

Overview

The global economy is continuing to grow, although conditions vary significantly across different regions. Growth in most of Asia, including China and India, remains strong and unemployment rates are generally low. The main exception is in Japan, where the mid-March earthquake is still having a major effect on domestic production and a significant impact on some global supply chains, and has led to a sharp drop in consumer spending. In contrast to the strong growth in the rest of Asia and in some others parts of the world, many of the North Atlantic economies continue to operate with substantial excess capacity, with unemployment rates remaining high.

Notwithstanding these differences, the world economy is expected to grow at an above-average pace over the next few years, albeit below the rate recorded in 2010. As a result, significant upward pressure on commodity prices has continued, with the expansion of global supply struggling to keep pace with the increase in demand. For some commodities, this pressure on prices has been exacerbated by adverse weather events and, in the case of oil, by political turmoil in the Middle East and North Africa.

The rise in commodity prices has led to an increase in headline inflation rates in many countries, with food and energy prices increasing significantly. In Asia, there are signs that more generalised inflationary pressures are building, with the high commodity prices flowing through to higher prices for final goods and many economies operating with limited spare capacity. Headline inflation rates have also

increased in the North Atlantic countries although, in these countries, there are few domestically sourced inflationary pressures, with wage growth subdued and medium-term inflation expectations having increased only a little.

In response to the increase in inflationary pressures, monetary policy has been tightened in a number of countries over recent months, including in all the major economies in Asia (except Japan). In contrast, in the United States the Federal Reserve has continued to expand its balance sheet in line with its previously announced policy. Overall, for the world as a whole, monetary policy remains expansionary, and there is a growing risk that global inflation will rise further in the period ahead.

Over the past few months, the US dollar has depreciated significantly, partly reflecting the difference in the stance of monetary policy in the United States compared with most other countries. While the renminbi has been allowed to appreciate a little against the US dollar, on a trade-weighted basis it has depreciated back to around its level at end 2009. The currencies of most other emerging market economies have recorded significant appreciations against the US dollar over the past year, although many of these countries have introduced or extended capital controls in an effort to limit short-term capital inflows. A number of emerging economies also continue to accumulate foreign reserves at a rapid pace.

One ongoing source of uncertainty for the global economy is sovereign creditworthiness. Over the past year, Portugal, Ireland and Greece have

sought assistance from the EU/IMF and investors remain concerned about the possibility of a debt restructuring. Since the previous *Statement*, the credit ratings of the United States and Japan have also been put on negative outlook, with both countries facing the difficult task of putting their public finances on a sounder footing. Despite these moves, longer-term sovereign bond yields in major markets have been broadly unchanged this year at low levels, though above the exceptional levels seen in the second half of 2010.

More generally, conditions in credit markets have continued to be favourable, with many credit spreads narrowing further, to be at levels seen around late 2007. Corporate bond issuance has also been quite strong in a range of markets, including Australia. The local securitisation market has continued to improve, with issuance picking up over recent months.

In Australia, the rise in commodity prices is providing a significant lift to real national income and is underpinning very strong investment plans in the resources sector, while also creating some of the same sorts of inflationary pressures seen elsewhere. Australia's terms of trade are likely to rise further in the June quarter, to be above the level assumed a few months ago – and at their highest level in at least 140 years – boosted in particular by high prices for iron ore and coal. While the prices of these commodities are generally expected to decline over the period ahead as new supply comes on line, strong growth in steel demand in Asia is expected to see them remain at historically high levels.

The strong terms of trade have been accompanied by a significant appreciation of the exchange rate. In trade-weighted terms, the real exchange rate is at its highest level since the mid 1970s. The appreciation has significantly lowered the price of imported goods for Australian consumers and businesses (see below), but has also adversely affected the competitive position of many firms, particularly in the manufacturing and tourism industries.

While the medium-term overall outlook for the economy remains positive, the summer floods and Cyclone Yasi have had a substantial effect on production over recent months. Coal production, in particular, has fallen significantly, and the recovery is taking longer than earlier expected due to ongoing difficulties in removing water from flooded mines. As a result, GDP is likely to have declined in the March quarter. Production should, however, recover over the months ahead, providing a boost to output in the June and September quarters.

In contrast to production, domestic demand appears to have grown at a reasonable pace so far in 2011. A number of large resource projects were announced over the past six months and investment is picking up. Survey-based measures of business conditions have also improved to be around their pre-flood levels. In addition, business credit has increased over recent months after declining during much of 2010, and there is some evidence of a greater willingness by banks to lend. Despite this, many commercial property developers continue to report that lending conditions are tight, and activity in this part of the economy is still subdued.

Households remain cautious in their spending and borrowing decisions. While there is general optimism about prospects for the economy, households are not as optimistic about their own finances. Higher prices for utilities, fuel and food, as well as higher mortgage rates, appear to be weighing on consumer confidence. Given the developments in asset markets over recent years, it is also likely that households view asset returns as more uncertain than they did a few years ago. Partly as a result, the household saving ratio has increased over recent years, to be at its highest level since the late 1980s.

In the housing market, conditions remain subdued. Credit growth has slowed and housing prices in most cities are either flat or lower over the past few months. New dwelling and home loan approvals have also softened in 2011, partly reflecting the fallout from the Queensland floods, although conditions have softened in most other states as well. Auction

clearance rates in Sydney and Melbourne have been below average in recent months.

Employment growth remains solid, although its pace has moderated recently. Over the past year, the unemployment rate has declined by nearly ½ percentage point, to be just below 5 per cent. Over this period, there has been strong growth in employment in the mining sector and in a number of related business services. Employment growth has also been strong in the health and utilities sectors, while employment in the manufacturing sector has declined. Most leading indicators point to further growth in employment over the months ahead, although at a slower pace than in 2010.

As the labour market has gradually tightened, wage growth has picked up from the low outcomes recorded in 2009, to be slightly above its average pace over the past decade or so. With growth in labour productivity remaining low, unit labour costs have been growing quite quickly. Wage increases have tended to be highest in mining-related occupations and in Western Australia and Queensland. While there are some reports of shortages for specific occupations, most firms are not reporting unusual difficulties in hiring new workers. Average hours worked are lower than when the unemployment rate was last around 5 per cent (in early 2006), suggesting there may still be some additional capacity in the labour market. A further rise in the participation rate would be helpful in adding to that capacity.

The effects of the natural disasters in Australia earlier in the year, as well as high global energy prices, were clearly evident in the consumer price index for the March quarter, which increased by 1.6 per cent to be 3.3 per cent higher over the year. In the quarter, fruit and vegetable prices increased by 15 per cent, fuel prices rose by nearly 9 per cent, and there were large seasonal increases in the prices of health and education services. Electricity prices also rose by a further 5 per cent. In contrast, the prices of many imported retail goods continued to decline due to the appreciation of the Australian dollar. Over

the year, the price indices for clothing, footwear, furniture, household appliances and audio-visual equipment all fell.

In underlying terms, year-ended inflation looks to have now troughed at around 2¼ per cent, down from a peak of a little over 4½ per cent in 2008. The March quarter outcome for underlying inflation was slightly higher than expected, although this followed a lower-than-expected outcome in the December quarter.

The Bank's medium-term central scenario for the economy remains similar to that discussed over the past year or so. For most of the forecast horizon, growth is expected to be at, or above, trend and the unemployment rate is expected to decline gradually. Compared with three months ago, the forecasts for growth in 2012 and into 2013 have been lowered a little, largely reflecting the recent appreciation of the exchange rate. In the short term, the quarterly profile for GDP will be significantly affected by the floods; as noted above, aggregate output is likely to have declined in the March quarter, but a bounce-back is expected in the June and September quarters. Through 2011, growth is expected to be above 4 per cent, although this partly reflects the weak starting point in late 2010 due to the disruption to coal production.

While GDP growth is expected to be at, or above, its trend pace over much of the forecast horizon, large differences in the performance of the different sectors are likely to continue. Some areas of the economy are expected to be very strong, while conditions will be quite difficult in others due to the appreciation of the exchange rate and subdued consumer spending. This challenging environment for parts of the economy reflects the very large changes in relative prices that are occurring at a time when spare capacity in the overall economy is relatively limited.

In underlying terms, inflation is expected to increase gradually over the next few years, after having troughed in the bottom half of the medium-term

target band. While the recent appreciation of the exchange rate and a continuation of the relatively high saving ratio by households will help to offset some of the inflationary pressures associated with the resources boom, underlying inflation is expected to be in the top part of the target band over much of the next couple of years. By the end of the forecast horizon, underlying inflation is forecast to be above 3 per cent based on the technical assumption that the cash rate moves broadly in line with market pricing at the time this *Statement* was finalised. Headline inflation is forecast to remain above underlying inflation – and above 3 per cent – for the remainder of 2011, largely due to the increases in fruit and vegetable prices. It is then forecast to be below underlying inflation for much of 2012, as fruit and vegetable prices normalise.

As always, these forecasts are subject to a range of uncertainties. At the international level, developments in Asia are particularly important and, more broadly, it remains unclear as to how the pick-up in global inflation and the concerns about sovereign creditworthiness will ultimately be resolved. Domestically, the behaviour of the household sector will have a bearing on how the economy evolves, with there being plausible scenarios in which the

saving ratio increases further and others in which it declines. The behaviour of the labour market in an environment of low unemployment will also be important, as will the effect of the higher exchange rate on both activity and inflation.

Since November last year, the Board has held the cash rate steady at 4.75 per cent. With interest rates on most loans a little above average, this represents a mildly restrictive stance of monetary policy, which the Board has viewed as appropriate over this period given the general outlook facing the Australian economy. Consistent with the Board's long-standing approach, it will continue to focus on the medium term in setting monetary policy and look through the volatility in inflation and economic activity as a result of the natural disasters during the summer. The central outlook sketched above suggests that further tightening of monetary policy is likely to be required at some point for inflation to remain consistent with the 2–3 per cent medium-term target. In the challenging economic environment that is likely to lie ahead, the Board will set policy to ensure a continuation of the low and stable inflation that has made an important contribution to Australia's strong economic performance over the past two decades. ❧