Country Report for Australia and Outline of the Securities Market

September 2013

Executive Summary

This report is divided into three sections covering economic developments and the outlook, the performance of financial markets and other factors affecting prospects for financial markets in Australia. The report covers developments over the 2012-13 financial year period, unless otherwise stated.

The Economy

The output of the Australian economy has been stable and continues to show resilience despite uncertainties in the global economy. Overall, Australia's economic outlook remains positive, with the economy forecast to return to trend growth in 2015, supported by strong balance sheets in the business and household sectors.

The Financial Markets

Activity in Australia's financial markets in aggregate grew by 5.3 per cent in 2012-13, though the performance of individual markets varied. In the equities market, increased trading volume over the year has been offset by diminishing trade sizes, resulting in an overall small decline in the value of turnover. There was increased trading in the debt securities market, due to significantly higher turnover in private sector bonds. The equity and debt capital markets continued to provide a stable source of funding to Australian businesses, notwithstanding demanding business conditions within the industry.

Industry Prospects

Prospects for the industry will be affected by a number of key policy and market developments that are currently at the forefront. This includes domestic reforms to the regulation of over-the-counter (OTC) derivatives that mirror international developments on central counterparty clearing; continuing reforms to the exchange market focused on high frequency trading and dark liquidity; reforms to the regulation of retail financial markets and products, particularly in relation to the provision of financial advice; and the implementation of bank prudential reform to mirror the tightening of global rules on capital and liquidity.

1. The Economy

1.1. Economic Growth

The Australian economy continues to perform strongly within an uncertain global environment, with gross domestic product (GDP) up 2.75 per cent, down slightly from the 3.4 per cent growth the previous year. Economic growth was underpinned by strong export growth, counterbalancing the more subdued growth in domestic consumption and investment.

Table 1

Economic Conditions and Outlook

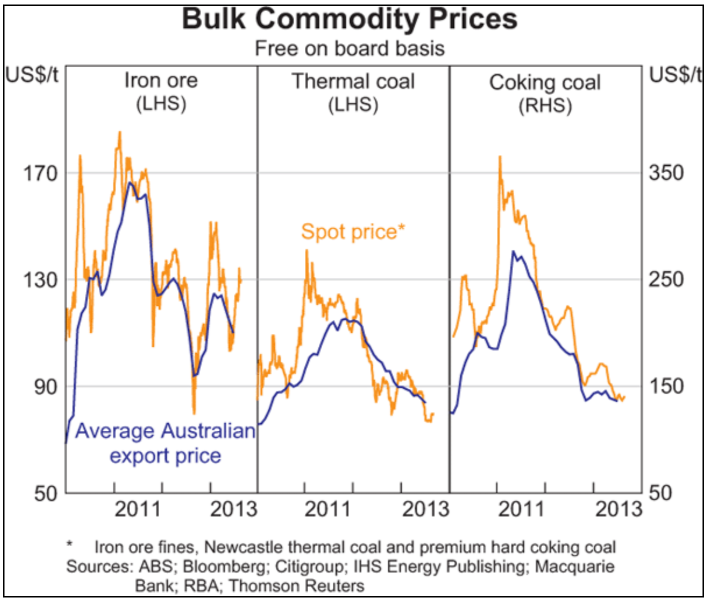
Fiscal year – 12 months to end-June	2009-10	2010-11	2011-12	2012-13	Forecast 2013-14#
Economic growth (GDP, %)	2.3	1.9	3.4	2.75*	2.5
Household consumption growth (%)	2.5	3.1	3.7	2.5*	2.5
Business investment growth (%)	(5.1)	6.1	22.1	6.5*	1.5
Balance of payments					
Current a/c deficit (% of GDP)	4.3	2.3	2.8	3.0*	3.75
AUD/USD (year-end)	0.8523	1.0739	1.0191	0.9275	n/a
Inflation (yearly growth, %)					
- Consumer price index	3.1	3.5	1.2	2.4	2.5
- Underlying rate of CPI	2.9	2.6	1.8	2.6	2.25
Employment growth (yearly growth, %)	2.9	2.0	0.4	1.3	1.0
Unemployment rate (June, %)	5.2	5.0	5.3	5.6	6.25
Wage price index (yearly growth, %)	3.1	3.8	3.7	3.25	3.25

* Estimates; from the Commonwealth (Federal) Government "Economic Statement", August 2013
# Forecast average year outcome for each item; from the Commonwealth (Federal) Government "Economic Statement", August 2013.

Real GDP grew at a slightly below trend rate in 2012-13, mainly reflecting modest growth in household consumption and public final demand. Economic growth was also affected by a fall in Australia's terms of trade as a result of declining commodity prices over the year, reflecting more moderate global growth and an expansion in the global supply of commodities. The fall in price for some commodity exports have been significant, for example, bulk commodities including iron ore, coking coal and thermal coal prices are down 15 per cent (see **Graph 1**). This, alongside low wage growth, dampened growth in nominal GDP.

The economy is forecast to grow at a more subdued rate of 2.5 per cent in 2013-14, with above trend growth not expected until 2015. The forecast accounts for the expectation that Australia's terms of trade will continue to fall, signalling the end of the resources and mining boom that has provided significant stimulus to the economy over the past decade. The challenge for the economy in the medium to longer term is this transition to a broader-based growth. In the near term, the economy should be supported by the recent fall in the Australian currency by boosting the competitiveness of non-commodity exports. In the longer term, the domestic economy will benefit from the gradual strengthening of the global economy, which global growth projected to increase from 3 per cent in 2013 to 3.75 then 4 per cent in 2014 and 2015 respectively.

Graph 1



Source: Reserve Bank of Australia

There are downside risks to this forecast, particularly in relation to persistent economic and financial problems in the euro area. As well, the transition to broader based growth in the domestic economy may not be seamless. On the other hand, the balance sheets of the domestic business and household sectors remain in good shape and the financial system has continued to show resilience in supporting real economic activity.

1.2. Political Developments

The key political development over the year was the federal government election held on 7 September. The election resulted in a new government being formed by the Liberal Party of Australia and the National Party of Australia coalition. The Australian Labor Party had governed for two terms over the past 6 years. While the new Coalition Government has won a significant margin of seats in the House of Representatives (lower house), it is likely that any policy decisions will need to be negotiated with a number of minor parties and independent members that hold the balance of power in the Senate. At the time of writing, votes are still being counted and the final results are not yet known.

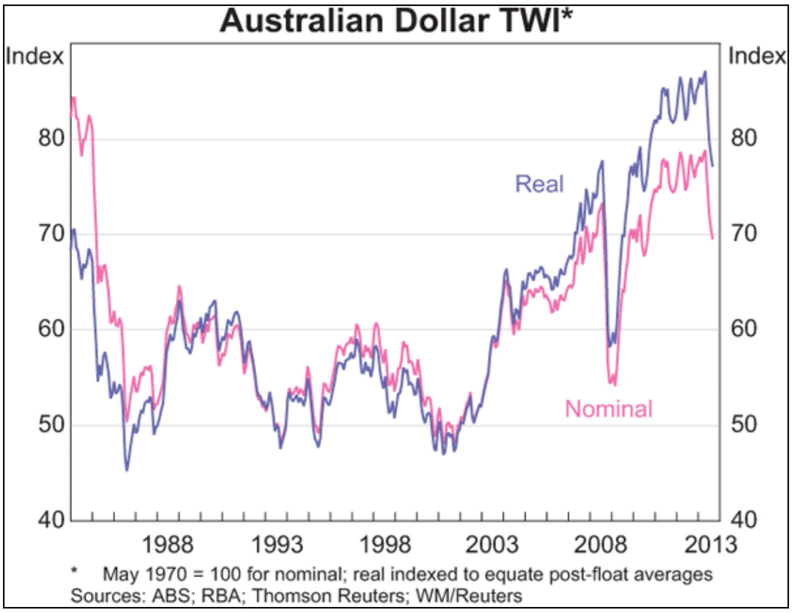
The new Government intends to introduce greater checks and balances in the regulation policy process and to reduce the regulatory burden in the economy. The Government does not intend to proceed with the commencement of a planned emissions trading scheme but instead will introduce of plan of direct action to reduce carbon emissions.

Other key policy announcements made by the Coalition during the election campaign include a discontinuation of a commitment by the previous government to reduce interest withholding tax levied on financial institutions; a financial system inquiry to provide a comprehensive review of financial regulation; reduction of the company tax rate by 1.5 per cent from 1 July 2015; and the introduction of an extensive paid parental leave scheme.

1.3. Exchange Rates

The Australian dollar is currently around 15 per cent lower on trade weighted terms than its peak in April 2013, which reached its highest level since 1985 (see **Graph 2**). Several developments have contributed to this depreciation; including heightened uncertainty in the future direction of US monetary policy, lower commodity prices and the fall in interest rates over this period. Although the dollar is at its lowest since August 2010, it remains high by historical standards.

Graph 2



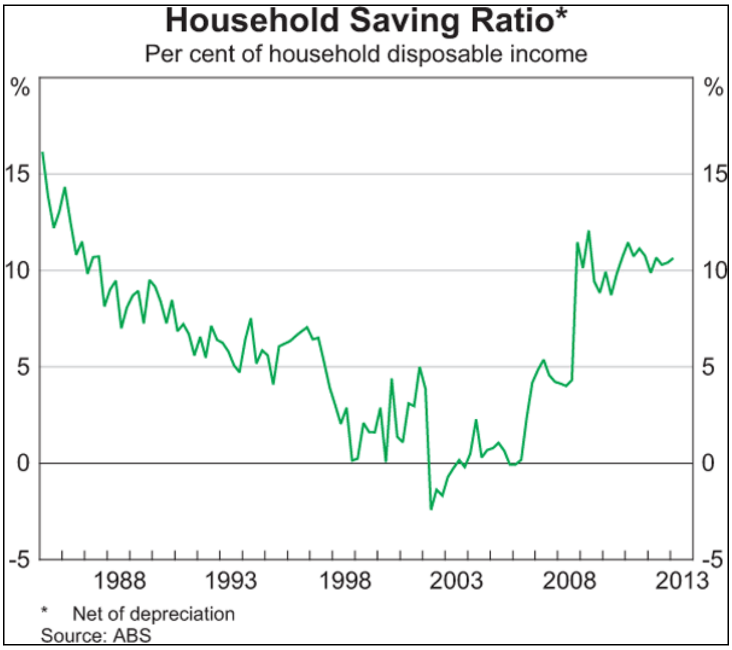
Source: Reserve Bank of Australia

Against major currencies, the Australian dollar has depreciated 15 per cent against the US dollar; 14 per cent against the UK pound sterling; 18 per cent against the Chinese renminbi; and 21 per cent against the European euro. The Australian dollar has appreciated 5 per cent against the Japanese yen.

1.4. Consumption and Investment

Private household consumption grew by 2.5 per cent, compared to 3.7 per cent the previous year. The slowing rate of consumption growth over the year is attributable to below average income growth and softer labour market conditions. Measures of consumer sentiment are at average levels, despite the low interest rate environment. The household saving ratio, at 10 per cent of income, is well above the levels seen in 1990s and 2000s (see **Graph 3**). The household sector has continued to exhibit more prudence in managing its finances, with a higher rate of saving and slower credit growth having persisted for several years now. Growth in consumption spending is expected to be below trend for the remainder of 2013, before gradually rising to around trend in 2015.

Graph 3



Source: Reserve Bank of Australia

Business investment has moderated significantly from the robust rates of growth achieved the previous year; growing by 6.5 per cent in 2012-13 compared with 22.1 per cent in 2011-12. Business investment growth in the mining sector was countered by a contraction in non-mining sectors. Business investment growth is forecast to contract further to 1.5 per cent in 2013-14. While investment in the mining sector has made significant contributions to overall investment growth over the past three years, the investment phase of a number of mining projects is beginning to wind down. As well, the overall decline in commodity prices over the past year has led to an increased focus on managing costs in the mining sector. Weak domestic demand remains a key concern for business in general, and will put a floor on investment decisions within the near term.

Overall, weaker domestic demand over the year has dampened economic activity somewhat. However, the balance sheets of the domestic business and household sectors remain in good shape. Aggregate profits of incorporated businesses increased by about 4.5 per cent over the first half of 2013. Further, profitability has been forecast to improve in 2013-14, with profits expected to grow by 14 per cent for the listed resources sector and 8 per cent for other listed non-financial companies.

1.5. Inflation

The Consumer Price Index (CPI) has recorded headline inflation over the year of 2.4 per cent, up from 1.2 per cent the previous year. Underlying inflation of 2.6 per cent is well within the Reserve Bank of Australia's target band of 2 – 3 per cent. The falling prices of tradables since 2010 have put downward pressure on inflation, due to the appreciation of the Australian dollar. The recent currency depreciation is not likely to have had an impact on inflation as yet. Producer price data suggests that domestic inflation pressures were modest across all stages of production over the year.

Headline inflation is projected to remain steady at 2.5 per cent. While the weaker labour market is expected to exert downward pressure on inflation, this is countered by higher import prices from the depreciation of the Australian dollar. The Reserve Bank of Australia expects underlying inflation to remain close to the lower end of the inflation target this year, before picking up to around the middle of the target range in the first half of 2014 and staying close to that level thereafter.

1.6. Government Finance, Balance of Payments and the Labour Market

The Australian Government has projected a continuing budget deficit, currently at $18.8 billion or 1.2 per cent of GDP, throughout 2013-14 and 2014-15. The fiscal position of the Australian Government is underscored by a conservative net debt position of 10.6 per cent. The return to a budget surplus is not expected until 2016-17.

Export growth has been particularly strong for the resources sector; the increased volume of exports has been the result of additional supply becoming available as investment projects reach completion. However, the fall in prices in commodity exports have resulted in an overall decline in the value of exports of 6 per cent over the year. At the same time, lower capital imports due to subdued business investment dampened import growth, which fell by 1 per cent over the year. Overall, the current account deficit rose slightly from 2.8 to 3 per cent in 2012-13, and is projected to increase further to 3.75 per cent in 2013-14. This forecast accounts for a projected terms of trade decline of 5.75 per cent in 2013-14.

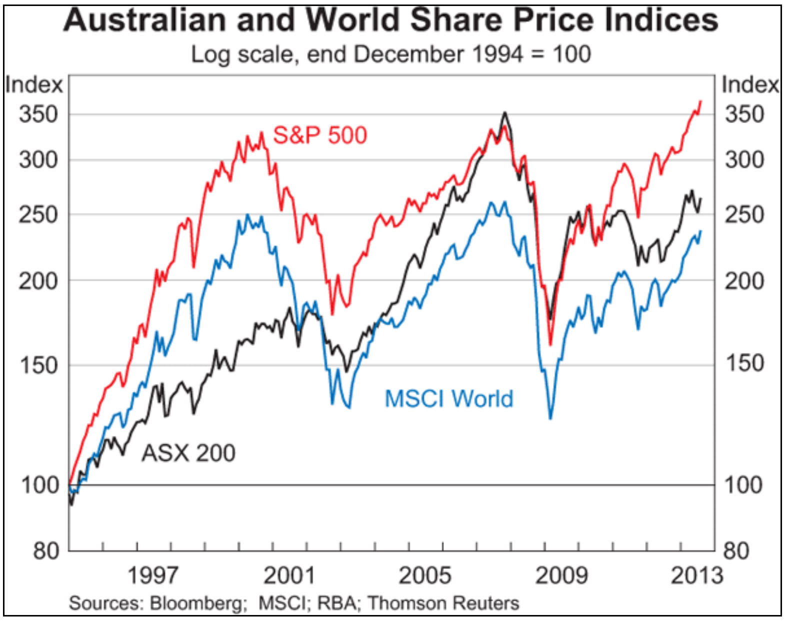
Employment growth was up 1.3 per cent in 2012-13, up from 0.4 per cent the previous year. However, employment growth remains below the growth of the working-age population and unemployment levels correspondingly rose to 5.6 per cent. These softer labour market conditions have seen the pace of growth in wages decline to the lowest rate in a decade. Employment growth is expected to be below trend at 1 per cent through the year to the June quarter 2014, before rising to 1.5 per cent through the year to the June quarter 2015 in line with gradually improving economic conditions. The unemployment rate is expected to increase from 5.6 per cent in the June quarter 2013 to 6.25 per cent in the June quarter 2014, and stabilise at that rate through to the June quarter 2015.

2. Outline of the Securities Markets

2.1. Price Trends of Equities

Over the 2012-13 financial year, returns from Australian equities generally tracked those of world markets; the S&P/ASX All Ordinaries index rose 15.5 per cent compared to the increase of 16 per cent for the MSCI World Index and 17.9 per cent for the S&P 500 (see **Graph 4**). The strong performance of bank (up 21 per cent) and industrial stocks (up 19 per cent) counterbalanced the fall in share prices in the resources sector (down 9 per cent), which accounts for a larger share of the local market than is generally the case in other markets. The decline in price for resources stock over the year, which has rebounded in recent months, is reflective of declines in commodity prices over the year.

Graph 4



Source: Reserve Bank of Australia

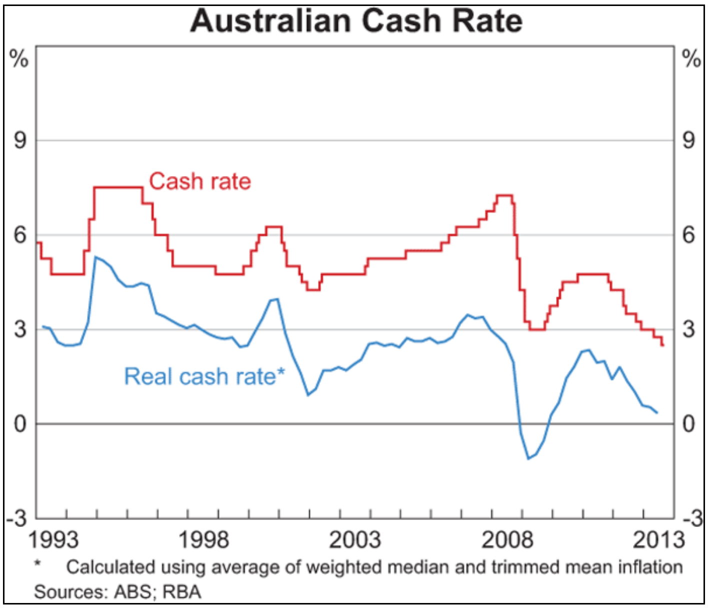
Despite a few outbreaks, volatility was moderate throughout most of the year, with the S&P/ASX 200 VIX averaging 14.6, down significantly from 23.5 in the previous year.

Looking forward, equity prices should be supported by forecasted improvements in business profitability in 2013-14.

2.2. Trends in Interest Rates

Over 2012-13, the Reserve Bank of Australia reduced the cash rate on three occasions by 25 basis points each. The Reserve Bank recently decided to further reduce the cash rate by 25 basis points in August, which brings the cash rate to 2.5 per cent (see **Graph 5**).

Graph 5



Source: Reserve Bank of Australia

Reflecting the movement in the cash rate, yields in the money market are at historically low levels. The spread between 3-month bank bills and Overnight Index Swaps (OIS), which is often viewed as a measure of Australian bank funding pressures, has been relatively stable and is currently about 15 basis points, attesting to the general strength and liquidity of the short term debt market.

In the bond market, yields for Australian sovereign bonds, Commonwealth Government Securities (CGS), have increased significantly in recent months, reflecting global trends. The yield for 10 year CGS reached an 18-month high of 4.04 per cent in late June, but has subsequently declined. In the non-Government bond market, spreads on corporate bonds are at their lowest levels since the financial crisis. Spreads between AA-rated corporate bonds over CGS reached a low of 86 basis points in May, and has fallen by almost 50 per cent over the year. Spreads on residential mortgage-backed securities (RMBS) have also been steady throughout the year, and are also at their lowest levels since the beginning of the financial crisis in 2007.

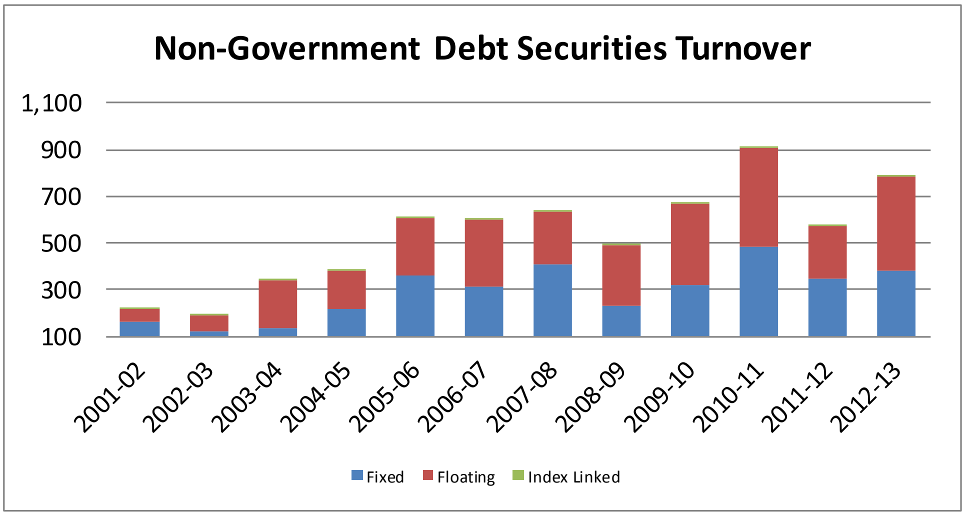
2.3. Activity Levels in the Markets for Stocks and Bonds

Trading activity in the secondary market for equities was subdued over the year, with market turnover down 2.1 per cent overall. Both the trading in physical shares and equity derivatives were impacted, with turnover down 2.9 and 1.8 per cent respectively.

Despite subdued trading conditions in the equities market, trade volume continued to surge upwards. A daily average of 693,454 trades was executed on the Australian Securities Exchange (ASX) over the year, which was up 5.8 per cent from the previous year. The average number of trades exceeded a million per day in the last quarter. However, underlying the growth in trade volumes was a 20.5 per cent reduction in the average trade size, explaining the overall decline in turnover value.

Activity in the debt market was more robust over the year, with trading turnover up 4.8 per cent in 2012-13. Of note is the 33 per cent increase in turnover activity in the non-Government bond market, reflecting an improvement in investor sentiment and risk appetite from previous years (see **Graph 6**).

Graph 6



Source: Australian Financial Markets Association

Also noteworthy is the decline in credit derivatives turnover of 43 per cent over the year, notwithstanding an apparent increase in risk appetite which led to a narrowing of credit spreads over the year. Positions outstanding were largely unchanged suggesting that core hedging strategies are outweighing trading opportunities as markets transition into a higher capital structure for uncleared trading portfolios. The largely interbank indices trading market now represents 79 per cent of total market volume, up from 70 per cent in 2011-12.

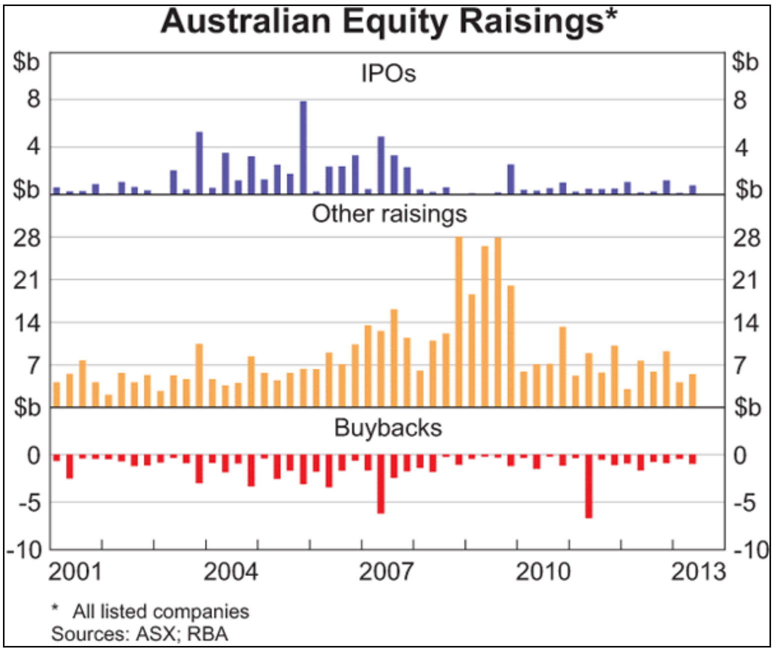
Aggregate interest rate product volumes rose slightly, with increases in swaps and overnight indexed swap activity largely offset by declining volumes in forward rate agreements and interest rate options. It is anticipated that swaps volumes will improve subsequent to the Bank for International Settlements' release of the final framework for margin requirements for non-centrally cleared derivatives and the clarity this provides.

A highlight over the year was the commencement of trading of Commonwealth Government Securities (CGS), Australian Government bonds, on the ASX on 21 May 2013; both nominal bonds and Treasury Indexed Bonds are now accessible to retail investors on the exchange. The introduction of exchange-traded CGS makes a new asset class available to retail investors and is an important step in the development of a corporate bond market.

2.4. Activity Levels in Equity and Debt Capital Markets

After a slow first half, momentum in primary markets accelerated in the latter half of the year, with $9.9 billion in initial capital raised during FY13, down slightly on FY12 (see **Graph 7**). Overall, 82 new entities listed, a decrease of 17.2 per cent on the previous year. The resources industry was heavily represented in initial offerings; 38 per cent of domestic floats in FY13 were miners and 15.5 per cent were energy companies. Overall, the total amount of capital raised, of $46.4 million, is a drop of 8.3 per cent from the previous year.

Graph 7



Source: Reserve Bank of Australia

The largest listing of the year was Mighty River Power Ltd, the first in a series of privatisations of New Zealand state-owned enterprises. On listing in April, it had a market capitalisation of $2.8 billion and raised almost $1.4 billion in capital, also the largest raising of new funds for the year. Other notable listings were APT Pipelines, raising $515 million and Shopping Centres Australasia Property Group which raised $472 million.

Global investment opportunities for local investors increased over the year with a number of foreign firms completing successful listings. The majority of these were in the mining sector, including Xero Limited, Marengo Mining Canada Limited, Bathurst Resources (New Zealand) Limited and Laramide Resources Limited.

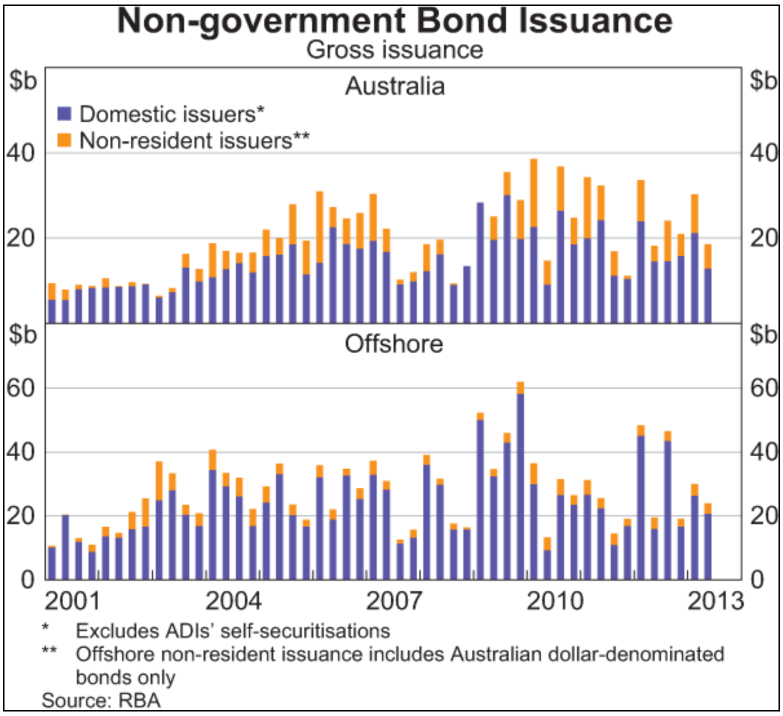
Secondary raisings of equity capital in 2012-13 totalled $32.4 billion, on par with the previous year. Placements accounted for a bulk of secondary raisings, followed by dividend reinvestment plans and rights and accelerated issues.

In the debt capital market, issuance from both the Commonwealth and state governments increased over the year. The $53.75 billion of debt raised over the year brings total long-term government securities issued from $406 billion to $461 billion.

The year has seen progress in non-Government debt issuance, as investor sentiment and risk appetite has improved over previous years. As a result, both the volume of issuance and the number of new bonds across the various sectors have increased. The first two quarters of 2013 have seen $53 billion issued in the domestic market, with the financial sector accounting for over 50 per cent of the market. Non-financial corporate issuance was particularly strong towards the end of last year, led by some large deals in the mining sector.

Over this period, Australian issuers tapping offshore markets have raised $43 billion USD. The market has benefited from strong international demand for Australian dollar assets and local issuers continue to be viewed favourably by offshore investors looking to diversify credit exposures.

Graph 8



Source: Reserve Bank of Australia

Issuance in the securitisation market has also picked up of late, with $13 billion issued in the first two quarters of 2013. Encouragingly, recent issuance has been completed with little or no support from the Australian Office of Financial Management (AOFM) due to strong private investor demand.

Conditions have also picked up in the Kangaroo market, supported by the reduction in spreads, with total outstanding issuance of $153 billion as at July 2013. Ten kangaroo issuers debuted in the market in 2012; the diversity of new issuers was also a notable feature, and included Asian names and non-financial corporates.

Table 2

Australian Non-government Bonds Outstanding

	Outstanding ($ billion)		Share (percent)	
	Jul 09	Jul 13	Jul 09	Jul 13
Financials	844.9	795.6	67%	62%
Asset-backed	172.3	109.2	14%	9%
Corporates	147.5	218.0	12%	17%
Kangaroo	104.6	153.2	8%	12%
Total	1269.3	1276.0	100%	100%

Source: Reserve Bank of Australia. Data include short and long term debt issues.

Looking forward, global investors, particularly in the Asian region, may look to the relative high yields that Australia has to offer. The debt capital markets continue to provide an effective way for borrowers to achieve their funding targets.

3. Prospects for the Securities Industry

A wide range of regulatory and taxation factors will help to shape the evolution of financial markets over coming years. This section of the report briefly identifies some of the more significant developments in this regard.

3.1. OTC Derivatives Market Reform

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, has been significantly influenced by global regulatory developments under the coordination of the Financial Stability Board (FSB).

For Australia, the crucial development was the passing of framework legislation, the Corporations Legislation Amendment (Derivatives Transactions) Act 2012, which established a regime for the imposition of mandatory requirements in respect of trade reporting, central clearing and platform trading of OTC derivatives. Following on from this, determinations and regulations were made under the new law to allow the Australian Securities and Investments Commission (ASIC) to make rules around trade reporting. The Australian regulators are placing high importance on trade reporting to provide the means to monitor, in close to real time, the nature and flow of operational and credit risk management exposures.

In Australia, a couple of central counterparty (CCP) service offerings are being developed to allow clearing and settlement of AUD interest rate swaps under Australian law. For trade execution, no decision will be taken on any mandatory trade execution requirements until further assessments are done by the regulators in 2014. Future recommendations for trade execution are being made separately from mandates to centrally clear particular derivative products.

All of these reforms are creating significant operational changes within the industry, with an associated increase in regulatory and compliance costs.

3.2. BBSW Initiatives and Benchmark Rate Regulation

In mid-July, the International Organisation of Securities Commissions (IOSCO) finalised its Principles for Financial Benchmarks which crystallised the plan for the global reforms to financial benchmark rates. The Principles draw from the earlier Wheatley Review of LIBOR and seek to improve governance and structures around financial benchmarks.

While Australia's Bank Bill Swap (BBSW) benchmark rate has remained under regular review by AFMA and its supporting processes were enhanced and updated in recent years, AFMA commenced work on a more comprehensive review following the release of Wheatley and as the likely shape of IOSCO's Principles became clearer.

Though AFMA's research supported the view that the risks associated with BBSW were structurally much lower than with LIBOR, given the substantial increases to compliance costs post-Wheatley for both panellist firms and benchmark administrators, it was decided to leverage BBSW's grounding in an actively traded market. This involved a transition away from a submission-based mechanism to a system that collects tradeable bids and offers directly from multiple market venues. This National Best Bid and Offer (NBBO) approach draws on analogies from the equity markets while introducing protections including an obligated market making scheme and maximum acceptable spreads to ensure the markets are sufficiently supported and that rates are set by 'at-risk' bids and offers.

3.3. Financial Transactions Tax Proposal

Pursuant to a directive issued by the European Commission, eleven members of the European Union resolved to implement a Financial Transactions Tax (FTT) on all transactions in financial instruments, including debt and equity securities. For participants in the Australian financial markets, there are concerns that, as was proposed, the FTT would have significant extra-territorial impacts; insofar as it may apply to transactions where the parties to the transaction have no nexus to the FTT zone but the underlying instrument was issued within the FTT zone, or where one party that has entered into a transaction is dealing with an FTT zone counterparty.

3.4. Implementation of Prudential Reforms

As the global Basel III reforms have solidified over the year, the implementation of the new capital and liquidity reforms in Australia by the Australian Prudential Regulation Authority (APRA) has commensurately taken shape. While the Australian prudential regime will largely reflect the agreed international standards, APRA and the Reserve Bank of Australia have announced the establishment of a Committed Liquidity Facility (CLF). The facility addresses a key problem for the Australian market; the shortage of eligible high quality liquid assets. For a fee, a bank can establish a CLF with the Reserve Bank of sufficient size to meet any shortfall in measurement against the new Basel Liquidity Coverage Ratio.

Meanwhile, the Government has also proposed additional reforms to strengthen APRA's crisis management powers and to better align Australia's resolution framework with international standards, such as that of the Financial Stability Board.

3.5. Exchange Market Reform

The year has been another intensive one in terms of regulatory change in exchange traded markets. There has been no respite from continued market reforms since the bedding down of a new regulatory regime for a multi-operator market environment that commenced in 2010, with a range of new proposals on the regulation of high frequency trading and dark liquidity.

ASIC has responded to industry calls for any measures in relation to dark liquidity to be appropriately targeted as opposed to being applied whether or not there is an issue with price formation in a particular stock. Importantly, an earlier proposal to introduce a minimum threshold for participation in dark pools will not be proceeding. In relation to high frequency trading, ASIC's investigations have found that there are no substantive issues to address, and has abandoned an earlier proposal to introduce a minimum resting time for small orders.

Over the year, the Government has also considered the need to introduce competition in the clearing and settlement of the Australian cash equity market. Currently, ASX Clear and ASX Settlement, operated by the ASX, clear and settle all trades in the cash equity market. Within the industry, there were mixed views as to whether competition in clearing would deliver net benefits to the Australian financial system in the near term, having regard to a range of factors affecting industry participants. While some are in favour of competition, there was also concern that significant costs could be imposed across the industry. The Government has decided to place a moratorium on any decision to licence a central counterparty (CCP) seeking to compete in the Australian cash equity market for two years. This moratorium does not apply to clearing competition in relation to OTC derivatives and debt markets which have quite distinct characteristics.

3.6. Regulation of Retail Financial Markets

The Future of Financial Advice (FOFA) reforms, a package of reforms on improving the quality of financial advice, became fully effective on 1 July 2013. The key reforms include a ban on conflicted remuneration structures, including commissions and volume payments, as well as a requirement for advisers to obtain client agreement to ongoing advice fees every two years.

Over the year, ASIC has increasingly focused on structured products marketed at retail investors, including capital protected and capital guaranteed products. ASIC is concerned that these products have complexities, risks and conditions that are not always well understood by retail investors.