Statement on Monetary Policy

The year to date has been marked by a contrast between a disappointing global environment and a resilient domestic economy. The recovery in the major economies has so far remained patchy, and information becoming available in the first half of the year tended to suggest that the likelihood of a more extended period of global weakness was increasing. During that period an additional source of external risk was presented by a strongly rising Australian dollar. Against this background, the Board took the view at its June meeting that the economy had entered a period where the monetary policy decision would be whether to hold interest rates unchanged or to reduce them. This assessment was made public shortly afterwards at the Governor's Parliamentary appearance on 6 June. Within the context of this broad strategic assessment, the Board judged at the time of the June meeting that the case for an easing was not sufficiently strong and, in the event, subsequent developments tended to weaken that case further, so that the cash rate was again held unchanged at the July and August meetings.

In broad outline the domestic non-farm economy remains in a strong condition, as is evident from a round-up of the major economic aggregates. Growth of non-farm GDP over the latest four quarters for which we have data was just over 4 per cent; domestic demand, while slowing a little from its most recent peak, expanded by 5½ per cent over that period; employment growth over the past year has been around trend, though lower in recent months, and the unemployment rate has remained close to the lower end of the range in which it has fluctuated over the past two decades. Inflation, both as measured by the CPI and according to most underlying measures, is currently 2¾ per cent, slightly above the target mid-point.

While the Australian economy remains in a position to perform relatively well against a weak international background, the pace of growth of the non-farm economy is likely to ease during the remainder of 2003. The growth of domestic demand is now in the process of slowing from its recent rapid pace, and in the short term this is unlikely to be offset by stronger external conditions. As a result, a slowing in the overall growth of non-farm GDP is expected, bringing it below trend during the course of 2003, before growth returns to around trend the following year. With conditions in the farm sector improving, the growth in total GDP should pick up earlier than the non-farm component. In the short term, since the Australian economy is still growing more strongly than its trading partners, this scenario would probably see some further widening of Australia's current

account deficit. Underlying inflation is expected to decline to around 2 per cent next year as the effects of the exchange rate appreciation work through, though on a longer time scale, trends in domestic labour costs are seen as consistent with inflation returning to around the middle of the target. In summary then, the outlook is for a temporary period of below-trend growth with inflation below the target mid-point. This follows a period in which growth and inflation have both been above those norms.

On its own, this outlook does not present a strong case for interest rates to be lower than they currently are. Australia's flexible inflation-targeting framework does not aim to fine-tune economic outcomes, but rather is designed to ensure that inflation remains on track over the medium term. This being the case, an inflation rate that is expected to move a modest distance away from the target mid-point would not of itself be a trigger for policy action, provided the medium-term outlook is consistent with the target. In the current context, the expectation of a temporary period of lower growth and inflation may well point to a case for monetary policy to be on the expansionary side of neutral, as it already is, but it is not of itself a case for moving to a more expansionary stance than is currently in place. That said, the current outlook would not stand in the way of a reduction in interest rates should a broader consideration of the balance of risks require it.

The key risks raising the possibility of an easing in monetary policy over recent months have been external. One is a possible failure of the world (particularly the US) economy to pick up. The central economic outlook described above is based on an assumed pick-up in global growth in the second half of 2003, along the lines that is widely incorporated in conventional forecasts. If the global economy were to fall short of those expectations it would further set back prospects for a recovery in Australia's exports. A second source of risk would be a further sharp appreciation of the Australian dollar, which might be driven by additional interest rate reductions around the world to combat a weakening global economy. If this occurred, it would have an additional contractionary effect on the export sector, as well as further dampening inflation.

Both of these risks increased appreciably in the first half of the year, with the international economic data generally disappointing and the Australian dollar on a strong upward trend during that period, particularly during May. More recent developments, however, suggest that the risks from these two sources have lessened.

First, regarding the global outlook, there have been some slightly more encouraging signs recently. Economic data in the United States have been a little more positive, showing, among other things, stronger-than-expected GDP growth in the second quarter, improvements in business sentiment, a rise in capital goods orders and a small pick-up in industrial production in the past couple of months, though the performance of the labour market has so far remained disappointing. While the signs of improvement are still tentative at this stage, they have been accompanied by a noticeable lift in sentiment in international financial markets. Bond yields around the world have increased sharply over the past two months, reversing the declines that occurred earlier in the year. In the US, yields are now over 100 basis points above the troughs reached in early June. Equity prices have also increased over the past few months to be more than 20 per cent above their recent troughs in most major international markets. Thus financial markets are now taking a more optimistic reading of economic prospects than was the case a couple of months ago.

Second, the strong upward trend in the exchange rate seen during the first half of the year has not continued. The exchange rate against the US dollar peaked at US68.5 cents in early July, but it subsequently came down quite sharply, falling by almost 4 cents in the middle of the month, and has shown little net change since. On a trade-weighted basis, the exchange rate is now around 4 per cent below its recent peak. The significance of this is not so much the new level of the exchange rate as the apparent change in direction and market

sentiment. The strong rise in the currency in the first six months of the year had been driven by investors chasing yields in the more stable economies, in what was a deteriorating climate for the world economy and share markets. More recently, however, investors have started to position themselves for a growth pick-up, and capital has flowed back into the US economy. This has taken the upward pressure off the Australian dollar. The same sort of sentiment can be seen within the share market, as investors have moved out of 'defensive' stocks (i.e. stocks thought likely to do well in an economic downturn) to 'cyclical' stocks which will respond best to a pick-up in economic activity.

For the present, then, the downside risks to the Australian economy from external sources appear less severe than they were a couple of months ago. Nonetheless, developments in these areas are subject to ongoing change and will continue to have a strong bearing on the policy assessment in the period ahead.

An additional complication for Australian monetary policy at present is posed by the rapid growth of credit and its flow-through into strongly rising housing prices. Currently, credit to the household sector is growing at an annual rate of about 20 per cent, well in excess of what could be considered sustainable in the medium to longer term (see the chapter on 'Credit Growth' for a detailed discussion). Much of this is flowing into the housing sector and is fuelling a rate of housing price increases of the order of 20–25 per cent around the country. Apart from inner Melbourne where apartment prices are falling, there are few signs yet of these pressures easing off. The latest indicators of housing prices continue to show strong growth in most areas, and new finance approvals for housing have been accelerating in the past few months.

The risk presented by these developments is that, the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn. Banks report that they are taking a prudent approach to lending for housing, with property loans well collateralised to withstand a fall in housing prices and significant safety margins built into households' loan repayments. But increasingly there are signs of worrying practices elsewhere in the financial system. This is not untypical of a prolonged bull market, and could cause a good deal of distress to the economy when the housing price cycle turns.

Alongside the borrowing for the purchase of housing assets, there is the phenomenon of housing equity withdrawal, whereby households are borrowing against rising housing values to fund other forms of spending. This process is estimated to have been augmenting household cash flows in the past year by around 4 per cent. In the short term, absent an adverse shock, this is likely to continue, thereby supporting demand growth. But were Australia to enter at some stage a period of declining housing prices, it is likely that this equity withdrawal would be scaled back, or would possibly go into reverse, resulting in a cutback in spending, with a potentially destabilising effect on the broader economy. The risk of a large impact from such an event will be greater the longer these current trends in credit and housing markets persist.

The current situation, in summary, suggests an outlook that is consistent with the medium-term inflation target but subject to two broad sources of risk – the potential for further weakness arising from external factors, and the destabilising influence of a growing imbalance in the domestic credit market. These two factors have conflicting implications for monetary policy, since lower interest rates would help to offset the first of these risks but would amplify the second. In its policy deliberations the Board has had to take into account the balance of these risks and the way they have evolved over time.

The Board's assessment at the time of its June meeting was that the balance of risks had shifted to a point where a case for reducing the cash rate needed to be brought under consideration. On balance, however, it was judged at that time that the case for an easing in policy was not sufficiently strong, so that the cash rate was held unchanged pending an assessment of further developments. While the situation is still subject to considerable

uncertainty, the external risks to the economy seem subsequently to have receded, at least for the time being, with global prospects looking a little better and the exchange rate no longer rising quickly as it had in the first half of the year. At the same time, the risks posed by developments in credit and asset markets have not diminished. Given these considerations, and the current assessment of the economic outlook, the case for an easing was judged to have weakened since June, and thus the cash rate was again kept unchanged at both the July and August meetings. ✠

International Economic Developments

Developments in the global economy were disappointing in the first half of the year, with little or no growth in Europe and only modest growth in the US, although most forecasters continue to expect a solid recovery in the second half of the year. In east Asia, China continues to record strong growth, although elsewhere the pace of growth has generally slowed. The latest Consensus forecasts are for GDP growth in the G7 group of countries of $1^1/_2$ per cent in 2003, similar to that achieved last year, rising to $2^1/_2$ per cent in 2004 (Graph 1). While downside risks to these forecasts remain, recent data in the United States have been slightly more encouraging and, in response, equity markets and bond yields have recorded solid increases (see the chapter on 'International and Foreign Exchange Markets'). In contrast, the recent European data provide little cause for near-term optimism.

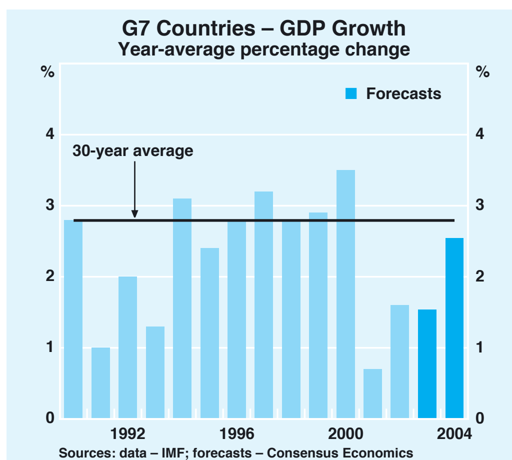
Given the disappointing growth outcomes over the first half of 2003, policy settings in the major economies have become more expansionary. The Federal Reserve, the ECB, the Bank of England and the Bank of Canada have all cut their policy rates in the past three months, as have central banks in many Asian economies. In addition, in a number of countries, fiscal policy has become more expansionary.

United States

The US economy has continued to recover from the recession in 2001, though the pace of growth slowed a little in the first half of the year, with GDP increasing by 2.3 per cent over the year to the June quarter (Graph 2, Table 1). In part, this outcome reflects the continuing headwinds arising from the unwinding of the excesses of the late 1990s and the reduced appetite for risk by executives following the corporate governance scandals. In response to the slow recovery, macro policy settings have become very expansionary. Nominal interest rates are at historical lows and new fiscal measures have shifted the budget into a sizeable deficit. Recently, financial conditions have also become more supportive of growth, with the stock market recording significant gains and the US dollar depreciating in trade-weighted terms.

It is too early to tell with certainty whether the headwinds are dissipating to allow the expansionary policy settings and easier financial conditions to deliver a pick-up in the

Graph 1



Graph 2

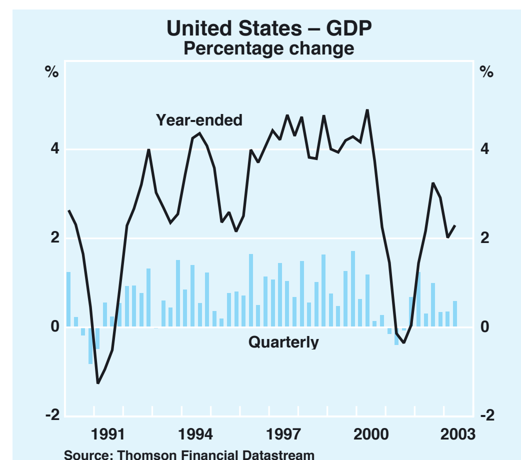


Table 1: United States National Accounts
Percentage change, seasonally adjusted

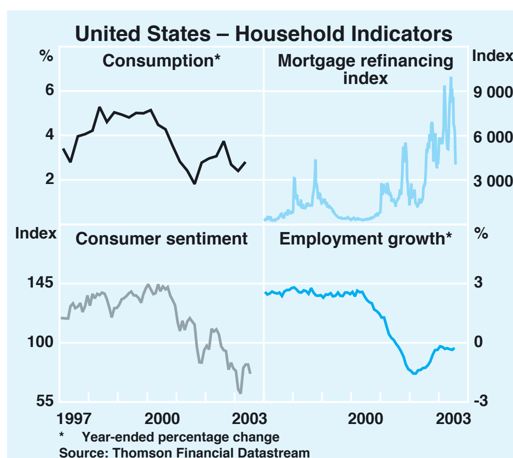
	March quarter 2003	June quarter 2003	Year to June 2003
Private consumption	0.5	0.8	2.8
Residential investment	2.4	1.5	6.6
Business investment	–1.1	1.7	0.9
Public expenditure	0.1	1.8	3.8
Change in inventories(a)	–0.2	–0.2	–0.2
Net exports(a)	0.2	–0.5	–0.7
– Exports	–0.3	–0.8	–1.5
– Imports	–1.6	2.2	3.2
GDP	**0.4**	**0.6**	**2.3**

(a) Contribution to GDP growth
Source: Thomson Financial Datastream

pace of growth. Nevertheless, there have been some positive signs of late. Manufacturing production rose in both May and June, with capacity utilisation edging up from its recent trough. Sentiment in the manufacturing industry, as measured by the ISM survey, has also improved to levels consistent with increases in production, and orders of durable goods have recently looked a little stronger.

Consumption has also continued to grow at a reasonable pace, to be up by 0.8 per cent in the June quarter (Graph 3). It has been underpinned by low interest rates and the associated pick-up in mortgage refinancing, along with solid growth in wages. While consumer sentiment fell in July, it still clearly exceeds its recent lows associated with the war in Iraq.

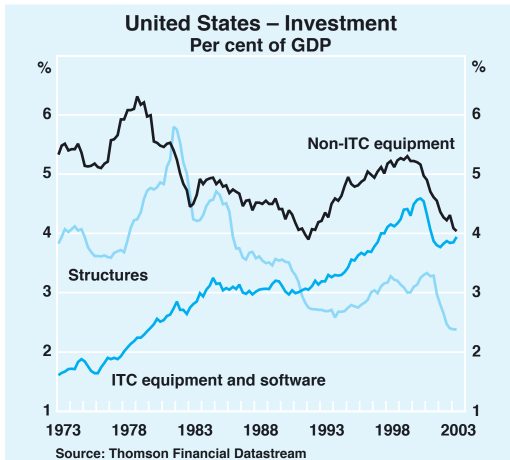
Graph 3



Fiscal policy has become more expansionary over the past year, with the recent fiscal package contributing to an estimated federal budget deficit of just over 4 per cent of GDP this year, up from around $1^1/_2$ per cent in 2002. Key elements of the package are the acceleration of scheduled income tax cuts and the reduction of the income tax rate on dividends and capital gains. All up, these tax cuts will cost US$350 billion (around 3.2 per cent of annual GDP) over the next five years, of which nearly half is to be implemented over the next year.

Two areas of the US economy that have been weak are business investment and employment, although recent data have been more positive. Following falls over the past two and a half years, business investment recorded an increase of 1.7 per cent in the June quarter (Graph 4). Investment in structures increased for the first time since the September quarter of 2001, although it remains at historically low levels as a share of GDP. Equipment investment also rose in the quarter, underpinned by strong spending on computer equipment, to be 3.8 per cent higher than a year ago. In addition, residential

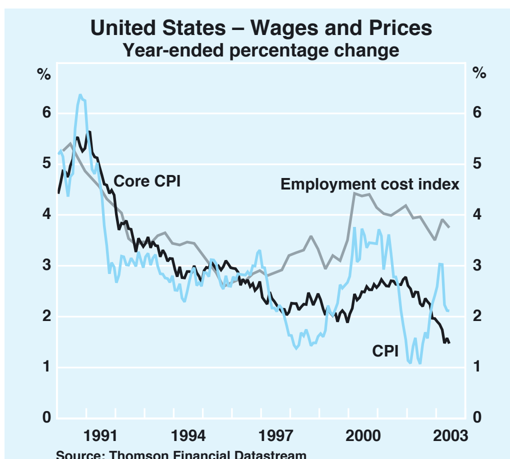
Graph 4



investment increased solidly in the quarter, to be up by 6.6 per cent on its year-ago level and forward-looking indicators suggest a continuation of high levels of activity in the housing sector.

Employment has fallen further in recent months and the unemployment rate has risen to 6.2 per cent, around the highest rate in nearly a decade. The pace of decline in employment has, however, slowed recently and job losses are noticeably less widespread across sectors than was the case earlier in the year. There are also signs that new claims for unemployment benefits have begun to fall.

Graph 5



With oil prices dropping after the onset of war in Iraq, year-ended consumer price inflation slowed to 2.1 per cent in June (Graph 5). Core inflation also eased to 1.5 per cent over the year to June as growth in services prices edged lower and goods prices fell by 1.9 per cent. Stating that the risk of a substantial fall in inflation was greater than the risk of a substantial rise, the Fed lowered the federal funds rate by 25 basis points to 1 per cent in June.

Asia-Pacific

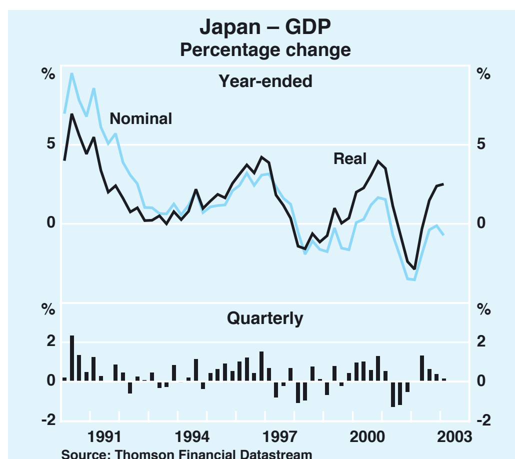
Japan

Recent indicators in Japan have been slightly more positive than those earlier in the year, with business sentiment and profits looking stronger. Despite little growth in production, business investment rose strongly in the March quarter and the Tankan survey measure of investment intentions in the manufacturing sector lifted in the June quarter. Machinery orders have also picked up in recent months.

In contrast, the services sector has shown few signs of improvement with the Tertiary Activity Index remaining broadly flat. The labour market has also remained weak, with the unemployment rate continuing to hover around 5¼ to 5½ per cent, as has been the case for the past 18 months or so.

Japan continues to experience deflation, although recently some temporary factors have slowed the decline in consumer prices. The CPI fell by 0.4 per cent over the year to June, compared with falls of nearly 1 per cent in the past few years. However, fresh food, petroleum products and medical expenses (which have risen temporarily due to health sector reforms) accounted for most of the apparent slowing in the rate of deflation. In contrast to consumer prices, the GDP deflator has fallen particularly sharply, to be 3¼ per cent lower over the year to March. The level of nominal GDP is now lower than it was in 1995 and this is complicating the challenge of correcting Japan's ongoing business and bank balance sheet problems (Graph 6).

Graph 6



Non-Japan Asia

After a strong performance during 2002, growth in most of the economies of non-Japan Asia has weakened so far in 2003 (Table 2). The slowdown was evident prior to the outbreak of Severe Acute Respiratory Syndrome (SARS), and was most evident in consumption growth. This was particularly the case in Korea, where policy initiatives aimed at restraining household borrowing contributed to a decline in consumption of 2 per cent in the March quarter.

In the June quarter a number of economies in the region were affected by SARS, although with the outbreak now contained, signs of a recovery are evident, particularly in Hong Kong and Singapore (see Box A on 'SARS'). Notwithstanding recent weakness in the region, both Thailand and China continue to record relatively healthy growth, despite some slowing of late. In China, GDP grew by just under 7 per cent in the year to the June quarter, with the value of exports increasing by around 35 per cent over the year (see Box B on 'China and International Trade').

Consistent with the generally weaker outcomes across the region, consumer price inflation has slowed in most countries and labour markets appear to have softened. The unemployment rate rose to a record high in Hong Kong in June and was also up in Korea over recent months. These weaker outturns across the region and the outbreak of SARS prompted several countries to implement supplementary fiscal packages. Malaysia released a package worth around 2 per cent of GDP, and measures introduced by Korea, Hong Kong and Taiwan amounted to approximately 1 per cent of GDP in each case. In addition, monetary policy has been loosened in most countries in recent months.

New Zealand GDP grew by 0.6 per cent in the March quarter to be 4 per cent higher over the year. Domestic demand, which had been strong for several quarters, has, however, lost

Table 2: Non-Japan Asia GDP
Percentage change

	December quarter 2002	March quarter 2003	Year to March 2003
China	–	–	9.9
Hong Kong	1.7	–0.3	4.6
India	–1.2	1.8	4.9
Indonesia	0.0	0.6	3.6
Korea	2.0	–0.4	4.0
Malaysia	0.5	0.2	4.0
Philippines	2.4	–0.5	4.4
Singapore	0.1	0.3	1.5
Taiwan	1.1	0.4	3.1
Thailand	2.1	1.5	6.8

Source: CEIC

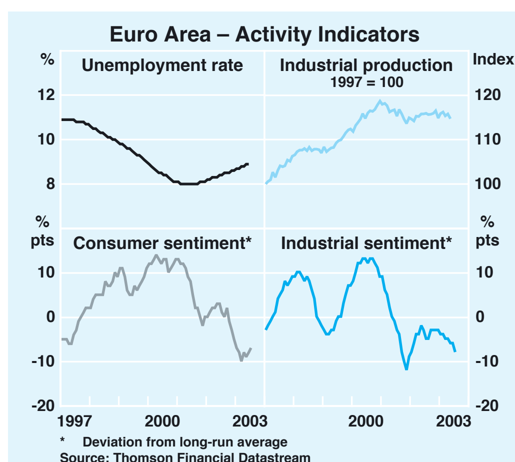
some momentum recently. Net exports have been little changed over the year, although merchandise exports have fallen over the past few months. The value of retail trade has also weakened recently. Year-ended inflation slowed further to 1.5 per cent in the June quarter, partly due to the appreciation of the New Zealand dollar and the recent decline in oil prices. Against this background, the Reserve Bank of New Zealand cut official interest rates by 25 basis points in both June and July to 5.0 per cent.

Europe

The euro area economy appears to have all but stalled after showing some tentative signs of recovery earlier last year. Output rose only marginally in the March quarter, to be 0.9 per cent higher than a year ago, with little sign of improvement in prospect for the June quarter (Table 3). Export weakness, partly related to the appreciation of the euro, has been a key factor, as has the continuing contraction in investment spending. Industrial production has also fallen in recent months to be back around its end 2001 level, and business sentiment has generally shown renewed weakness (Graph 7). Conditions remain particularly unfavourable in Germany and have now worsened in France, with falling production and exports and a pronounced weakening in business sentiment in recent months.

Household consumption has been one of the few areas showing positive, albeit modest, growth in the euro region. While recent retail sales figures point to continuing growth in consumption in the near term, the poor state of the labour market and low levels of consumer confidence are likely to crimp future household spending (Graph 7). The unemployment rate for the euro area as a whole stood at 8.9 per cent in June, up almost 1 percentage point from the late 2001 trough. This has resulted in some slowing in labour cost growth, with the area-wide measure of labour costs 2.8 per cent higher over the year to the March quarter, compared with an increase of 3.7 per cent over the year to the December quarter.

Graph 7



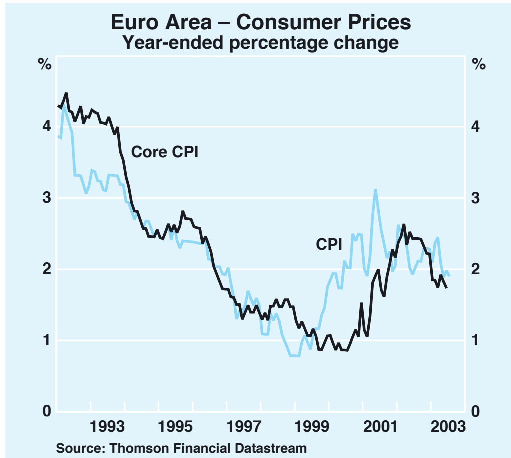
Euro area consumer price inflation was 1.9 per cent in the year to July (Graph 8). Given an absence of inflationary pressures and weak economic conditions, the ECB cut its key policy rate by 50 basis points to 2 per cent

Table 3: Europe GDP
Percentage change

	December quarter 2002	March quarter 2003	Year to March 2003
Euro area	0.1	0.1	0.9
– Germany	0.0	–0.2	0.2
– France	–0.1	0.3	1.1
– Italy	0.4	–0.1	0.8
United Kingdom	0.5	0.1	2.1

Source: Thomson Financial Datastream

Graph 8



in June. This followed a clarification by the ECB in May that its monetary policy strategy is to aim for year-ended inflation below, but close to, 2 per cent. Efforts have also been made recently to maintain expansionary fiscal policy settings. Despite an 'excessive' deficit under the provisions of the Stability and Growth Pact, Germany intends to implement additional tax cuts early in 2004.

Economic activity in the United Kingdom has been more buoyant than in the euro area for the past few years. More recently, however, growth has also slowed, with GDP increasing by 0.3 per cent in the June quarter, after posting little growth in the previous quarter, to be 1.8 per cent higher over the year. A major contributor to the weakening has been a drop-off in the pace of household spending, as wages growth and the rate of increase in housing prices have both slowed. On the production side of the economy, manufacturing output looks to have stabilised after two years of contraction, partly as the result of the depreciation of the pound against the euro. Overall, the labour market remains firm, with the claimant measure of the unemployment rate at 3.1 per cent in June, close to historical lows.

Inflation in the United Kingdom has slowed recently. In June, year-ended retail price inflation was 2.8 per cent, down from 3 per cent earlier in the year. Year-ended growth in the harmonised measure of prices, which is comparable to the measure targeted by the ECB, has slowed more sharply to be 1.1 per cent, down from 1.6 per cent at the beginning of the year. On average, the harmonised measure has been 3/4 of a percentage point below the retail series, although the differential between these measures has widened recently. Citing weak external demand and the prospect of below-trend growth, the Bank of England cut official interest rates by 25 basis points in July.

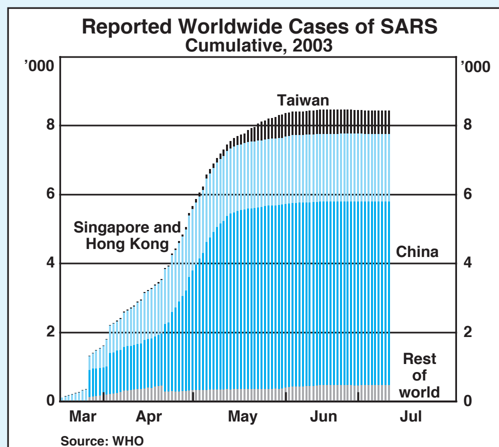
Box A: Severe Acute Respiratory Syndrome (SARS)

The world economy has been subject to a series of 'one-off' events over recent years, the latest of which has been the outbreak of the respiratory disease known as SARS in mid March. Initially, the disease spread quickly, sparking fears of a possible global health crisis. However, effective public health responses meant that by early July, the World Health Organisation (WHO) was able to declare the SARS outbreak contained and had lifted all SARS-related travel warnings. In total, around 8 500 cases of the disease have been detected and 800 deaths recorded, with countries in east Asia most affected (Graph A1). The number of cases has been considerably less than that initially feared and much less than the 250 000 to 500 000 deaths that occur worldwide from influenza each year.

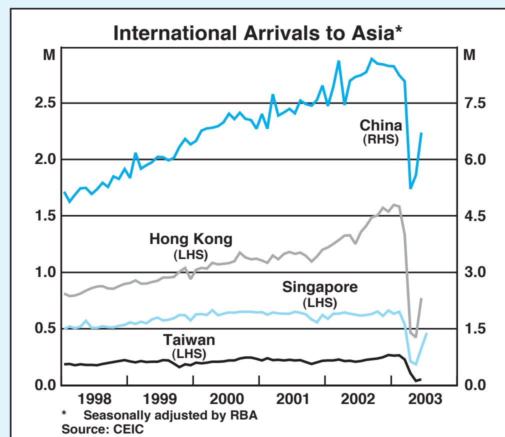
International organisations generally estimated the adverse effect of SARS on GDP growth in non-Japan Asia to be around $^1/_2$ percentage point, with the effect concentrated in the June quarter. The economic impact was quickly apparent in the international travel data. Given their heavy reliance on tourism, and their importance as business centres, Hong Kong and Singapore have been the hardest hit, with international arrivals falling by 70 per cent between March and May (Graph A2). The effect of this fall was compounded by a sharp drop in spending by domestic residents with retail sales falling by $8^1/_2$ per cent in Hong Kong in April. While international arrivals and retail spending have since recovered somewhat, both the Hong Kong and Singapore economies appear to have contracted sharply in the June quarter. China's economy was also adversely affected by SARS in the June quarter, although year-ended growth remained almost 7 per cent. More generally, the economic effect of SARS on east Asian economies seems to have been less than was originally feared.

While SARS was largely confined to Asia, it led to a world-wide downturn in international travel that affected many countries, including Australia. Internal quarantine arrangements saw a sharp drop-off in international travel from SARS-affected countries, and by those travelers from Europe and the United States seeking to avoid Asian stopovers. There was also less

Graph A1

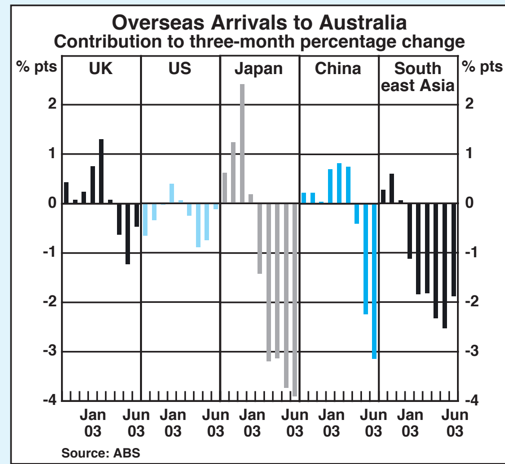


Graph A2



outbound travel from those countries that are traditionally sensitive to travel warnings, such as Japan. For Australia, the drop-off in inbound travelers from Japan contributed significantly to the decline of around 20 per cent in international arrivals between January and May this year. In June, however, there was some pick-up in international travel with overseas arrivals increasing from south east Asia, while arrivals from China and Japan remained very low (see Graph A3 and the chapter on the 'Balance of Payments'). Furthermore, airport bodies report that the recovery in arrivals continued into July and that forward bookings for August are looking more positive. ✠

Graph A3

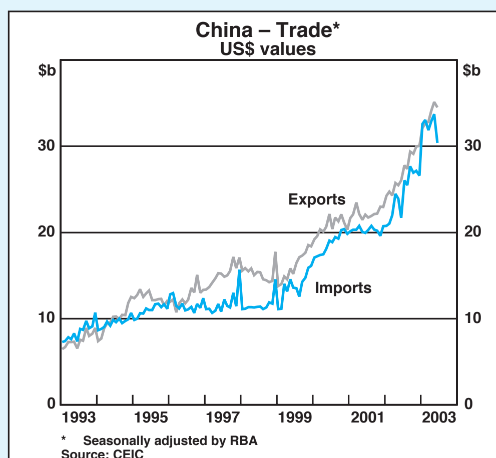


Box B: China and International Trade

The ongoing integration of China into the world economy is reshaping the trading patterns of many countries, including Australia. Over the past year, the value of China's international trade has risen by around 35 per cent, and in the March quarter, China surpassed Japan to become the third largest goods trading country in the world (Graph B1). China now accounts for around 5 per cent of world merchandise trade, up from 2 per cent 10 years ago.

The majority of China's trade is with countries in the Asian region, with around 65 per cent of China's imports sourced from the region, and around half its exports going to the region (Table B1). China's trade with a number of Asian countries, most notably Japan, Korea and Taiwan, has grown particularly strongly, and this has contributed to a 32 per cent rise in intra-regional east Asian trade since 1999. Excluding China, intra-regional trade has increased by a much more modest 13 per cent over this period. China has also recorded strong growth in trade with countries outside Asia, with exports outside the region more than doubling since 1999. In contrast, east Asia's exports (excluding China) to the rest of the world are broadly the same as they were in 1999.

Graph B1



China runs large trade deficits with most east Asian countries, but these are more than offset by trade surpluses with the United States and Europe. Overall, China's trade

Table B1: China – Merchandise Trade by Region
US dollars, per cent

	Exports			Imports		
	Share of total	Annual growth		Share of total	Annual growth	
	2002	1999 to latest	Latest year	2002	1999 to latest	Latest year
United States	21	13	31	9	1	27
Europe	15	11	47	13	7	44
Japan	15	7	27	18	11	37
Hong Kong	18	14	16	4	6	1
Rest of Asia	20	16	39	43	22	44
Australia	1	14	36	2	13	29
Other	10	20	44	11	24	50
Total	**100**	**13**	**33**	**100**	**14**	**40**

Source: CEIC

surplus has averaged around $2^1/_2$ per cent of GDP over recent years.

China's imports and exports are both dominated by manufactured goods, with intermediate manufactured goods, including machinery and transport equipment, comprising a higher share of imports than exports (Table B2). In part, this reflects the increasingly important role that China plays in the processing of higher value-added goods. Both imports and exports of information technology and communications (ITC) equipment have grown strongly over recent years, with China now accounting for a larger proportion of world ITC equipment exports than any other country in the region except Japan.

Like a number of other countries, Australia has benefited from the rapid growth in China's trade, with its merchandise exports to China more than doubling over the past four years. China is now the fourth most important destination for Australia's exports, up from tenth position in 1990. The main impetus to this increase has come from China's demand for resources, with resource exports having grown at an average annual rate of 15 per cent over the past decade (Graph B2). As a result of this sustained growth, the share of Australia's total exports to China accounted for by resources has increased from 45 per cent in 1990 to around two-thirds today. Overall, Australia has maintained its share of Chinese imports since the late 1980s, with Australia accounting for around 10 per cent of China's resource and rural-based imports on average.

Graph B2

Australia's imports from China have also grown rapidly over recent years, with over 90 per cent of merchandise imports being manufactured goods, of which an increasing share is ITC equipment. The strong growth in low-cost imports from China has contributed to the relatively weak pricing pressures in the markets for many manufactured goods. ✠

Table B2: China – Merchandise Trade by Commodity
US dollars, per cent of total

	Exports		Imports	
	1999	2002	1999	2002
Primary products	10	9	16	17
Manufactured goods	90	91	84	83
– Machinery and transport equipment	30	39	42	46
of which ITC goods	23	31	25	29
– Clothing and footwear	20	16	1	1
– Other manufactured goods	40	36	41	36
Total	**100**	**100**	**100**	**100**

Source: CEIC

International and Foreign Exchange Markets

Soon after the previous *Statement* was published, sentiment in financial markets began to deteriorate noticeably. Markets were worried by the fact that incoming economic data were on the weaker side of expectations in both the US and Europe. They also interpreted statements from the US Federal Reserve around that time as indicating that the Fed was increasingly concerned about the possibility of deflation in the US economy and that it might buy long-term bonds to add to monetary stimulus. The impact of this was most pronounced on bond yields, though there was also a pause in the recovery in the US share market that had been underway and the US dollar weakened further.

Market pessimism intensified through to the first half of June, with bond yields falling to their lowest level for about 50 years. Thereafter, however, the situation began to change. A trigger for this was the release of consumer price data which showed a significant increase for the month of May, reducing market concerns about deflation. This was reinforced later in June by economic data which showed that the economy was not deteriorating further and by the Fed's decision to cut official interest rates by 25 basis points rather than the 50 basis points that had been widely anticipated. All this served to restore some confidence in prospects for a recovery in US growth in the second half of 2003. In the process, bond yields rose and, by late July, they had more than reversed the fall that had occurred since May. Share markets also resumed their rise, and the US dollar recovered somewhat.

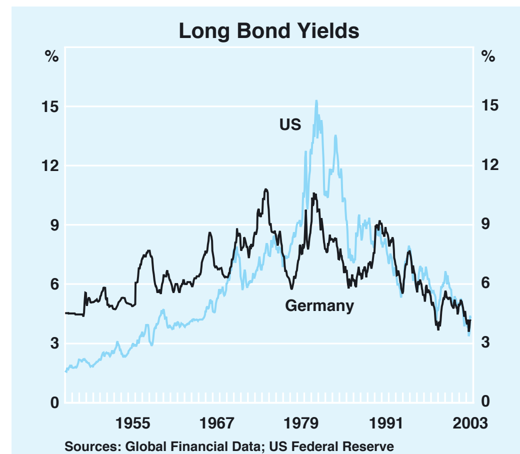
All in all, sentiment in financial markets has swung quite widely in the period since the last *Statement*, from gloomy in the first half of the period to more positive in the second half.

Money and bond yields

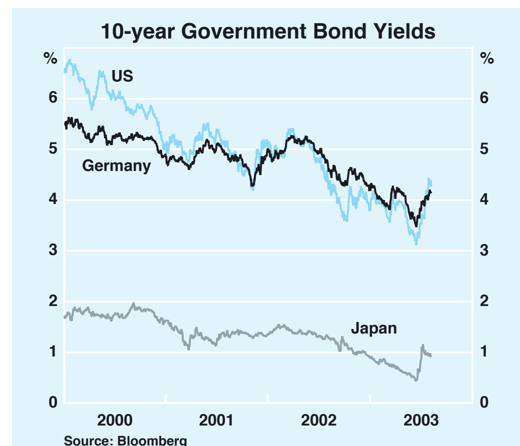
After being relatively stable at around 4 per cent over April, US yields on 10-year treasury bonds fell to 3.1 per cent by mid June (Graph 9). This was the largest fall in such a short period since the collapse of Long Term Capital Management in late 1998. Since mid June, however, yields have risen back to 4.3 per cent, for the reasons noted above (Graph 10). The movements over the period (both up and down) were amplified by 'convexity' trading associated with mortgage-backed securities.

Yields in most other countries took their lead from the US. In Europe, yields on

Graph 9



Graph 10

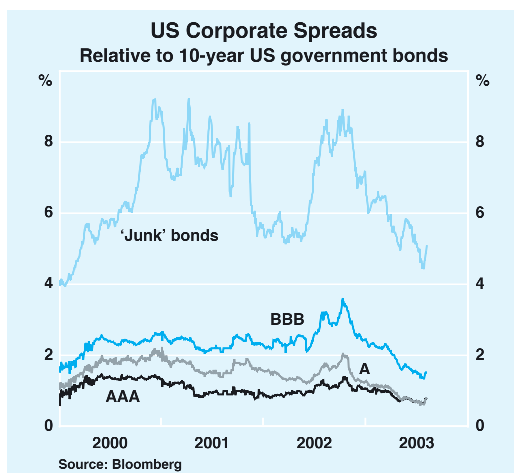


German 10-year government debt fell by nearly 60 basis points over May and early June to an 80-year low of just under 3.5 per cent, before rising to around 4.2 per cent by late July. With the outlook for growth in the euro area remaining fairly subdued, German bond yields are now below those in the US after having been around 30 basis points higher for much of the past year.

The rise in yields on government bonds was particularly sharp in Japan. After reaching a new low of a little over 0.4 per cent in mid June, yields rose to an intraday high of 1.4 per cent very quickly, before falling back to around 0.9 per cent.

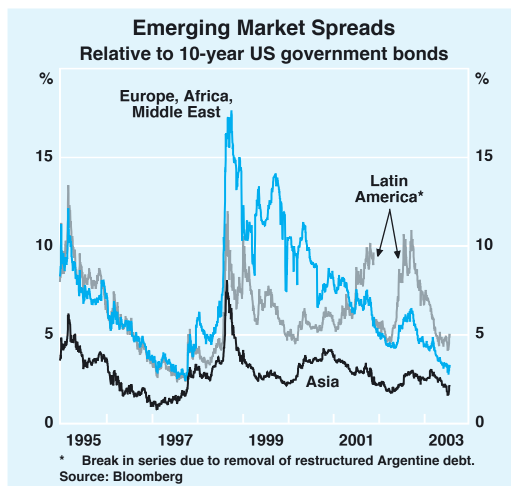
Despite these gyrations in yields on government bonds, the willingness to take credit risk has not diminished. Spreads on US corporate debt to US Treasuries have stabilised after falling significantly over the later part of 2002 and in the first few months of 2003 (Graph 11). While spreads are now generally at levels well below those seen during 2002, they remain above the average of the 1990s. The switch by investors out of mortgage securities and into government securities following the announcement by Freddie Mac (the US's second largest mortgage finance provider) that several of its senior executives had left in the face of accounting irregularities, has caused the spread of US agency securities to US Treasuries to rise, from around 30 basis points to around 50 basis points.

Graph 11



Yield spreads between emerging market sovereign debt and US Treasuries have remained relatively low over the past three months in most markets (Graph 12). Latin American spreads have held steady at around 500 basis points, well down on their peak of around 1 000 basis points around the time of the Argentinian and Brazilian crises; Asian spreads are currently around 200 basis points.

Graph 12



A number of central banks eased monetary policy around the middle of the year (Table 4). In the US, the Federal Open Market Committee (FOMC) cut the Fed funds target by 25 basis points to 1 per cent at its meeting in late June. In Europe, the European Central Bank reduced its official interest rate in June by 50 basis points to 2 per cent; the Bank of England also lowered its policy rate in July by 25 basis points to $3^{1}/2$ per cent; and official interest rates in Sweden declined by 75 basis points to $2^{3}/4$ per cent in moves of 50 and 25 basis points in June and July.

Other central banks to ease included the Bank of Canada which cut its policy rate by 25 basis points in July to 3.0 per cent, and the Reserve Bank of New Zealand, which cut a further 25 basis points to 5.00 per cent in July, after similar-sized cuts in April and June.

Table 4: Policy Interest Rate Changes

	Current level Per cent	Cumulative reductions in down cycle Basis points	Changes in policy rates Basis points	
			Jan-Jul 2002	Since Aug 2002
US	1.00	–550		–75
Canada	3.00	–375	50	25
Switzerland	0.25	–325	–100	–50
UK	3.50	–250		–50
Australia	4.75	–200	50	
NZ	5.00	–175	100	–75
Euro area	2.00	–275		–125
Sweden	2.75	–150	50	–150
Norway	4.00	–300	50	–300
Japan	0.00	–25		

Source: Central banks

The Bank of Japan raised the target for bank reserves held at the central bank in May to ¥27–30 trillion from ¥22–27 trillion. It also announced in June that it would purchase up to ¥1 trillion of asset-backed securities from commercial banks. This is equivalent to around 1 per cent of the central bank's assets.

Elsewhere in the Asian region, Indonesia, Korea, Malaysia, the Philippines, Taiwan, Thailand and Hong Kong all lowered official interest rates, while Singapore announced that it too would ease monetary policy by lowering the target trading band for the Singapore dollar. In Latin America, Brazil moved to lower official interest rates back towards more accommodative levels following earlier increases aimed at supporting the Brazilian real.

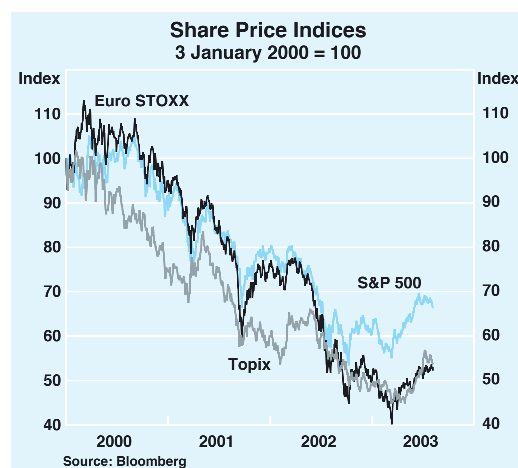
Equity markets

After reaching multi-year lows in mid March, the major global equity indices have rallied significantly over recent months, initially due to declining concerns about the Iraq war and, more recently, to greater confidence in a global economic recovery in the second half of 2003 (Graph 13).

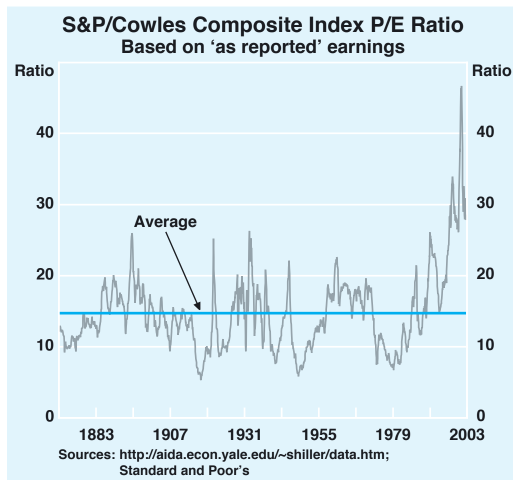
In the US, the S&P 500 has risen by 21 per cent since its March trough, while the Nasdaq has risen by 30 per cent. In 2003 to date, the respective increases are 10 per cent and 24 per cent. These rises follow declines in each of the previous three years.

The price-earnings (P/E) ratio for the S&P has stabilised at around 30, though it remains at a level well above its long-run average of 14 (Graph 14). Operating earnings for the June quarter came in slightly ahead of expectations on average and they have now reversed about three-quarters of the fall seen in 2000 and 2001. Company analysts are expecting further strong growth in earnings over the next few

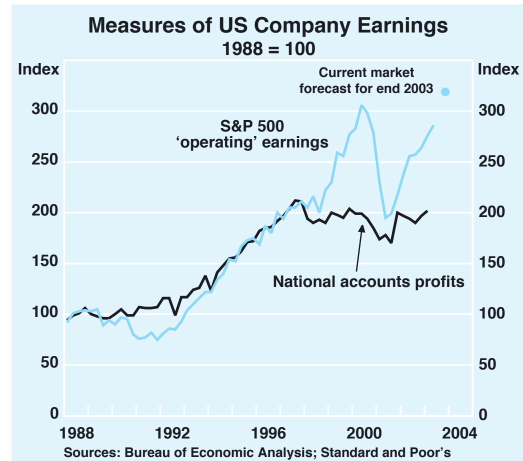
Graph 13



Graph 14



Graph 15



quarters, based on a more optimistic outlook for the US economy and the latest company earnings reports (Graph 15). If realised, the falls that occurred in the earlier period would have been fully reversed.

Movements in share prices in the other major countries have generally followed those in the US. The European Euro STOXX index has increased by around 30 per cent from its March low. The relatively stronger rebound in European share prices may be due to the fact that the decline over the previous nine months had been larger for Europe than for the US (Table 5). The Japanese Topix is also up around 20 per cent. Stock markets in emerging economies have also recovered; share prices in Asian emerging economies rose by around 17 per cent, while in Latin America, they increased by a more modest 8 per cent.

Table 5: Major Country Share Prices
Percentage change

	Since 2000 peak	2001	2002	2003 to date	Since 2003 trough
United States					
– Dow Jones	–23	–7	–17	9	20
– S&P 500	–37	–13	–23	10	21
– NASDAQ	–67	–21	–32	24	30
Euro area					
– STOXX	–54	–20	–35	5	30
United Kingdom					
– FTSE	–41	–16	-24	3	24
Japan					
– TOPIX	–47	–20	–18	9	20
Canada					
– TSE 300	–37	–14	–14	8	15

Source: Bloomberg

Exchange rates

After falling quite sharply in May – owing largely to weaker-than-expected US economic data and comments by US administration officials which were perceived by the market as a softening of the 'strong dollar' stance of the US – the US dollar stabilised in early June before appreciating towards the end of the period. The recent appreciation appears to reflect growing confidence that the economic recovery in the US will be stronger than in the other major economies. The US dollar, as measured by the major currency trade weighted index has fallen by about 17 per cent from its peak in early 2002. The broader measure of the US TWI, which reflects currency moves against all significant trading partners, has not adjusted down as much. This is mainly because some of these countries have exchange rates which are directly fixed to, or closely managed against, the US dollar.

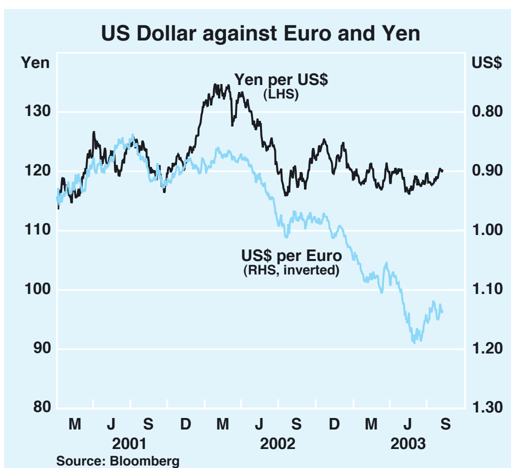
Similar to the pattern that has been evident over the past year, much of the movement of the US dollar has been against European and dollar bloc currencies (Graph 16 and Table 6). Against the Japanese yen, the US dollar has been broadly stable as the Bank of Japan has been intervening heavily to limit any appreciation in the yen (Graph 17). As a result, the Bank of Japan's holdings of foreign exchange reserves have risen significantly further in recent months. Likewise, there has been little movement in a number of Asian currencies against the US dollar (for a discussion of the Chinese renminbi see Box C).

Table 6: US Dollar Against Major Currencies
Percentage change

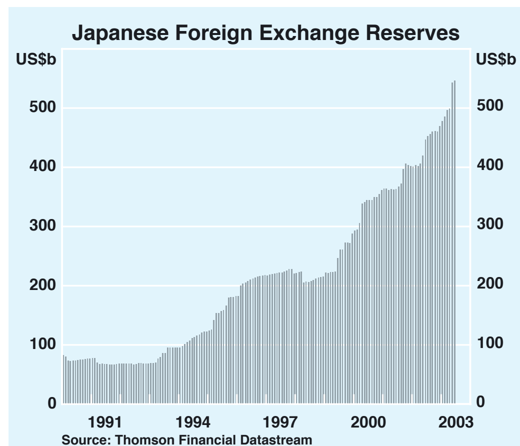
	Since peak in 2002	Jan to mid June 2003	Since mid June 2003
Japanese yen	–11	–1	2
European euro	–24	–12	5
Swiss franc	–21	–6	4
Canadian dollar	–13	–15	5
Pound sterling	–13	–4	4
Australian dollar	–22	–16	3
Swedish krona	–24	–12	6
US TWI (narrow)	–17	–10	4
US TWI (broad)	–8	–6	3

Source: Bloomberg

Graph 16



Graph 17



Australian dollar

The exchange rate of the Australian dollar rose strongly through the first half of 2003. This was a consequence of negative sentiment toward the US economy and the associated depreciation in the US dollar, together with the continuing strong performance of the Australian economy. With interest rates falling to very low levels in the US, global investors

focused on investments with a yield pick-up. In addition to Australian dollar denominated assets, demand for assets in other floating currencies with positive interest differentials relative to the US was also strong. Interestingly, the differences in the size of the interest differential among countries did not seem to have much impact on the rate of appreciation of the respective currencies. For example, the Australian, Canadian and New Zealand dollars all increased by similar amounts against the US dollar over the six months, even though Canada's interest differential relative to the US was a lot less than that of Australia and only about half that of New Zealand.

Hedging activity by Australian exporters appears to have been supportive of the Australian dollar over the past year. According to the NAB quarterly business survey, mining companies increased their hedging of exposures from less than 10 per cent a year ago to just under 30 per cent in June (Table 7). This would have involved these companies buying Australian dollars in excess of that stemming from the conversion of export receipts. Of the firms that were hedging, a majority reported a favourable hedging position relative to the current exchange rate.

The Australian dollar reached a peak of US68.5 cents in early July, but then fell sharply, by around US4 cents in a little over a week (Graphs 18 and 19). This was part of a general correction experienced by several other currencies around this time. It seems to have been associated with a waning in the importance of interest differentials in relation to capital flows. With sentiment about the outlook for the US economy improving at that time, financial markets increasingly began to look towards the relative prospects for growth. Capital seemed to flow back to the US, as investors moved out of investments that had relatively high yields to those which would benefit from a pick-up in world (and particularly US) economic activity. Within share markets in various countries, the same sentiment could be seen as investors moved

Graph 18

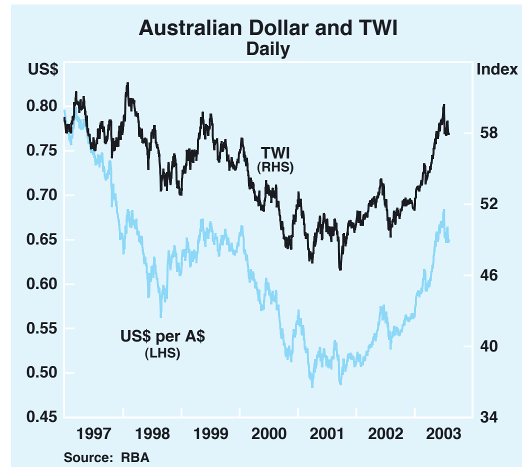
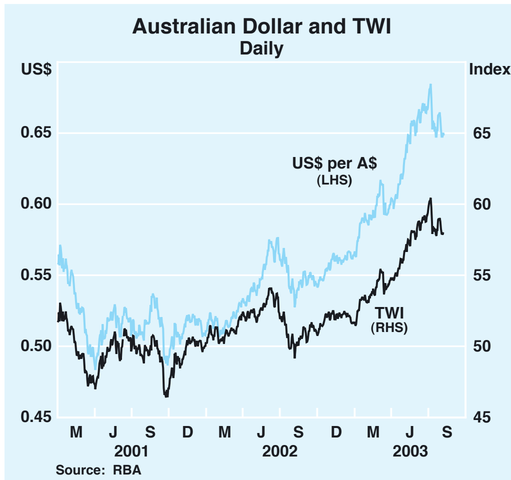


Table 7: Currency Hedging by Australian Resource Companies

	Share of net exposure hedged Per cent	Average term Months	Average exchange rate US$
Jun 2001	24	24	0.51
Sep 2001	20	19	0.51
Dec 2001	23	37	0.51
Mar 2002	9	41	0.52
Jun 2002	9	6	0.55
Sep 2002	22	26	0.55
Dec 2002	39	28	0.56
Mar 2003	24	26	0.59
Jun 2003	29	32	0.64

Sources: NAB Quarterly Business Survey; RBA

Graph 19



out of 'defensive' stocks (i.e. those that would be least affected by a downturn in economic activity) to 'cyclical' stocks which would benefit most from stronger activity. The exchange rate against the US dollar was a little under US65 cents in early August.

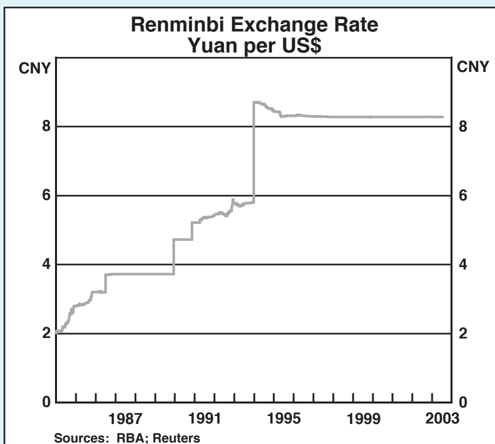
In trade-weighted terms, movements in the Australian dollar were more muted than those in relation to the US dollar, though only a little more so. With most Asian currencies moving closely with the US dollar over the period, and these currencies having a large weight in the Australian dollar TWI, over 70 per cent of the TWI was in effect determined by movements in the US dollar. In early August, the TWI was around 58, a little above its post-float average of 57.5.

The RBA continued to rebuild its foreign currency reserves by making purchases over the past few months which more than covered the Government's requirements. In the three months to July, net purchases amounted to around $1.4 billion, while earnings on foreign reserves added a further $0.5 billion. Valuation effects, however, reduced reserves by $0.9 billion. Net reserves currently stand at around $12.2 billion. The Bank also made substantial use of foreign exchange swaps during the past few months to manage domestic liquidity. The swap position currently stands at $35.1 billion. Total reserve holdings (i.e. reserves held outright plus reserves held under swap agreements) currently total $47.3 billion.

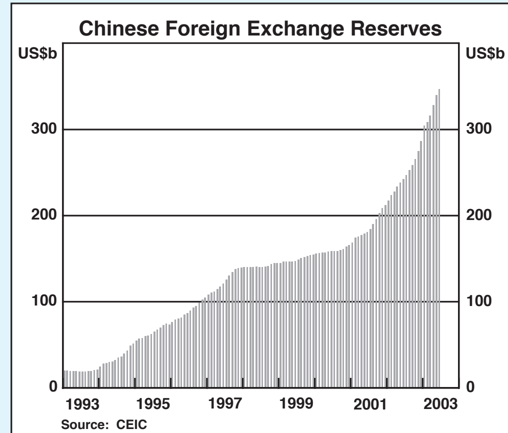
Box C: The Chinese Renminbi

Since the devaluation in 1994, China has maintained its exchange rate within a 0.3 per cent band either side of its target rate[1] (Graph C1). In the context of continuing trade surpluses, strong capital inflows and sharply rising official reserves (Graph C2), there have been calls from time to time from various commentators for China to free up its exchange rate, with the implication that it should appreciate.

Graph C1



Graph C2

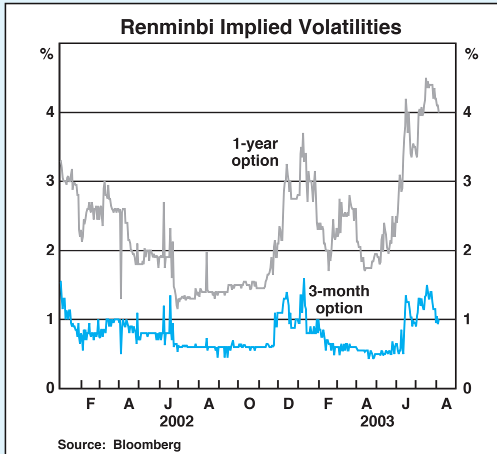


Financial markets pricing suggests that market participants see the possibility of a revaluation of renminbi as having increased. This is evident in both implied volatilities from the currency options market and in non-deliverable forward (NDF) rates. The implied volatility from a currency option is a measure of the variability that the market sees in future movements in the exchange rate over the life of the option contract. In the context of a fixed exchange rate, implied volatility largely reflects the expectations of an upward or downward adjustment to the peg. Over the past year, on two occasions when US officials have talked about the possibility of China adopting a more flexible exchange rate, there has been a significant reaction in the options market. In June 2003, for example, implied volatilities on options to buy or sell renminbi rose sharply from around 2.5 per cent to 4 per cent for 1-year contracts, and from 0.5 per cent to 1.3 per cent for 3-month contracts (Graph C3). Also implied volatilities were larger for 'out of the money' options to buy renminbi, than for equally 'out of the money' options to sell the currency, thereby suggesting that the balance of expectations was skewed towards an appreciation of the Chinese currency against the US dollar.

Another gauge of the anticipated direction of a change in the value of renminbi is the NDF rates relative to the spot exchange rate. NDFs are forward contracts in which, at the expiry of the contract, the difference between the prevailing spot exchange rate and the contract rate is settled in cash.

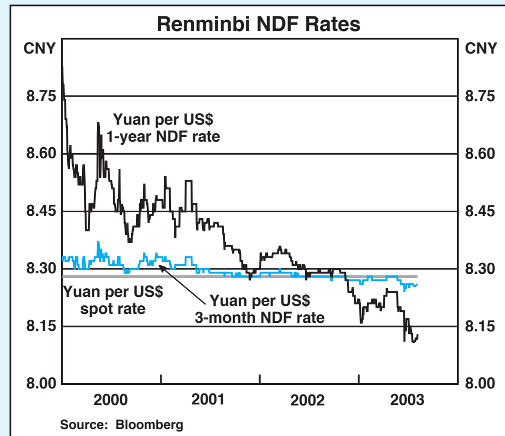
1. China's currency is generally known as renminbi, or 'People's currency', but the unit of measurement is the yuan (the terms are parallels of 'sterling' and 'pound' in the UK).

Graph C3



Given that China has higher interest rates than the US, in the absence of expectations of a change in the target exchange rate one would expect the forward exchange rate (expressed as yuan per US dollar) to be higher than the spot exchange rate so as to eliminate the possibility of earning a risk-free profit over the term of the contract. However, since November 2002, NDF rates have typically been below the prevailing spot exchange rate. The discrepancy between NDF rates and the spot exchange rate was particularly pronounced in June 2003, when NDF rates temporarily fell 2 per cent below the spot exchange rate for one year contracts, and 0.4 per cent below the spot exchange rate for 3-month contracts (Graph C4). This suggests that investors had attached a higher probability to an upward revaluation of renminbi, with expectations being more pronounced at longer horizons. ✢

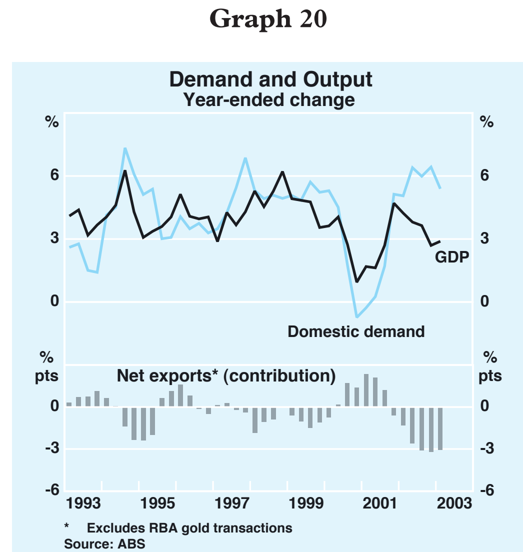
Graph C4



Domestic Economic Activity

The Australian economy has continued to expand at a moderate rate, although the pace of growth has slowed over recent quarters, largely due to the weak world economy and the effect of the drought. The latest national accounts show that real GDP rose by 0.7 per cent in the March quarter, to be 2.9 per cent higher than a year earlier (Table 8). The pace of domestic demand growth has eased from the rapid rate seen in 2002, as dwelling investment has levelled off and consumption growth has moderated to a more sustainable pace (Graph 20). In contrast, the upswing in business investment remains strong despite a small decline in the March quarter.

Graph 20



The effect of the drought and weak external demand can be most clearly seen in the international trade figures (see the chapter on 'Balance of Payments'). Over the year to the March quarter, net exports subtracted 3 percentage points from GDP growth, partly offsetting the strong growth of private final demand of 6.5 per cent. The effect of the drought can also be seen in farm output, which fell by around one-third over the year to the March quarter, subtracting 1.1 percentage points from aggregate GDP

Table 8: National Accounts
Percentage change

	March quarter 2003	Year to March quarter 2003
Private final demand[a]	0.4	6.5
– Consumption	1.0	3.5
– Dwelling investment	–0.7	18.4
– Business investment[a]	–0.9	17.1
Public final demand[a]	–1.1	1.5
Domestic final demand	0.1	5.4
Change in inventories[b]	1.1	0.9
Exports	–0.4	–0.1
Imports	0.6	13.2
Net exports[b]	–0.2	–3.0
Gross domestic product	**0.7**	**2.9**

(a) Excluding the effect of transfers between the private and other sectors
(b) Contribution to GDP growth
Source: ABS

growth. Excluding the farm sector, GDP grew by slightly more than 4 per cent over the year to the March quarter.

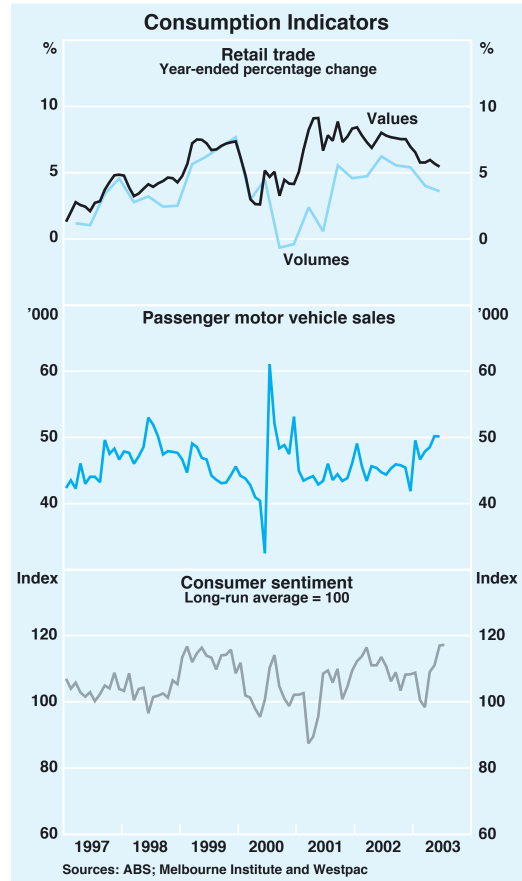
The sharp contrast between the strength of domestic demand and weak external demand is expected to diminish gradually in the year ahead. Domestic demand is expected to grow less quickly over 2003 than over 2002, but the pace of growth should still be solid. Dwelling investment is likely to decline a little in coming quarters, after a period of strong expansion. In contrast, resilient investment intentions and a considerable stock of work in the pipeline suggest that growth in business investment should remain reasonably strong in the period ahead. Consumption remains supported by rising incomes and buoyant confidence levels. In line with overall developments in domestic demand, growth in imports is expected to ease in the period ahead, while exports are expected to return to growth in the second half of the year, partly because of the anticipated pick-up in farm output following the breaking of the drought.

The household sector

Household consumption growth remains solid, despite easing from the rapid pace seen in 2002. In the March quarter, consumption grew by 1 per cent, to be 3.5 per cent higher than a year earlier. Growth in expenditure on goods picked up sharply in the quarter, while expenditure on services increased more modestly. Over the year, both components increased at the same rate.

Recent indicators suggest continued solid growth in consumer spending. The volume of retail sales, which accounts for more than a third of household consumption, increased by 1.9 per cent in the June quarter, to be 3.6 per cent higher over the year (Graph 21). This was noticeably stronger than the 0.1 per cent increase recorded in the March quarter. The pick-up occurred in all major components, but was particularly marked in sales by department stores and household goods retailers, consistent with a continuing strong housing sector. Sales of passenger motor vehicles also increased strongly during the first half of this year, to be 12 per cent

Graph 21



higher in June than a year ago, partly due to the high level of affordability of vehicles and the popularity of new models released in late 2002.

The factors underpinning the near-term outlook for consumption growth remain quite favourable. Growth in wage incomes remains firm, and consumer sentiment has risen strongly in recent months, partly because of the end of the war in Iraq. The cumulative increases in wealth associated with rising housing prices in recent years are also likely to continue to support consumption in the period ahead.

Real household disposable income has been relatively subdued, increasing by 1.1 per cent over the year to the March quarter, compared with average annual growth of around 3 per cent over the previous two years. In the March quarter, strong employment growth

and higher wages were partly offset by lower farm incomes. With consumption growing more quickly than disposable income, there has been a significant fall in the household saving ratio. Some of this fall should be temporary, since the expected recovery in farm incomes is likely to boost income growth in the near term.

As discussed in the chapter on 'Credit Growth', households have continued to borrow at a rapid pace. Household credit increased at an annualised rate of around 23 per cent over the June quarter, with lending for investment housing expanding at an even more rapid annualised rate of 34 per cent over the quarter. Over the past year, the strong pace of debt accumulation has outstripped the growth in the household sector's assets, despite further significant gains in housing wealth (Table 9). As a result, household gearing – the ratio of debt to assets – increased to around 15 per cent in the March quarter.

Reflecting the rapid pace of credit growth and the increases in variable lending rates in mid 2002, households' gross interest payments are estimated to have increased strongly over the past year. The debt-servicing ratio reached 7.6 per cent of household disposable income in the March quarter (Graph 22). While this ratio is below the peak in the late 1980s, it is around the same level as the peaks of the interest-rate cycles in 1995–1996 and 2000, despite the lower level of interest rates currently prevailing.

Graph 22

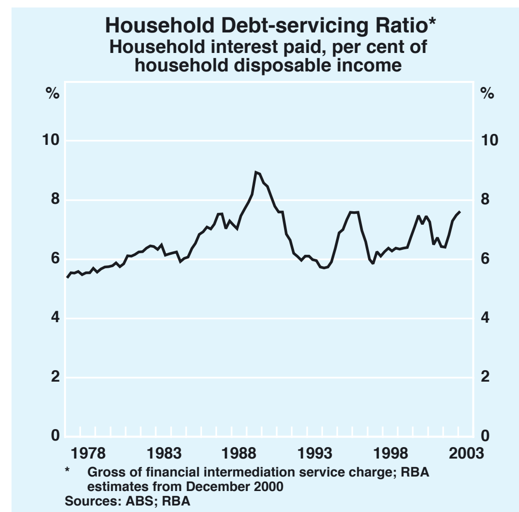


Table 9: Household Assets[(a)]
March quarter 2003

	Level	Share of total	Annual growth Per cent	
	$billion	Per cent	**Year to Mar 2003**	**Average Mar 1997–Mar 2002**
Housing	2 280	62.3	20.5	13.2
Consumer durables	139	3.8	3.2	3.9
Financial assets	1 238	33.9	–4.0	9.3
– Superannuation and life offices[(b)]	643	17.6	–3.1	9.4
– Currency and deposits	317	8.7	10.2	6.2
– Equities and unit trusts	198	5.4	–25.5	17.0
– Other	80	2.2	8.9	1.6
Total	**3 657**	**100.0**	**10.3**	**11.1**

(a) Includes some assets of unincorporated enterprises
(b) Includes unfunded superannuation
Sources: ABS; RBA

Housing

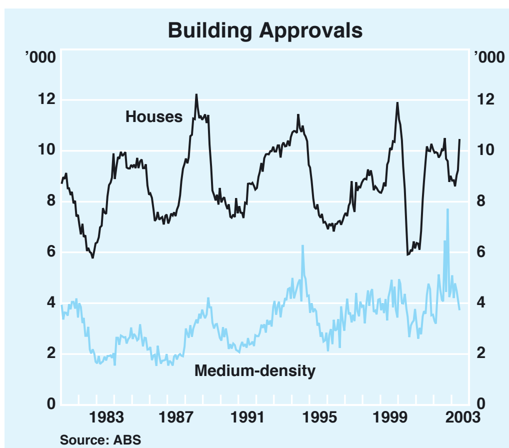
The housing construction cycle appears to have reached a peak around the end of 2002. Following two years of solid growth, dwelling investment fell slightly in the March quarter, though it was still 18 per cent higher than a year earlier. Leading indicators of housing construction activity point to further easing in new dwelling investment. However, there is a large amount of work in the pipeline in the medium-density sector, as well as significant renovation activity and signs of strength in leading indicators of housing demand and finance. Consequently, the downturn in dwelling investment is likely to be quite mild relative to that seen in previous cycles, and somewhat smaller than expected at the start of this year.

The number of building approvals for detached houses has increased strongly over the past couple of months, to be around the peak reached in the second half of 2002 (Graph 23). In line with this renewed strength, builders are reporting an increase in commitments to construct new houses. In contrast, approvals in the medium-density sector, where investor activity has been concentrated in recent years, have been on a downward trend since reaching a peak last October. Approvals for dwellings in buildings of four or more storeys have been particularly weak. Anecdotal evidence suggests that investor interest in new apartments has been waning for some time, and some apartment developers report difficulties in meeting required pre-sales and face escalating construction costs, particularly in Melbourne. As a result, a number of projects have recently been deferred or cancelled. Despite this, activity and work yet to be done remain at high levels, particularly on large inner-city apartment projects.

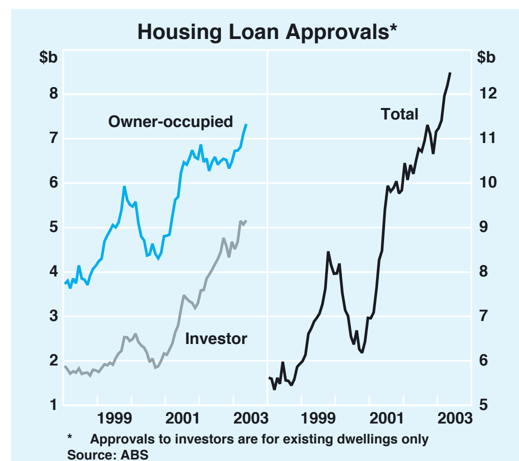
Expenditure on alterations and additions has grown strongly, in part because of rising house prices. Despite a fall in the three months to May, loan approvals for alterations and additions have risen rapidly over the past year, and the value of building approvals for this purpose rose by 8.8 per cent in June.

Indicators of financing activity in the housing market more broadly remain buoyant. The value of loan approvals to both owner-occupiers and investors has picked up since the beginning of the year (Graph 24), along with refinancing activity. The value of total new housing loan approvals in May was around 19 per cent higher than a year earlier. Reflecting this high level of loan approvals, credit extended for housing continues to grow rapidly, expanding at an annual rate of nearly 24 per cent over the June quarter. Given the lags between loan approvals and the increase in credit outstanding, the strong pace of credit growth can be expected to continue, at least in the near term.

Graph 23



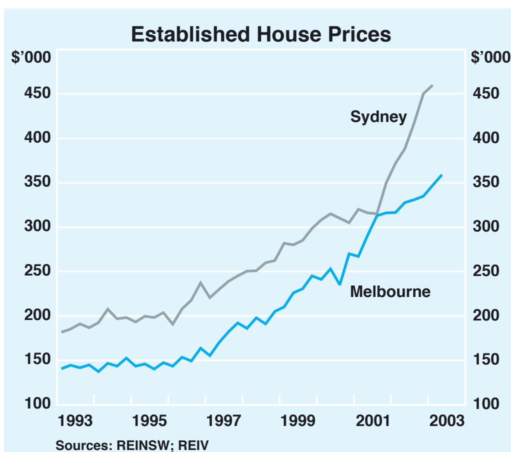
Graph 24



According to most sources, overall measures of dwelling prices increased substantially in the March quarter. Data from the Commonwealth Bank suggest the pace of growth was maintained in the June quarter, with established house prices rising by 10 per cent, to be 26 per cent higher over the year. In contrast, preliminary June quarter data from Residex on repeat sales, which attempt to abstract from compositional changes in the stock of dwellings being sold, are suggestive of a slowdown in the pace of price growth in Sydney and Melbourne. However, these data can be subject to significant revision. Overall measures of prices of medium-density dwellings have also recorded solid gains over the year to the June quarter, although rents have been subdued. Experience has varied significantly across cities and in different parts of cities, with prices rising more quickly in Sydney than in Melbourne (Graph 25).

In the inner Melbourne apartment market, prices have been flat for some time and falling in some areas, and rents have been under downward pressure, partly in response to the rapid increase in the supply of new apartments. To date, however, there is little evidence that weakness in this part of the market is having a significant flow-on effect on the broader market for apartments in Melbourne.

Graph 25

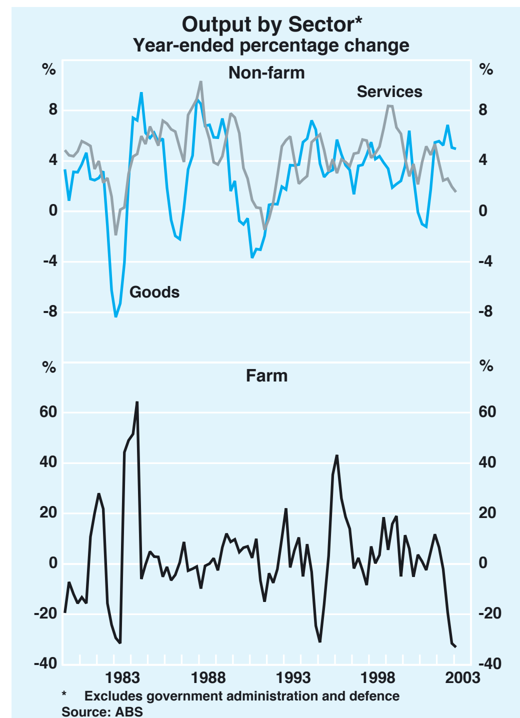


The strong increases in housing prices over recent years have reduced measures of housing affordability. This appears to have contributed to a decline in the participation of first-home buyers in the market, with their share of new loan approvals for owner-occupation declining over the past two years to be slightly below 20 per cent in May.

The business sector

The growth of the economy over the past year has been characterised by sharply contrasting performances in the farm and non-farm sectors and, within the non-farm sector, between goods and services industries. Much of the overall growth in the non-farm economy has been accounted for by the goods sector (Graph 26), largely because of continued strength in the construction industry. Conditions in the business services sector have been more subdued, as firms have continued to rein in discretionary spending, especially the subsidiaries of global firms facing weak conditions overseas.

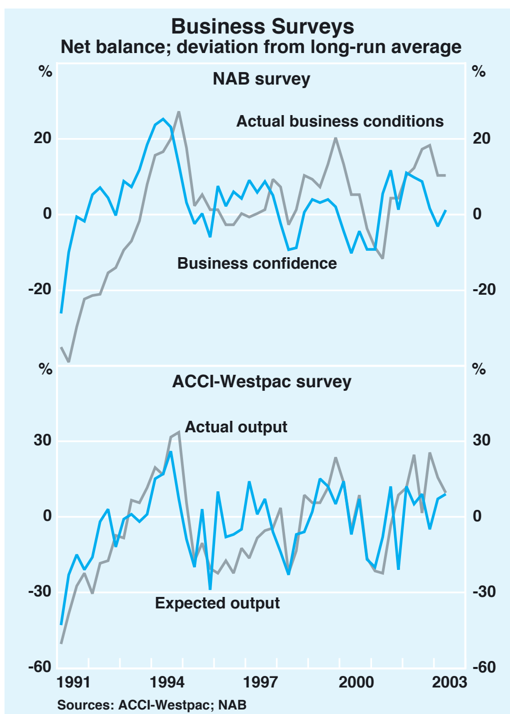
Graph 26



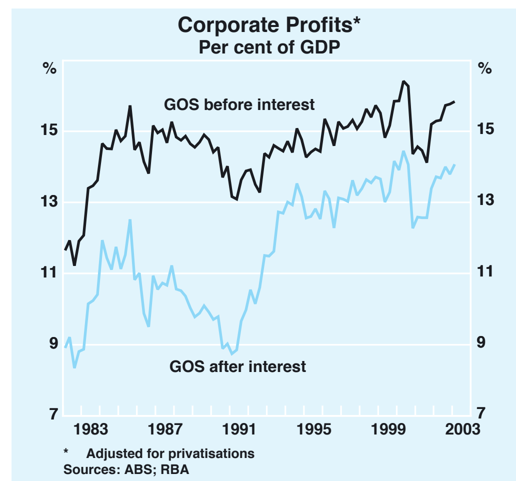
Reports from most business surveys indicate that conditions generally remain close to – or better than – average, though there are some significant variations across industries (Graph 27). The NAB survey for the non-farm economy reported that current and expected conditions remained above average in the June quarter, though not as strong as at the end of 2002. Buoyant conditions in domestically oriented industries, particularly construction, offset weaker conditions faced by export-oriented firms, including some parts of manufacturing. The June quarter ACCI-Westpac survey of manufacturers similarly reported actual and expected output at above-average levels. In recent months, the Dun & Bradstreet survey, which covers the manufacturing, wholesale and retail sectors, has reported a significant lift in actual and expected business conditions, back to long-run average levels, after reporting more pessimistic readings than most other major surveys in 2002.

In line with the strength in the domestic non-farm economy, businesses in aggregate have recorded high levels of profitability in recent quarters. Profits of the private corporate sector, as measured by gross operating surplus, increased by 2.2 per cent in the March quarter, to be 9½ per cent higher over the year and a relatively high share of GDP (Graph 28). Profits of non-farm unincorporated businesses fell slightly in the March quarter, but growth over the year remained robust at almost 9 per cent. This is consistent with strong construction and retail activity, where unincorporated businesses have a relatively large presence. With growth in the non-farm economy easing, however, some moderation in profit performance may now be in prospect. According to the NAB survey, businesses' expected levels of profitability have eased in the past couple of quarters, but remain well above their long-run average.

Graph 27

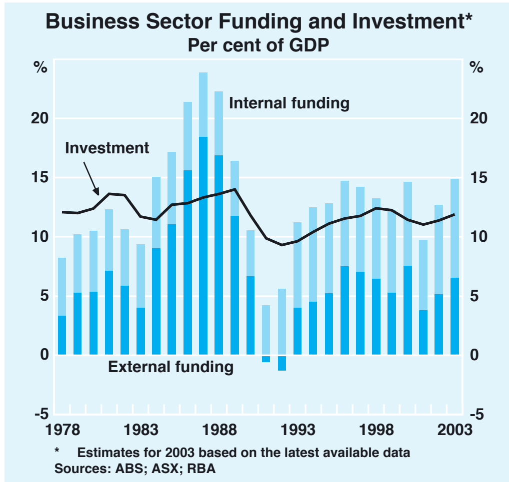


Graph 28

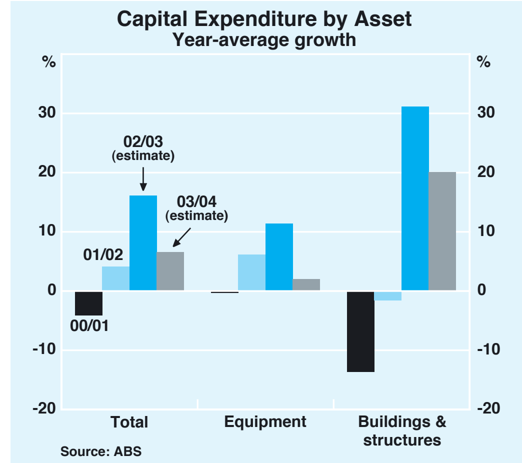


Strong profit growth has meant that firms have been able to rely relatively heavily on internal funds to finance investment (Graph 29). As a result, business borrowing from intermediaries has been soft for much of the past six months, increasing by around 5 per cent on an annualised basis over this period. Larger firms have, however, maintained a fairly solid pace of non-intermediated debt raisings, mainly through offshore bond issuance. Equity raisings by non-financial firms strengthened in the June quarter, but remain fairly low.

Graph 29



Graph 30

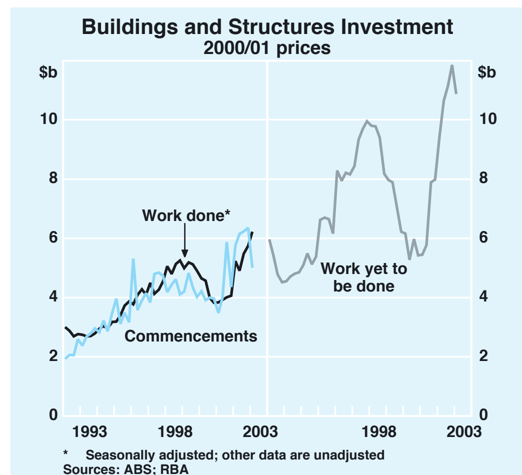


Business investment still appears to be in a solid upswing, underpinned by accommodative financial conditions and a relatively high level of capacity utilisation. While overall investment declined slightly in the March quarter, this was entirely due to lower spending on civil aircraft, which had been exceptionally strong in the previous quarter. Over the past year, capital spending rose by more than 17 per cent, with the main categories of investment – machinery and equipment investment (abstracting from civil aircraft deliveries), buildings and structures, and spending on computer software – all recording robust growth in the quarter and over the year.

Indicators of investment intentions have proven quite resilient in the face of weakness in global economic conditions. They continue to point to further growth in investment, though at a slower pace than seen in the past year (Graph 30). The March quarter ABS capital expenditure (Capex) survey suggests growth of around 6½ per cent in nominal business investment spending in 2003/04, with this growth skewed towards the buildings and structures component. For expenditure on machinery and equipment, growth of around 2 per cent is expected in nominal terms. However, this is likely to translate into somewhat stronger growth in real terms given falls in equipment prices, in part due to the appreciation of the Australian dollar.

Other forward-looking indicators confirm the strong outlook for buildings and structures investment in the current financial year (Graph 31). Engineering construction has risen by 50 per cent over the past year, to reach very high levels, and is set to expand further in the near term, driven by a considerable stock of resource and infrastructure work in the pipeline. Non-residential building activity is also expected to remain strong in the period ahead, with work done currently running well behind approvals, which remained at around 13-year highs over the past six months. The

Graph 31



positive outlook for buildings and structures investment is supported by the Access Economics *Investment Monitor*, with a sharp pick-up in the number of projects committed for construction pointing to renewed strength in project commencements in the period ahead.

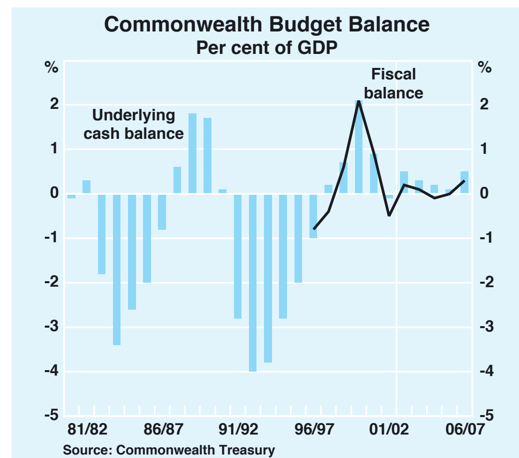
Non-farm businesses engaged in heavy inventory accumulation in the March quarter, leading to a 1 percentage point contribution to quarterly GDP growth. Non-farm inventory-to-sales ratios nonetheless remain relatively low and the expected pick-up in agricultural production will generate some re-stocking in that sector. These factors point to a further build-up of inventories over 2003, but at a more moderate pace, implying a partial reversal of the significant contribution of inventories to March quarter growth.

The farm sector continued to subtract from growth in the March quarter, and the ABS projects a further decline in farm output, with output reaching a trough in the June quarter (Graph 26). The latest ABS projections, based on Australian Bureau of Agricultural and Resource Economics (ABARE) estimates, indicate that farm GDP fell by around 30 per cent over the year to the June quarter 2003, subtracting a little under 1 percentage point from GDP growth, which is a slightly smaller subtraction than previously expected. While the improvement in weather conditions across the country in autumn was rather uneven, ABARE is expecting a significant rebound in farm production in 2003/04. However, it is expected to be more muted than that following the breaking of the 1982/83 drought, when rainfall was more favourably timed and placed. According to ABARE's current forecasts, farm production is not expected to reach the high levels prevailing in the years immediately preceding the onset of the drought. Continuing dry conditions in some cropping areas prevented or delayed the sowing of winter crops and are likely to result in lower yields than is typical of recoveries from drought. Even so, ABARE expects crop production to rise by over 40 per cent in 2003/04. At the same time, conditions for livestock and irrigated-crop farmers are expected to remain difficult, with shortages of stored water persisting in many areas.

Commonwealth Budget

The 2003/04 Commonwealth Budget, presented in May, announced a small reduction in the expected surplus in both underlying cash and accrual terms. New policy decisions announced in the Budget included personal income tax cuts, increased spending on defence and domestic security, and reform of higher education and Medicare. Using the change in the underlying cash balance between financial years as an approximate indicator of the fiscal impact, the Commonwealth Budget is expected to add to growth by around 1/4 per cent of GDP this financial year, compared with a contractionary effect of around 3/4 per cent in 2002/03 (Graph 32). On a similar basis, state budgets are expected to have a combined expansionary impact of around 1/4 per cent of GDP in the current financial year.

Graph 32

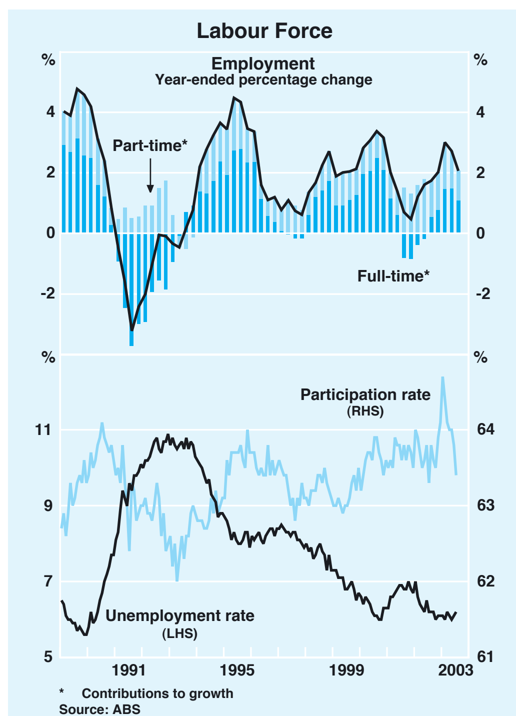


The labour market

Over the past year, employment growth has been around trend, though lower in recent months. In the three months to July, the average level of recorded employment was 2.1 per cent higher than a year earlier, but lower than the average level in the previous three months (Graph 33). To some extent, recent trends in employment growth have

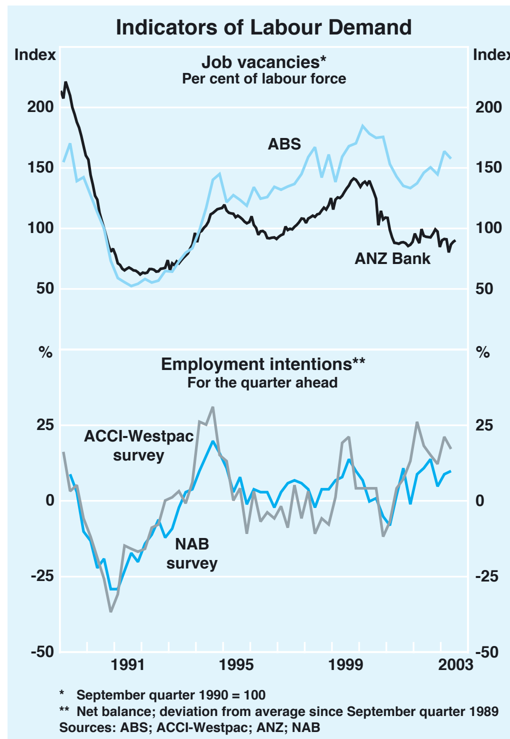
been made more difficult to interpret by volatility resulting from changes to the Labour Force Survey. Notwithstanding this, and consistent with trend growth in employment, the unemployment rate has been largely unchanged over the past year, averaging 6.1 per cent in the three months to July. At this level, the unemployment rate is close to the cyclical lows reached during the past two decades. The participation rate has returned to around 63¾ per cent in recent months, following the bedding down of the changes to the Labour Force Survey.

Graph 33



Recent job vacancy and hiring intentions data have been providing divergent signals about the prospects for the labour market. Business surveys report that hiring intentions for the September quarter remain well above historical average levels (Graph 34). The ABS employer-based measure of job vacancies also appears consistent with firm labour demand. While the reported number of vacancies declined in the June quarter, the series has trended upwards for some time and in the June quarter was still more than 10 per cent higher than a year earlier. In contrast, the ANZ print-based vacancy measure has declined over the past year. On balance, these indicators appear consistent with relatively good employment outcomes, though employment growth in the near term appears likely to be lower than the pace recorded over the past 12 months.

Graph 34



Over the past year, South Australia and Queensland have had the strongest labour markets, with employment growth well above trend, and relatively large falls in their unemployment rates (Table 10). In contrast, employment growth has been weaker in New South Wales and Victoria, with the unemployment rates in these two states broadly unchanged over the year.

On an industry basis, growth in employment in the retail trade sector made the largest contribution to aggregate growth over the year to the June quarter (Table 11). The ongoing strength of employment outcomes for this industry is consistent with robust growth in retail sales. Large contributions to

Table 10: State Labour Markets
Per cent

	Employment growth		Unemployment rate	
	Three months to July	Year to three months to July	Three months to July	Year to three months to July[(a)]
NSW	–0.8	1.5	6.2	0.0
Victoria	–0.7	1.6	5.9	0.1
Queensland	0.4	3.5	6.7	–0.7
WA	0.3	2.1	5.8	–0.2
SA	1.1	4.0	6.1	–0.6
Tasmania	1.2	3.2	7.7	–1.0
Australia	**–0.3**	**2.1**	**6.1**	**–0.2**

(a) Percentage point change
Source: ABS

employment growth over the past year were also made by the public sector and the property and business services industry, which has benefited from robust sales activity in housing markets. Employment in the manufacturing and construction industries fell in the June quarter, following strong employment growth over the previous year. With the effect of the drought beginning to recede, there has been a marked turnaround in agricultural employment, but the level of employment in this industry remains well down on levels of a year ago in most regions.

Table 11: Employment by Industry
Percentage change

Industry	Share of total employment, 2002 Per cent	June quarter 2003	Year to June quarter 2003
Public sector[(a)]	22.2	–1.4	3.4
Retail and wholesale trade	19.9	1.5	5.7
Manufacturing	12.0	–3.3	–0.2
Property and business services	11.5	4.2	5.2
Construction	7.6	–5.5	2.2
Accommodation, cafes and restaurants	4.9	3.3	–0.4
Agriculture	4.3	8.8	–11.2
Transport and storage	4.3	2.5	4.5
Personal and other services	4.0	–3.6	3.8
Finance and insurance services	3.7	–6.9	0.2
Cultural and recreational services	2.6	2.5	–4.3
Communication services	1.8	–3.5	6.6
Total[(b)]	**100.0**	**–0.3**	**2.5**

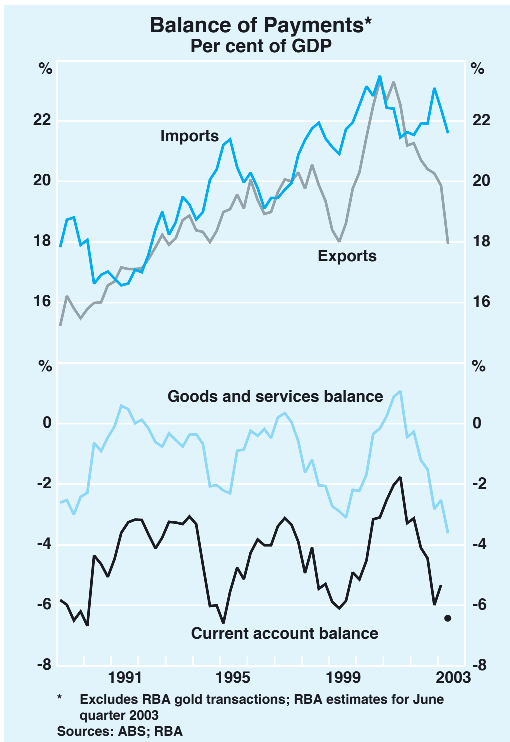
(a) Includes utilities, public administration & defence, education and health & community services
(b) Includes mining. May differ from the sum of individual industries due to differences in seasonal adjustment.
Source: ABS

Balance of Payments

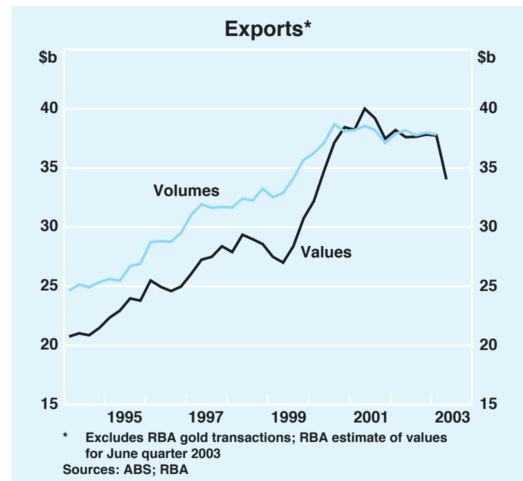
Slow world growth and the effects of drought have weighed on exports recently, while strong domestic growth has underpinned demand for imports. As a result, Australia has recorded a substantial increase in its deficit on trade in goods and services over the past year and a half, with the deficit standing at around $3^1/_2$ per cent of GDP in the June quarter, compared with around $^1/_2$ per cent in late 2001 (Graph 35). The current account deficit is expected to have widened to around $6^1/_2$ per cent of GDP in the June quarter (assuming that the net income deficit remains constant as a proportion of GDP).

Export values fell significantly in the June quarter to be down by nearly 10 per cent over the year. An important driver of this has been the fall in export prices, partly due to the appreciation of the Australian dollar, which on a trade-weighted basis averaged $8^1/_2$ per cent higher than in the June quarter a year ago (see 'Commodity Prices' for a more detailed discussion of export prices). Data on export volumes are not yet available for the June quarter; however, with the exception of rural exports, volumes have been relatively flat over the past couple of years, after strong average growth through the 1990s (Graphs 36 and 37).

Graph 35



Graph 36



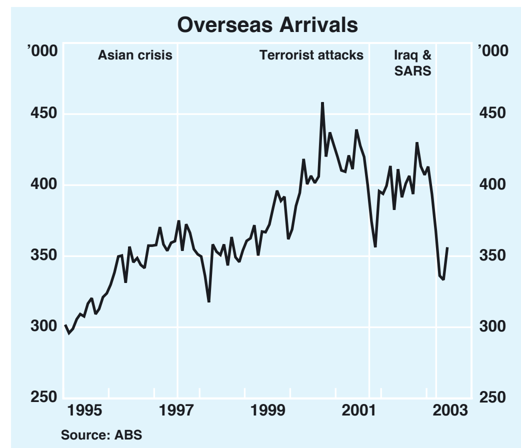
Graph 37

The fall in the value of exports has been broadly based, with declines in most classes of goods and services, and to most markets. The fall in rural exports has been especially sharp, with the value of exports in the June quarter down by over 27 per cent on the level of a year ago, largely reflecting the effect of the drought. In the June quarter, the weakness was compounded by lower wool exports, due to temporarily low demand from Chinese buyers owing to the SARS outbreak. The value of beef and veal exports also fell sharply in the quarter in response to weaker demand from the US. Looking ahead, a strong recovery in rural exports is expected in 2003/04, in line with the predicted rebound in agricultural production that will stem from harvesting the current winter crop. The increase in rural exports may, however, be somewhat smaller than that following the breaking of previous droughts, given downward revisions to the estimated size of the 2003/04 crop. The recovery in other classes of rural produce will be more muted as a result of their less favourable production prospects in the near term.

The value of resource exports also fell in the June quarter, to be around 9 per cent lower than a year ago. This follows several quarters in which resource exports were relatively flat. A key influence has been the subdued growth in the world economy, which has resulted in weak demand for many commodities, particularly metals. In addition, there have been declines in the world prices of some commodities and lower Australian dollar receipts, particularly in the June quarter. The value of manufactured exports fell by 2 per cent over the year to the June quarter, compared with average annual growth of around 15 per cent for much of the 1990s.

There was a marked fall in the value of Australian service exports in the June quarter, in line with the world-wide downturn in international travel associated with the Iraq war and the spread of SARS (see Box A on 'SARS'). Service exports were around 7 per cent lower than a year earlier. Early in the quarter, the number of overseas arrivals fell particularly sharply, to approach levels seen in the aftermath of the Asian financial crisis, driven largely by falling arrivals from Japan and SARS-affected countries in east Asia (Graph 38). Reflecting this, there has been weak demand for a range of tourism services consumed by international visitors. However, with the number of SARS cases having stabilised, overseas arrivals began to recover in June, with the increase in arrivals sourced largely from east Asia. Airport bodies report that this continued in July. While part of the recent increase reflects the carry-over of travel that had been planned for the period affected by SARS, forward bookings are also increasing and suggest the recovery may consolidate.

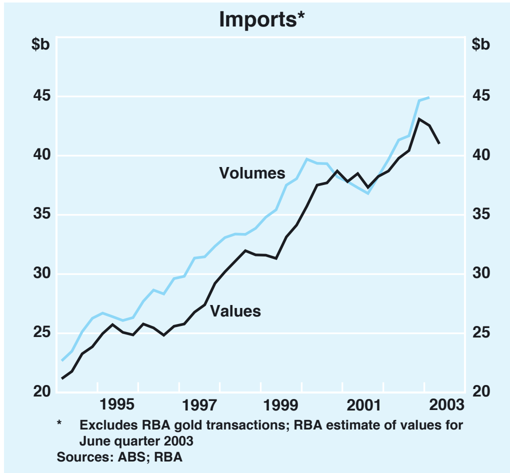
Graph 38



The value of imports increased over the year to the June quarter by around 3 per cent. With import prices lower in Australian-dollar terms, this implies that the volume of imports has increased solidly, in line with robust growth in domestic demand (Graph 39). A strong rise in the value of merchandise imports over the year offset a fall in services imports. Imports of consumption goods continue to grow rapidly, with imports of motor vehicles the main contributor to the strength, while capital imports remain volatile, owing to the periodic importation of civil aircraft.

The net income deficit narrowed significantly in the March quarter to stand at a near-decade low of 2.8 per cent of GDP. While lower global interest rates have

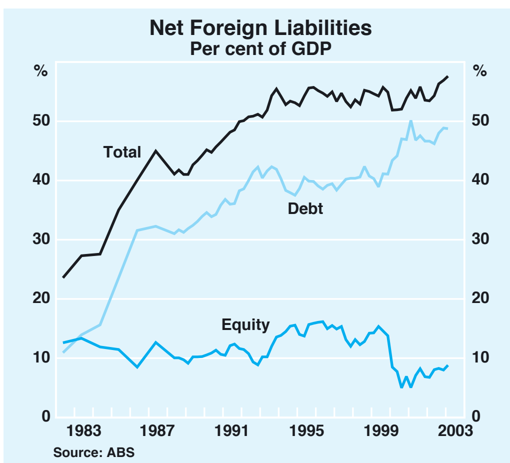
Graph 39



helped contain debt-servicing costs, the past year or so has seen a significant increase in net dividend payments. This partly reflects relatively solid profit growth in Australia.

Australia's net foreign debt rose slightly in the March quarter, but remained around 48½ per cent of GDP. Net foreign equity liabilities also increased in the quarter, as the appreciation of the Australian dollar lowered the Australian-dollar value of foreign equity assets (Graph 40). The trend over the past few years of strong net debt inflows and moderate net equity outflows continued in the quarter. Overall, total net foreign liabilities rose by 2.7 per cent, to around 57½ per cent of GDP.

Graph 40

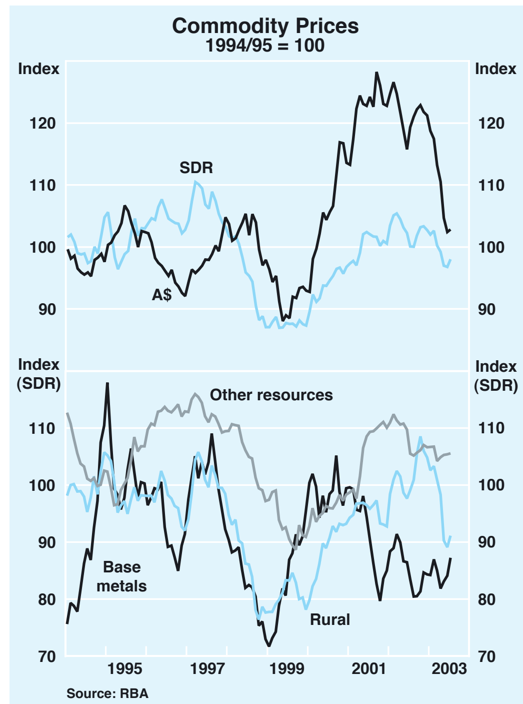


Commodity prices

In SDR terms, rural commodity prices have fallen markedly since mid last year, to be at their lowest level in three years. Other commodity prices, while displaying some volatility, are only slightly lower than their levels of a year ago. In aggregate, commodity prices in the three months to July were 4.5 per cent lower than a year ago (Graph 41). Despite this fall, the aggregate commodity price index is only slightly below the average of the past 10 years in SDR terms. The fall in commodity prices in Australian-dollar terms has, however, been much larger, reflecting the appreciation of the Australian dollar.

The weakness in rural commodity prices has been broadly based. In SDR terms, sugar prices fell by around 18 per cent in the three months to July, to be nearly 12 per cent lower than a year ago, largely as a result of increased world production. Beef prices have also fallen since mid 2002, as drought in North America and Australia has induced higher slaughter rates. Wheat prices remain weak and in the three months to July were around

Graph 41

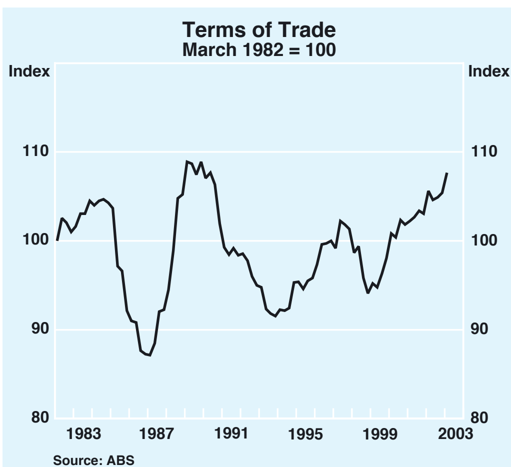


8 per cent lower than the same period a year ago, though they spiked in late 2002 as a result of drought. In contrast, base metals prices have ebbed and flowed with changes in sentiment about the global economy, but have edged up in the past three months. Some other resource prices have also edged higher with, for example, the US dollar contract prices for iron ore for the Japanese fiscal year 2003/04 (beginning 1 April 2003) rising by around 9 per cent on levels of the previous year. The gold price remained roughly flat in the three months to July, though traded in a broad band.

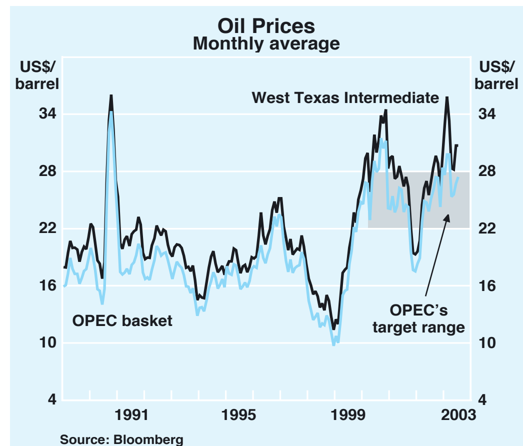
Import prices have also declined recently, falling by around 6¼ per cent over the year to the June quarter in Australian-dollar terms; in SDR terms, they are around ½ per cent lower than a year ago. This weakness in world prices reflects low prices for a range of manufactured goods, combined with a trend of falling relative prices of information and communications technology goods, which account for a growing share of imports. In Australian-dollar terms, falls in import prices have been proportionately greater than those for exports, so that there has been a rise in the terms of trade over the year (Graph 42). However, recent price data suggest the terms of trade are likely to have fallen slightly in the June quarter.

In contrast to weakness in most commodity prices, oil prices remain relatively high and volatile. Having peaked ahead of the Iraq war and fallen sharply following its commencement, the price of West Texas Intermediate crude oil has since risen again, amidst uncertainty about the resumption and continuity of Iraqi export supply. At present, oil production in Iraq is still well below its pre-war level, though there are expectations that this will increase to around three-quarters of the pre-war level by the end of the year. The price of West Texas Intermediate crude oil has averaged around US$30 per barrel in the past three months and is currently just under US$32 per barrel (Graph 43).

Graph 42



Graph 43



Domestic Financial Markets

Interest rates and equity prices

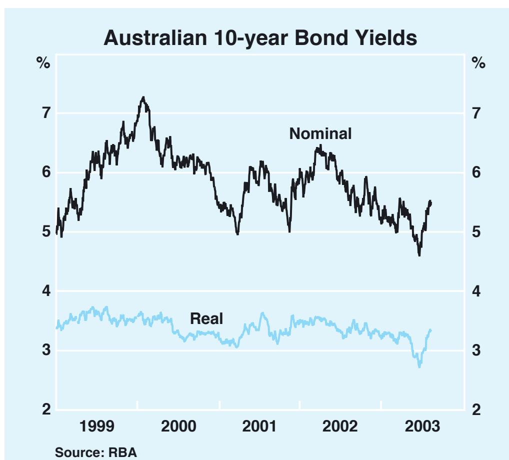
Money and bond yields

The cycle in overseas markets over the past three months, as described in the chapter on 'International and Foreign Exchange Markets', has been reflected in domestic markets. From early May to mid June, domestic bond yields followed global yields lower on concerns about potential deflationary pressures in the US and related expectations of easier monetary policy abroad and in Australia. Over these six weeks, Australian 10-year yields fell by 70 basis points, to a 40-year low of 4.59 per cent (Graph 44).

The decline in bond yields was more than unwound over the second half of June and July, again reflecting US market developments. By early August, the yield on 10-year bonds was 5.5 per cent, some 25 basis points above its level in early May.

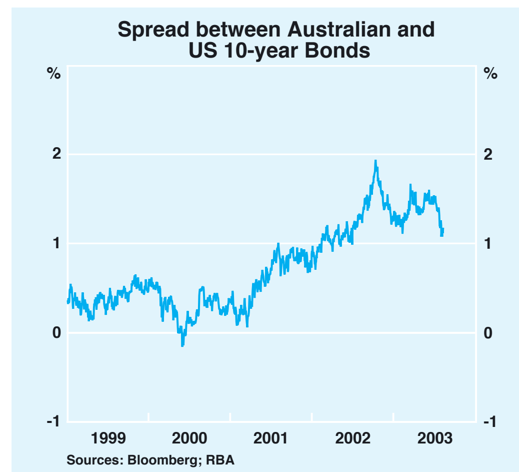
Yields on inflation-indexed bonds have moved in a similar way to nominal yields since the last *Statement*. After touching a low of 2.7 per cent in June, yields on 10-year indexed bonds now stand at around 3.3 per cent, 15 basis points higher than their level in early May.

Graph 44



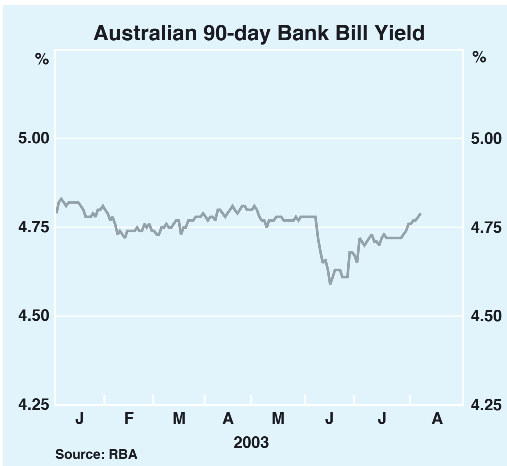
While movements in yields on Australian government bonds have generally followed those in the US market, the spread between the two widened in early June when US yields fell particularly sharply (Graph 45). At one point, the spread reached 160 basis points. As US bond yields subsequently rose over the following weeks, the spread retraced, narrowing to around 110 basis points by early August. At this level, it remains around the average of the past couple of years.

Graph 45



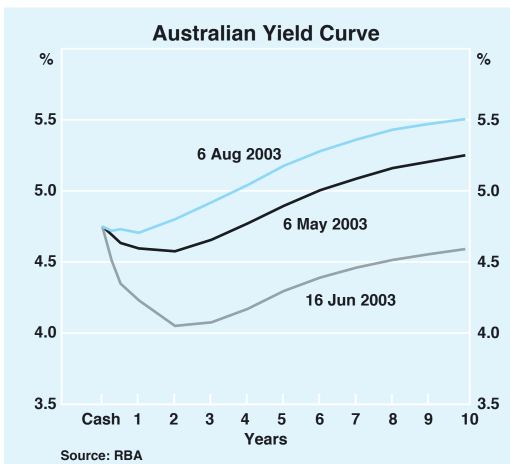
Throughout the three months, the target cash rate has remained unchanged at 4.75 per cent. Expectations of monetary easing in the second half of the year increased in May and into early June, due to concerns about continued global weakness and upward pressure on the exchange rate. At one point, markets had priced in a cash rate of 4.0 per cent by year-end. Since then, improved sentiment about global prospects, the decline in the exchange rate and rising concerns about the rapid growth of housing credit have seen these expectations scaled back markedly. Consistent with these developments, yields on 90-day and 180-day bank bills have risen back to levels around the cash rate (Graph 46).

Graph 46



The relative movements of short and long rates have seen the shape of the yield curve change noticeably over the past three months (Graph 47). A pronounced negative slope for maturities out to three years emerged during May and June. In fact, at one stage, even 10-year yields were below the overnight cash rate, the first inversion of the curve in two and a half years. The subsequent improvement in market sentiment has restored the yield curve to a shape similar to that in early May; this has long yields above the cash rates, though yields on 2-year bonds remain around the cash rate.

Graph 47

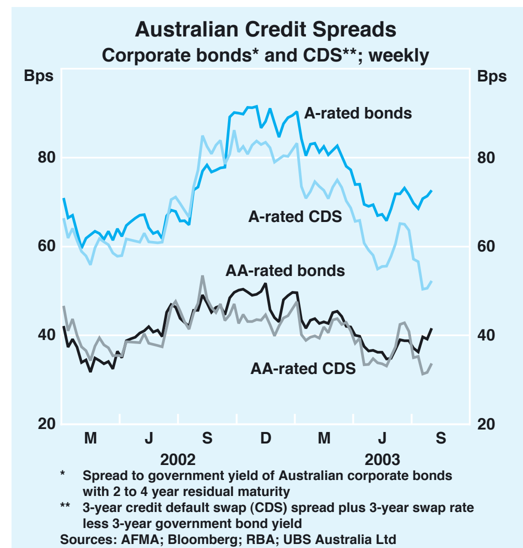


Credit spreads

Abstracting from changes in the composition of corporate bond indices, spreads between yields on government and corporate bonds have shown a small net decline over the past three months (Graph 48).[1] Despite brief increases in the first half of June and early August, spreads are now 10 to 20 basis points below the peaks seen in October–November 2002. Comparable measures of credit risk derived from credit default swaps have declined by even more (see 'New Measures of Credit Risk', Reserve Bank *Bulletin*, July 2003, for a discussion of these measures). The narrowing of spreads indicates growing optimism regarding corporate creditworthiness. In addition, investors have shown a greater willingness to invest in riskier bonds as they seek out relatively high-yielding investments in the low-yield environment.

The rise in government bond yields has, however, more than offset the decline in corporate spreads. As a result, yields on corporate bonds are about 30 basis points higher than at end April.

Graph 48



1. The rise in the indices in mid July is due to half a dozen bonds falling out of each of the A and AA indices.

Intermediaries' interest rates

Variable indicator rates have remained unchanged since June 2002, reflecting the unchanged cash rate target (Table 12). From around that time, fixed lending rates for both businesses and housing declined steadily; in June 2003, 3-year fixed business rates reached their lowest level since comparable data were first collected in September 1994. Since then, fixed business rates have increased, though by less than the rise in the cost of funding these loans. Banks' 3-year fixed housing rates have also moved slightly higher since June, but remain nearly 100 basis points lower than in mid 2002. Three-year fixed housing rates are now 60 basis points below the standard variable rate (Graph 49). Nevertheless, and despite increasing marginally in June, the share of fixed-rate housing loan approvals in total approvals remains low by historical standards.

Graph 49

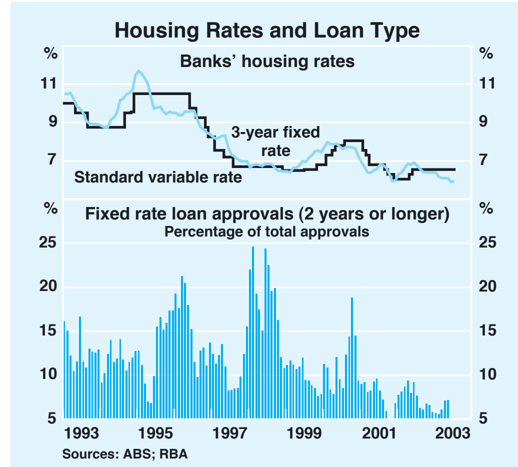


Table 12: Indicator Lending Rates
Per cent

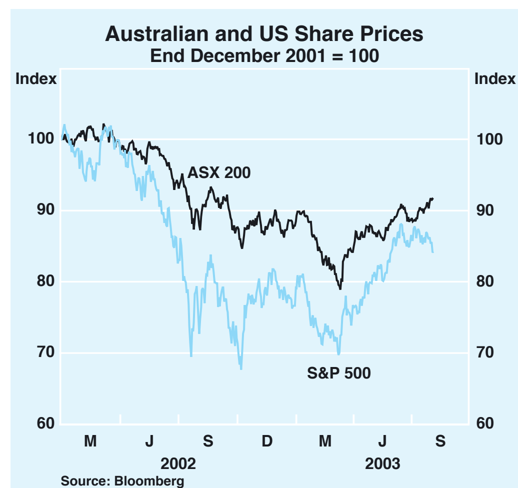
	Current level (6 August)	Change since end April
Variable rates		
Household		
Mortgages:		
– Standard variable	6.55	..
– Basic housing	6.00	..
– Mortgage managers	6.35	..
Personal lending:		
– Home equity	6.70	..
– Credit cards	16.00	..
Small business		
Residential secured:		
– Overdraft	7.45	..
– Term loan	6.75	..
Other security:		
– Overdraft	8.35	..
– Term loan	7.35	..
Large business	8.35	..
Cash rate	4.75	..
Fixed rates (3 years)		
Housing	5.95	–0.15
Small business	6.60	0.15
Swap rate	5.20	0.30

Source: RBA

Equity prices

Continuing the rebound in share prices which started in March, the Australian share market has risen another 4 per cent in the past three months; the ASX 200 is up 16 per cent since mid March (Graph 50). While the Australian market has not kept pace with the rises seen in the US over recent months, over the longer term it has been considerably more stable; the ASX 200 is now around the same

Graph 50



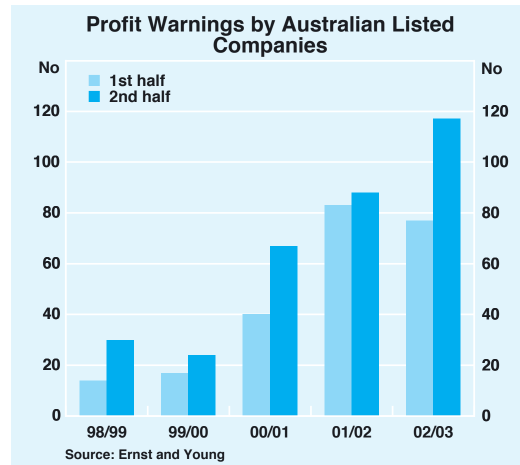
level as at the end of 1999, whereas the S&P 500 has fallen by about one-third over that period.

The rise in share prices has been broadly based with all sectors apart from the consumer staples and utilities sectors rising over the three months. The materials, energy and telecommunications sectors have outperformed. The strength in the materials and energy sectors reflects a perceived improvement in prospects for export markets in the year ahead and speculation regarding mergers and acquisitions, while the rise in the telecommunications sector is due to a re-rating of Telstra. Within the financial sector, prices for the insurance industry continued to fall, due in large part to the sharp fall in AMP's share price in early June following the announcement of a de-merger of its UK and Australian operations. The insurance sector index has fallen by more than 20 per cent since the start of the year.

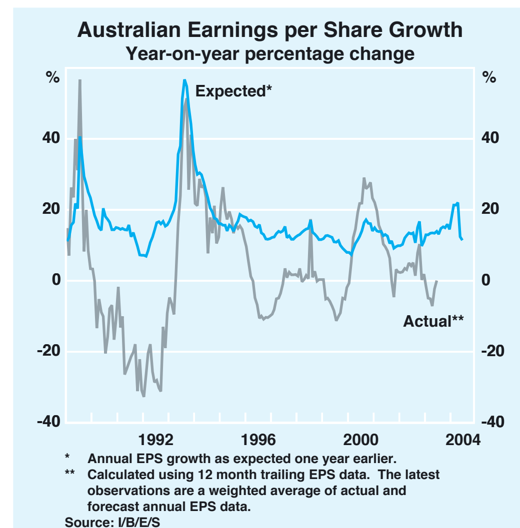
Following the end of formal hostilities in Iraq in April, the options market's assessment of likely share market volatility fell noticeably. In particular, the market has scaled back its view of downside risk, with the expected likelihood of a fall of 15 per cent or more over the next three months dropping from 8 per cent to 3 per cent.

The rise in share prices has come despite a marked increase in the number of profit warnings issued by Australian listed companies. Many of the considerations underlying these profit warnings had already been factored into share market valuations. The increase in profit warnings, from 77 in the six months to December 2002 to 117 in the six months to June 2003, is more than can be explained by the usual seasonality in profit warnings (Graph 51). The tourism/leisure and manufacturing/food industries saw the largest increases in the number of warnings, reflecting the outbreak of SARS in Asia, the Iraq war and weak global economy. Around a dozen warnings (mostly in the materials, industrials and consumer sectors) cited the appreciation of the Australian dollar as a contributing factor. The profit warnings have resulted in analysts' estimates of profits for the 2002/03 year being scaled back. The one-year-ahead forecast had also been scaled back but, at around 11 per cent, is similar to what it has been in the past (Graph 52).

Graph 51



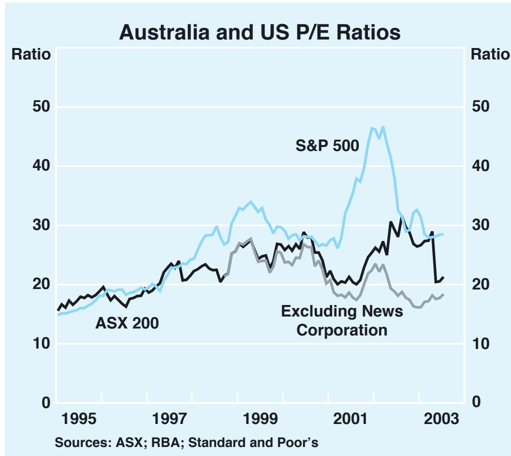
Graph 52



The Australian price-earnings (P/E) ratio dropped in May to around 20 (Graph 53). This measure is based on trailing earnings over the prior year and the May fall largely reflects the 'dropping out' of the large losses recorded by News Corporation a year ago. The ratio is still a little above its long-run average.

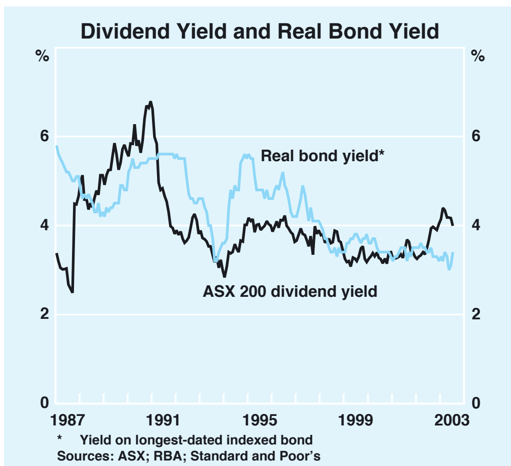
The dividend yield on shares, at around 4 per cent, remains relatively attractive

Graph 53



compared with the general level of interest rates. The dividend yield is in effect a real yield, so that the more direct comparison is with real interest rates. Through much of the 1990s, the dividend yield was below the real government bond yield, but recently it has moved noticeably above (Graph 54).

Graph 54



Financing activity

Debt markets

Bond issuance by Australian non-government issuers was again robust in the June quarter, driven by continued strong issuance into offshore markets (Table 13). Total bond issuance by these entities amounted to $33.8 billion in the June quarter, up slightly from the March quarter and well ahead of the quarterly rate in 2002. Financial institutions were the main issuers, accounting for over half the quarterly total, with the remainder fairly evenly spread between asset-backed vehicles and non-financial companies.

Domestic issuance by Australian entities was $7.3 billion, up a little on the previous quarter. A new record, of $1.5 billion, was set for issuance at a single maturity in the June quarter. Also, since late last year, two new types of bonds have appeared. The first is a property developer's issue of securitised debt backed by a revolving portfolio of off-the-plan apartment sales. The second is portfolio credit-linked notes. These are debt securities that package together a standard bond with a credit default swap. The interest rate paid on the credit-linked note reflects the creditworthiness of the company underlying the credit default swap. In the case of a portfolio credit-linked note, the rate reflects the combined creditworthiness of a portfolio of companies underlying the credit default swap rather than a single company.

At the end of June, the volume of outstanding non-government bonds in the domestic market was $131 billion, up from $127 billion in March (Graph 55). Commonwealth government bonds and state

Graph 55

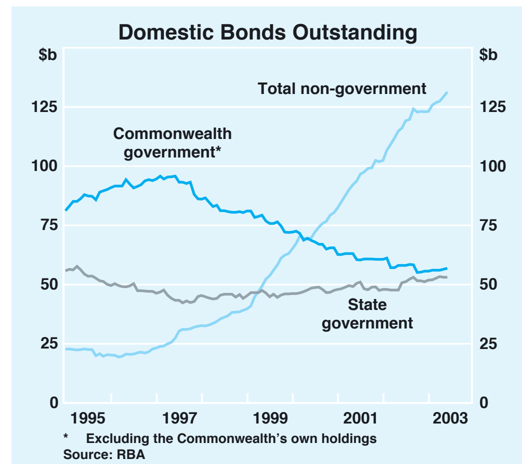


Table 13: Non-government Bond Issuance by Sector
$billion

Sector	2000	2001	2002	2003 March quarter	2003 June quarter	2003 July
Bond issues by Australian entities						
Onshore						
Financial institutions	5.1	6.0	7.4	1.3	3.5	0.8
Non-financial institutions	7.6	5.9	7.6	1.7	0.4	0.7
Asset-backed	11.3	15.0	19.3	3.0	3.4	3.0
Total	**24.1**	**26.9**	**34.3**	**6.0**	**7.3**	**4.5**
Offshore						
Financial institutions	23.2	29.3	31.8	14.4	15.3	5.2
Non-financial institutions	5.1	8.8	8.8	4.2	6.1	0.7
Asset-backed	8.9	14.3	16.5	6.4	5.1	1.5
Total	**37.2**	**52.4**	**57.1**	**25.1**	**26.5**	**7.5**
Total	**61.3**	**79.3**	**91.4**	**31.0**	**33.8**	**12.0**
A$ bond issues by non-resident entities						
Onshore	3.5	7.8	3.1	0.2	0.7	1.1
Offshore	1.0	4.3	17.3	11.9	5.4	0.3
Total	**4.5**	**12.1**	**20.4**	**12.1**	**6.0**	**1.4**

Source: RBA

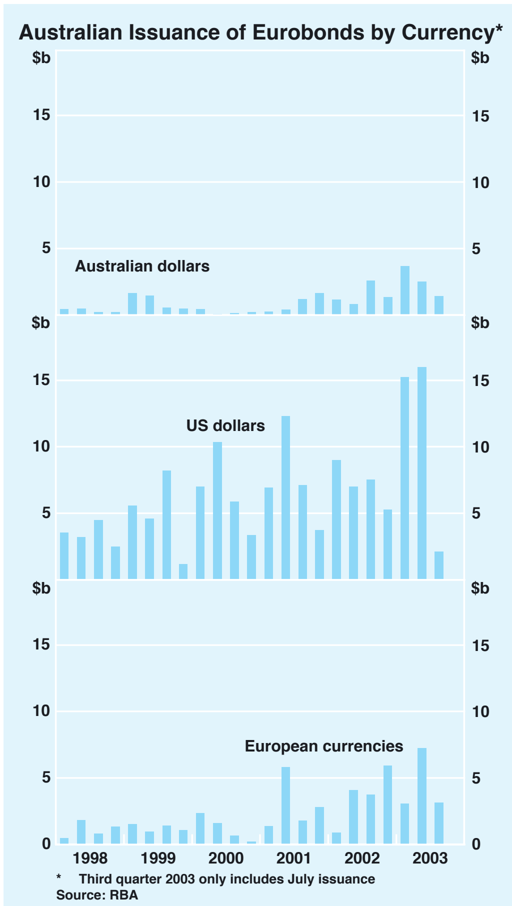
government bonds outstanding were little changed at $57 billion and $53 billion respectively.

Offshore issuance by Australian entities increased further in the June quarter, to $26.5 billion – that is, about four times as large as domestic issuance. The month of July, however, saw some slowing, in part because of a diversion to domestic issuance.

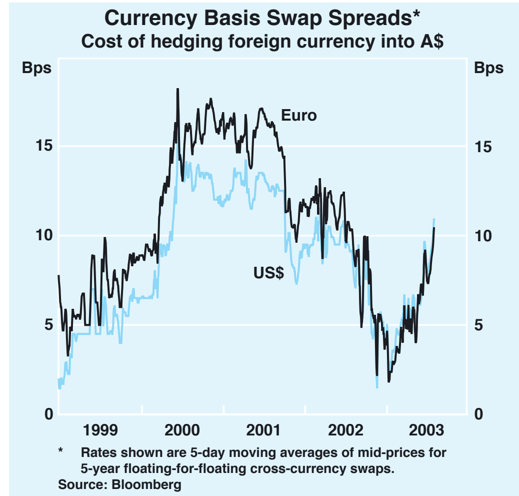
Most offshore issuance by Australian borrowers in the June quarter was denominated in foreign currencies (Graph 56), with US dollar debt continuing to account for the bulk of such issuance. However, a shift by financial intermediaries towards borrowing in euros and UK pounds, as they seek to diversify their funding sources, saw those currencies' share of offshore foreign currency issuance increase sharply to almost 30 per cent. Non-financial companies and asset-backed vehicles continued to predominantly borrow in US dollars. Even though these primary issues are mainly in foreign currencies, the bulk is subsequently swapped back to Australian dollars using derivatives markets.

As discussed in Box D of the May 2003 *Statement on Monetary Policy*, spreads on cross-currency basis swaps fell sharply during 2002 making it more attractive for Australian borrowers to issue offshore (Graph 57). This fall in spreads was largely a result of the increase in Australian dollar issuance by non-Australian borrowers into the Japanese retail market (the uridashi market) which boosted demand to receive an Australian dollar interest rate under cross-currency swap agreements. Although these spreads have since risen from their lows, as foreign currency issuance by Australian corporates has picked up and the wave of uridashi issuance has peaked, they remained relatively attractive for Australian borrowers through the June quarter. That said, the recent pick-up in these premia is consistent with the easing in offshore issuance by Australian companies in the month of July.

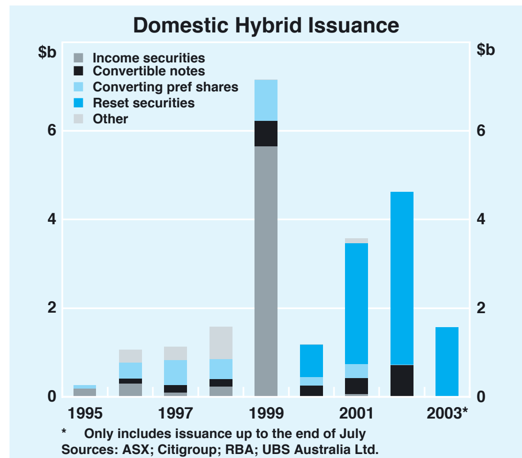
Graph 56



Graph 57



Graph 58



Non-residents raised a total of $6.0 billion of Australian dollar securities during the June quarter, mostly in offshore markets. This was only about half the size of issues in the previous quarter, reflecting a considerable lessening of demand for Australian dollar paper by the Japanese retail market.

Hybrid securities

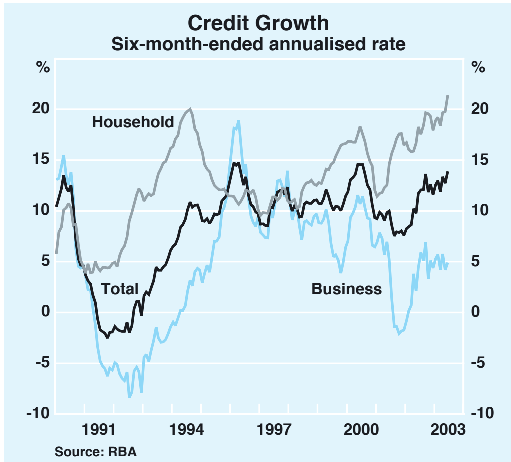
Domestic issuance of hybrid securities (that is, those securities that contain features of both debt and equity) has also been strong recently, with $0.8 billion issued in the June quarter, and a further $0.8 billion in July. Consistent with the pattern seen in 2001 and 2002, most issuance this year has been in the form of reset securities (Graph 58).[2]

Intermediated borrowing

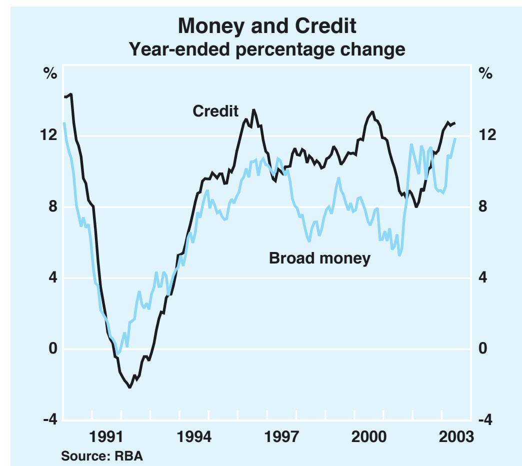
Total credit increased at an annual rate of 13.9 per cent over the six months to June, slightly faster than growth over the previous six-month period (Graph 59). The growth in total credit continues to mask divergent movements in its components, with credit to

2. Reset securities offer a fixed coupon until their first reset date. At each reset date the issuer may announce a change to the security's coupon payment, with investors having the option of holding their securities until the next reset date, or converting them into ordinary equity at that point.

Graph 59



Graph 60



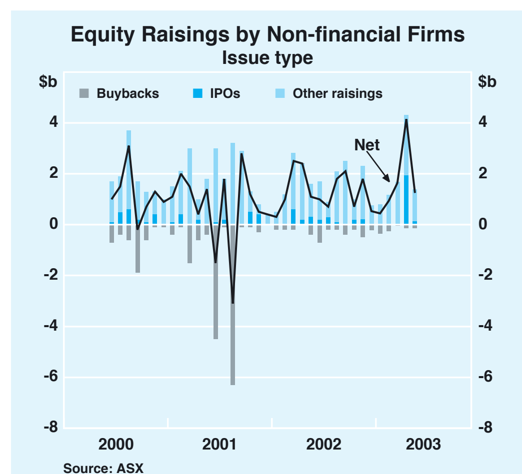
the household sector growing at an exceptionally strong pace, while borrowing by businesses has remained relatively subdued (see the chapter on 'Credit Growth'). The strong pace of household credit growth has been driven predominately by housing-related borrowing. However, personal borrowing for non-housing purposes has also been strong recently, increasing at an annualised rate of 14.6 per cent over the six months to June. The pick-up in growth has been concentrated in revolving finance and personal term loans, while growth in credit card lending slowed to an annual rate of 12¹/4 per cent in recent months, after running at an average annual rate of around 18 per cent over the past five years. As discussed in the chapter on 'Domestic Economic Activity', the subdued business borrowing largely reflects that businesses have been able to rely on strong profits to finance investment.

On the other side of intermediaries' balance sheets, growth in the broader monetary aggregates has remained fairly strong in recent months, to be running at an annualised rate of 11.8 per cent over the six months to June, slightly lower than growth in total credit (Graph 60). This strength has been partly driven by growth in wholesale deposits with banks.

Equity raisings

Equity raisings were very strong in the June quarter with net issuance totalling $7 billion, the highest quarterly total on record (excluding privatisations; Graph 61). Issuance was dominated by two large raisings: Promina's $1.9 billion new listing and AMP's institutional placement of $1.2 billion (AMP raised an additional $500 million in July). In addition to these issues, other equity raisings were quite strong, with a number of private placements by property trusts and solid raisings through dividend reinvestment plans.

Graph 61

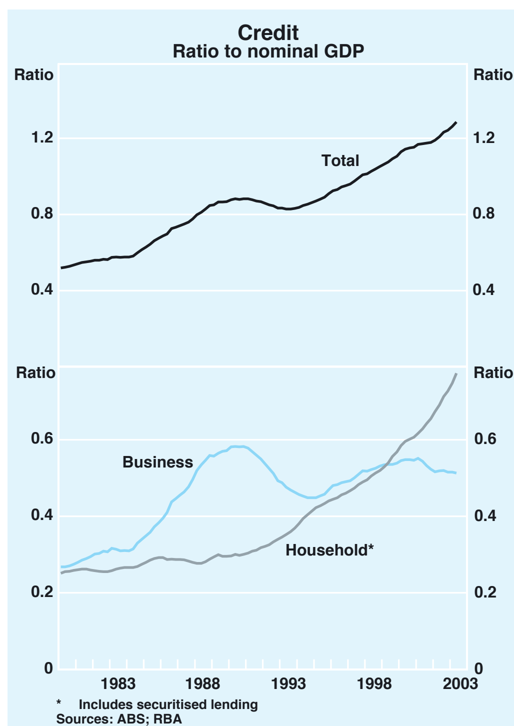


Credit Growth

Recent trends

Credit has grown at an average rate of 11 per cent per annum since 1995 and 13 per cent over the past year. In comparison, growth in nominal GDP has averaged 6 per cent since 1995. The result of this extended period of rapid credit growth has been a strong upward trend in the ratio of credit to GDP (Graph 62).

Graph 62



Unlike the period of rapid credit expansion in the late 1980s, the current episode has been characterised by a strong increase in credit extended to the household sector, rather than to the business sector. Household credit has grown at an average annual rate of 14 per cent since the mid 1990s, and by almost 20 per cent over the past year. The result has been a doubling in the ratio of household credit to GDP since 1995. In contrast, business credit has recorded average annual growth of 7½ per cent since the mid 1990s and, as a share of GDP, has changed little in net terms since 1987.

The pace of credit growth in Australia has been unusually fast by international standards (Table 14). Of the major industrialised economies only the Netherlands and Spain have recorded broadly similar growth to that in Australia since 1995.[1] In other countries, it has not been uncommon for credit growth to average between 6 and 9 per cent per year over this period. If anything, the divergence between developments in Australia and elsewhere has become more pronounced over the past couple of years, with most countries experiencing a decline in the pace of overall credit expansion in line with the slowdown in economic growth.

The available international data indicate that in most countries growth in household credit has generally been around the same pace as that in total credit since the mid 1990s. Over the past year or so, however, household credit growth has generally picked up, partly in response to low interest rates and strong housing markets. Despite this, the scale of the divergence between household and total credit growth in Australia is unusual by international standards. Another unusual aspect of the Australian experience is the high proportion of total household credit growth accounted for by investors, with, for example, investors accounting for around 40 per cent of the value of all new housing loan approvals over recent months.

1. Rapid credit growth in the Netherlands is partly due to the tax-deductibility of interest payments on mortgages for owner-occupied properties. This practice has led financial institutions to develop products that allow households to delay repayment of principal. In Spain, strong credit growth partly reflects the decline in nominal interest rates associated with European Monetary Union.

Table 14: Credit Growth
Per cent

	Total		Household	
	1995 to latest[(a)]	Year to latest	1995 to latest[(a)]	Year to latest
Australia	11.1	12.7	14.2	19.6
US	7.6	7.5	8.0	10.3
Japan	–1.5	–6.2	2.9	3.1
Germany	5.0	0.8	5.6	2.7
France	3.8	–0.3	4.5	6.4
UK	8.2	8.0	7.4	9.4
Canada	6.4	5.0	6.0	8.0
Spain	12.3	12.2	15.7	12.7
NZ	9.0	7.1	10.2	11.0
Sweden	7.5	2.2	6.2	9.5
Netherlands	12.5	7.1	14.1	6.6
Finland	4.3	8.9	5.4	10.9

(a) Average annual growth
Sources: IMF; national sources; RBA

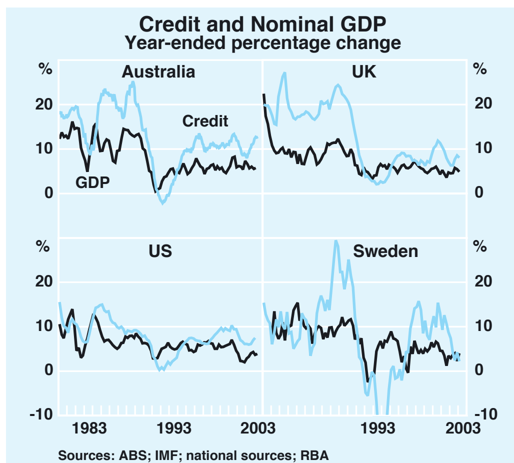
There are a number of factors that help explain the persistently strong household credit growth in Australia. Innovation in the provision of mortgage finance and expectations of relatively attractive after-tax returns on residential property have played a role, as have cyclically low interest rates over recent years. A more important influence though is the continuing adjustment by the household sector to the structural decline in nominal lending rates since the 1980s. Importantly, this decline has allowed households to borrow roughly twice as much relative to income as was possible in the late 1980s, while maintaining a given debt-servicing ratio. In addition, greater stability in both interest rates and the economy has encouraged some households to increase their level of gearing. These changes have resulted in a significant upward shift in the ratio of household debt to GDP, and thus a period of above-average credit growth. However, at some point this transitional process must come to an end, which would require household credit growth to return to something more closely in line with the growth of nominal GDP.

Credit and nominal GDP growth

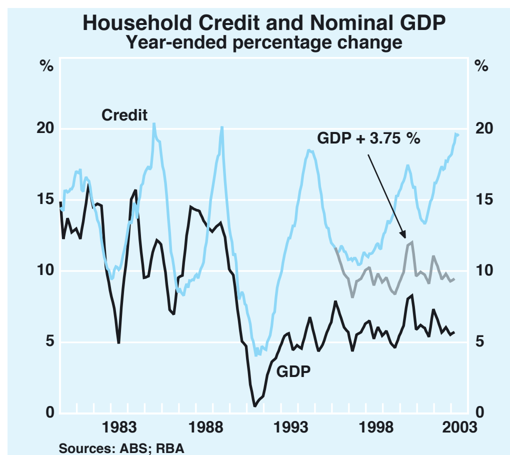
There is no firm benchmark as to what constitutes a 'normal' relationship between credit growth and nominal GDP growth. A stable ratio of credit to GDP would require that they both grow at the same rate, but international evidence suggests that it is not unusual for credit to grow, on average, a little faster than nominal GDP. History and international comparisons provide some guide as to what might be seen as 'normal' in this context. While this guide is only approximate, the current pace of household credit growth in Australia exceeds any reasonable benchmark by a large margin.

In interpreting past experience, one needs to take into account that, over recent decades, financial systems in most countries have been liberalised. As constraints on the availability of credit were removed in the 1980s, there was a 'catch-up' effect as firms and households increased their borrowings. In addition, and partly as a result of financial liberalisation, the 1980s saw an unsustainable boom in business credit associated with rapid increases in asset prices, particularly commercial property. The

Graph 63



Graph 64



result in a number of countries, including Australia, was average credit growth over the late 1980s almost 10 percentage points faster than the growth in nominal GDP (Graph 63).

Ultimately, the credit and asset price boom of the 1980s led to financial difficulties in a range of countries. In Finland, Norway, Sweden and Japan, the outcome was a full-scale banking crisis, while in the United Kingdom and Australia financial institutions experienced significant losses. In the years immediately following these problems, credit outstanding grew more slowly than nominal GDP and, in a number of countries, fell in absolute terms as businesses and financial institutions sought to correct the excessive debt positions built up during the 1980s. It was not until the mid 1990s that the pace of credit growth again generally exceeded that in nominal GDP, although in Japan credit outstanding has continued to fall.

This turbulent history makes it difficult to draw strong conclusions about 'normal' relationships. One country that may provide a guide is Canada, which has a long history of a relatively deregulated financial system and was not greatly affected by the financial excesses of the late 1980s. There, credit has grown on average by around $1^1/_2$ percentage points faster than nominal GDP since 1980.

In Australia, the unusually rapid credit growth at present is confined to the household sector. At around 14 percentage points above nominal GDP growth, household credit growth is clearly faster than is sustainable in the medium term. As a basis for comparison, between 1980 and 1995, household credit grew, on average, by around $3^3/_4$ percentage points faster than nominal GDP. Had this differential been maintained since 1995, the level of household credit outstanding would have been almost one-third lower than is currently the case (Graph 64).

While a continuation of the rapid pace of credit growth into the indefinite future is not sustainable, it remains unclear how the current episode of rapid credit expansion will be drawn to a close. Historically, credit booms have tended to end only after a protracted period of higher-than-average interest rates and/or a significant contraction in the economy. Neither of these events looks likely in the immediate future. While there is evidence of weakness in rents, there are, as yet, few signs that this is flowing through to house prices or to loan applications.

As discussed above, in the past when credit and asset price booms have ended, they have often resulted in financial and economic instability, with banks suffering losses and the business and household sectors cutting back spending as they repair their balance sheets. Notwithstanding this historical experience, as far as can be judged, recent developments in

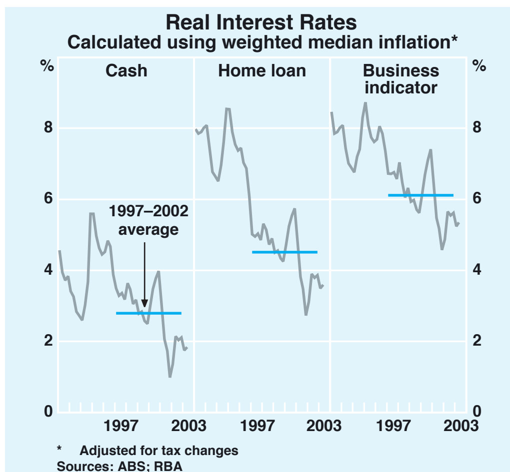
Australia do not pose a significant direct risk to the financial system. They do, however, make household consumption more sensitive to changes in economic conditions than in the past. Moreover, the longer the rapid increase in household borrowing continues, the greater is the risk that, at some point, households will need to adjust the structure of their balance sheets with potentially adverse consequences for the economy and financial institutions.

Assessment of Financial Conditions

As has been the case for some time now, financial conditions are generally supportive of continuing growth in the domestic economy.

The target cash rate has been unchanged at 4.75 per cent since June 2002, and similarly, most variable lending rates have remained unchanged over this period. Measured in real terms, variable loan rates are as much as 1 percentage point below their average level over the past five years, and up to 2¼ percentage points below their average since the early 1990s (Graph 65). The low level of interest rates, relative to historical benchmarks, suggests that the setting of monetary policy is accommodative.

Graph 65



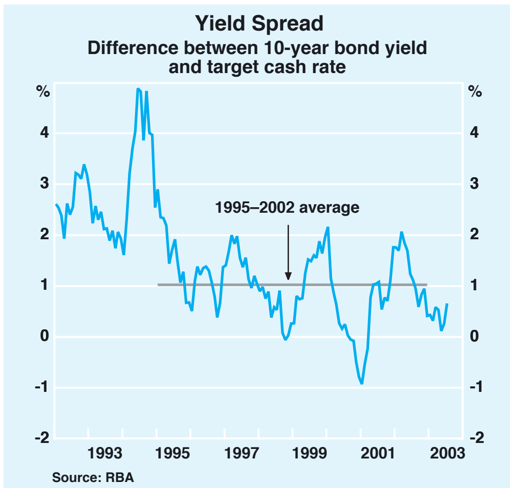
This assessment is supported by the continuing rapid growth in household credit (see the chapter on 'Credit Growth'). Over the past year, household credit has increased by around 20 per cent, and with the value of housing loan approvals continuing to rise over recent months, there seems little prospect for a near-term slowing in the pace of growth. Borrowing for housing has been the main driver behind the expansion of debt, with borrowing by investors rising by 29 per cent over the past year, continuing to outpace borrowing by owner-occupiers, which increased by 18 per cent. While some financial institutions have reportedly tightened their credit standards for loans to investors in inner-city apartments, finance remains readily available on attractive terms.

In the business sector, few firms report interest rates or access to finance as being significant constraints on investment activity. Further, corporate bond spreads have fallen recently to relatively low levels, suggesting that access to external finance is not being constrained by concerns over credit quality. Share prices have also risen over recent months on the back of a general improvement in market sentiment, with the ASX 200 returning to around its level of a year ago. While growth in borrowing by businesses has been relatively subdued over the past year, this primarily reflects the ready availability of internal funding that has resulted from solid profit growth.

Long-term bond yields have been quite volatile since the previous *Statement*, and in net terms are up slightly, although they remain around ½ a percentage point lower than in mid 2002. Fixed-term lending rates on housing and business loans have fallen over the past year. In response, there has been only a slight increase in the share of loans with fixed rates recently, suggesting that borrowers see little prospect of an increase in interest rates in the foreseeable future.

The fall in bond yields over the past year, combined with an unchanged target cash rate, has seen a flattening of the yield curve. In early August, yields on 10-year bonds were around 75 basis points above the cash rate, slightly less than the average differential since the mid 1990s (Graph 66). One interpretation of this is that monetary conditions are not as accommodative as is suggested by the level of real short-term interest rates. An alternative, and perhaps more likely, interpretation is that the market expects that the target cash rate

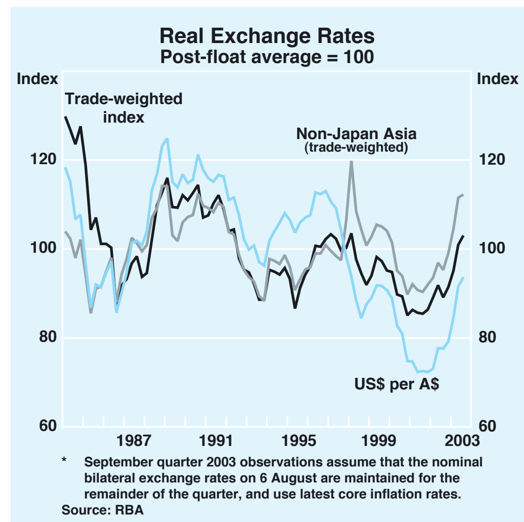
Graph 66



will remain below its average over recent years for some time, and this expectation is reflected in bond yields.

Another element of domestic financial conditions is the exchange rate, which has appreciated, in trade-weighted terms, by around 18 per cent over the past year, reducing the stimulus provided to the traded goods sector. This appreciation has occurred at a time when the terms of trade is above its average level of the past two decades and has been on an upward trend over recent years. While significant, the appreciation follows a period in which both real and nominal exchange rates were considerably below their average values over the post-float period (Graph 67). At its current level, the real trade-weighted index is around 3 per cent above its average over this period. Against both the US dollar and the euro, however, the value of the Australian dollar, in real terms, remains below its post-float average. In contrast, the real exchange rate against the currencies of non-Japan Asia is around 12 per cent above its average value, reflecting the depreciation of these currencies at the time of the Asian crisis, and more recently, their close link to the weakening US dollar.

Graph 67



Inflation Trends and Prospects

Recent developments in inflation

Consumer prices

The Consumer Price Index (CPI) was flat in the June quarter, and increased by 2.7 per cent over the year (Table 15, Graph 68). Measures of underlying inflation increased by 1/2 per cent in the June quarter and, with the exception of the *market goods and services excluding volatile items* measure, increased by between 2 1/2 and 3 per cent in year-ended terms (Graph 69). Overall, the Bank's assessment is that underlying inflation is running at around 2 3/4 per cent, in year-ended terms.

The main positive contributions to CPI inflation in the June quarter and over the year came from increases in the housing and health components. House purchase costs increased by 2 per cent in the June quarter and by 5 1/4 per cent over the year, as ongoing strength in the construction sector resulted in rising costs of materials and labour. The cost of health services also increased strongly in the quarter, to be up by almost 9 per cent over the year, partly due to higher insurance costs for both consumers and service providers. The exclusion of health services, as well as a

Graph 68

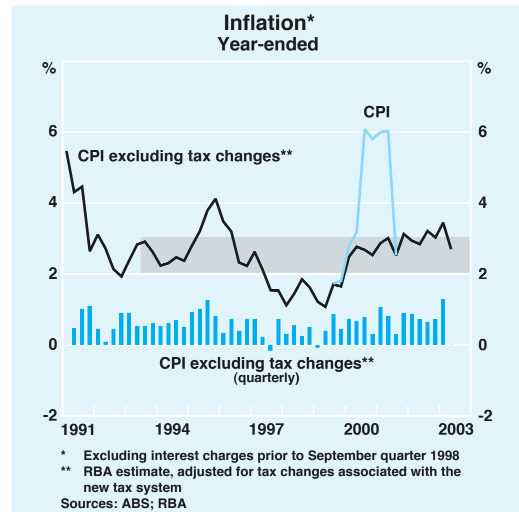


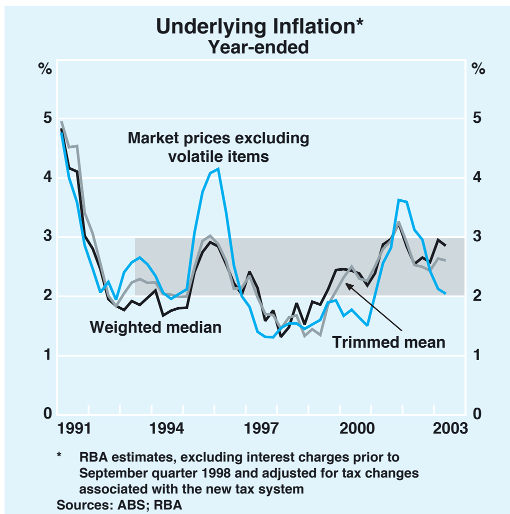
Table 15: Measures of Consumer Prices
Percentage change

	Quarterly		Year-ended	
	March quarter 2003	June quarter 2003	March quarter 2003	June quarter 2003
CPI	1.3	0.0	3.4	2.7
– Tradables	1.2	–0.9	2.7	1.0
– Non-tradables	1.3	0.7	4.0	4.1
Underlying inflation				
Weighted median[(a)]	0.9	0.5	3.0	2.9
Trimmed mean[(a)]	0.8	0.5	2.6	2.6
CPI excluding volatile items	0.8	0.6	2.7	2.7
Market goods and services excluding volatile items	0.5	0.5	2.1	2.0

(a) For more information on these measures see 'Box D: Underlying Inflation' in the May 2002 *Statement on Monetary Policy*.

Sources: ABS; RBA

Graph 69



number of other services provided by the public sector, largely explains the relatively modest increase in the *market goods and services excluding volatile items* measure of underlying inflation over the past year. This measure has typically been more volatile than other underlying measures, for example showing a higher peak in inflation (adjusted for the effects of tax changes) in 2001.

Overall, food prices were flat in the June quarter as sharp falls in fruit and vegetable prices were balanced by price rises for most other items. Over the year, food prices rose by $4^1/_2$ per cent, with above-average price rises being recorded for a number of commodities affected by the drought.

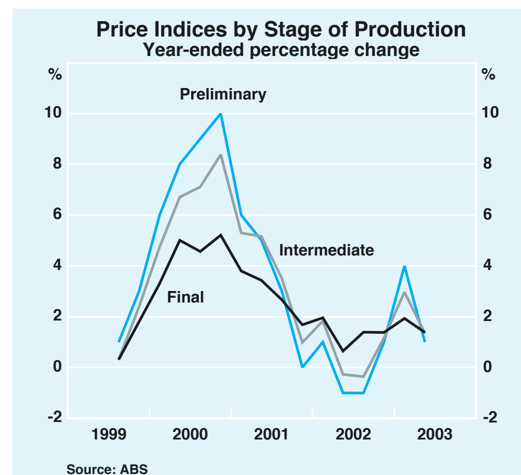
As anticipated, the recent moderation of world oil prices resulted in a fall in fuel prices of almost 10 per cent in the June quarter. This fall reversed an earlier rise, so that movements in fuel prices have had little effect on the year-ended CPI inflation rate. Domestic holiday travel and accommodation prices also fell significantly in the quarter, partly due to seasonal factors, and increased only moderately over the year.

The downward trend in the prices of audio, visual and computing equipment continued in June, due to falling world prices for these goods and the appreciation of the Australian dollar. Prices of these goods have declined by $17^1/_2$ per cent over the year. The effects of the exchange rate are also apparent in the significant fall in prices for imported motor vehicles in the June quarter, and in the further moderation of tradable goods and services prices, which fell by almost 1 per cent in the quarter to be 1 per cent higher over the year. In contrast, the prices of non-tradable goods and services have increased by 1 per cent per quarter, on average, for the past year.

Producer prices

In general, producer price pressures eased significantly in the June quarter, largely because of the fall in prices of oil and related products, and the generalised downward pressure on the prices of imported goods resulting from the exchange rate appreciation (Table 16). Producer price inflation also moderated over the year, particularly at the earlier stages of production (Graph 70), even though the effect of movements in oil prices was fairly small over this period.

Graph 70



Growth in prices of domestically produced items eased in the quarter, but continued to be boosted by large increases in the prices of housing-related items such as construction and real estate services. In contrast, the appreciation of the exchange rate has led to widespread price falls for imported items at all stages of production. The falls have been

Table 16: Stage of Production Producer Prices
Percentage change

	June quarter 2003	Year to June quarter 2003	Year to March quarter 2003
Preliminary	**–1.7**	**1.3**	**3.8**
– Domestic	–0.9	2.3	4.2
– Imported	–6.0	–4.3	2.1
– Excluding oil	–0.5	1.5	1.4
Intermediate	**–1.3**	**1.3**	**3.0**
– Domestic	–0.6	2.5	3.6
– Imported	–5.4	–5.2	–0.8
– Excluding oil	–0.5	1.4	1.3
Final	**–0.4**	**1.4**	**1.9**
– Domestic	0.5	3.5	3.9
– Imported	–4.3	–7.4	–6.3
– Excluding oil	0.0	1.5	1.3

Source: ABS

particularly large for imported electronic equipment.

Indicators of upstream inflationary pressures from business surveys have also moderated. The NAB survey reported that growth in average purchase costs slowed to 0.3 per cent in the June quarter, more than unwinding the pick-up reported in March. Average purchase costs for the September quarter are expected to increase by 0.2 per cent. Similarly, the ACCI-Westpac survey reported that a larger proportion of manufacturing firms experienced a fall in their costs per unit of output in the June quarter than in the previous quarter, while the proportion reporting cost increases remained fairly steady.

Graph 71

Labour costs

Most labour cost indicators continued to signal solid wages growth in the March quarter. The wage cost index (WCI) for total pay increased by 0.9 per cent in seasonally adjusted terms, to be 3.6 per cent higher than a year earlier (Graph 71). At the industry level, the education sector recorded the fastest annual growth in the WCI at 5.1 per cent, while the smallest increase was again recorded in the communications sector (1.5 per cent).

Preliminary indications are that wages growth remained firm in the June quarter. The NAB survey measure of wages growth, while typically showing slower growth than other indicators, picked up a little in the June quarter. The survey also indicates that firms are continuing to find it difficult to attract suitable labour. This is consistent with a recent increase in the ACCI-Westpac survey measure, and suggests that labour market conditions remain relatively tight. The latest

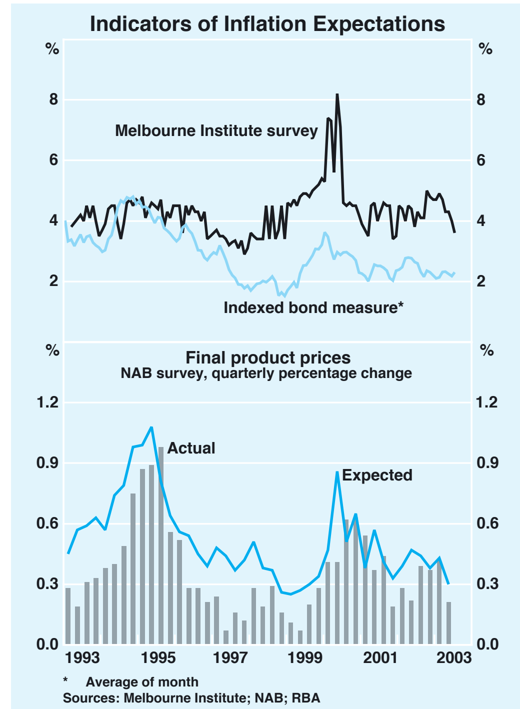
Mercer *Quarterly Salary Review* suggests that annual growth in executives' base salaries also picked up to 4.4 per cent in the June quarter from 4.0 per cent in March.

Average weekly ordinary-time earnings of full-time adults (AWOTE) grew by 1.3 per cent in the March quarter, to be 4.6 per cent higher over the year. The national accounts measures of compensation both grew by 0.2 per cent in the March quarter, but these relatively low outcomes appear to have been affected by the recent changes to the Labour Force Survey. Over the year, compensation per employee increased by 2.8 per cent and compensation per hour worked increased by 3.0 per cent. Unit labour costs (based on compensation per hour worked) increased by 0.9 per cent in the March quarter, to be 2.4 per cent higher over the year.

Inflation expectations

Most indicators point to subdued expectations for inflation in the period ahead. The latest Melbourne Institute survey suggests that consumers now expect lower inflation over the next year than was the case in the early part of this year (Graph 72). In line with this moderation in expectations, the NAB survey reports that firms expect near-term price rises for both retail and all final products to be smaller than the rises they expected over the past few years. In the September quarter, retail prices are expected to increase by 0.2 per cent, while final product prices overall are expected to rise by 0.3 per cent.

Graph 72



Longer-term inflation expectations of investors have been similarly subdued; the difference between 10-year bond yields and indexed bonds continues to fluctuate within the 2–2½ per cent range it has remained in since mid last year. Over the past three months, the financial market economists surveyed by the Bank have made no substantial revisions to their near-term forecasts for inflation, with the median CPI inflation forecast for the year to June 2004 remaining unchanged at 2.3 per cent (Table 17). In contrast, trade union officials

Table 17: Median Inflation Forecasts
Per cent

	Year to June 2004			Year to June 2005
	February 2003	May 2003	August 2003	August 2003
Market economists[(a)]	2.4	2.3	2.3	2.5
Union officials[(b)]	4.0	3.5	3.0	3.1

(a) RBA survey
(b) ACIRRT survey

surveyed by the Australian Centre for Industrial Relations Research and Training (ACIRRT) have revised down their forecasts for inflation by around $^1/_2$ of a percentage point over the next year and now expect inflation of around 3 per cent over the next two years.

Inflation outlook

As indicated above, the Bank's assessment is that the underlying rate of inflation in the year to the June quarter was around $2^3/_4$ per cent, the same as in the year to the March quarter. At the time of the previous *Statement* the Bank judged that underlying inflation was likely to fall slightly to around $2^1/_2$ per cent in the second half of 2003, and to remain around that rate over the following year. Since that time, while domestic sources of inflation pressure have evolved broadly as expected, there has been a further net appreciation of the Australian dollar. Largely as a result, year-ended underlying inflation now appears likely to decline to around 2 per cent in the first half of 2004. Assuming no further change in the exchange rate, it would be expected to remain around that level during the second half of the year before edging up slightly in mid 2005 as the effects of the appreciation on prices begin to dissipate.

Given this path for underlying inflation, CPI inflation is expected to dip temporarily below 2 per cent in early 2004 as the large March 2003 CPI figure drops out of the year-ended calculation. Furthermore, the standard assumption that international oil prices will fall to the middle of the OPEC target band by mid next year also contributes to expected CPI inflation being lower than underlying inflation through much of 2004. As these effects abate in the first half of 2005, CPI and underlying inflation are expected to be more closely aligned.

Underpinning these inflation forecasts is an expectation of a continuation of wages growth around current rates. Over the past year, the rate of increase in wages has picked up moderately, consistent with a strong labour market. But a sustained further increase in wages growth is not anticipated with the economy expected to grow below trend in 2003. Overall, unit labour costs are expected to increase at an average rate of between $2^1/_2$ and 3 per cent over the next couple of years.

Indicators of upstream price pressures, such as producer price data and business surveys, continue to suggest moderate rates of inflation. World prices of traded goods have been broadly unchanged recently. Moreover, the appreciation of the Australian dollar has led to declines in the prices of a number of intermediate goods, and there are some signs that it is already flowing through into consumer prices for imported goods. In contrast, domestic price pressures are evident in a number of areas. In particular, ongoing strength in the construction sector has led to significant increases in the cost of building materials and in house purchase costs. Rising insurance costs have also contributed to price increases, in particular for health services.

As has been the case for some time, the global economy remains a major source of uncertainty for the inflation outlook. While the risks to the global outlook seem more balanced than they have been for some time, the prospects for a pick-up in global growth remain subject to significant uncertainty. If the global recovery were to fall short of current expectations, prospects for the Australian economy would be adversely affected and global deflationary forces could gain momentum. The outcome would be weaker inflationary pressures in Australia.

Sources of upside risks to the inflation outlook include a stronger-than-expected construction sector and continuing housing price increases, together with firmer conditions in the Australian labour market. In a scenario with a reasonably benign world environment, these factors could see a strengthening of demand pressures and hence upward pressure on wage and price inflation. At present, the risks to the inflation forecast appear to be evenly balanced.