

Overview

Global economic growth slowed a little in recent months after picking up in early 2012. Concerns about the fiscal and banking problems facing the euro area continue to weigh on the global economic outlook and have led to considerable volatility in financial markets. The flow of data over recent months suggests that economic activity contracted further in Europe. The US economy is expected to continue to experience only modest growth. Below-trend growth in Europe and the United States appears to be dampening growth in much of Asia, although in China there are signs that economic growth may have stabilised at a more sustainable pace of 7–8 per cent. Policymakers in a number of jurisdictions have responded to concerns about the outlook for economic growth and a moderation in inflation by easing monetary conditions further over recent months.

These developments, and the flow of data since the May Statement, have led to small downward revisions to forecasts of growth for most economies around the world, so that expectations are for global growth to be close to average in 2012, at around 3½ per cent, before picking up to about 4 per cent in 2013. The increasing importance of the faster-growing emerging market economies, particularly in Asia, is helping to drive global growth, while in the advanced economies, fiscal consolidation and the ongoing effects of deleveraging by the private sector are likely to be a drag on growth for some time.

Prices for most of Australia's key commodity exports have moved lower since the *May Statement*, as the softening in the outlook for global demand led

to falls in prices for crude oil, base metals, thermal coal and iron ore. The spot price for coking coal was supported for a time by disruptions to coal production in Queensland, but declined more recently as global steel prices fell. In contrast, prices for some grains have risen sharply owing to droughts in the major cropping regions of the United States and the Black Sea. The available data suggest that the terms of trade declined in the June quarter to be lower than the peak in the September quarter of last year by 10 per cent or more. Further declines are anticipated over coming years, in line with rising productive capacity for bulk commodities in Australia and elsewhere. Nevertheless, the terms of trade are likely to remain at an historically high level.

The Australian dollar has appreciated a little over the past three months. This is despite the deterioration in the global economic outlook, fragile global financial sentiment and declines in key commodity prices over this period, and may in part reflect increasing international demand for highly rated Australian dollar securities.

Financial market sentiment has been subject to large swings in response to developments in the euro area and the evolving outlook for global economic growth. The outcome of the Greek elections in June, and various announcements by European policymakers since then, helped to boost confidence, but only temporarily. This pattern has been evident in the volatile movements in spreads on government bonds for Spain, and other vulnerable euro area countries, which have trended higher in recent months. Notwithstanding volatility

in financial markets, capital markets continued to supply funding to corporations and highly rated banks. Australian banks accessed both onshore and offshore term funding in size in the past quarter and at spreads little changed from earlier in the year. The banking system's focus on increasing deposits to fund credit continues to underpin elevated spreads on deposits.

Information released over the past two months suggests that the Australian economy grew more rapidly over the past year than had previously been indicated by the available data. The national accounts now report that GDP growth was around trend over the second half of 2011, and was even stronger at 1.3 per cent in the March quarter of this year. More recent indicators suggest that in the June quarter the economy expanded at a somewhat slower pace than in the previous quarter.

Over the year to date, resource investment has continued to expand rapidly; work continued on the very large pipeline of committed projects, capital imports grew strongly and some additional resource projects commenced or gained approval in recent months. Exports of iron ore rebounded in the June quarter from earlier weather-related disruptions, but coal production was hampered in part by industrial disputes in Queensland. The high Australian dollar and weak conditions in the housing market have weighed on production and investment in a number of non-resource industries. Nevertheless, following a period of deleveraging, business credit is now growing at its fastest pace in three and a half years.

The available data suggest that household consumption also grew strongly over the first half of 2012. Retail sales growth picked up in the March and June quarters to around its strongest pace in over two years; liaison suggests that various government payments made to households through May and June had a noticeable effect on sales at some retailers. Motor vehicle sales to households also increased strongly in recent months.

There are tentative signs that housing market conditions and residential building activity may be starting to improve. Dwelling prices have increased modestly in recent months in most capital cities, but remain down a little over the year. Demand for housing finance is broadly unchanged from a year ago. With building approvals rising from low levels in recent months, there are signs that residential activity may start to pick up some time in the second half of 2012; lower interest rates, rising rental yields and population growth are likely to provide support for new housing construction.

In line with the growth in aggregate output, employment increased a little faster in the first half of 2012. Reflecting differences in demand conditions across industries, employment has been expanding strongly in resource and resource-related industries, while job shedding continued in the manufacturing, hospitality and building construction industries. The unemployment rate remains relatively low at around 5¼ per cent. Forward-looking indicators, such as surveys and job vacancies, have weakened to some extent over recent months, and are consistent with moderate employment growth and the unemployment rate edging up in the near term.

Private sector wage growth was little changed in the March quarter, to be around the average of the past decade in year-ended terms, but below the elevated rates seen over 2005–2008. Business surveys and liaison suggest that private sector wage pressures may have eased a little further in more recent months, consistent with the generally subdued demand for labour across many non-resource industries. Over the year to the March quarter, public sector wages grew at the slowest pace in around a decade.

Headline and underlying inflation have eased over the past year. The CPI increased by 0.6 per cent in the June quarter on a seasonally adjusted basis, to be 1.2 per cent higher over the year, with this low annual outcome heavily influenced by earlier large falls in the prices of fruit and vegetables from flood-affected levels a year ago. The various measures indicate that

underlying inflation was around ½ per cent in the quarter, and 2 per cent on a year-ended basis, the lowest rate since the late 1990s. The change over the year reflected a decline in the prices of tradables, following the earlier appreciation of the exchange rate, and more moderate inflation in a range of non-traded goods and services prices, in line with weak demand conditions affecting a number of industries.

Since 2011, inflation in non-tradable prices has moderated to a pace around the average of the inflation-targeting period. This moderation has been broad based across goods, such as food and new dwellings, and a range of market-based services.

In the June quarter, prices of tradables rose slightly, the first increase in around six quarters, with stronger outcomes for cars, clothing, footwear and some household goods. More generally, the outcome for tradable prices suggests that the significant downward pressure on inflation from the earlier exchange rate appreciation is lessening.

The outlook for the Australian economy is largely unchanged from the *May Statement*. Real GDP growth is forecast to slow somewhat over the second half of 2012 as the strong growth of domestic demand in the first half of the year moderates. While the forecast for growth in the second half of 2012 is similar to that in the *May Statement*, the stronger-than-expected growth in the first half of 2012 has boosted the forecast for GDP growth over 2012 to 3½ per cent. The economy is then expected to grow at around 3 per cent over 2013 and 2014.

In the near term, growth in domestic demand is expected to moderate from its recent strong pace, reflecting some easing in consumption growth and the impact of fiscal consolidation on public demand. Resource investment appears likely to evolve broadly in line with the Bank's earlier forecast profile. While some resource companies have adopted a more cautious approach to investment opportunities still under consideration (but to which they are not yet committed), some major projects have gained final approval over the past few months. As had long

been factored into the Bank's forecasts, resource investment is expected to decline gradually in the latter part of the forecast period. The effect of this on GDP growth is expected to be roughly offset by faster growth in resource exports and, in time, a gradual recovery in non-resource investment, though that seems unlikely to begin in the near term.

Forecasts for inflation are little changed from those presented in the *May Statement*. Given the outlook for economic activity and the expectation of a sustained improvement in productivity growth, non-tradables inflation is expected to remain around its average over the inflation-targeting period. Inflation in the prices of tradable items is forecast to increase as the lagged effect from the earlier appreciation of the exchange rate wanes. This, combined with the increase in the price level associated with the introduction of the carbon price in July, is forecast to result in underlying inflation being in the top half of the inflation target range over the year to mid 2013, easing back to be around the middle of the target range thereafter. CPI inflation is forecast to rise to 3 per cent over the coming year – reflecting the effects of earlier volatility in fruit and vegetable prices and the carbon price passing through to consumer prices – before also returning to the middle of the target range over the remainder of the forecast period.

The economic and financial problems in the euro area remain the most significant downside risk to the forecasts for global economic growth. The tasks ahead for authorities in the euro area remain substantial. As has been the case for some time, the forecasts assume that financial market volatility will remain high, but that a severe economic and financial disruption in the euro area will be avoided. Other risks to the global economy are also tilted to the downside, but much less so than those emanating from Europe. In China, the difficulty of calibrating policies in a rapidly changing economy means that there are risks to both sides associated with the authorities' attempts to help keep the economy on a sustainable path for growth.

An adverse shock to global demand would be expected to reduce commodity prices, and hence Australia's terms of trade, by more than is currently forecast. This would lead to lower growth in incomes and weaker domestic demand. Even so, Australia remains relatively well placed to respond to such shocks given the scope to adjust macroeconomic policies and a robust financial system; movements in the exchange rate would also be expected to play an important role in adjusting to such shocks.

In the domestic economy, important risks revolve around exchange rate developments. The exchange rate has been high for some time; indeed, this is a key part of the significant structural adjustment process that the economy is going through. However, it is possible that the persistently high level of the exchange rate may be more contractionary for the economy than historical relationships suggest.

The risks to economic activity, and movements in the exchange rate, would of course be reflected in inflation in time. The inflation forecasts are also subject to a number of other risks. One is that the improvement in productivity growth is not sustained as is assumed, which would tend to put upward pressure on inflation.

The Board reduced the cash rate in late 2011, and again in May 2012, taking rates for most borrowers back to a little below their medium-term averages. By early June, the global economic outlook had weakened (after earlier signs of a slight improvement) and financial sentiment had deteriorated on the back of heightened concerns about Europe's economic and financial problems. With the data to hand at that time suggesting that domestic growth had been modest, the outlook for inflation afforded scope for a further cut to the cash rate of 25 basis points at the Board's June meeting. The data subsequently released pointed to stronger growth domestically than had earlier been indicated but confirmed the decline in inflation. Over the same period, the global economy weakened further, financial market sentiment remained fragile and commodity prices

generally declined while the very early signs of the effects of the easing of monetary policy began to appear. The Board weighed up these developments at its July and August meetings. The Board judged that, with a more subdued international outlook, inflation expected to be consistent with the target and growth of the Australian economy close to trend, the stance of monetary policy – which had resulted in borrowing rates a little below average – remained appropriate.

The Board will continue to monitor information on economic and financial conditions and adjust the cash rate as necessary to foster sustainable growth and low inflation. ✎