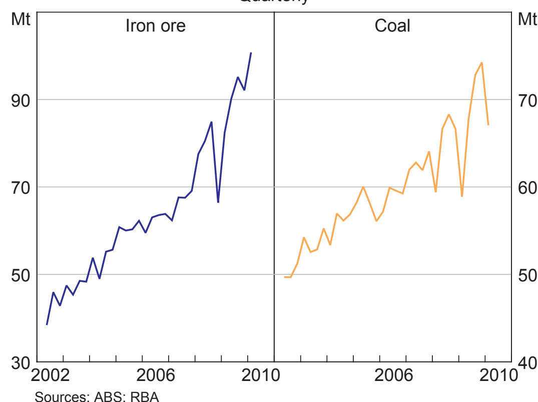
Export volumes held up through the financial crisis, which was a considerably better outcome than for almost all major economies where exports suffered large falls in late 2008 and early 2009. More recently, demand for Australian exports of resource commodities has been strong, and prices for most commodities have risen significantly (Graph 47). While coal exports were affected by weather-related

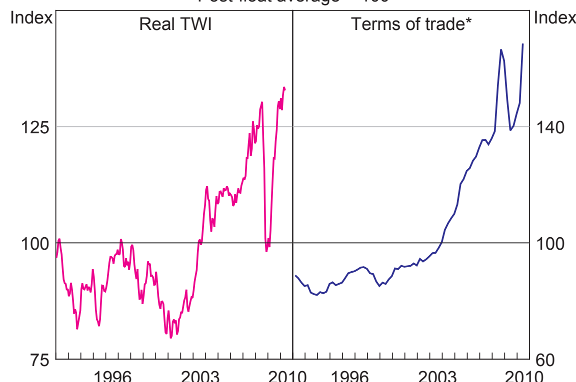












disruptions in the March quarter, iron ore and coal export capacity has increased as a result of the high levels of mining investment over recent years (Graph 48). Looking ahead, major investments in the resources sector – particularly for iron ore, coal and LNG – are expected to underpin solid growth in resource export volumes in coming years.

Manufactured exports remain well below their pre-crisis peak, although exports of motor vehicles have continued to recover. Slow non-commodity export growth partly reflects the dampening effect of the appreciation of the exchange rate.

Import volumes are estimated to have risen further in the March quarter, and have reversed almost all of the nearly 15 per cent fall that occurred between mid 2008 and early 2009. However, the pace of growth has slowed from the second half of 2009, as the effects of the inventory restocking and the rapid appreciation of the exchange rate during 2009 have begun to ease.

The terms of trade are estimated to have risen further in the March quarter. Looking forward, significant contract price increases in the June quarter are expected to see the terms of trade rise by around 20 per cent over 2010 – a significantly better outcome than was expected a year ago. Together with a recovery in global investor sentiment, this has contributed to the considerable appreciation of the exchange rate since early 2009, which in real terms is now around its highest level in the post-float period (Graph 49).

Labour Market

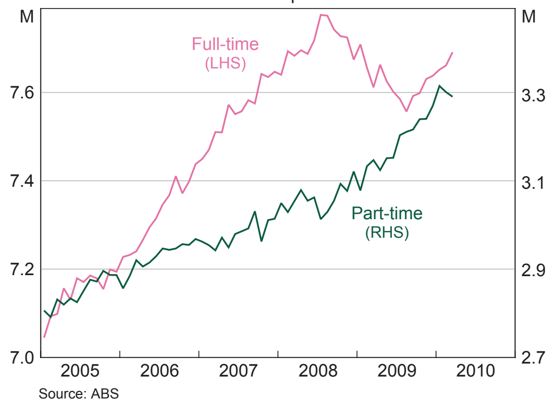
Conditions in the labour market have remained solid in the early part of 2010, following surprisingly strong employment growth in late 2009. After the large recorded increase in January, employment has grown more modestly in the past couple of months, although the full-time component continues to post solid gains (Graph 50). Aggregate employment is now 1½ per cent above its earlier peak in late 2008.

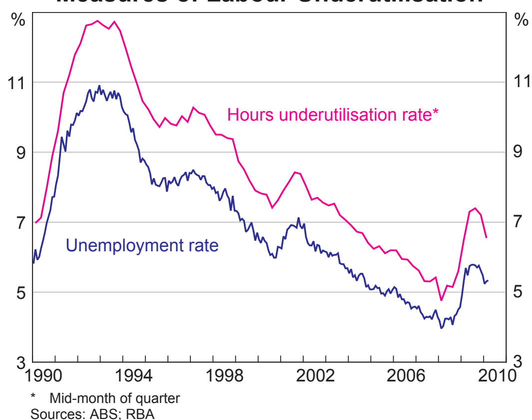
After falling to 5¼ per cent in January, the unemployment rate has been broadly unchanged in recent months and is ½ percentage point below its recent peak (Graph 51). A broader measure of labour underutilisation that includes the 'underemployed' – those workers who would like to work more hours – has also fallen since late 2009, but is still above pre-downturn levels. The recent decline in underemployment has been driven by a decrease in the number of full-time workers who are on reduced hours for economic reasons (such as insufficient work available), while the number of part-time workers who prefer more hours has remained elevated.

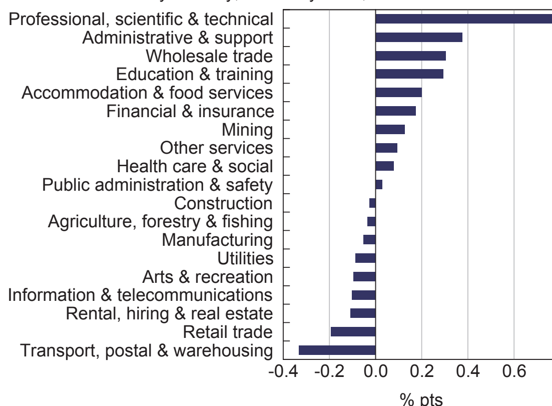
All states have recorded growth in employment in recent months. Since the trough in aggregate employment in mid 2009, employment growth in Victoria has been particularly strong. On an industry basis, employment growth has been concentrated in the services sector, particularly professional, scientific & technical services, as well as in wholesale trade and mining (Graph 52).

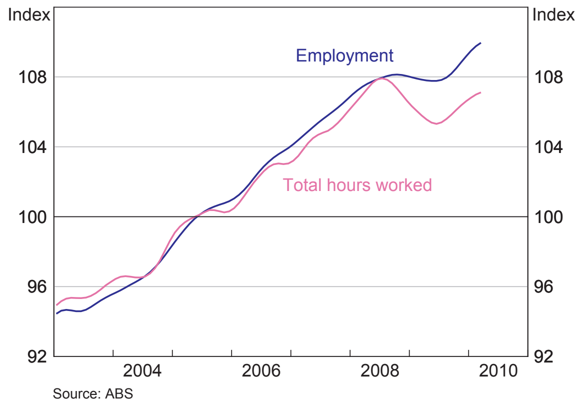
With much of the adjustment during the recent labour market downturn occurring via a reduction in average hours worked, it might have been expected that average working hours would have picked up before the number of people in employment. However, employment has grown at a solid pace over the past year, while average hours worked have remained subdued (Graph 53). The softness in average hours worked partly reflects the relatively strong growth in part-time employment since mid 2009; part-time employment has grown by over 4 per cent, while full-time employment has grown by 1¼ per cent. It also reflects that average hours worked by full-time employees are yet to retrace the declines recorded during the recent labour market downturn, when working hours were reduced in order to lower labour costs and preserve jobs.

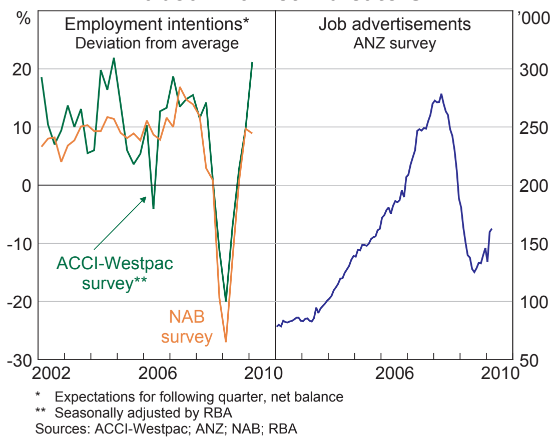
Forward-looking indicators point to solid employment growth in coming quarters. Business survey measures of hiring intentions have risen in











recent months to above-average levels (Graph 54). The recently reinstated ABS survey of job vacancies posted a strong increase in the three months to February, although vacancies as a proportion of the labour force still remain below mid-2008 levels. Likewise, the ANZ measure of total job advertisements continues to trend upwards, but also remains well below its peak in mid 2008. Consistent with these data, households continue to expect less unemployment in a year's time.

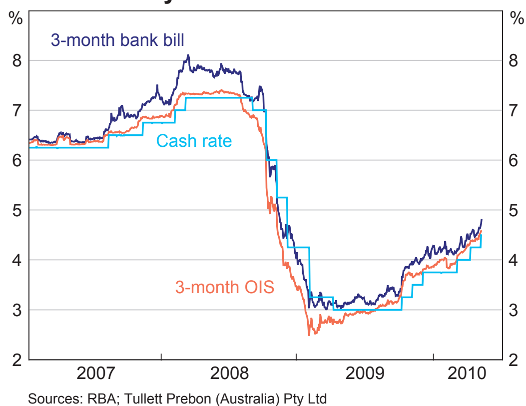
Domestic Financial Markets

Money Markets and Bond Yields

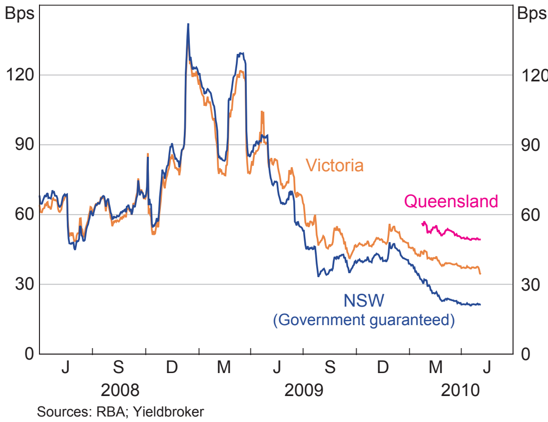
Over the past three months, the Reserve Bank Board has increased its target for the cash rate to 4.50 per cent. Money market yields indicate that the target is expected to rise to about 5 per cent by year-end. Bank bill rates have risen with the cash rate but have continued to be somewhat volatile (Graph 55). On average, bank bill spreads to overnight indexed swaps (OIS) have narrowed to pre-crisis levels for short maturities and are around their lowest since the onset of the crisis for longer maturities. Through its market operations, the Bank has kept exchange settlement (ES) balances around $1½ billion, although it accommodated somewhat higher ES balances over the quarter-end.

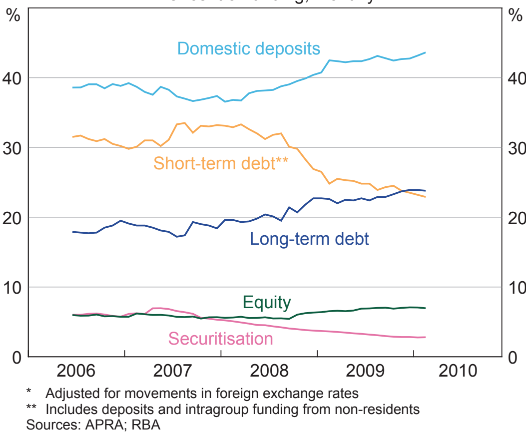
The yield on 10-year Commonwealth Government Securities (CGS) has increased by about 20 basis points since the February *Statement* to around 5.60 per cent, largely reflecting the strength of recent economic data. This has seen the spread to US Treasuries widen by a similar amount to reach 200 basis points. Yields on shorter-dated CGS have increased by a greater amount, as they are generally more responsive to changes in cash rate expectations. As a consequence, the yield curve has flattened with the spread between 10- and 3-year bonds declining by 30 basis points over the period (Graph 56). The issuance by the Australian Government continues to be met by strong investor demand, with bid-to-cover ratios averaging well above 3.

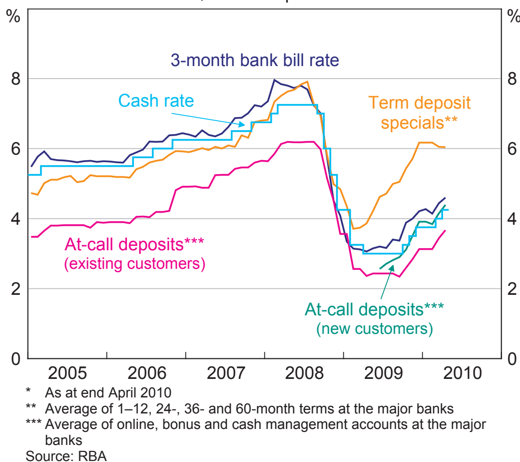
In February, the Australian Government announced that it would no longer offer a guarantee on new State and Territory borrowings after 2010. Both



NSW and Queensland – the two states to make use of the guarantee – have since issued several new unguaranteed securities of significant size, cheaper than if they had used the guarantee. NSW has also offered investors the capacity to switch from







some existing guaranteed debt into unguaranteed securities; the latter trades about 15 basis points higher in yield than the former (Graph 57). For Queensland, which has a lower credit rating, the spread between guaranteed and unguaranteed debt is about 20 basis points.

Financial Intermediaries

There has been a small change in the composition of banks' funding in the March quarter, with an increase in the share of funding sourced from deposits (Graph 58). There has been little change in the share of funding that comes from long-term capital market debt and domestic equity, while banks' use of short-term capital market debt continued to contract.

The intense competition for deposits has eased somewhat, though pressures for retaining deposit funding at a high level remain strong. The average interest rate on the major banks' existing at-call deposits (including online savings, bonus saver and cash management accounts) has risen broadly in line with the cash rate (Graph 59). Rates on new at-call deposits have also risen in line with the cash rate.

The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has declined slightly since end January. Nevertheless, it is still about 230 basis points higher than its level in early 2009, and around 80 basis points above market rates of equivalent duration. The major banks continue to offer higher interest rates on 'special' term deposits than on wholesale funds of equivalent maturity (both for short and long maturities). The smaller Australian banks' 'special' term deposit rates have increased by an average of 5 basis points since end January, to be slightly above the major banks' average rates.

Australian bank bond issuance proceeded at a more moderate pace over recent months after the large amount of issuance observed last year (Graph 60). Since the previous *Statement*, Australian banks issued

a total of $40 billion of bonds and continued to access a wide range of markets and currencies. Just over half of the issuance has been offshore and Australian banks have continued to lengthen the maturity of their liabilities by issuing longer-dated bonds. The average tenor of bonds issued recently is 4.4 years, up from 3.6 years a year ago.

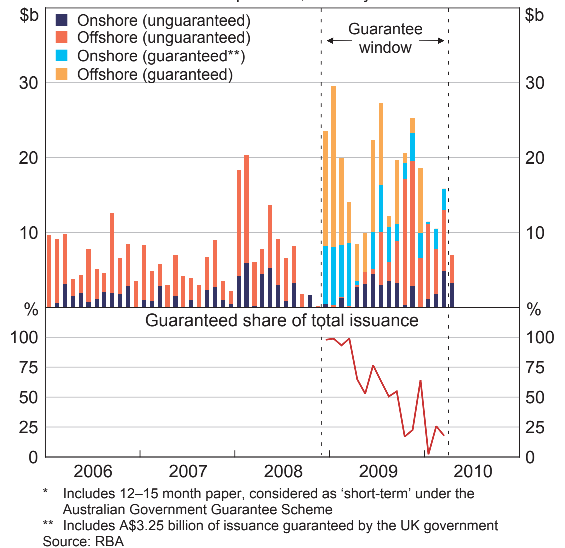
In early February, the Australian Government announced that the Government Guarantee Scheme would close to new issuance on 31 March. In the months prior to the closure of the Scheme, the guarantee was only used by non-major financial institutions. Since the inception of the Scheme in October 2008, a total of $171 billion was raised through the issuance of guaranteed bonds with a term of one year or more. About two-thirds of this total was issued in foreign currency, mainly US dollars, but also in eight other denominations. The maturity profile of Australian banks' guaranteed bonds is concentrated in 2012 and 2014 (reflecting sizeable issuance of 3- and 5-year guaranteed debt in 2009). Maturities in 2010 amount to around $10 billion, $730 million of which has already matured (Graph 61).

Over the last few months, secondary market spreads on guaranteed and unguaranteed bonds issued domestically by the major banks have narrowed and are around the lowest level since October 2007. The cross-currency basis swap spread – which represents an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – declined substantially over the last few months to around the levels of mid 2009, though it remains elevated compared with pre-crisis levels (Graph 62). The elevated cross-currency basis swap provides an incentive to non-resident issuers who borrow in Australian dollars and hedge into foreign currencies, including Kangaroo bonds which are issued in the Australian market. Over recent months, Kangaroo issuance has been very strong with the total amount outstanding reaching a record level

Graph 60

Australian Banks' Bond Issuance*

A$ equivalent, monthly

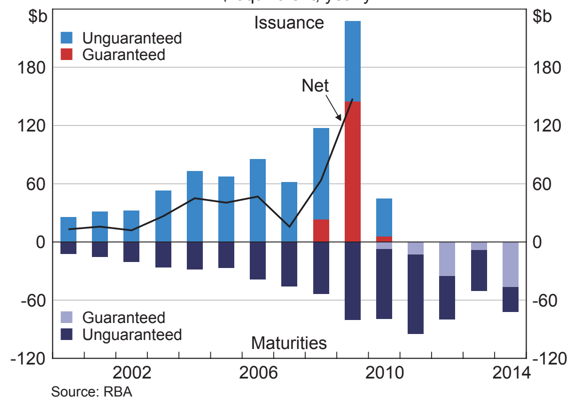


* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Includes A$3.25 billion of issuance guaranteed by the UK government
Source: RBA

Graph 61

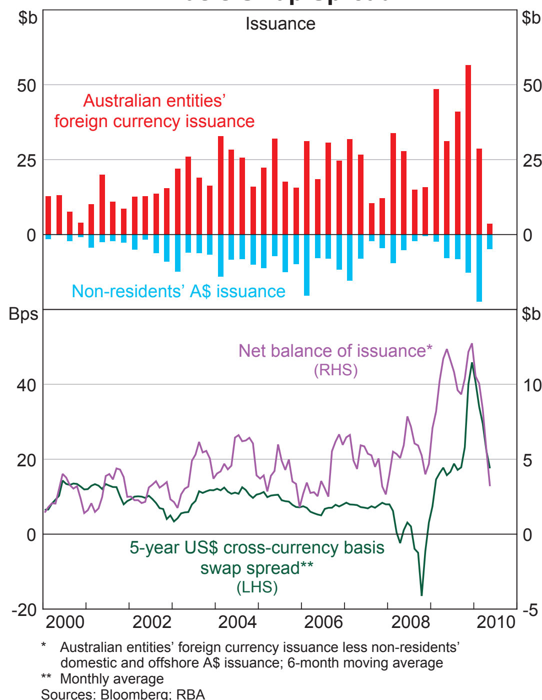
Australian Banks' Bonds

A$ equivalent, yearly



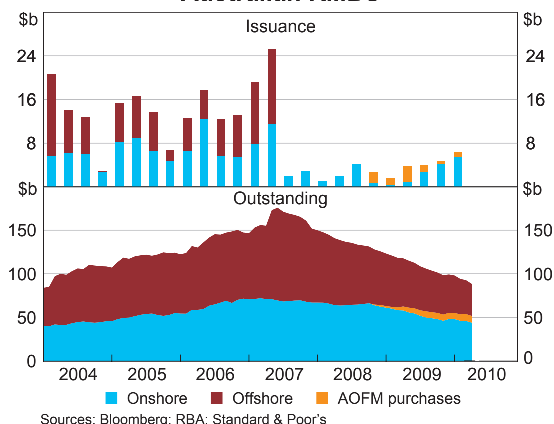
Source: RBA

Graph 62
Bond Issuance and the Cross-currency Basis Swap Spread



* Australian entities' foreign currency issuance less non-residents' domestic and offshore A$ issuance; 6-month moving average
** Monthly average
Sources: Bloomberg; RBA

Graph 63
Australian RMBS



Sources: Bloomberg; RBA; Standard & Poor's

of $125 billion. At the same time, foreign currency issuance that Australian resident issuers hedge into Australian dollars has slowed, broadly reflecting the more moderate pace of Australian bank bond issuance. This combination of issuance patterns has put downward pressure on the cross-currency basis swap spread.

Conditions in securitisation markets have continued to show signs of improvement, with issuance in the March quarter totalling $7½ billion, the largest quarterly amount issued since June 2007 (Graph 63). Since the last *Statement,* seven residential mortgage-backed securities (RMBS) deals amounting to $5.4 billion have been issued. This includes two deals totalling $1.8 billion issued without the support of the Australian Office of Financial Management (AOFM), one of which consisted of a larger share of low-doc loans than in recent deals. Around 15 per cent of issuance during the March quarter was purchased by the AOFM, down from around 80 per cent over the first half of 2009.

Domestic issuance of RMBS is around the levels required to offset the ongoing amortisation of principal (i.e. mortgage repayments). However, with no new offshore issuance since mid 2007 the stock outstanding has continued to decline, to be around half its June 2007 peak.

Spreads on AAA-rated RMBS tranches trading in the secondary market have remained broadly stable in the last few months, at around 140 basis points above BBSW, close to the spreads on new issues. At these spreads, new issues are likely to have been marginally profitable for issuers. Over the past year there has been a substantial narrowing in the gap between secondary and primary market spreads, suggesting the market has worked through much of the overhang of supply created by the portfolio liquidation of structured investment vehicles, which used to account for around one-third of the investor base.

The high quality of underlying collateral continues to underpin Australian securitisation markets. Losses on Australian RMBS (after proceeds from property sales),

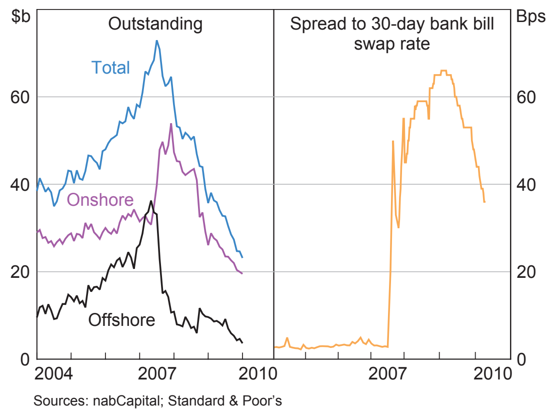
remain low as a share of the stock outstanding, at around 8 basis points per annum for prime and 165 basis points for non-conforming RMBS. Credit enhancements, such as lenders' mortgage insurance and the profits of securitisation vehicles, continue to provide cover for losses.

Conditions in shorter-term securitisation markets have improved over recent months. Spreads on asset-backed commercial paper (ABCP) have declined substantially and are now back to the level observed in November 2007, at 35 basis points (Graph 64). However, the amount of ABCP outstanding continues to decline, to $23 billion in January 2010 (the latest comprehensive data available). This 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).

Household Financing

Financial intermediaries have largely passed on the March and April cash rate increases to variable housing rates (Table 9). On average, variable interest

Graph 64
Australian ABCP



rates on prime full-doc housing loans (including discounts) increased by 50 basis points to 6.57 per cent in the three months to end April, though there was some variation across individual lenders. At the time of writing, the major banks have announced rate increases in line with the cash rate increase in May.

The major banks' interest rates on new 3-year and 5-year fixed rates on housing loans have increased

Table 9: Intermediaries' Variable Lending Rates
Per cent

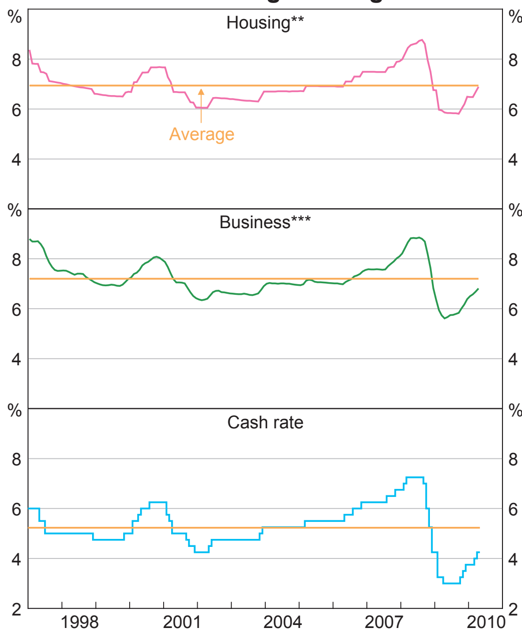
	Level at end April 2010	Change since: End Jan 2009	End April 2009	End Aug 2008
Cash rate	4.25	0.50	1.25	–3.00
Housing loans				
Prime full-doc	6.57	0.50	1.38	–2.48
Prime low-doc	7.17	0.50	1.36	–2.25
Personal loans	12.39	0.52	1.44	–0.70
Small business				
Residentially secured				
Term loans	8.34	0.50	1.26	–1.76
Overdraft	9.20	0.50	1.31	–1.71
Average actual rate[a]	8.26	0.50	1.15	–2.03
Large business				
Average actual rate, variable and bill funding[a]	6.36	0.33	1.35	–2.24

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

slightly since end January, reflecting increases in capital market yields. With fixed rates around 1½ percentage points higher than variable rates, the share of owner-occupier loan approvals at fixed rates has remained around its historical low of 2 per cent. This share has been well below its decade average of 11 per cent for almost two years, with the result that the share of outstanding loans at fixed rates has declined substantially. This has meant that the average interest rate on all outstanding housing loans (variable and fixed) has tended to move more in line with the variable housing rate during the latest tightening cycle, having increased by around 110 basis points from its low in 2009. It is now broadly in line with its average since 1997 (Graph 65).

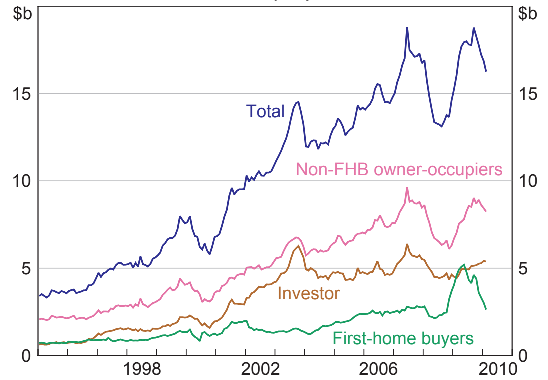
The value of housing loan approvals has fallen in recent months, after levelling out in mid 2009, with approvals to owner-occupiers decreasing by over 20 per cent since their peak in September 2009 (Graph 66). Preliminary evidence suggests that the value of loan approvals to first-home buyers has more than halved since its peak in May 2009, as government incentives were wound back from October and interest rates have risen. Housing loan approvals to investors have picked up.

Graph 65
Average Interest Rates on Outstanding Lending*



* As at end April 2010
** RBA estimates prior to 2001
*** RBA estimates; includes small and large businesses
Sources: ABS; APRA; Perpetual; RBA

Graph 66
Housing Loan Approvals*
Seasonally adjusted



* Excludes owner-occupier refinancing, alterations and additions, and investor approvals for new construction and by 'others'
Sources: ABS; RBA

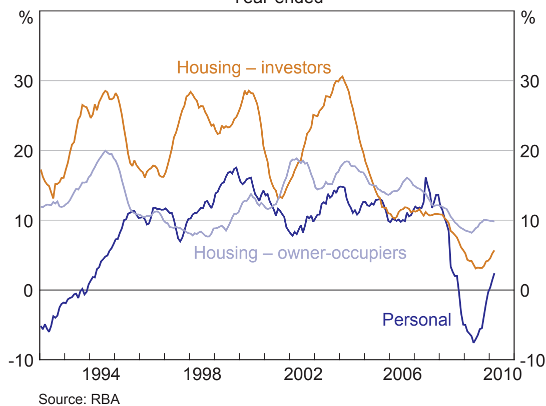
The five largest banks' share of gross owner-occupier loan approvals has declined a little over the 12 months to February, to around 79 per cent, though it is still well up from 60 per cent prior to the onset of the financial market turbulence in mid 2007. Correspondingly, the market shares of the smaller banks and credit unions and building societies have picked up slightly in recent months, while wholesale lenders' were little changed.

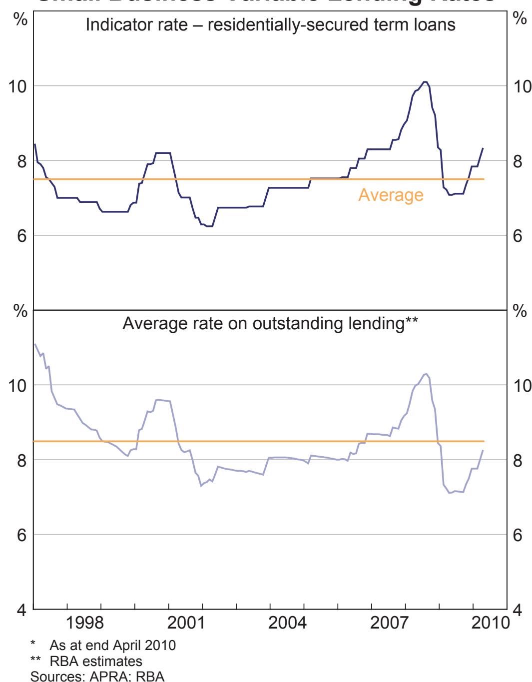
Housing credit growth has continued at a monthly average pace of 0.7 per cent in the March quarter (Graph 67). While owner-occupier housing credit has been the main driver of growth over the past year, lending to investors has picked up in the March quarter.

Financial institutions' rates on variable personal loans have risen by an average of 48 basis points in the three months to end April. Average variable rates on unsecured personal loans, home equity loans and standard credit cards have increased by 50 basis points, while rates on margin loans and low-rate credit cards have risen by around 45 basis points.

At the time of writing, most institutions had yet to announce any changes resulting from the May cash rate increase.

Personal credit, which is a small component of household credit, rose at a monthly average pace of 0.5 per cent during the March quarter. Growth in recent quarters was largely due to increased credit card lending together with more favourable conditions in the equity market supporting growth in margin lending. Despite the recent pick-up, the value of margin loans outstanding is little changed over the year, at around $19 billion. Given there was only a slight increase in volatility in equity markets over the quarter, the incidence of margin calls remained very low (at less than one margin call per day per 1 000 clients). Borrowers' gearing levels have also remained broadly stable at 35 per cent, as the value of collateral was largely unchanged.





Business Financing

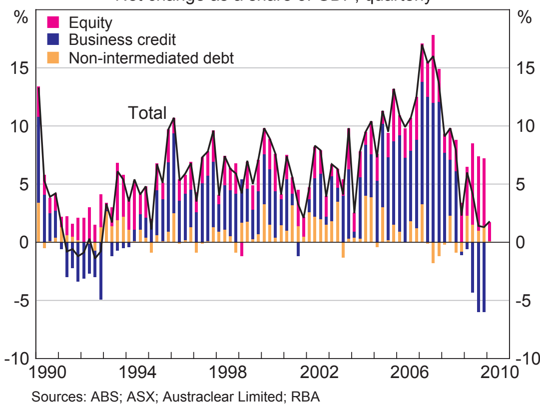
The major banks have increased their variable indicator rates on small business lending in line with the 125 basis points increase in the cash rate since the beginning of monetary policy tightening in October 2009 to end April (Table 9, Graph 68). Several of the larger banks have announced increases in their indicator rates following the latest tightening earlier this month. Average indicator rates on 1–5 year fixed-rate facilities have increased by 20–30 basis points since end January, broadly in line with corresponding swap rates.

Despite indicator rates on small business loans generally being above their averages since 1997, the average rate actually paid on outstanding small business loans will be around its average once the effects of the May tightening flow through to borrowers (Graph 68). The outstanding rate is more representative of the cost of finance to businesses, because it captures the fact that businesses have shifted to lower-interest rate products. Over the past decade, in particular, small businesses have made increasing use of loans secured by residential property. These loans usually do not have significant

additional risk margins attached to them and are more cost-effective than unsecured borrowings.

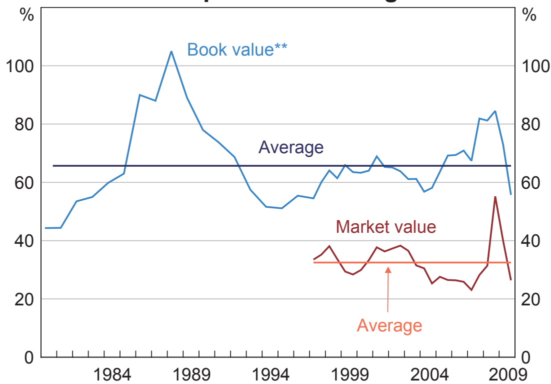
The average interest rate on banks' outstanding variable-rate lending to large business (i.e. variable-rate facilities of $2 million or more, including bill funding) is estimated to have increased by 33 basis points in the three months to end April, to 6.36 per cent. These loans are repriced at regular intervals off a money market benchmark (e.g. the 3-month bill yield) with the rise in line with higher market rates and a small increase in average risk margins as spreads on new loans are higher than those on existing loans. While the average spread on outstanding lending has continued to rise slowly, there are signs that credit conditions are easing for some borrowers and that the average spread on new lending has declined from mid 2009.

Graph 69
Business External Funding
Net change as a share of GDP, quarterly



Sources: ABS; ASX; Austraclear Limited; RBA

Graph 70
Listed Corporates' Gearing Ratio*



* Data exclude foreign-domiciled companies
** Data from 1997 include real estate companies
Sources: ABS; Morningstar; RBA; Statex; Thomson Reuters

Net corporate external funding was little changed over the March quarter, reflecting a moderate amount of equity raisings. Non-intermediated debt and business credit were little changed (Graph 69).

Commercial loan approvals have picked up modestly since last year. The process of corporate balance sheet consolidation that was occurring through most of last year seems to have run its course, with estimates of the rate of debt repayments declining in recent months. While there were only a small number of syndicated loan approvals in the March quarter, this followed a significant pick-up in syndicated loan approvals during the second half of 2009.

This balance sheet consolidation saw a continued reduction in listed corporates' gearing ratios. Book value gearing – the ratio of debt to the book value of shareholders' equity – declined by 17 percentage points over the December half 2009 to 56 per cent, to be around 30 percentage points lower than its peak in December 2008. This measure of gearing is currently around its lowest level since June 1997, and around 10 percentage points below its longer-run average (Graph 70). Declines in gearing were broadly based, with the largest reductions made by the most highly geared corporates (see 'Box B: Listed Corporates' Gearing Ratios').

Aggregate Credit

Total outstanding credit increased over the March quarter, reflecting the solid growth in household credit. Business credit was little changed over the quarter following falls throughout 2009 (Table 10). Growth in broad money has increased in recent months, partly reflecting a pick-up in term deposits. Over the year to March, broad money increased by about 4 per cent.

Table 10: Financial Aggregates
Percentage change

	Average monthly growth		Year to March 2010
	December quarter 2009	March quarter 2010	
Total credit	0.1	0.4	2.1
– Owner-occupier housing	0.8	0.7	9.8
– Investor housing	0.5	0.7	5.7
– Personal	0.6	0.5	2.4
– Business	–0.9	0.0	–6.9
Broad money	–0.3	0.8	3.8

Source: RBA

Equity Markets

Since the previous *Statement*, the ASX 200 is up 1 per cent, underperforming overseas markets. While the index is around 50 per cent higher than its March 2009 trough, it remains more than 30 per cent below its 2007 peak (Graph 71, Table 11). Falls in resources' share prices were more than offset by gains in financials' share prices, with rises reflecting stronger-than-expected earnings announcements by banks, both in Australia and overseas.

Graph 71

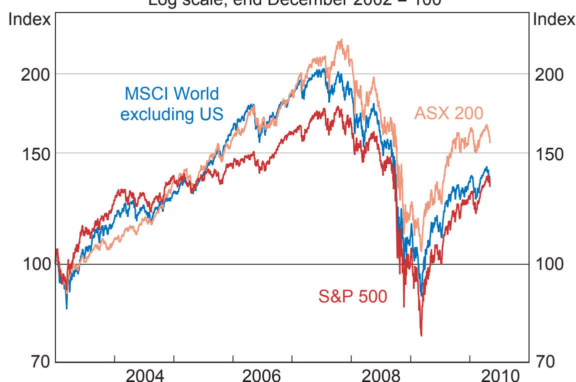


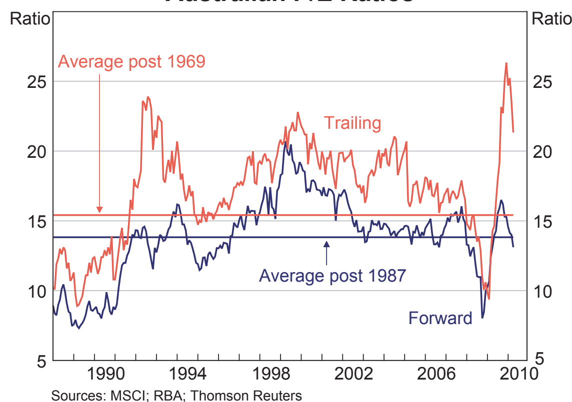
Table 11: Sectoral Movements in the ASX 200

	Per cent change since:		
	February *Statement*	Trough (March 2009)	Peak (November 2007)
Resources	–2	38	–24
Financials	4	74	–36
Other	0	33	–32
ASX 200	**1**	**49**	**–32**

Sources: Bloomberg; RBA

Graph 72

Australian P/E Ratios



Sources: MSCI; RBA; Thomson Reuters

Incorporating improved earnings expectations, the forward P/E ratio – which uses earnings forecasts for the next 12 months – is currently around 13, close to its long-run average (Graph 72). In contrast, the trailing P/E ratio remains high as share prices incorporate the anticipated rebound in earnings from the recently low reported earnings used in the trailing P/E ratio.

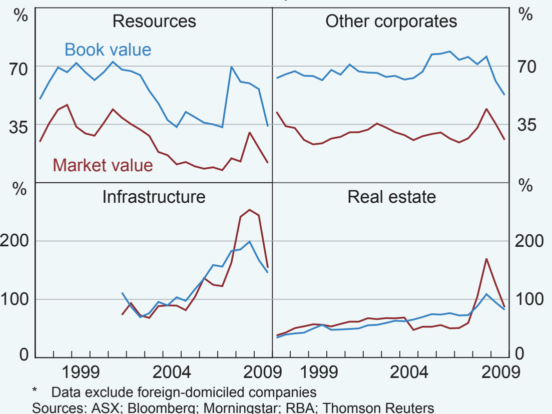
There has been a pick-up in M&A activity since the February *Statement* with a total of around $25 billion of deals announced. Recent deals continue to be funded by companies' high levels of cash holdings and by equity rather than by debt. As a percentage of assets, cash held by non-financial corporates is at its highest level since at least June 1997.

Box B

Listed Corporates' Gearing Ratios

The leverage of listed companies declined in all key industry sectors throughout 2009, although this masked significant differences in the behaviour of individual firms.[1]

For resource companies, which account for 54 per cent of market capitalisation but 24 per cent of debt, gearing declined sharply, falling close to historical lows. Rio Tinto's $18 billion capital raising to repay debt accounted for close to half of the fall. Domestically, resource companies raised a further $26 billion in equity over the course of 2009, lowering the gearing ratio for resources companies to around 34 per cent, half the level seen in 2008 (Graph B1).



In the non-resource sector, real estate and infrastructure companies continued to have the most highly leveraged balance sheets. Infrastructure companies reduced their gearing ratio to 146 per cent as they lowered their debt levels by 21 per cent over the course of 2009. Real estate companies also reduced their gearing, with the gearing ratio declining by 27 percentage points to 82 per cent. However, attempts by some real estate companies to reduce gearing over the course of 2009 were hampered by asset write-downs; ASX 200 real estate companies wrote off around $13 billion due to asset revaluations and asset sales over 2009.

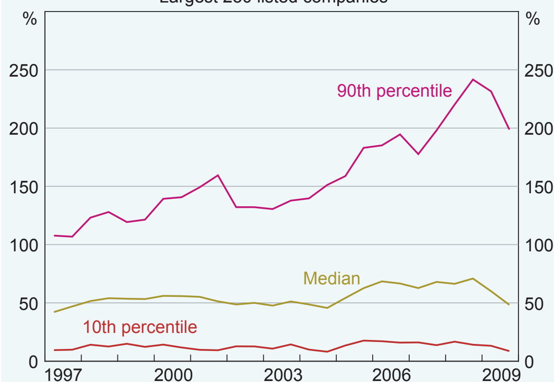
Other corporates (which account for 46 per cent of companies but hold 33 per cent of debt) experienced a more pronounced decline in gearing amidst equity raisings and debt repayments. In 2009, net equity raisings for other corporates totalled over $20 billion, over a third of which was raised with the intention to repay debt. Their gearing ratio declined to 53 per cent, close to the lowest level on record.

Over the year to December 2009, the decline in listed corporates' aggregate gearing was largest for the more highly geared firms. Companies with gearing ratios in excess of 100 per cent reduced their gearing by over 45 percentage points. Falls were especially prominent among resource companies.

Consistent with the more pronounced deleveraging of highly geared companies, the distribution of large non-financial companies'

1 This Box uses the book value measure of gearing unless otherwise stated.

gearing ratios narrowed further by the end of 2009 (Graph B2). The gearing of the company at the 90th percentile fell from a peak of around 240 per cent at December 2008 to around 200 per cent, while the gearing of the median company is now slightly below its long-run level. ✠



* Gross debt/shareholders' equity at book value

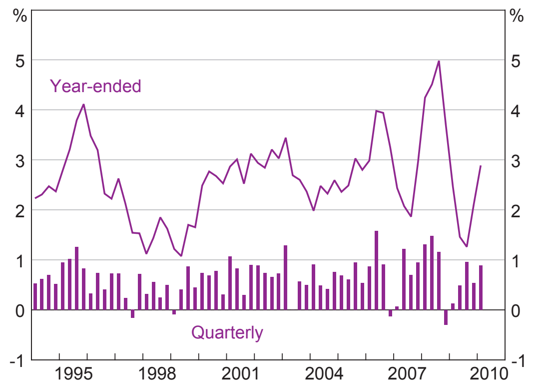
** Listed non-financial companies' excluding foreign companies, and including real estate companies; ranked by total assets

Sources: Morningstar; RBA

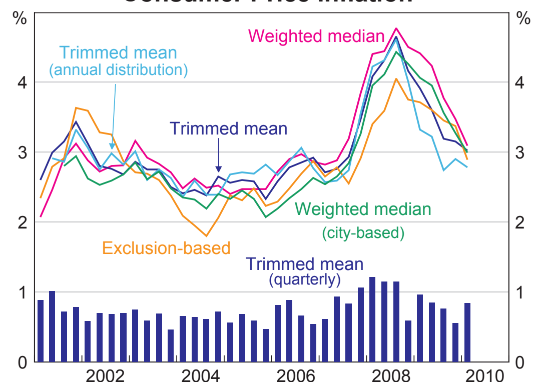
Price and Wage Developments

Recent Developments in Inflation

The consumer price index (CPI) increased by 0.9 per cent in the March quarter, to be 2.9 per cent higher over the year (Table 12, Graph 73). The quarterly outcome was boosted somewhat by seasonal price increases in items such as pharmaceuticals and education, and by increases in automotive fuel and deposit & loan facilities prices. Based on a range of measures, underlying inflation is estimated to have been around 0.8 per cent in the March quarter, which was a little higher than had been expected and above the outcome for the December quarter (Graph 74).[1] In year-ended terms, underlying inflation continued to moderate, to around 3 per cent, well down from the peak of a little above 4½ per cent over the year to September 2008. Accordingly, underlying and CPI inflation were broadly the same over the year to March, following a period since late 2008 when year-ended CPI inflation was considerably lower. The previous gap largely reflected sharp price declines in the volatile automotive fuel and deposit & loan facilities items in 2008/09, which have now largely dropped out of the year-ended calculations.



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



* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA

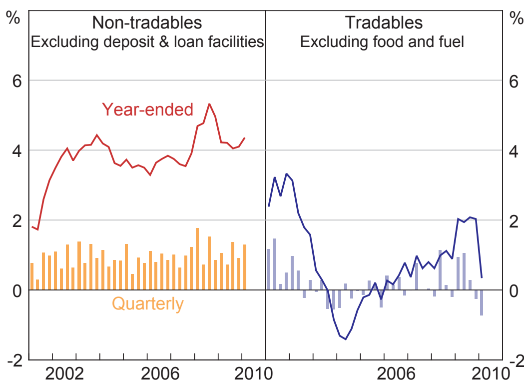
1 The exclusion-based series is the CPI excluding fruit, vegetables, automotive fuel and deposit & loan facilities. The weighted median (city-based) series is calculated using disaggregated quarterly price change data for each CPI item in each of the eight capital cities, rather than using national average 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).

Table 12: Measures of Consumer Price Inflation

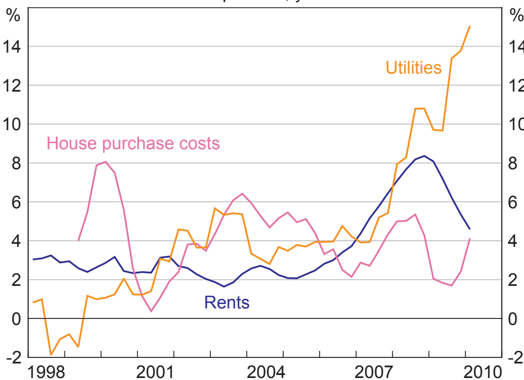
Per cent

	Quarterly		Year-ended	
	December quarter 2009	March quarter 2010	December quarter 2009	March quarter 2010
CPI	0.5	0.9	2.1	2.9
– Tradables	0.1	0.2	1.4	1.1
– Tradables (ex food & fuel)	–0.3	–0.7	2.0	0.3
– Non-tradables	0.8	1.5	2.6	4.2
Selected underlying measures				
Trimmed mean	0.5	0.8	3.2	3.0
Weighted median	0.6	0.8	3.5	3.1
CPI ex volatile items[(a)] and deposit & loan facilities	0.5	0.7	3.4	2.9

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



* Adjusted for the tax changes of 1999–2000
Sources: ABS; RBA



* Adjusted for the tax changes of 2000
Sources: ABS; RBA

Inflation in tradable and non-tradable items diverged further in the March quarter (Graph 75). Non-tradables inflation (excluding deposit & loan facilities) picked up to 1.3 per cent in the quarter, and 4.4 per cent in year-ended terms. Housing-related prices continued to make a significant contribution (Graph 76). Utilities prices continued to increase strongly in the quarter, largely driven by increases in Melbourne electricity and gas prices. More broadly, utilities prices have increased strongly in a number of states over the past year, or are expected to in coming quarters, partly reflecting the implementation of large price increases to help fund the upgrade of infrastructure. Inflation in house purchase costs has increased since mid 2009, partly due to the fall in the Federal Government's first-home buyer grant back to its earlier level. Rent inflation remained firm at 1 per cent in the quarter, consistent with the tight rental market.

In contrast, tradables prices (excluding food & fuel) fell by 0.7 per cent in the quarter, following a small decline in the December quarter, to be little changed over the year. The quarterly decline was due to fairly broad-based falls in retail goods prices, reflecting discounting by retailers, the appreciation

of the exchange rate through 2009, and the reduction in tariffs on motor vehicles (and parts) and a range of textile, clothing and footwear products, which took effect in January. The largest declines over the past year were recorded for audio, visual & computing prices, which declined by more than 6 per cent, and clothing & footwear prices, which fell by around 2 per cent.

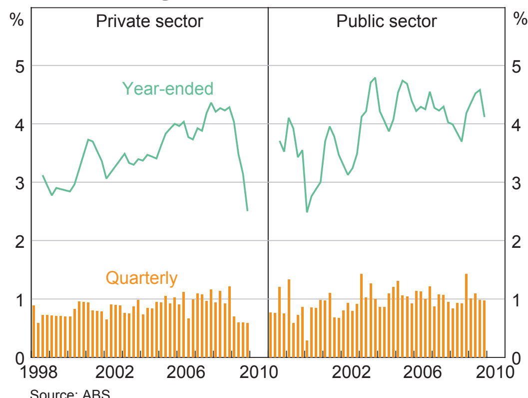
Overall, as expected, inflationary pressures have moderated substantially since late 2008, reflecting the significant easing in demand and capacity pressures and in wage growth, which act over time to dampen inflation. A further modest decline in year-ended underlying inflation is expected in the near term, although inflation is now forecast to fall by less than at the time of the February *Statement.*

Costs

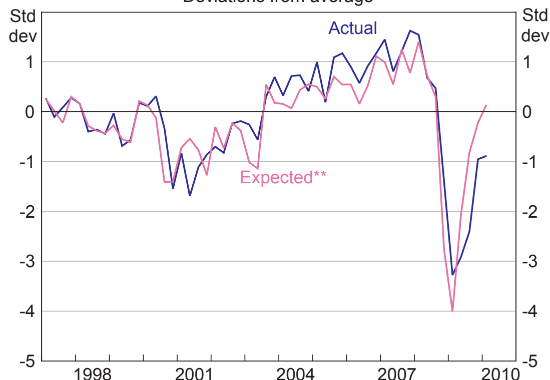
Labour costs have continued to grow at a below-average pace, due to the earlier easing in labour market conditions. The wage price index (WPI) increased by 0.6 per cent in the December quarter, half the pace recorded a year earlier. In year-ended terms, WPI growth moderated to 2.9 per cent, nearly 1½ percentage points below the peak in late 2008. This was largely due to an easing in private-sector wage growth to 2.5 per cent over the year to December, the slowest pace in the 12-year history of the series (Graph 77). Growth in public-sector wages remained solid, at 4.1 per cent over 2009. The moderation in wage growth was broad-based across states and industries, although it was particularly pronounced in Western Australia and South Australia.

Business surveys and the Bank's liaison suggest that wage growth remained below average in early 2010 (Graph 78). Firms are continuing to report relatively little difficulty finding suitable labour, although conditions have tightened somewhat over the past year (Graph 79). Consistent with the tightening in the labour market, growth in labour

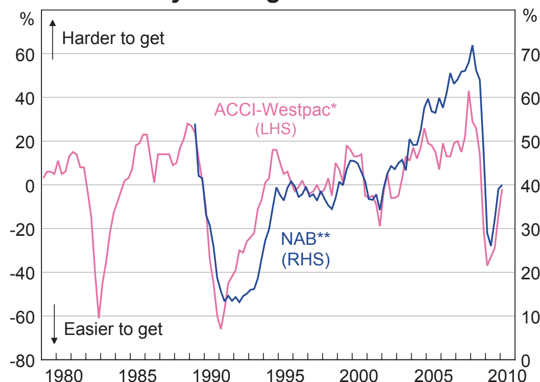
Graph 77
Wage Price Index Growth



Graph 78
Surveys of Business Labour Costs*
Deviations from average



Graph 79
Difficulty Finding Suitable Labour



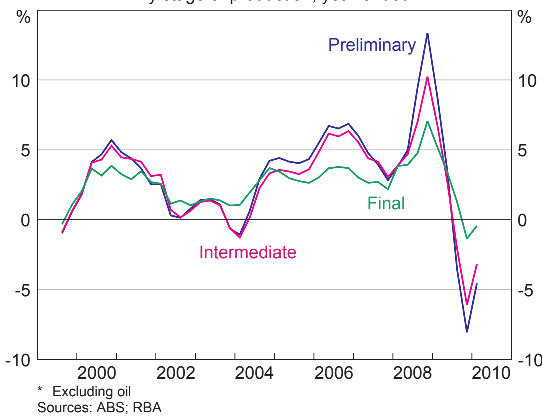
costs is expected to pick up over the next year, although not to pre-downturn levels.

Estimated labour productivity growth was relatively strong over 2009, which is not unusual during the early stages of an economic recovery. This followed fairly weak productivity growth in the years prior to the downturn. The combination of solid productivity growth and weak average earnings growth over 2009 – the national accounts measure of average earnings per hour was broadly unchanged – implied a significant moderation in labour costs per unit of output.

Upstream price pressures picked up in the March quarter, after pronounced weakness over 2009. Final-stage producer prices (excluding oil) rose by 0.8 per cent in the quarter, after falling through 2009 (Graph 80). This turnaround reflected developments in the prices of imported goods, with final-stage import prices (excluding oil) increasing by 1.2 per cent in the quarter, after declining by more than 12 per cent over 2009 as the exchange rate appreciated significantly. Domestic upstream price pressures were relatively firm in the March quarter, driven by increases in construction and utilities prices. Manufacturing output prices (excluding oil) rose by nearly 2 per cent in the quarter, after declining over 2009.

Inflation Expectations

Measures of inflation expectations have generally drifted up through 2009 and early 2010, following the sharp declines in 2008, with most measures now around, or a little above, average levels. Market economists' and union officials' inflation forecasts for 2010 and 2011 are around the top of the medium-term inflation target (Table 13),



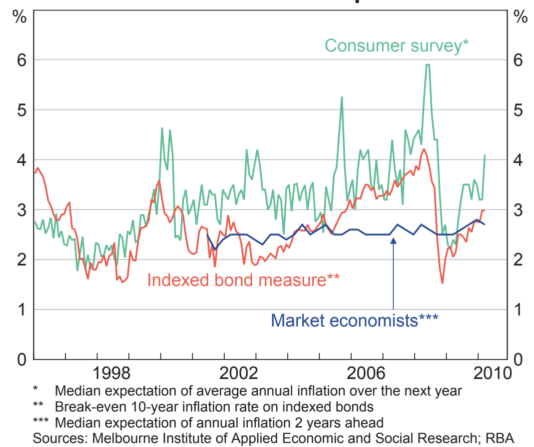


Table 13: Median Inflation Expectations
Per cent

	Year to December 2010			Year to December 2011	
	November 2009	February 2010	May 2010	February 2010	May 2010
Market economists[(a)]	2.2	2.3	3.1	2.9	3.0
Union officials[(b)]	2.6	3.0	3.1	3.0	3.0

(a) RBA survey
(b) Workplace Research Centre

although market economists expect inflation to moderate in 2012 (Graph 81). Measures of inflation expectations derived from financial markets have drifted upwards in recent months, with the measure derived from indexed bonds now slightly above its average over the inflation-targeting period. The Melbourne Institute's survey measure of consumer inflation expectations rose noticeably in April, but this series can be volatile at times. Business survey measures of expected selling price growth in the near term remain at below-average levels, despite some increase recently.

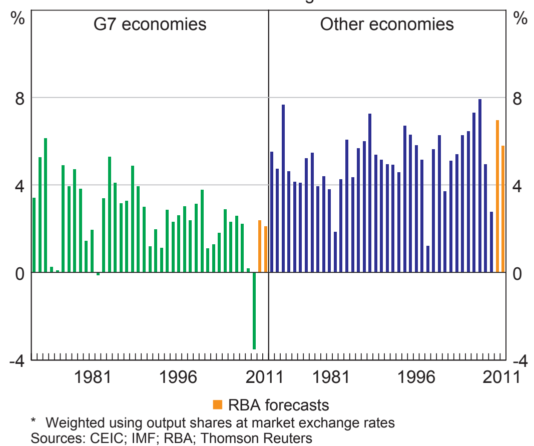
Economic Outlook

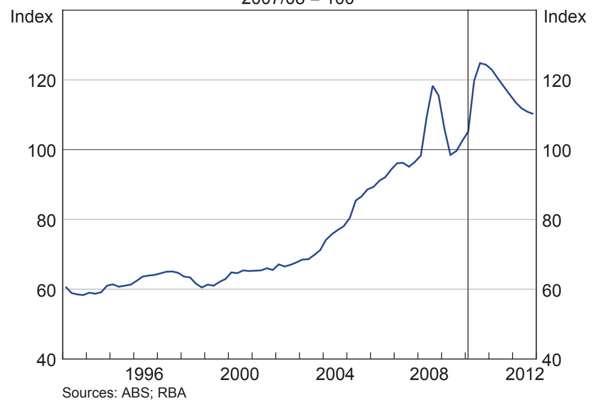
The International Economy

Conditions in the world economy have continued to improve since the February *Statement*. The recovery in Asia remained strong in the March quarter, representing a fourth consecutive quarter of rapid and broad-based expansion across the region. The recovery is less advanced in other parts of the world, although output has recently grown strongly in both North and South America, maintaining the momentum developed in the latter part of last year. In contrast, activity remains weak across the euro area.

The domestic forecasts are based on the expectation that global output will grow by just under 4½ per cent in year-average terms in 2010 and by around 4 per cent in 2011, with the forecast modest slowing in growth in 2011 reflecting the expectation of some withdrawal of policy stimulus in both the advanced and emerging economies (Graph 82). These forecasts are a little stronger than three months ago, particularly for 2010, reflecting the generally stronger-than-expected run of data over the past three months, especially in Asia. If achieved, they would be modestly above the average rate of global growth recorded during the decade prior to the recent global downturn. Risks to these forecasts are discussed below.

Australia's terms of trade are increasing strongly, and this year will probably regain the peak seen in 2008 (Graph 83). This is primarily due to higher prices for coal and iron ore, supported by an





increase in demand from China as well as the ongoing recovery in demand from other trading partners such as Japan and Korea. Although the recent upward momentum in spot prices suggests that contract prices could increase further, the forecasts assume a medium-term decline in prices and the terms of trade, as supply expansions come online and rising prices of steel products dampen end-user demand.

Domestic Activity

As discussed in earlier chapters, growth in the economy over the past year has been stronger than expected, supported by stimulatory settings for fiscal and monetary policy, the rebound in Asia, and a high rate of growth in the population. Business conditions are at above-average levels and employment is growing solidly, supporting household spending. Activity in the construction sector has been boosted by fiscal measures, although this boost will be wound back over the period ahead, with private demand becoming a more important driver of growth.

The central forecasts are summarised in Table 14 and are based on the technical assumption of some further rise in the cash rate over the forecast period, with the assumed path broadly consistent with market expectations. As noted in previous *Statements*, this technical assumption does not represent a commitment by the Board to any particular path for policy.

In year-ended terms, GDP growth is forecast to be around 3¼ per cent over 2010 and to strengthen to around 3¾–4 per cent over the remainder of the forecast period. In year-average terms, GDP is expected to grow by 2¼ per cent in 2009/10, 3½ per cent in 2010/11 and 3¾ per cent in 2011/12. Growth in the economy outside of the mining sector would be slower, reflecting the reallocation of resources within the economy. This is partly due to the high level of the real exchange rate, which is reducing the international competitiveness of import-competing and other exporting sectors such as manufacturing and tourism.

The rise in the terms of trade is expected to increase domestic incomes by around 4 per cent this year (although the boost to national income – the income accruing to Australian residents – will be smaller) and nominal GDP is expected to rise by close to 10 per cent over 2010. The high level of commodity prices and the terms of trade are contributing to a strong outlook for investment in the mining sector over the forecast period. The strength in the terms of trade will also have broader stimulatory effects on the economy via a number of channels. However, compared to a few years ago, a higher share of the income gain from the terms of trade is expected to be saved, reflecting both the difference in the Government's budget position and the current relative cautiousness of households. Growth is likely to be driven less by consumption than in earlier periods, with a modest increase in the

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

	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012
GDP growth	2.7	2½	3¼	3¾	3¾	3¾	4
Non-farm GDP growth	2.5	2½	3¼	3¾	3¾	3¾	4
CPI inflation	2.1	3¼	3¼	3	2¾	3	3
Underlying inflation	3¼	2¾	2¾	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$0.91, TWI at 71, WTI crude oil price at US$87 per barrel and Tapis crude oil price at US$90 per barrel.
Sources: ABS; RBA

saving rate expected, reflecting households being more cautious about the amount of debt they take on.

While the central forecast is for GDP growth in 2011 and 2012 to be above its longer-run average rate, this partly reflects the forecast above-average growth in the capital stock and the labour force. Nevertheless, the labour market is expected to tighten gradually over the forecast period, with solid employment growth and a gradual fall in the unemployment rate.

Inflation

Underlying inflation slowed to around 3 per cent over the year to the March quarter – down from a peak of just over 4½ per cent in September 2008 – and a further modest easing in the year-ended rate is expected in the near term, to around 2¾ per cent. This moderation reflects the significant easing in wage growth, capacity utilisation and demand pressures in late 2008 and over 2009, as well as the substantial appreciation of the exchange rate since early 2009.

Underlying inflation is then expected to gradually trend higher, to around 3 per cent in 2012, reflecting a gradual increase in capacity utilisation and demand pressures in the economy and some pick-up in wage growth as the labour market tightens. Inflation for a range of non-tradable items is expected to remain firm, and the dampening influence of the exchange rate appreciation on inflation for tradable items is also likely to wane through the forecast period. Overall, this forecast represents an upward revision since February, reflecting the slightly stronger-than-expected outcome for underlying inflation in the March quarter, the higher terms of trade and the upwardly revised outlook for domestic activity, offset somewhat by the further appreciation of the exchange rate.

CPI inflation is expected to be higher than underlying inflation in the near term, largely reflecting the recent increase in tobacco excise. Further out, CPI inflation is assumed to move in line with underlying inflation.

Risks

As always, there are risks in both directions around the forecasts.

Domestically, it is possible that the fading of the fiscal stimulus and the increase in interest rates to normal levels might have a larger effect on demand than has been incorporated in the forecasts. The tax allowances for investment spending and payments to first-home buyers both provided significant incentive to commit to spending decisions before the end of 2009, and government spending on infrastructure is expected to ease later in 2010. However, an upside risk is the possibility that the surge in commodity prices has more of an effect on demand than assumed in the central forecasts, with the current cautiousness among consumers and firms outside the mining sector not persisting. Firms in the mining sector could also attempt to push ahead with investment projects more rapidly than assumed in the central forecast, and there is some possibility that non-residential construction might pick up more quickly than currently expected as credit constraints ease. If this were to occur, capacity constraints, particularly in the construction sector, would be likely to emerge and wages would accelerate more quickly than currently expected. Growth in household consumption would be stronger and there could be further increases in housing prices. Overall, this scenario would result in growth and inflation both being higher than expected, though this would be more likely to occur in 2011 rather than the current year.

Internationally, it is possible that growth in the global economy will again surprise on the upside. Over the past year, the upside risks noted a year ago, resulting from the effects of synchronised policy responses and higher confidence, were those that materialised. However, the risks that are getting most attention at present are some specific ones on the downside. One of these is the challenge that rising public debt ratios in a number of advanced economies pose for the global economy. The central forecast is for a gradual fiscal consolidation that results in some dampening effect on global growth in the medium term. However, investors might become increasingly concerned about the medium-term fiscal situation, resulting in renewed high levels of risk aversion. If this were to occur abruptly it could prompt another period of global economic weakness and falls in commodity prices. Australia's good fundamentals would help, but the experience of late 2008 suggests that the willingness to invest abroad declines in such circumstances. The other major international risk for Australia is that rising inflation in Asia prompts a significant tightening of financial policies in the region, including in China. This could result in a significant slowing in activity in that region in the medium term, especially in sectors such as construction. This would lead to a reduction in the demand for steel-related and energy commodities and a reassessment of prospects for the resources sector in Australia.