Country Report for Australia and Outline of the Securities Market

October 2014

Executive Summary

This report is divided into three sections on the economy and economic outlook, price and volume trends in Australian financial markets and securities industry prospects. The report covers developments in the 2013-14 June financial year and looks ahead to developments in 2014-15.

Economy

The Australian economy continues to grow, albeit somewhat below its long-term trend rate, having just recorded the 23 consecutive year of expansion. The economy is transitioning from a growth rate driven by mining investment to one driven by increased mining production and export volumes, as well as a recovery in non-mining business investment and new dwelling construction.

Inflation pressures remain subdued and the labour market is exhibiting increased spare capacity in line with sub-trend economic growth.

The external economic environment is characterised by a subdued global growth outlook, falling commodity prices and a weakening terms of trade. However, a weaker exchange rate is seen as positive for export and import-competing industries and supports Australian dollar-denominated export values, providing an offset to weaker commodity prices.

Financial Markets

Price trends and volumes in Australian financial markets remained tied to global trends. Australian equity markets have participated in the extended global rally in equity prices, but have underperformed the US and other markets. Debt markets have also performed well in absolute and relative terms, although turnover remains subdued as domestic official interest rates have remained steady. The Australian dollar exchange rate has pulled back from what was widely considered to be an extended period of over-valuation.

Industry Prospects

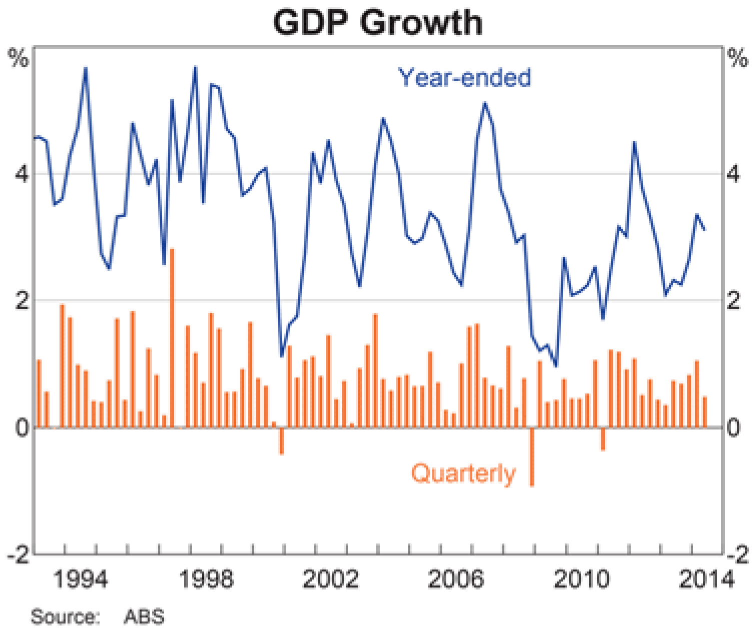
A major Financial System Inquiry will report to the Government in November 2014, with the government response expected in 2015. The Inquiry will set the policy stage for the further development of Australia’s financial institutions and markets.

1. The Economy

1.1. Economic Growth

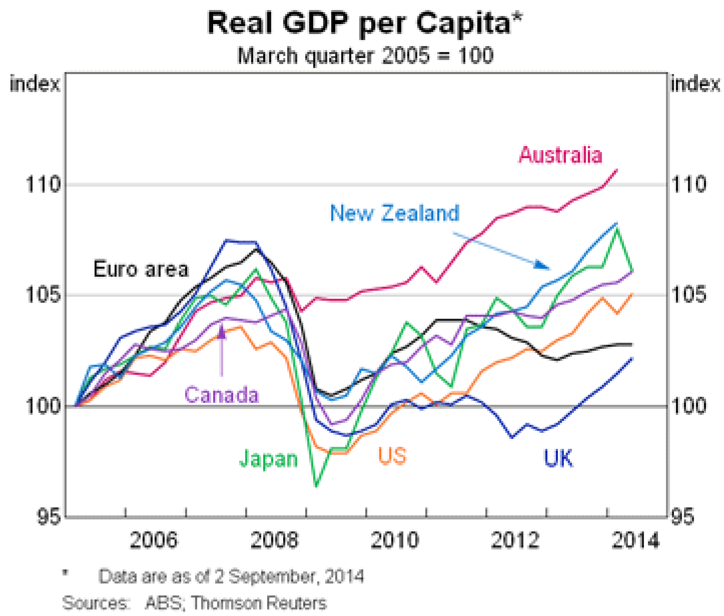
The Australian economy grew at an annual rate of 3.1% in the year ended June 2014, slightly below its long-run trend growth rate. This continues a 23 year economic expansion that has gone uninterrupted by recession (that is, two consecutive quarters of negative growth) since 1991 (Figure 1).

Figure 1



The Australian economy has significantly outperformed comparable developed economies in the wake of the 2008-09 financial crisis, with growth in living standards as measured by real GDP per capita outpacing that among Australia's developed country peers (Figure 2).

Figure 2



The Australian economy is currently transitioning from an economic growth rate driven primarily by mining investment to one driven by increased mining output and export volumes, as previous investment comes online and mining production increases. As mining investment moderates, export volumes have risen to record levels and will continue to support economic growth. Non-mining business investment and new dwelling construction will need to pick-up the slack left by the winding down of the mining investment boom. Low nominal and real interest rates have supported household consumption expenditure and new dwelling construction. However, consumption expenditure is likely to remain subdued as saving rates remain elevated in the wake of the financial crisis at around 10% of household disposable income.

The Reserve Bank of Australia's economic growth forecasts are shown in Table 1.

Table 1. Economic Growth Forecasts: RBA August 2014 Statement on Monetary Policy (year-ended percent change)

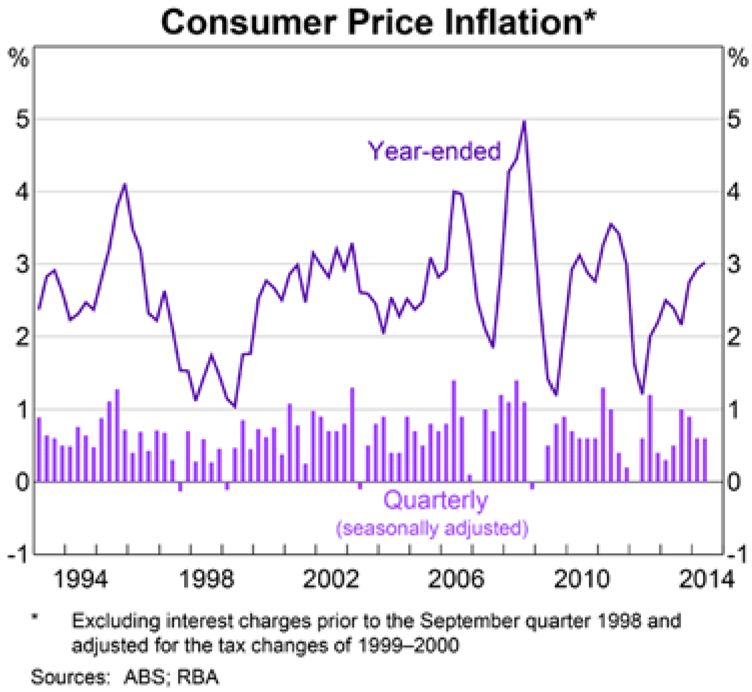
	Jun 2014	Dec 2014	Jun 2015	Dec 2015	Jun 2016	Dec 2016
GDP Growth	3	2.5	2-3	2.5-3.5	2.75-3.75	2.75-4.25

Economic growth is expected by the Reserve Bank of Australia to be somewhat below trend at around 3% during 2014-15 before firming to be consistent with trend at around 3.5% in 2015-16.

1.2. Inflation and Monetary Policy

While the real economy grew 3.1% in the year-ended June, nominal GDP rose only 3.3%, pointing to very subdued growth in economy-wide prices. The headline consumer price inflation rate was 3% for the year-ended in June 2014, with underlying inflation running at 2.75%. This is consistent with the Reserve Bank's 2-3% medium-term inflation target range.

Figure 3



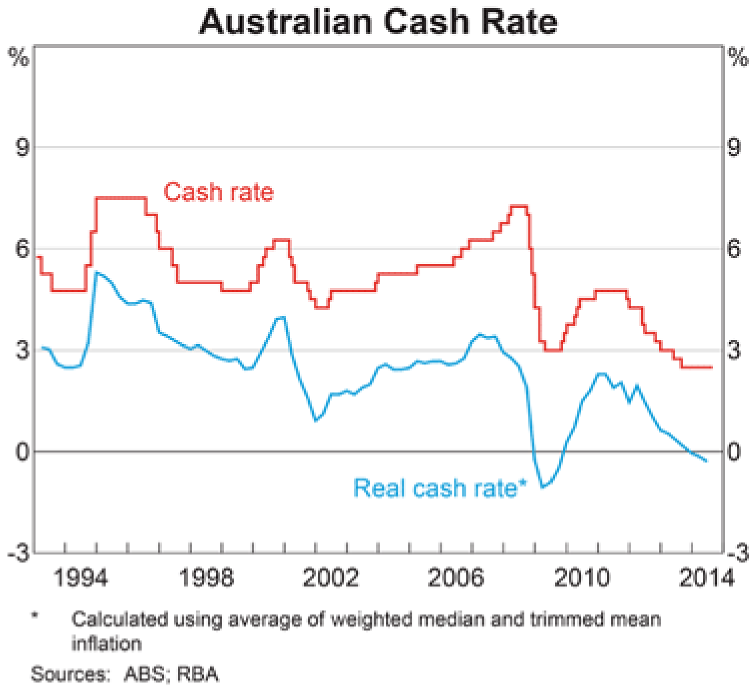
Inflation is expected to remain consistent with the RBA's target over the near term, although with risks seen as being skewed to a breach of the topside of the target range in 2016 as economic growth exceeds trend. The RBA's inflation forecasts are shown in Table 2.

Table 2. Inflation Forecasts: RBA August 2014 Statement on Monetary Policy (year-ended percent change)

	Jun 2014	Dec 2014	Jun 2015	Dec 2015	Jun 2016	Dec 2016
CPI inflation	3	2	1.75-2.75	2.5-3.5	2.5-3.5	2.25-3.25
Underlying inflation	2.75	2.25	1.75-2.75	2.25-3.25	2-3	2-3

With inflation pressures well contained, the Reserve Bank has left its official cash rate steady at 2.5% since August 2013, while signalling an extended period of steady rates in its most recent Statement on Monetary Policy. The ex post real official cash rate has turned slightly negative for the first time since the financial crisis of 2008-09, pointing to accommodative monetary policy (Figure 4).

Figure 4



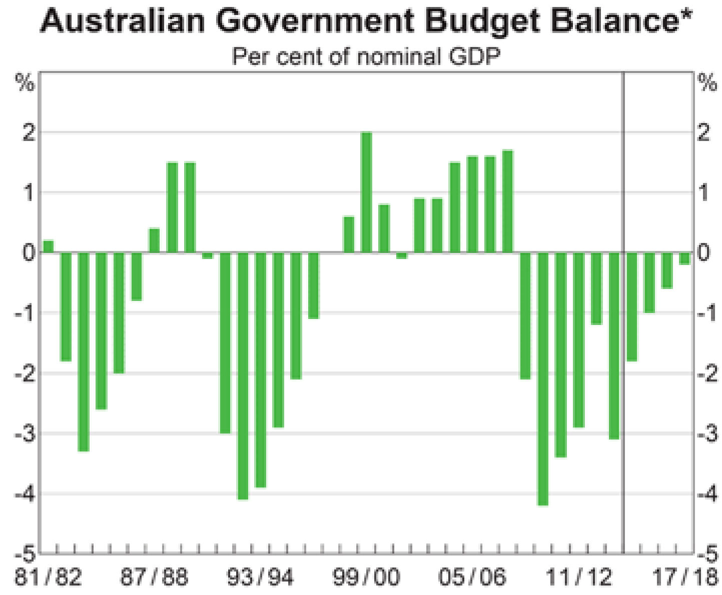
Although the official cash rate is well below historical averages, it is likely that there has been a reduction in the neutral real cash rate in Australia, in line with the declining global trend in real interest rates. Monetary policy may not be as stimulatory as comparisons with historical interest rate settings might suggest.

1.3 Fiscal Policy

The Government sought to implement a fiscal consolidation in its first Budget in May 2014, projecting a four percentage point improvement in the budget balance as a share of GDP over 10 years to target a budget surplus of around 1% of GDP. The budget deficit is forecast at 1.8% of GDP in 2014-15 (Figure 5). However, key budget initiatives have meet with resistance in the Senate, putting the Government's fiscal consolidation plans at risk.

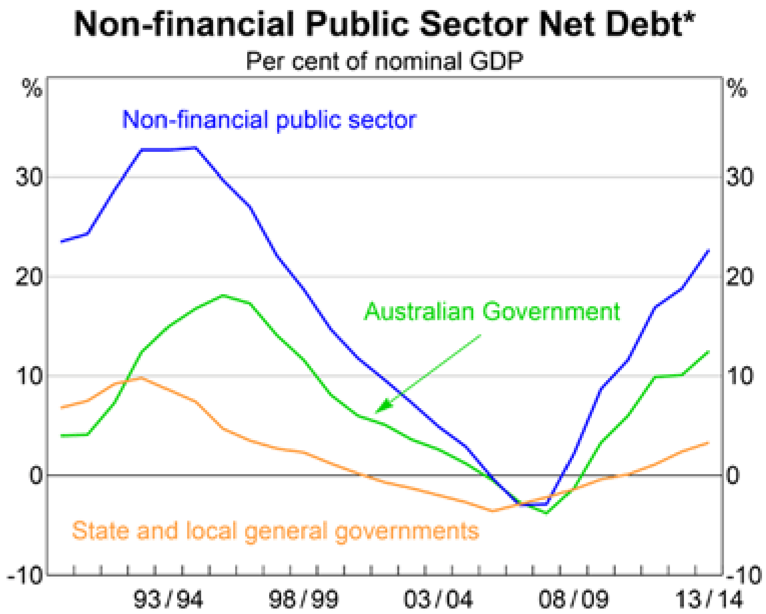
Australian government net debt is expected to be 13.9% of GDP in 2014-15 and is projected to rise to 14.6% of GDP by 2016-17, before falling again (Figure 6).

Figure 5



* Underlying cash balance
Source: Australian Treasury

Figure 6



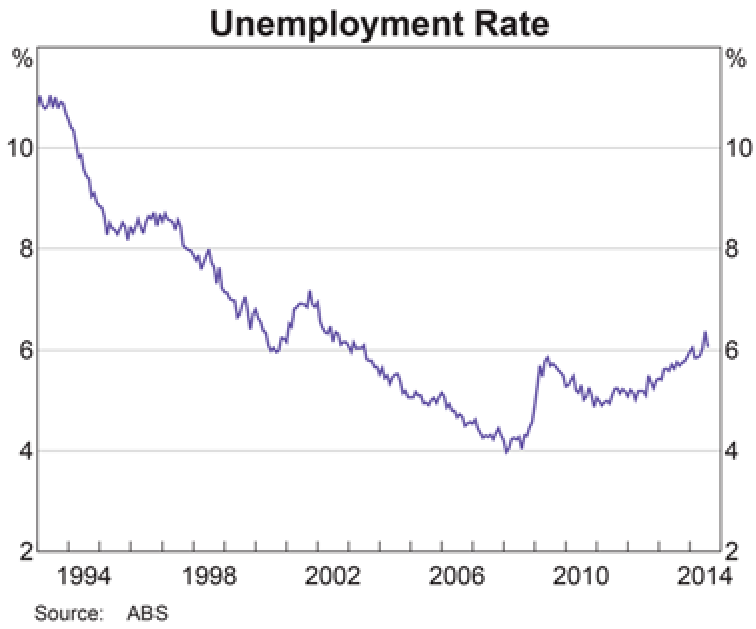
* Estimates as at the 2014/15 Budget
Source: Australian Treasury

The federal Government's budget deficit will ensure continued growth in Commonwealth Government Securities outstanding to around $450 billion by 2017-18 from $320 billion in 2013-14. State government central borrowing authorities had $230 billion in bonds outstanding as at June 2014, with a further $31 billion in issuance planned for 2014-15. The increased supply of Commonwealth and state government bonds has found no shortage of demand among domestic and offshore investors, who are attracted by relatively high yields.

1.4 Labour Market

The labour market in Australia has been soft in recent years, consistent with a period of somewhat below trend economic growth. The unemployment rate has risen to the highest level in more than a decade at 6.4%, exceeding the high seen during the global financial crisis (Figure 7).

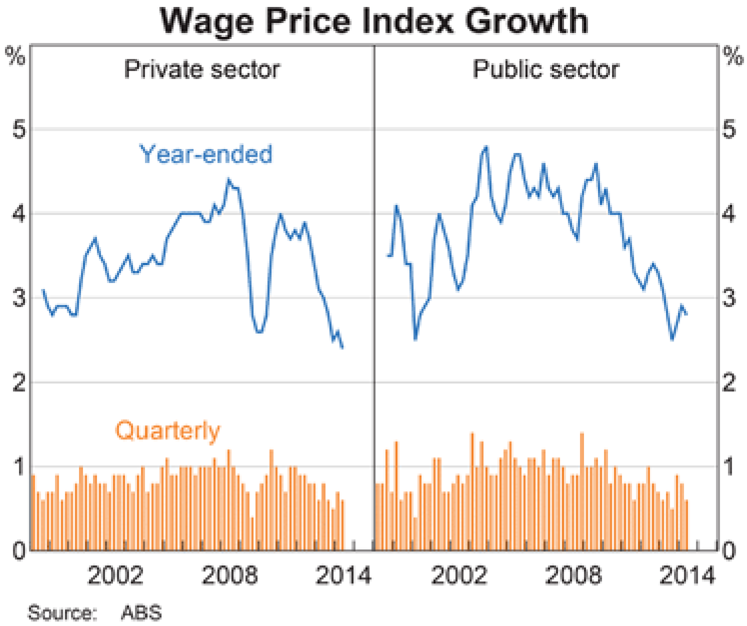
Figure 7



A period of above-trend economic growth will likely be required to stabilise and then lower the unemployment rate.

The growing excess capacity in the labour market has kept growth in nominal wages subdued, which is a further positive for the inflation outlook. Wages growth as measured by the wage price index has been the slowest in the 15-year history of the series and real wages growth has been flat (Figure 8).

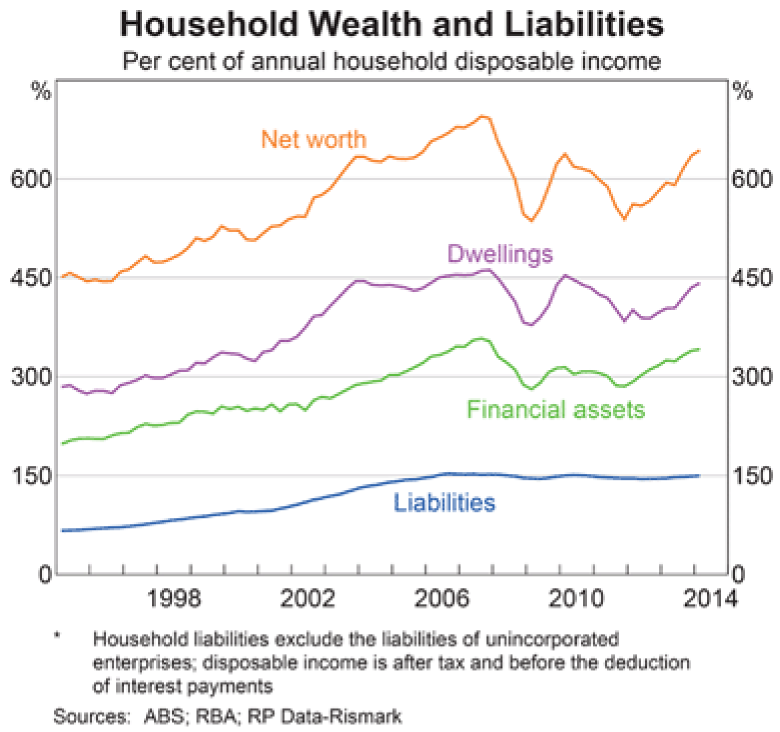
Figure 8



1.5. Saving and Investment

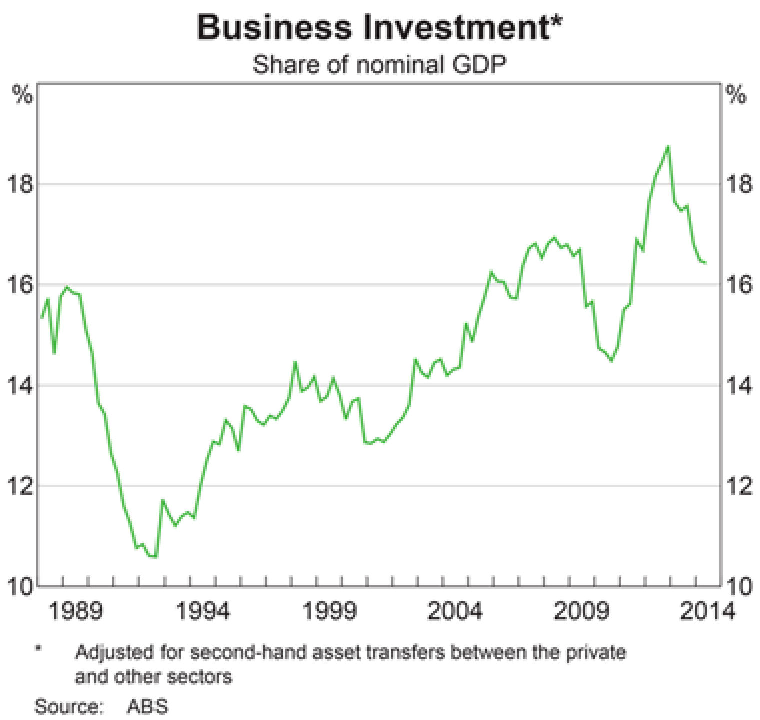
The Australian economy continues to exhibit high rates of saving and investment, much of which is intermediated by Australian financial markets. The household saving ratio remains at around 10% of household disposable income, as the household sector deleverages and seeks to rebuild wealth lost during the global financial crisis. Household net worth has yet to recapture the multiple over household disposable income attained before the financial crisis. However, household liabilities have remained broadly steady at around 1.5 times disposable income. This indicates that recent gains in household net worth have not been secured through increased leverage, as has been the case in previous decades (Figure 9).

Figure 9



Household saving, together with foreign capital inflows, have continued to underpin a strong investment share of GDP. Business investment has moderated from its record 20% share of GDP as the mining investment boom fades, but the investment share remains strong by historical standards (Figure 10).

Figure 10

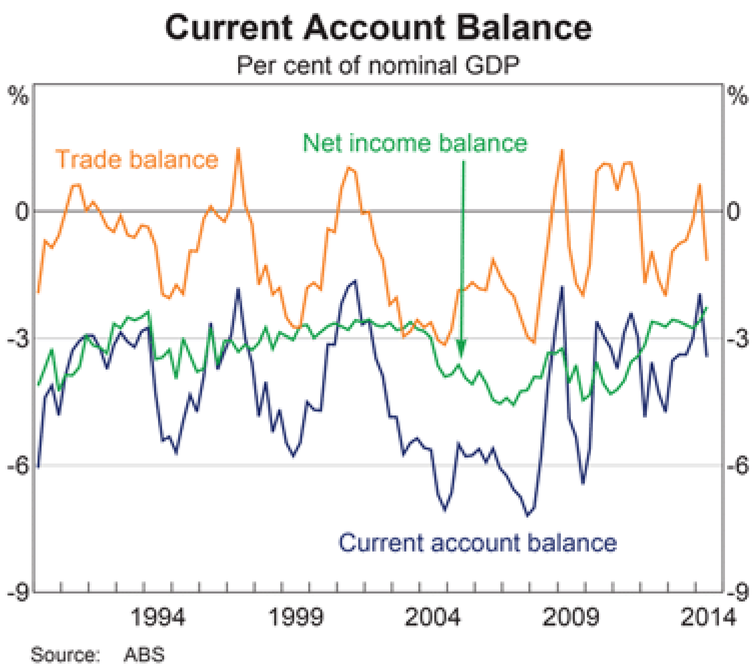


Non-mining business investment and new residential dwelling construction driven by lower interest rates is expected to fill much of the gap in investment expenditure left by the mining sector.

1.6. External Balance, the Exchange Rate, Commodity Prices and the Terms of Trade

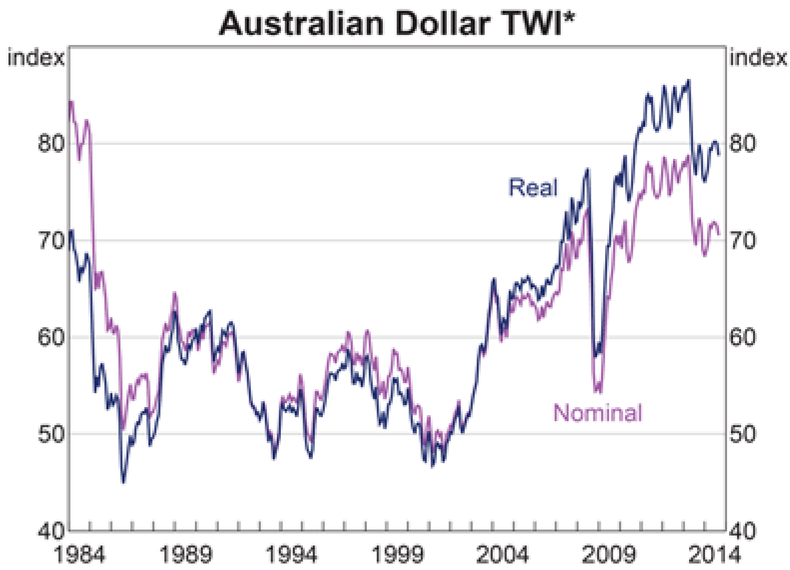
Australia's current account deficit has narrowed as a share of GDP in recent years, largely driven by a continued improvement in the trade balance as commodity export volumes post record highs on the back of previous investment in the mining sector (Figure 11).

Figure 11



The Australian dollar trade weighted index has declined from its recent post-float record highs in both nominal and real terms, but remains above its long-run average in real terms. The moderation in the exchange rate will alleviate competitive pressures on the export and import-competing sectors of the Australian economy (Figure 12).

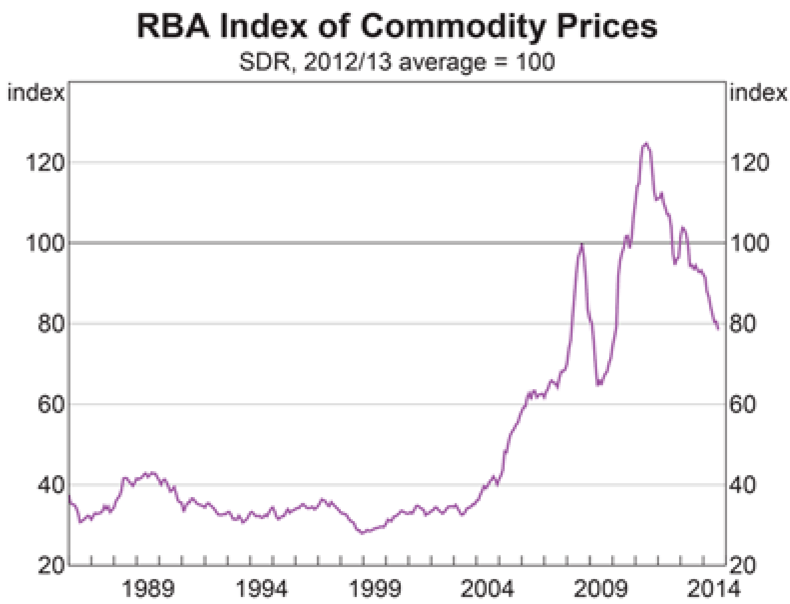
Figure 12



* May 1970 = 100 for nominal; real indexed to equate post-float averages
Sources: ABS; RBA; Thomson Reuters; WM/Reuters

Australian commodity export prices have fallen around 40% from their 2011 highs measured in terms of IMF SDRs, which abstract from exchange rate valuation effects on commodity prices (Figure 13). The weaker exchange rate and booming export volumes have provided an offset to lower US dollar and SDR-denominated commodity prices in supporting overall Australian dollar export values.

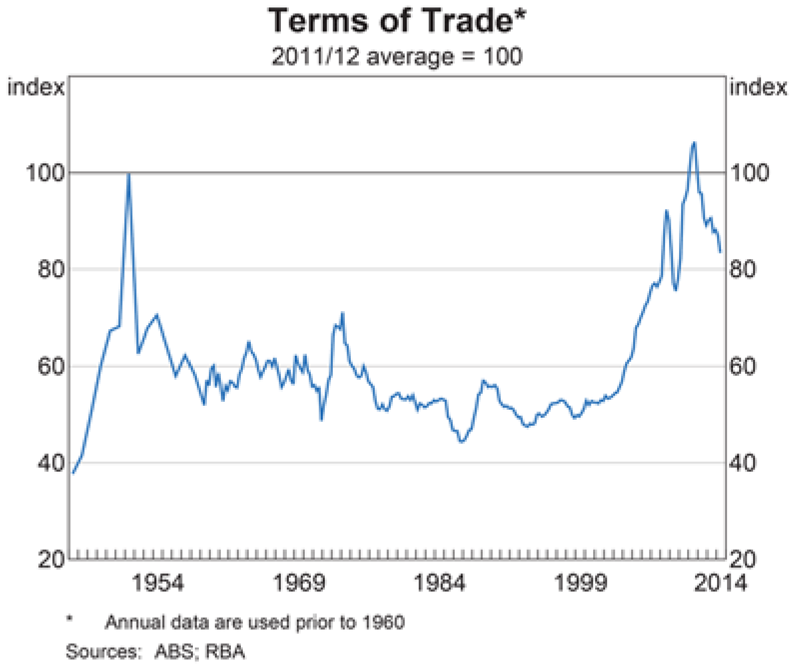
Figure 13



Source: RBA

The decline in commodity export prices has weighed on the terms of trade. This in turn has reduced the international purchasing power of Australian output and growth in national income. However, the terms of trade still remain at a high level by historical standards and are seen as unlikely to fully revert to their historical mean over the short to medium-term (Figure 14).

Figure 14



An important long-term question for Australian policymakers is whether the boom in the terms of trade represents a permanent shock to a higher average level of international purchasing power and national income or a temporary shock that will be unwound over the next decade.

1.7 Political Developments

The Liberal-National Party coalition government elected in September 2013 enjoys a strong majority in the House of Representatives, but holds a minority position in the Senate.

The Government has successfully negotiated with minor party Senators the repeal of the former Labor government's carbon and mining tax legislation. The government has been less successful to date in implementing key elements of its May 2014 Budget, putting its fiscal consolidation plans at risk.

Australia has the G20 Presidency in 2014 ahead of the G20 Leaders' Summit in Brisbane on 15-16 November 2014. The Australian Government has been pushing the G20 to implement an agenda to raise the level of GDP by 2% above its current trajectory across member economies through structural reform measures. However, it will be difficult to measure performance against this target given the long lead times and lags entailed in the implementation of structural reforms.

The G20 meeting is expected to address a number of issues relevant to financial markets, including global bank liquidity, capital adequacy and other prudential measures and the continued implementation of OTC derivative reforms.

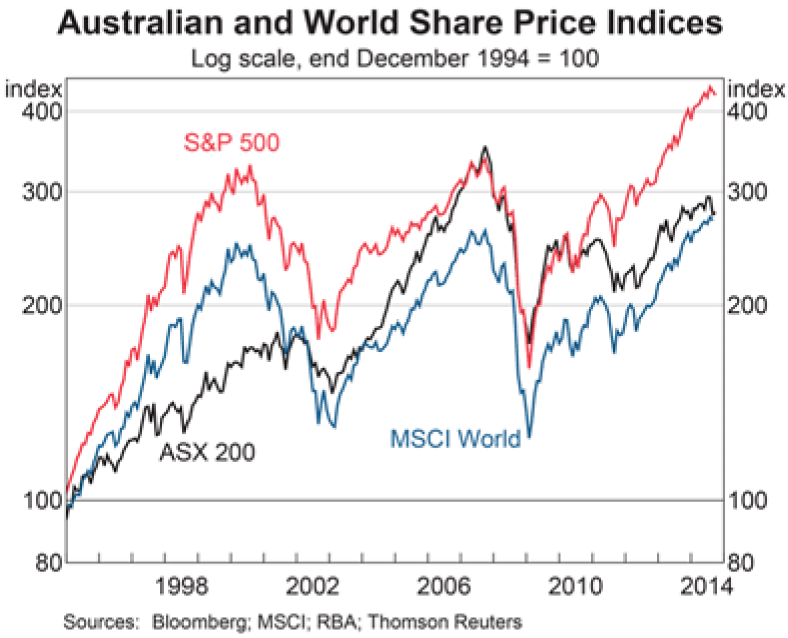
Australia has encouraged the G20 to focus on completing the core financial reforms and highlighted the the importance of promoting internationally coordinated regulation. The view being taken is that G20 countries should accept and recognise each other's regulatory regimes, where they achieve equivalent outcomes. In addition, recognising Australia’s interest in international financial standards being appropriately calibrated, the Government supports Australia continuing to engage in international forums so that we can help shape the development and implementation of international standards.

2. Outline of the Securities Markets

2.1. Price Trends in Equity Markets

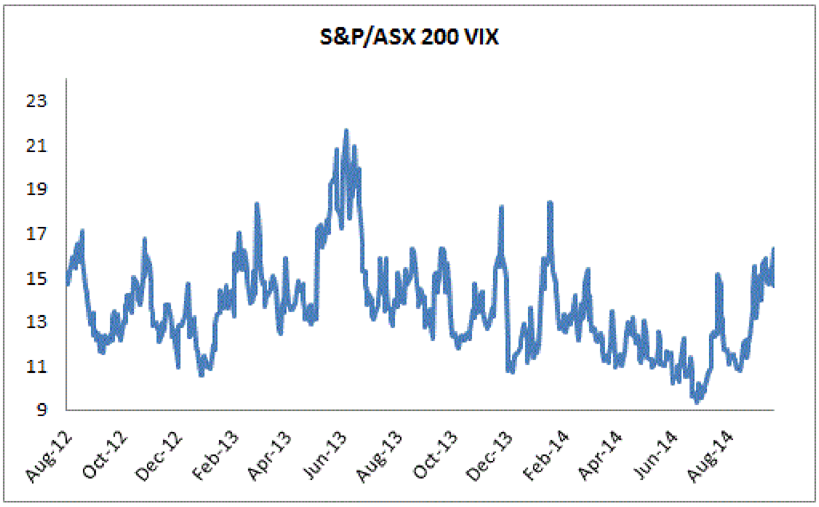
Australian equities performed well in absolute terms over 2013-14, posting gains of 12.4% in the benchmark S&P ASX 200 index, although underperforming gains in US equity markets. Resource stocks remained subdued in light of lower commodity export prices, with financials and other sectors driving overall gains (Figure 14).

Figure 14



Market volatility was relatively subdued for much of the last financial year, consistent with trends in global markets. The S&P ASX 200 VIX futures index trended lower for much of the year, but has been more elevated recently in line with a pick-up in global market volatility (Figure 15).

Figure 15



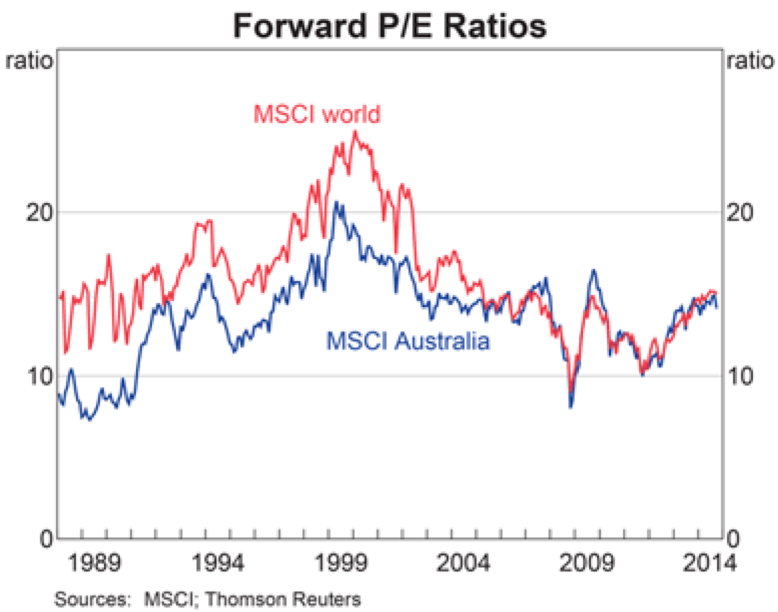
S&P/ASX 200 VIX

9-Oct-14	14.633
One Week Ago	15.372
One Month Ago	12.022
52 Week High	18.372
52 Week Low	9.309

Source: ASX

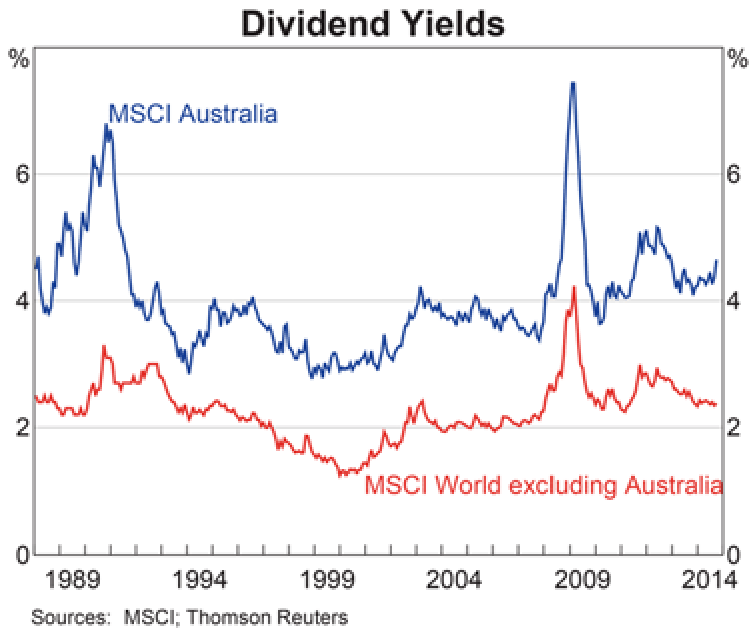
Local equity valuations are close to long-term averages and remain attractive compared to those found in world equity markets, as measured by forward price-earnings ratios (Figure 16).

Figure 16



Australian equities are still relatively high yielding compared to world market averages, with dividend yields above 4%, compensating somewhat for relatively subdued price growth (Figure 17).

Figure 17

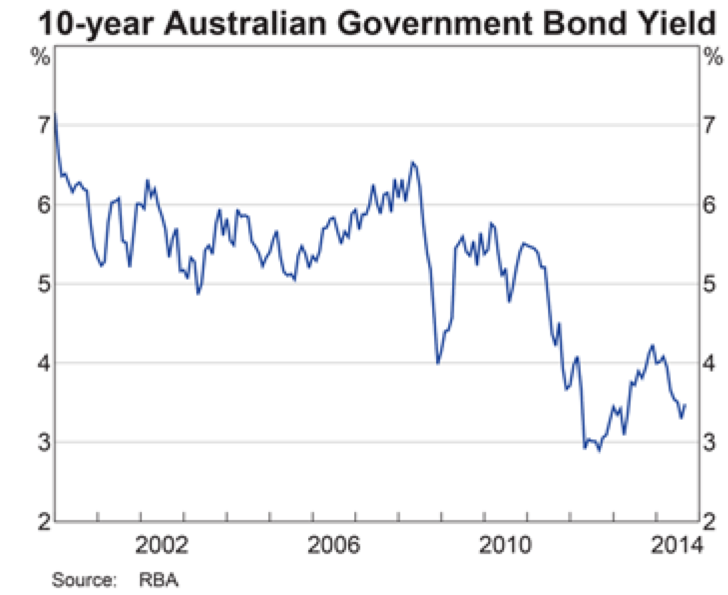


The absolute performance of Australian equities will remain closely tied to developments in world equity markets, but one view is that attractive valuations in some sectors and recent relative underperformace may provide opportunities in the year ahead.

2.2. Trends in Interest Rates

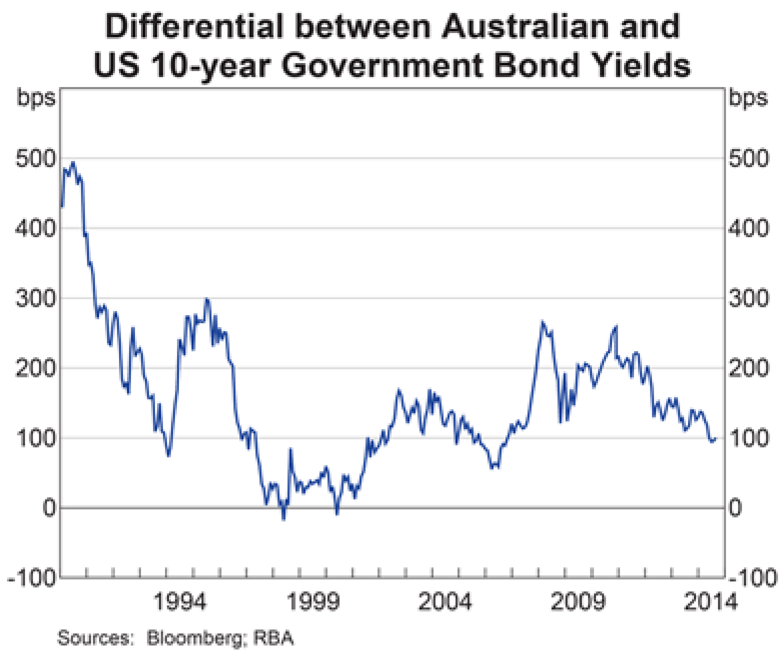
Australian interest rates participated in the global decline in nominal and real bond yields during 2014, reflecting a subdued global growth and inflationary environment, as well as increased risk aversion on geo-political tensions. Australian 10 year government bond yields trended lower, although remained above the lows in yield seen during the European and US debt crises of 2012 (Figure 18).

Figure 18



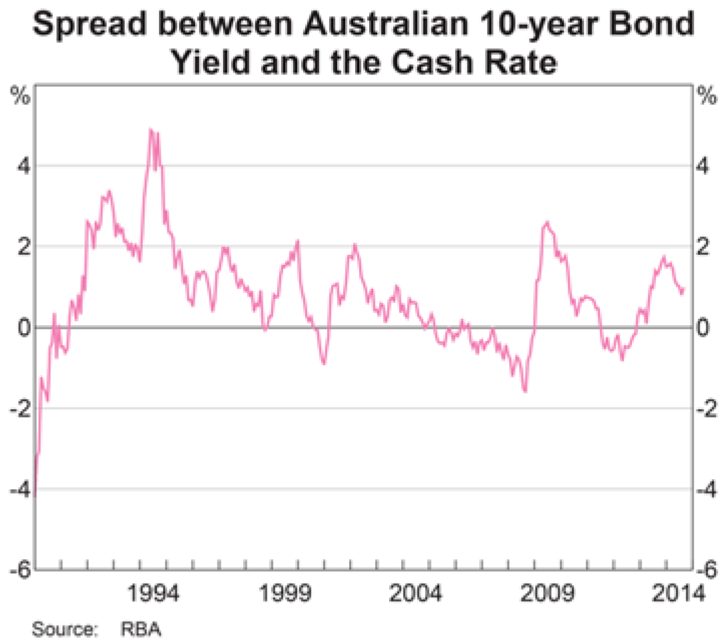
Australian government bonds also performed well in a relative sense, with the spread between Australian 10 year bonds and 10 year US Treasuries narrowing to below 100 basis points, narrows not seen since 2006 (Figure 19). This was part of a global trend for bond yield spreads to narrow against relatively risk-free assets such as US Treasuries.

Figure 19



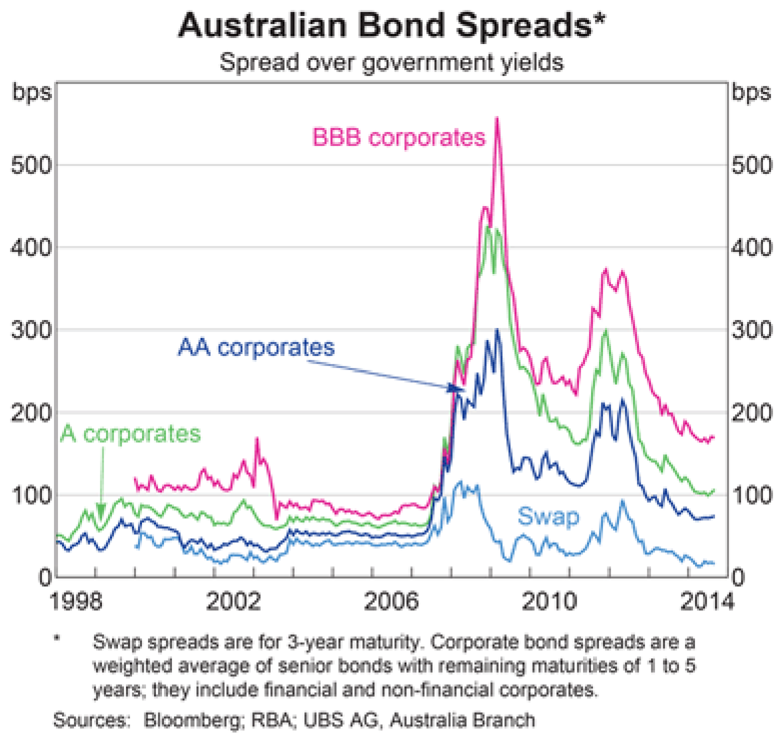
The rally in the long end of the curve, coupled with a steady official cash rate drove a flattening in the yield curve which can be interpreted as pointing to more subdued economic conditions ahead, although the overall slope of the yield curve remains firmly positive, consistent with continued economic expansion (Figure 20).

Figure 20



Corporate bonds also performed well in an absolute and relative sense, participating in the global decline in nominal and real yields and with spreads over government bonds narrowing across the spectrum of credit quality (Figure 21).

Figure 21

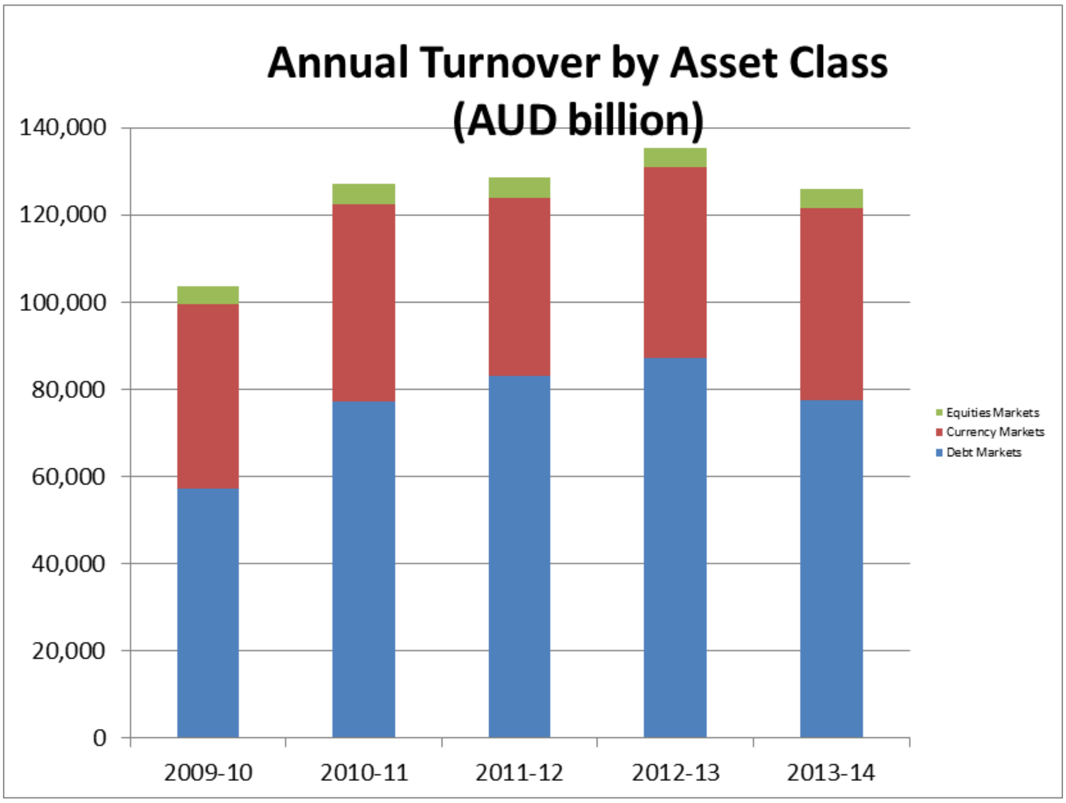


2.3. Market Turnover and Activity Levels

Overall turnover in Australian financial markets was more subdued in 2013-14 than in the previous financial year, with total turnover across all asset classes down 6.6% (Figure 22).

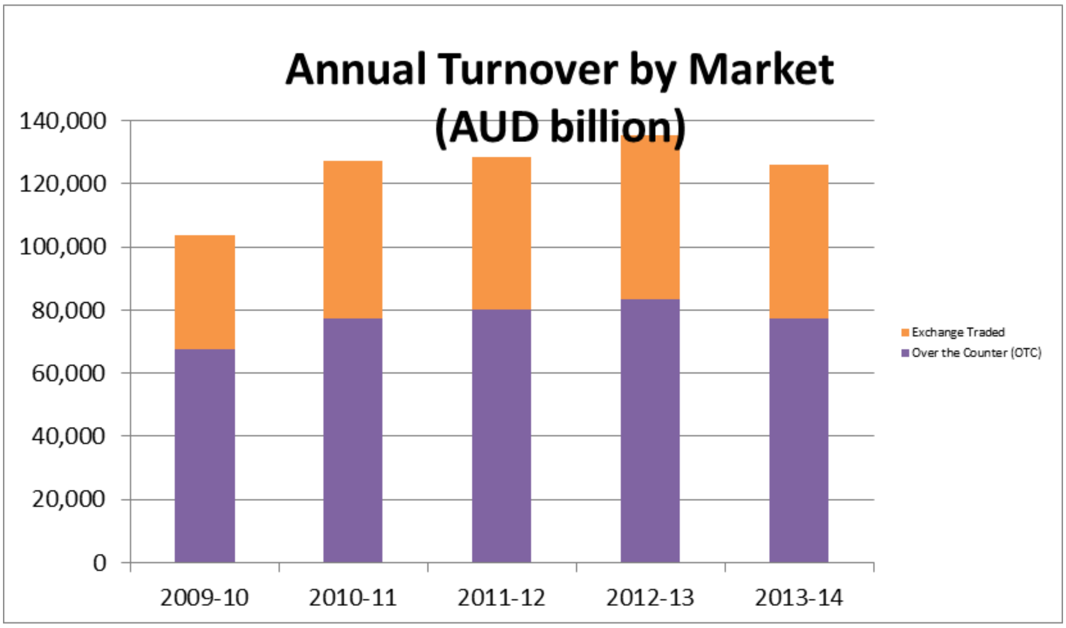
Both exchange traded and OTC markets saw declines in turnover of 6.7% and 6.6% respectively (Figure 23).

Figure 22



Source: 2014 Australian Financial Markets Report, Australian Financial Markets Association

Figure 23



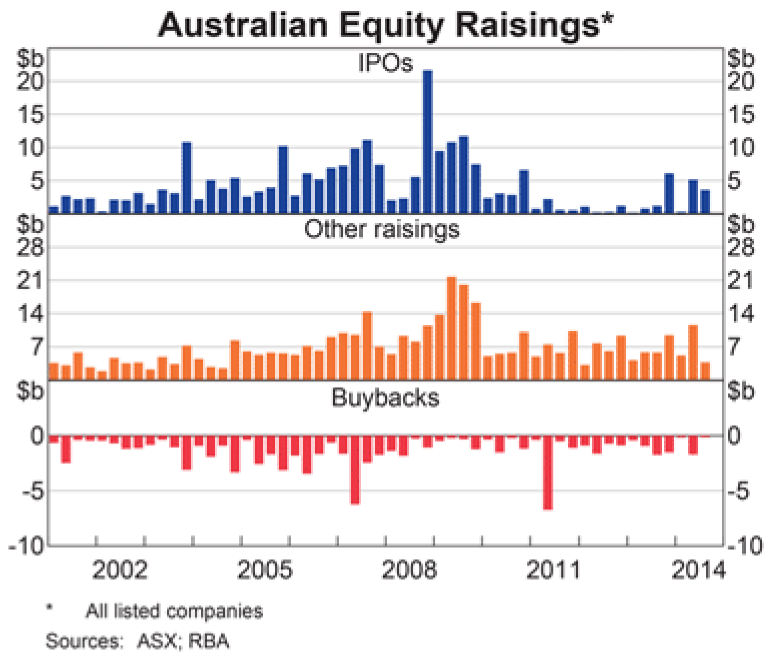
Source: 2014 Australian Financial Markets Report, Australian Financial Markets Association

The decline in overall financial market turnover can be partly attributed to a decline in volatility across the three main asset classes, consistent with global trends in these markets. A steady domestic interest rate environment over the last 12 months has also reduced market turnover. Reduced volatility and steady interest rates have reduced both hedging and speculative demand for a wide range of exchange-traded and OTC financial products.

2.4. Turnover and Activity Levels in Equity Markets

Initial capital raised in cash equity markets increased nearly three-fold, from $9.9 billion to $27.7 billion (see Figure 24). 107 new entities listed on the ASX, a 30.5% increase on the previous year. The largest floats came from the utilities, commercial and professional services, and real estate industries, while mining was relatively subdued compared to previous years. Secondary raisings of equity capital totalled $33.4 billion, up 2.9% on the previous financial year. Placements accounted for 55.1% of secondary raisings or $18.4 billion.

Figure 24



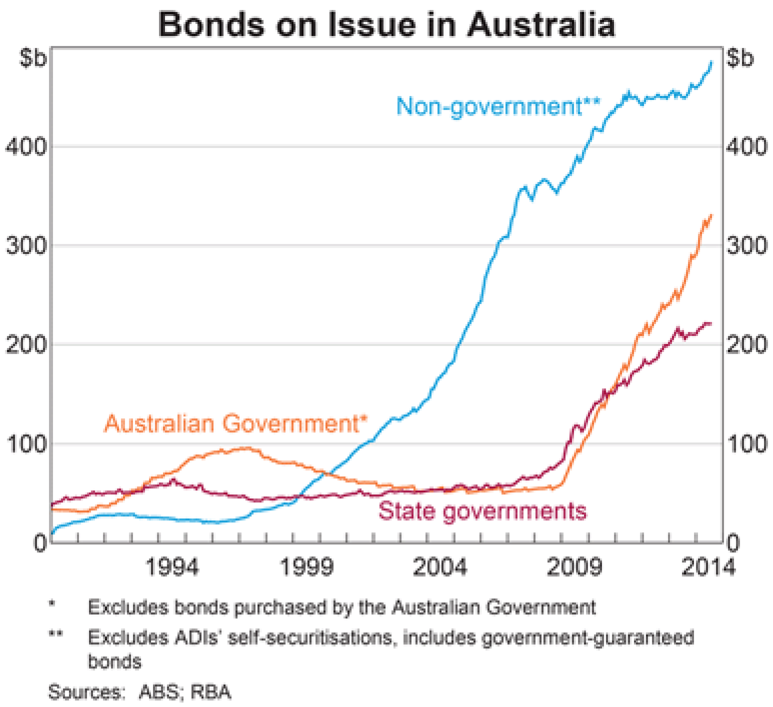
There has been only modest growth in equity market turnover, with on market value traded per day increasing by 4.3% on the Australian Securities Exchange over the last financial year. Consolidated average daily turnover on the ASX was $4.6 billion. A daily average of 719,000 trades were executed on ASX, a 3.7% increase on the previous year. New market entrant Chi-X saw a 36% increase in average daily trade volumes and a 69.5% increase in average daily value traded to $707 milliom.

2.5. Turnover and Activity Levels in Debt Markets

Debt markets saw a 10.6% decline in total market turnover to $77,960 billion in 2013-14, with a steady interest rate environment and narrow trading ranges weighing on overall turnover.

Turnover in government debt securities rose by 6.8% as continued budget deficits at a state and federal level and on the part of foreign issuers saw a continued increase in supply. Declining yields and narrowing spreads imply that this increased supply found no shortage of demand among local and foreign investors. Non-government debt securities saw little change in turnover at around $722 billion, but issuance remained strong, supporting continue growth in the stock of debt outstanding (see Figure 25).

Figure 25



Mortgage-backed securities turnover rose 6%, with issuance up around 13%, the best year for new issuance since 2008, as the Australian Office of Financial Management wound-down its support for this market.

Australian debt markets remain attractive in terms of the absolute level of yields and in terms of credit quality. These two factors should continue to support demand and turnover in these markets.

3. Prospects for the Securities Industry

Australian financial markets continue to experience considerable change in the wake of the global financial crisis. The securities industry has continued to focus on the implementation of regulatory changes instituted by global and local regulators, as well as responding to a number of government inquiries and policy initiatives.

3.1. Financial System Inquiry

The Government has proceeded with an inquiry into the Australian financial system chaired by former Commonwealth Bank CEO David Murray AO. The inquiry is due to report in November 2014. The Government response to the report is not expected until 2015. The inquiry is the first major review of the financial system since the Wallis Inquiry in 1997.

The Inquiry's interim report released in July sought feedback on a broad range of possible reforms to the regulatory framework for Australian financial markets and institutions. Key issues being addressed by the inquiry include the adequacy of existing prudential frameworks and regulatory architecture, consumer protection, access to funding including the development of the corporate bond market, the effects of technology on financial services and the retirement income system (superannuation).

AFMA made two submissions to the inquiry and has worked with the Inquiry secretariat on a number of issues of particular interest to securities industry participants, including development of the domestic corporate bond market.

The Inquiry's final recommendations will be significant in setting the stage for the further development of Australia's financial institutions and markets.

3.2 Tax White Paper

The federal Government has also initiated a review of the Australian taxation system. An issues paper and a final report are expected in 2015 and tax reform proposals will likely feature prominently at the next federal election. Further reform of the tax system will be an important determinant of Australia's international competitiveness.

Australia is currently the fifth most highly rated country on the Tax Foundation's International Tax Competiveness Index, but only ranks 22nd out of 34 OECD countries in terms of the competitiveness of its international tax rules.

3.3 OTC Derivatives Market Reform

Australian regulators and financial markets continue to bed down reforms to the OTC derivatives markets in response to initiatives coming out of the G20 and Financial Stability Board. The past year has been an intensive period of OTC derivatives market law reform in Australia. The reforms being developed and implemented in Australia, as in other jurisdictions, have been significantly influenced by global regulatory developments under the coordination of the Financial Stability Board (FSB).

In August, AFMA wrote to the Assistant Treasurer to request a policy review by the Government of the OTC derivatives trading reporting rules being applied to so-called 'Phase 3' reporting entities by ASIC, through what is known as a 'double-sided' reporting regime. We proposed that a less burdensome and more efficient 'singled-sided' reporting regime along the lines that has been adopted in the United States and Canada be substituted.

The Government has already consulted on a proposal to exempt 'end users' from being defined as trade reporting entities in the March 2014 'Proposals Paper G4-IRD Central Clearing Mandate'. This proposal has received widespread support from companies that use derivatives to manage their commercial risk. While welcome, ASIC's Phase 3 rules would still capture businesses that are in effect end users but happen to hold a financial services license for reasons other than their use of derivatives for hedging purposes. The practical effect of exempting end users would be a single-sided reporting regime in respect of transactions entered by those end users. As a result of the letter the Government has asked ASIC to look at how single-sided reporting could be made to work. There will be further consultation with ASIC at the technical level to look at ideas and solutions to problems ASIC sees with single-sided reporting.

3.4. T+2 Industry-wide shortened settlement cycle

As a move towards alignment with international standards and the introduction of best practice it has been recommended to AFMA by the Reserve Bank that Australia moves to a T+2 settlement environment for Debt Securities in Australia.

Shortening the cycle for Debt Securities to T+2 will also complement an ongoing initiative by ASX to introduce a T+2 settlement cycle for the cash equities market, which has been endorsed by the ASX Clearing and Settlement Forum.

It is expected that the move to T+2 and a shorter settlement cycle would mitigate counterparty risk for all industry participants, amongst other benefits. However, the industry is also assessing practical transition issues and costs that might be associated with this change.

With respect to Cash Equities, following a consultation process that demonstrated widespread industry support for the introduction of a T+2 settlement cycle, ASX is implementing a program to transition the market to T+2 for cash equities (with an expected introduction some-time in Q1 2016).

With respect to OTC Debt Securities, the Markets Governance Committee supports the introduction of T+2 settlement for Debt Securities and suggested an approach to planning and consultation. MGC recommended that the consultation process should begin in earnest as soon as possible and considers the Operations Committee to be the appropriate forum to take carriage of this effort. The Operations Committee is willing to take this responsibility.

AFMA will shortly embark on a market wide consultation with debt market stakeholders from our member community, in partnership with the Reserve Bank. The objective of this exercise is to understand the specific products and downstream requirements to implement a change of this magnitude successfully.

3.5 Equities clearing and settlement

Following a decision by the Government in February 2013 to place a two year moratorium on any decision to licence a central counterparty seeking to compete in the Australian cash equity market, the ASX developed a Code of Practice for the clearing and settlement of cash equities in Australia. The Code commenced operation in August 2013 and it established an advisory forum comprising senior representatives from ASX's clearing and settlement participants, and a range of other industry stakeholders (including AFMA) that are users of ASX's clearing and settlement services.

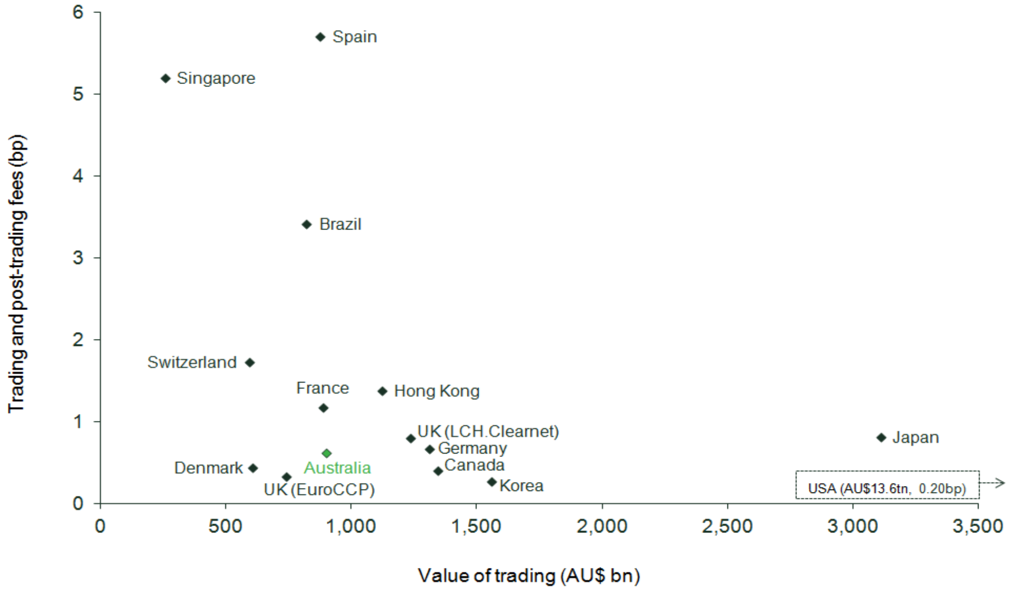
The objectives of the Forum include:

1. to provide user input to the Boards of ASX Clear and ASX Settlement from a wide range of users in relation to ongoing investment in the design, operation and development of the core clearing and settlement infrastructure;
2. to provide a formal mechanism for the Boards of ASX Clear and ASX Settlement to report to users on their strategic plans and investment decisions in relation to the design, operating and development of the core clearing and settlement infrastructure.

In the Code ASX committed to commission from an independent consulting firm an international cost comparison of cash market clearing and settlement services. This work was undertaken by Oxera in 2014 and the report is available at the following weblink – ASX benchmark report.

The overall conclusion from this Oxera analysis is that the fees charged by ASX for post-trading services - of 0.3–0.6 basis points (bp) relative to the value traded for institutional investors, and 0.9-2.0bp for retail investors - are within the range that markets of a comparable size charge to investors with the same trading characteristics. A summary chart for institutional investor trades is shown in figure 26.

Figure 26
Relationship between the fees for FMI trading and post-trading services (for institutional investors) and the value of trades



Source – Oxera analysis

3.6 Energy and Environmental Markets

Australia has active markets for electricity derivatives and environmental products. By their nature, these markets are susceptible to government policy changes, especially in relation to schemes designed to reduce carbon emissions.

During 2013-14, the electricity market was impacted by uncertainty regarding carbon pricing and in particular the prospect of the retrospective repeal of the carbon pricing mechanism. The combination of this uncertainly coupled with continued decline in demand had an adverse impact upon market liquidity. Consequently, turnover fell over the course of the year in over-the counter contracts, offset by increases in exchange traded contracts.

Looking ahead, the removal of the carbon pricing mechanism is likely to have a positive impact upon liquidity, in particular with respect to futures contracts, although uncertainties remain with respect to a future possible emissions trading scheme.

With respect to environmental products, both state and federal government schemes have continued to face significant regulatory risk. Due to consequent uncertainty, these markets have generally suffered from a lack of trading activity. The federal government has been undertaking a review of the renewable energy target in 2014. Many future projects have been frozen at the project-approval stage and building works delayed until the outcome of the 2014 review is clearer.

*****