Country Report for Australia and Outline of the Securities Market

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 Economy

The Australian economy has been resilient in the face of extreme volatility in global financial markets. Economic conditions in Australia have been stronger than expected in early 2009, with consumer spending, exports and business investment notable for their strength. The level of employment has not deteriorated as much as anticipated at the start of the financial year and credit growth overall remains quite modest. The better than expected performance and recovery in confidence has been dependent to a significant extent on the performance of Australia's major trading partners in the Asian region.

The Financial Markets

In Australia, the repricing of risk sparked by the collapse of Lehman Brothers in September 2008 resulted in a sharp deterioration in domestic credit markets, the effects of which spilled over into other markets, most evidently, the equities market. Recent developments indicate that markets are recovering broadly. Liquidity has been restored to money markets, with the elevated pricing of risk falling substantially. Banks have also been able to participate in capital markets, and over recent months, without reliance on the Government guarantee. Businesses have also tapped the equity market for funds substantially through the year. The securitisation market, on the other hand, continues to be impacted with investor demand for securitised assets at unprecedented lows.

Industry Prospects

As the crisis unfolded, unprecedented actions were taken by governments, regulators and central banks in an effort to prevent a collapse of financial systems. The global regulatory response to date has been swift, significant, and substantial. Further regulatory reform initiatives have been flagged and are expected over coming months. These developments will have a major influence on regulatory reform in Australia's financial markets.

1. The Economy

Taking into consideration the unprecedented falls in world output and extreme volatility in financial markets since late 2008, the Australian economy has performed relatively well in the 2008-09 financial year. The economy has weathered severe uncertainty in global financial markets due to the health of the domestic financial sector. With concerted action by governments worldwide to increase confidence in the financial system, a further downturn is not expected within the near future.

Table 1

Economic Conditions and Outlook

Fiscal year – 12 months to end-June	2005-06	2006-07	2007-08	2008-09	2009-10#
Economic growth (GDP, %)	3.0	3.3	3.7	1.0	(0.5)
Private consumption growth (%)	2.6	4.0	4.0	1.4	(0.3)
Business investment growth (%)	15.9	6.7	15.4	6.8	(18.5)
Balance of payments					
Current a/c deficit (% of GDP)	5.4	5.6	6.4	3.2	5.3
AUD/USD (year-end)	0.7433	0.8487	0.9626	0.8114	n/a
Inflation (yearly growth, %)					
- Consumer price index	4.0	2.1	4.5	1.5	1.8
- Underlying rate of CPI	2.4	2.6	4.2	2.5	n/a
Employment growth (yearly growth, %)	2.4	2.8	2.4	(0.2)	(1.5)
Unemployment rate (June quarter, %)	4.8	4.3	4.2	5.7	8.3
Wage price index (yearly growth, %)	4.1	4.0	4.2	3.8	3.3

Forecast (#) average year outcome for *each* item; from the Commonwealth (Federal) Government 2009-10 Budget.

1.1 Economic Growth

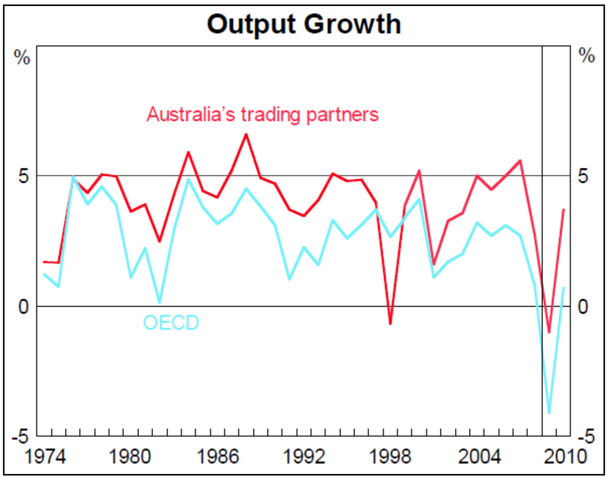
The Australian economy grew at a rate of 1 per cent in the 2008-09 financial year. This is compared with a gross domestic product (GDP) growth of 3.7 per cent the previous year. The contraction in the economy for the first time in 8 years in the December quarter contributed to the lower than average rate of growth. Shrinking domestic output is consistent with the contraction in world economic growth within the recent financial market downturn which has severely impacted global credit markets, market confidence and consumer demand. The Australian economy has fared well in comparison to the zero growth or contraction experienced by other economies.

The significant fall in world output demonstrates the strong linkages between financial markets and the real economy. The relative strength of the Australian economy is attributable to the health of the domestic financial sector, with the major Australian banks continuing to report solid profits over this period. These institutions were well capitalised leading up to the financial crisis, and continue to hold high credit ratings with the largest four banks maintaining their AA ratings.

The economy, weighed down by continued conservatism in consumption and business investment, is expected to contract in real terms by 0.5 per cent in 2009-10, compared with forecast contraction of the world economy of 1.5 per cent in 2009. Domestic economic recovery is expected in 2010-11, with a forecasted growth rate of 2.25 per cent.

The medium term expectation of a broad-based recovery in output is supported by recent economic data that suggests the downturn has bottomed. The IMF has accordingly raised the outlook for global economic growth for 2010 by 0.6 percentage points to 2.5 per cent. The estimated growth rate for this period is slightly higher for Australia's major trading partners at 3 per cent.

Graph 1



Source: Reserve Bank of Australia

The possibility of further weakness in the global financial system presents a risk to this outlook. However, the significance of global policy responses has reduced the likelihood of another downturn within the short to medium term. This, in conjunction with the possibility of an earlier recovery in China, could provide for better outcomes than that forecasted. On the other hand, a quicker than expected recovery may be hampered by instability created by the recent significant build up in public debt globally, as well as continued sluggishness in global demand.

1.2 Political Developments

Since the new Labor Government was elected into office in November 2007, it has had to move quickly to implement measures to support the financial sector and the economy more broadly. Of significance, the Government moved in line with other governments in October 2008 by guaranteeing the wholesale funding of Australian financial institutions. The Government has also guaranteed all deposits held with Australian financial institutions.

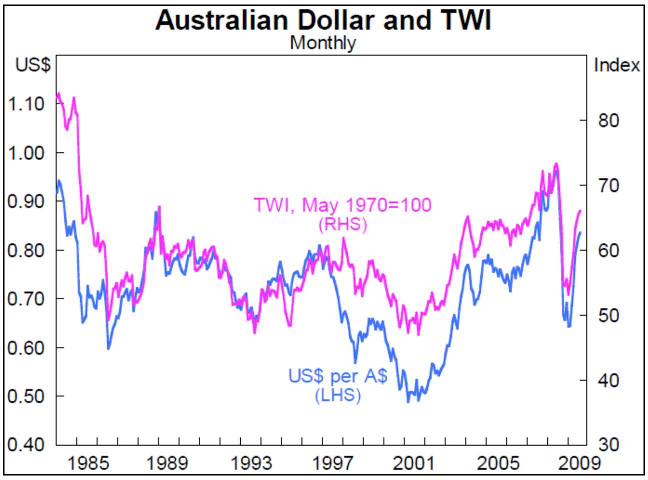
At the same time as the implementation of these measures to support the financial sector, the Government is also undertaking a broad review of financial market regulation. In line with international policy measures to strengthen global financial stability, domestic regulatory reform is underway on enhancing market transparency, retail investor participation in complex products and the broader framework for regulating over-the-counter (OTC) markets.

1.3 Exchange Rates

The Australian dollar depreciated sharply against the USD at the beginning of the year, reaching a trough in March 2009. Since then, the AUD has appreciated strongly against the USD, rising by 33 per cent. In line with this movement against the USD, the currency also appreciated against other major currencies, including the Sterling (up by 11 per cent), Euro (up by 16 per cent) and Yen (up by 29 per cent).

The currency has recently been supported by strength in commodity prices, as well as announcements by major economies of quantitative easing policies. With many policy rates at or close to zero per cent, the Australian policy rate of 3 per cent is attractive to investors undertaking carry trades.

Graph 2



Source: Reserve Bank of Australia

On a trade-weighted basis, the AUD has appreciated by 22 per cent from the trough in March, and is currently 12 per cent above the post-float average. The AUD traded in a relatively wide range towards the latter part of 2008, with volatility reaching unprecedented levels in October 2008. Volatility of the dollar against the USD has since fallen, but remains above the long-run average.

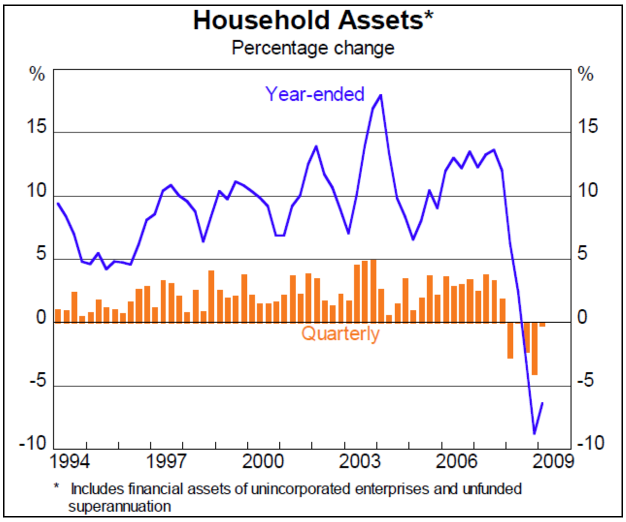
1.4 Consumption and Investment

Private consumption rose by 1.4 per cent in 2008-09, compared with 4 per cent the previous year. The fall in consumption growth is consistent with the contraction in global demand, with consumer sentiment negatively affected by the sharp fall in equity market values since the commencement of the financial crisis. Consumers are reacting to the significant slump in household wealth by taking a more conservative approach to discretionary spending.

In Australia, household net financial wealth has fallen by over 10 per cent in 2008, mostly due to depreciating share market values. Negative sentiment over a weaker employment market has been countered by assistance to households through government stimulus measures and falls in interest rates on mortgage repayments. The Government's fiscal stimulus transferred $20 billion to low-middle income households in the 4 months to May 2009.

Private consumption is expected to contract by 0.25 per cent in 2009-10, factoring in the rise in unemployment and slower income growth projected for this period. In addition, the effect of current stimulus measures is expected to be less pronounced than in the past financial year. The expected recovery of household wealth into 2009 supports a consumption growth forecast of 1.7 per cent in 2010-11.

Graph 3



Source: Reserve Bank of Australia

Business investment experienced similar declines in 2008-09, growing by just 6.8 per cent compared with the 15.4 per cent growth achieved the previous year. The recent contraction in growth follows robust business investment activity reaching 40 year highs by the end of 2008. A key contributor to the pre-crisis boom in business investment was rising commodity prices and record profitability in the mining sector. With the fall in global demand and a responding drop in commodity prices over the past year, business investment has been negatively impacted.

Business investment is expected to contract by 18.5 per cent in 2009-10. More positive economic data has been released since this projection by the Australian Government Treasury in May earlier this year. In particular, data has indicated a better than expected performance by Australia's major trading partners. In addition, the overall health of the business sector remains good with recent business surveys suggesting improved business conditions. Large firms have had good access to equity capital and access to debt markets appears to be improving, helped by the better-than-expected economic conditions and increased willingness on the part of investors to accept risk.

While consumption and investment activity are expected to be somewhat subdued in the upcoming year, overall domestic demand should be supported by a 25 per cent increase in total public investment.

1.5 Inflation

The Consumer Price Index (CPI) was 1.5 per cent higher in June 2009 than 12 months ago. The underlying rate of inflation, which excludes volatile items, is slightly higher at 2.5 per cent. Underlying inflation is within the Reserve Bank of Australia's (RBA) inflationary target band of 2 – 3 per cent.

The moderation in inflation has been supported by a 21 per cent fall in fuel prices over the year. Inflationary pressure on producer prices has diminished significantly since the beginning of year at all stages of production. Overall, the cooling in economic growth more generally has had a dampening effect on inflation.

The rate of inflation has been forecast to remain well below levels seen in mid-2008, with price pressures easing further through 2009-10. Both headline and underlying inflation is expected to fall to 1.75 per cent in 2009-10 and 1.5 per cent in 2010-11. This forecast is supported by the expected moderation in wages growth in 2009-10. It is likely that inflation will remain within its target band.

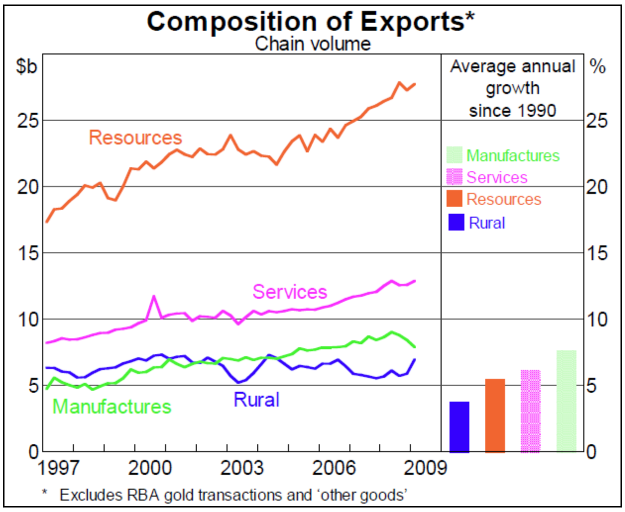
1.6 Government Finance, Balance of Payments and the Labour Market

The federal Government generated a budget deficit of $32.1 billion, or 2.7 per cent of GDP, in 2008-09, reversing a surplus position the previous year of $19.7 billion. The Government has announced an expansionary fiscal strategy to boost consumption and support economic growth more generally. The government stimulus measures, along with downward revisions to tax receipts of $23 billion in 2008-09, has brought the budget into deficit after surpluses over recent years. The fiscal position is not expected to return to surplus until 2015-16.

As in other economies, the balance of payments on exports and imports has been negatively affected by the collapse in global demand beginning in late 2008. From October to February, export values fell in a broad range of countries by double digit amounts. In Australia, the export of manufactured products fell 15 per cent over the three quarters to June 2009. However, the slump in the export market for manufactured products has not had as severe an impact in Australia due to the low proportion of manufactured exports relative to total exports. Further, total exports have held up well due to continued strong demand for coal and iron ore commodities, supported by recent strength in infrastructure investment in China. As well, a rise in farm output has seen rural export volume rise by nearly 20 per cent over the three quarters to June 2009.

Export volume is expected to fall by 4 per cent in 2009-10, in line with a forecast contraction in output in Australia's major trading partners. A recovery in export growth has been forecast for 2010-11 in line with broader global economic recovery.

Graph 4



Source: Reserve Bank of Australia

Imports remained stable in the June quarter, after the largest falls since 1975 in the preceding two quarters. The moderation in imports has been supported by a weaker currency during the period. Despite a stronger currency in recent months, imports are forecast to contract by a further 6.5 per cent in 2009-10, factoring in the projected contraction in consumption. Imports are expected to pick up in 2010-11.

Recent developments in world trade has seen the largest terms of trade boom in 6 decades unwind in Australia. The terms of trade is expected to decline by over 13 per cent in 2009-10, with negotiated prices for the export of coal and iron ore down 45-60 and 35 per cent respectively. Despite the significant falls in prices, the terms of trade is still about 45 per cent higher than the average in the decade preceding the commodities boom in the early 2000s.

With the value of imports declining more than that of exports, the trade surplus narrowed the current account deficit to a 7 year low of 2.2 per cent of GDP at the end of 2008. The current account deficit is expected to widen to 5.25 per cent of GDP in 2009-10.

The contraction in employment growth of 0.2 per cent in 2008-09 was smaller than expected, considering previous unemployment forecasts. The modest increase in unemployment to 5.8 per cent in August, from a low of 4.1 per cent a year ago, can be explained by businesses utilising more flexible work practices (as reflected in the decline in total hours worked) to cut down on labour costs rather than terminate employment. Employment growth is projected to fall by a further 1.5 per cent in 2009-10, to recover in 2010-11 with growth at 0.5 per cent. Despite the forecast employment growth, it is not expected to be enough to absorb new entrants to the labour market, and unemployment is expected to peak at 8.5 per cent in 2010-11.

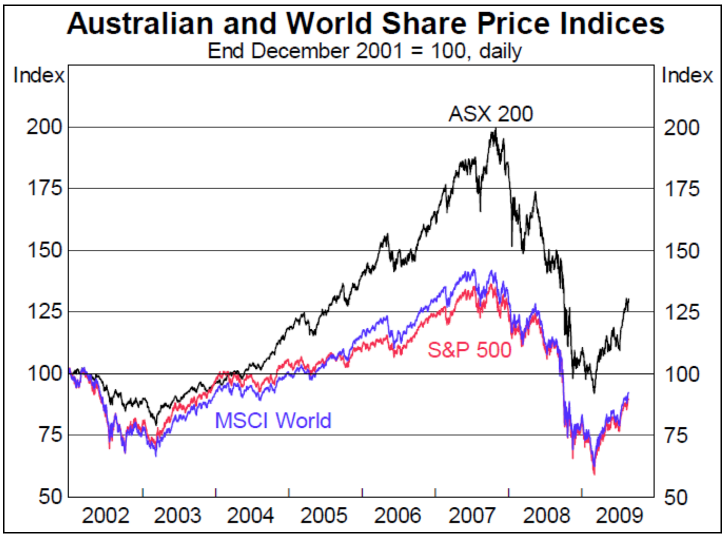
2. Outline of the Securities Markets

2.1 Price Trends of Equities

Equity market values had been falling since the end of 2007, reaching a trough in March earlier this year. The ASX 200 index, the benchmark index for the Australian share market fell significantly, demonstrated by a 54 per cent fall from peak to trough. The performance of the domestic equities market echoed similar movements in global markets, with the MSCI world index falling by 56 per cent over the same period. Since the trough in March, the ASX 200 index has recovered by more than 35 per cent.

The simultaneous falls in global equity values indicates a global crisis with a relatively uniform impact on individual share markets. Whilst the financial crisis started in credit markets with the collapse in values of financial assets, falling asset prices were later transmitted to the equities market. Similarly, the easing of credit conditions precipitated the recovery in equity market values.

Graph 5



Source: Reserve Bank of Australia

In line with trends in international markets, daily market volatility since the beginning of the year has been maintained at below the average recorded post the commencement of the financial crisis. Market volatility peaked following the collapse of Lehman Brothers with daily price movements of more than 3 per cent. Despite greater stability since the beginning of the year, volatility with current daily movements at over 1 per cent is nearly twice its long-run historical average.

The fall in equity values has been broad-based in the domestic market, but impacting financial and industrial stocks the most. The recent recovery in prices has also been broad-based, but improvements to financial stocks have been most significant due to improved sentiment from developments overseas. Resource companies have also benefited from the recent rise in values, reflecting the strong performance of commodity exports.

Earnings for the top ASX 200 companies in 2008-09 have been subject to widespread downward revisions. There is wide variation in analyst assessments, and considerable uncertainty remains. In general, profits are forecast to drop by 14 per cent in response to weakening domestic demand and the contraction in commodity prices. Profits are expected to fall by another 6 per cent in 2009-10, but rebounding significantly the following year.

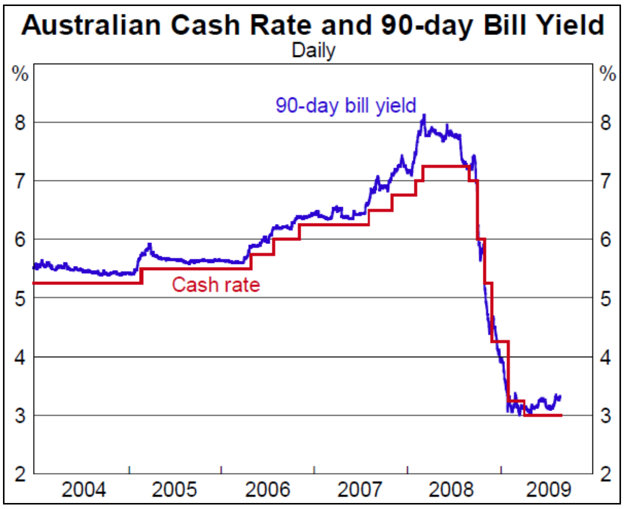
Whilst the share market has recovered from the lows, the weakness in projected profits provides a dampening effect on market outlook. It has been suggested that, from trends observed in previous market downturns, it can take between 3 to 6 years for the share market to completely recover losses.

2.2 Trends in Interest Rates

The RBA has eased policy rates since September 2008, reducing the cash rate by 425 basis points. The current cash rate of 3 per cent has been maintained since April. Over the past few months, stronger than expected economic data and improved sentiment globally has reduced the likelihood of further reductions to the policy rate.

Money market conditions deteriorated sharply in late 2008, with liquidity dropping in response to concerns in the inter-bank market about counterparty risk. The spread of BBSW, the Australian benchmark short-term rate, over overnight index swap (OIS) peaked at 90 basis points. Spreads have now fallen to just over 10 basis points, a little higher than the pre-crisis average.

Graph 6



Source: Reserve Bank of Australia

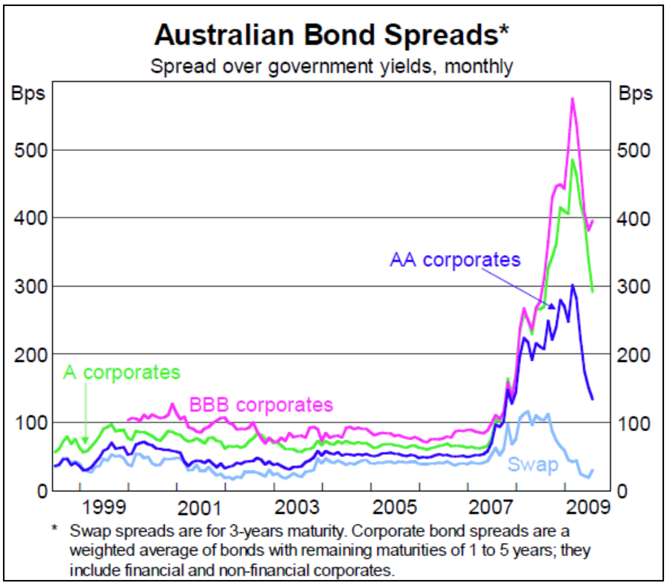
Despite improved funding conditions generally, spreads remain elevated in the RMBS market at 130 basis points above BBSW. The securitisation market remains dislocated, despite the low arrears rate of domestic securitised assets at less than 1 per cent. Spreads also remain elevated in the asset backed commercial paper market, which at 60 basis points above BBSW compares with the pre-crisis average of about 5 basis points.

Reflecting the thawing of credit markets since the beginning of the year and the progressive easing of monetary policy, mortgage rates are currently at the lowest levels since 1964. To illustrate, the standard variable rate for full documentation loans in August was 381 basis points lower than a year ago. There have been similar falls in the large and small business loan markets, with rates in August 341 and 300 basis points lower respectively. Tighter financial conditions have recently resulted in the easing of competition which has been particularly acute in the residential mortgage market, but also in the business loan market.

Bond market yields for Australian Government debt at the longer end of the maturity spectrum has been trending upwards since the beginning of the year, in line with global trends. The higher yields can be explained by improved economic sentiment increasing investor appetite for non-government debt, and also heightened concerns about increasing public debt levels. This is in contrast to the shorter end of the market, where yields have remained unchanged with continued expectations of low policy rates.

In line with the deterioration in money markets towards the end of 2008, spreads on term debt issued by banks rose sharply during that period. For example, spreads to five-year CGS rose above 250 basis points, compared with the pre-crisis average of around 60 basis points. More recently, strong investor appetite for Australian bank debt resulted in the lowest spreads to CGS since early 2008. Investor appetite has not been confined to just guaranteed debt, but also unguaranteed debt. Both guaranteed and unguaranteed 3 year bonds issued by banks are trading at about 100 basis points above CGS. At the longer end of the market, unguaranteed debt is still more expensive than guaranteed debt.

Graph 7



Source: Reserve Bank of Australia

Yields on highly rated corporate debt have fallen dramatically over 2008-09, reflecting easing credit concerns. At year-end, AA-rated corporate bonds were a little over 170 basis points over CGS, which represents a contraction of 42 basis points.

2.3 Activity Levels in the Markets for Stocks and Bonds

In conjunction with the fall of equity values, share turnover of $1.1 trillion on the Australian Securities Exchange (ASX) was down 30 per cent in 2008-09 from the previous year. The turnover in exchange-traded share options recorded a steeper decline, taking overall exchange-traded equities to a little under $1.5 trillion. Similarly, OTC equity derivatives also experienced a marked drop of 21 per cent over the year. The fall in trading value may be related to a greater aversion to risk by investors, with the stock of margin loans held by investors recording a corresponding fall of more than 40 per cent.

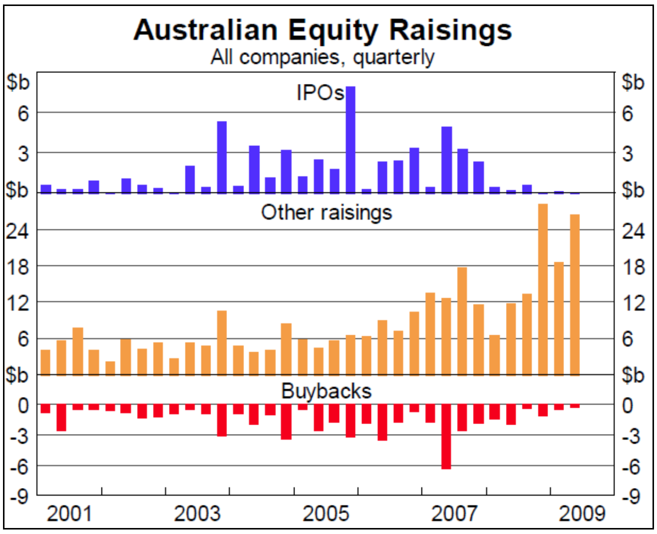
In contrast, secondary market turnover of $792 billion for Australian federal Government bonds represents an increase of over 10 per cent. The collapse of Lehman Brothers saw a dramatic flight to the quality of government securities as uncertainty over the global banking system reached extreme levels. This flight to quality reduced turnover of non-government debt securities by 6 per cent.

2.4 Activity Levels in Equity and Debt Capital Markets

The equity raising market has recorded buoyant activity, with nearly $78 billion raised over the year to August 2009. This is a 43 per cent increase from the previous 12 months. Strong issuance by banks, which raised $27 billion over the past year compared to an annual average of $4 billion since 2002, contributed to growth in equity raising. Corporates have responded to tightening credit markets by deleveraging, and raised nearly $45 billion of equity over the period. It is estimated that equity raisings so far this year has reduced corporate debt levels by 10 per cent.

At 99 per cent of total equity raised, secondary raisings proved popular. Rights issues have been especially robust, particularly in the first 2 quarters of 2009 with $17.7 billion raised. Equity raisings over the year has been led by the real estate sector, followed by materials, industrials, financials, and energy and power sectors.

Graph 8



Source: Reserve Bank of Australia

The value of bonds issued by the federal Government in the 12 months to August 2009 amounted to nearly $37 billion, compared with just $5.8 billion in the preceding 12 months. The Government had, prior to the financial crisis, issued on average about $5 billion of securities each year in order to maintain supply and liquidity in the government bond market during a period of budget surpluses. The sizeable increase in government bond issuance is reflective of the scope of the Government's stimulus measures.

Debt raising in the capital markets for non-government participants was led by financial intermediaries. Bank issuance has been strong since the commencement of the government guarantee of wholesale funding, raising about $140 billion from capital markets since the beginning of 2009. The proportion of bank wholesale funding liabilities that has been guaranteed sits at about 12 per cent. The guarantee has been instrumental in enabling financial intermediaries to fund through capital markets. In recent months, an increasing proportion of bonds issued by banks have been unguaranteed.

The tightening of credit markets since the commencement of the financial crisis has reduced the percentage of business funding from bond markets. With the trend towards deleveraging, corporate bond issuance has remained modest in the past few months. During this period, around half of funds were raised offshore.

The securitisation market remains dislocated, with $1.9 billion of the $2.6 billion issued since October last year being purchased by a government agency. The Government has already injected $6.7 billion into the securitisation market, accounting for 10 per cent of the total domestic market. Private investor appetite over recent months has been limited to short term and high quality securitisation assets. Total Australian RMBS outstanding has fallen by 40 per cent since the peak in mid-2007.

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. The paragraphs below briefly identify some of the more significant developments in this regard.

3.1 Government Measures to Address Credit Market Dislocation

Following the collapse of Lehman Brothers and the consequent dislocation in credit markets in September 2008, governments globally have undertaken unprecedented measures to support financial institutions and to improve liquidity in frozen money markets. The Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding, put in place on 13 October 2008, was designed to promote financial system stability in Australia and to ensure that Australian institutions were not placed at a disadvantage to offshore competitors which had access to similar government guarantees. The guarantee of deposits also ensured confidence in the financial system more generally, and discouraged a widespread withdrawal of funds from banks.

These domestic measures, in conjunction with initiatives undertaken globally, should ensure against further deterioration of markets and a broad-based recovery in the medium term.

3.2 Regulatory Response to Global Financial Crisis

The year in review has not only seen significant upheaval in market conditions but also dramatic changes in the regulatory environment. Global responses will have a major influence on the regulation of Australian financial markets.

The assessment by the International Organization of Securities Commissions (IOSCO) of unregulated markets and products has focused attention on the regulatory framework for OTC markets. Current developments in this area are focused on reducing operational and counterparty risk on OTC derivative markets, for example, by establishing central counterparties for the clearing of credit derivatives. In Australia, Government authorities have conducted review which shows that domestic wholesale OTC markets have shown resilience and integrity during a period of great strain in global financial markets.

In responding to regulatory changes in global markets, the challenge for Australia is the need to preserve its advantages as a relatively small but flexible, adaptive and well regulated financial market.

3.3 Regulatory Response to Market Volatility

The drying up of liquidity in money markets towards the end of 2008 caused widespread volatility in other markets. Substantial volatility experienced in equity markets resulted in concerted action by regulators worldwide to curb short selling activity, which was perceived to be a key driver in further depressing prices in a market downturn. In Australia, the Australian Securities and Investments Commission (ASIC) banned both naked and covered short selling of all stocks listed on the ASX in September 2008. Whilst the ban on covered short selling has now been lifted, a permanent ban on naked short selling has been put in place. The Government is now implementing a broader framework to govern the regulation of short selling, which will involve the development of a disclosure framework.

The Government has also been attuned to concerns raised around the impact of equity market devaluation on retail investors in leveraged financial products, such as margin lending. Although the instances of hardship created by the market downturn has been limited, the Government is working with industry to enhance disclosure around risks and the framework for regulating credit providers. In Australia, the retail market is able to invest in a range of financial products with varying risk attributes. Within the context of the effects of recent market volatility, the Government more generally is reconsidering the need for the industry to be more proactive in assessing client suitability for a range of complex products.

3.4 Equity Market Supervision

The Government recently announced that ASIC will take over the ASX's supervisory powers and perform supervision of real-time trading on all of Australia's domestic licensed markets. ASIC will be responsible for both supervision and enforcement of the laws against market misconduct. The securities industry supports the proposed changes, which provides a regulatory framework to meet the needs of a changing and increasingly more complex landscape for market supervision, as well as the emergence of new trading platforms.

3.5 Taxation Reform

The Government is currently undertaking a comprehensive review of the tax system, which will reconsider the balance of taxes on the returns from work, investment and savings, and consumption. Significantly, the Government has recognised the need for Australia to be better equipped to attract investments and international business. The industry has put forward proposals to make cross-border intra-bank funding more cost effective.

3.6 Australia as a Financial Services Hub

The Government is progressing its program of initiatives to develop Australia as a financial services hub. A range of measures have already been implemented, including the reduction of interest withholding tax on distributions by Australian managed funds to non-residents. A range of more substantial measures is currently being developed with industry.

3.7 Selected Other Issues

- The Australian Government has continued to work towards its commitment to establish a broad-based emissions trading scheme in Australia. The development of an emissions trading market should create new business opportunities for the industry. The Government has announced that a cap-and-trade market will commence in 2012.

- The industry has heightened activities around business continuity planning in the face of the ongoing Swine influenza (H1N1) pandemic. Since the onset of the outbreak in May earlier this year, transmission of the pandemic has occurred more swiftly in Australia than in other locations during the southern hemisphere winter. The industry has strengthened communication and information sharing between organisations.

- The industry has recognised opportunities to foster the growth of an Islamic finance market in Australia. Whilst global Islamic finance is still in its infancy, it presents new business opportunities, for example, the opening up of the Australian market to new Islamic banking operations for the intermediation of capital flows and investments from the capital rich Gulf region.

- AFMA recently signed a memorandum of understanding (MOU) with the Korea Finance Investment Association, following similar arrangements with the Japan Securities Dealers Association, the Securities Association of China and the Chinese Taiwan Securities Association. The MOU commits the associations to cooperate with each other on securities market development.

Association Contact:

Denise Hang
Policy Executive
Australian Financial Markets Association
dhang@afma.com.au