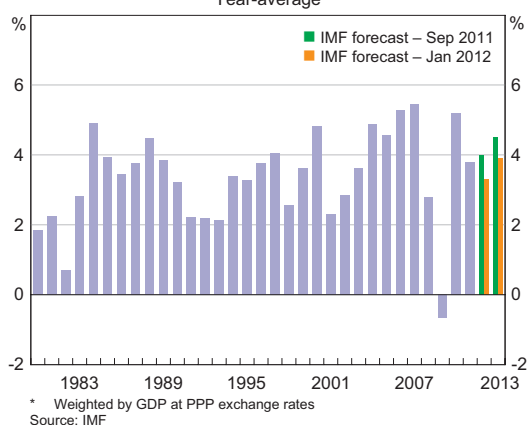


# 1. International Economic Developments

Sovereign debt problems in a number of advanced economies continue to be a major factor influencing developments in the global economy. The economic data in Europe have deteriorated significantly since mid 2011 and a feedback loop between sovereign debt problems and deteriorating economic conditions has developed in some countries. The European authorities, however, have made some progress in their efforts to craft a credible solution to the problems and, alongside the falls in sovereign bond spreads discussed in the chapter on 'International and Foreign Exchange Markets', there have been tentative signs of improvement in survey data over the past two months. The problems in Europe are having spillover effects to the rest of the world through trade, financial channels and an increase in broader economic uncertainty. Growth in Asia has slowed, although the region continues to expand at a faster pace than many other parts of the world. In the United States, economic indicators have picked up in recent months following a soft patch in mid 2011, although the fiscal position there also poses medium-term challenges.

In line with these developments, the International Monetary Fund's (IMF) January World Economic Outlook Update made downward revisions to the forecasts in the September 2011 Outlook (Graph 1.1, Table 1.1). Global growth is now forecast to be below trend at 3.3 per cent in 2012 and 3.9 per cent in 2013, with forecast growth in Australia's major trading partners around one percentage point higher in each year, reflecting Australia's strong trading links with Asia. A further intensification of sovereign debt problems in Europe is still seen as the biggest risk to global growth.

**Graph 1.1**  
**World GDP Growth\***  
Year-average



With the pace of growth of the world economy slowing over 2011, global inflationary pressures have lessened. Headline rates of inflation have fallen as oil and food price inflation has eased; rates of core inflation have generally moderated, consistent with the significant spare capacity in much of the advanced world.

## Asia

In east Asia, growth has slowed reflecting weaker export demand from the North Atlantic economies and the earlier policy tightening, as well as some temporary supply factors. Merchandise exports from east Asia (excluding Japan) fell in the December quarter, with particular weakness in the value of exports to Europe and of electronics (Graph 1.2). Natural disasters (most recently the floods in Thailand) are also affecting production and feeding through regional supply chains. Exports to the United

**Table 1.1: World GDP Growth**  
Year-average, per cent

|                                             | 2010       | 2011       | 2012          | 2013       |
|---------------------------------------------|------------|------------|---------------|------------|
|                                             |            | Estimate   | IMF forecasts |            |
| United States                               | 3.0        | 1.7        | 1.8           | 2.2        |
| Euro area                                   | 1.9        | 1.6        | −0.5          | 0.8        |
| Japan                                       | 4.4        | −0.9       | 1.7           | 1.6        |
| China                                       | 10.4       | 9.2        | 8.2           | 8.8        |
| Other east Asia <sup>(a)</sup>              | 7.7        | 4.5        | 4.1           | 4.7        |
| India                                       | 9.9        | 7.4        | 7.0           | 7.3        |
| <b>World<sup>(b)</sup></b>                  | <b>5.2</b> | <b>3.8</b> | <b>3.3</b>    | <b>3.9</b> |
| Australia's trading partners <sup>(c)</sup> | 6.9        | 4.4        | 4.4           | 4.9        |

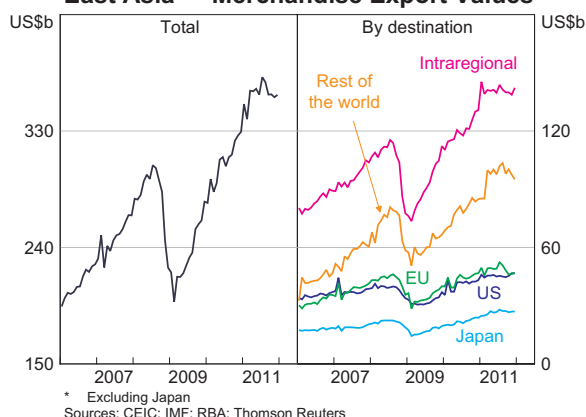
(a) Based on the IMF forecasts for the newly industrialised Asian economies and the ASEAN-5 categories

(b) Weighted using GDP at PPP exchange rates

(c) Weighted using merchandise export shares

Sources: IMF; RBA

**Graph 1.2**  
**East Asia\* – Merchandise Export Values**



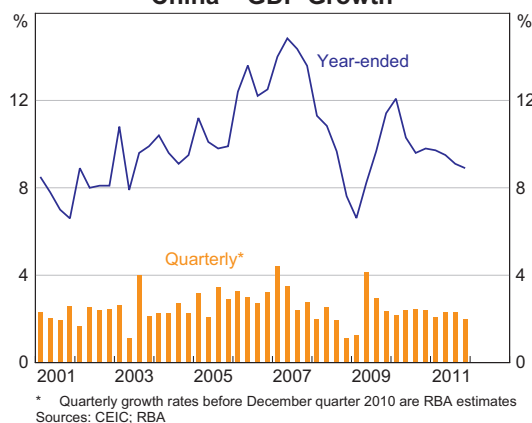
States have been stronger, however, in line with recent signs of improvement in the US economy.

There are also signs that domestic demand in Asia has softened a little. Greater uncertainty about growth prospects is likely to have been a dampening influence. The policy-induced tightening in credit conditions that occurred in early to mid 2011, particularly in China, is also likely to have weighed on domestic demand growth. Reflecting these factors, sentiment has softened, credit growth has eased across the region and aggregate output growth has slowed.

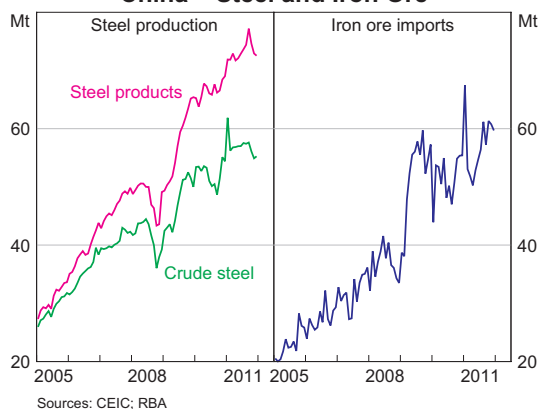
The Chinese economy continues to record strong growth, although the pace of expansion has slowed, with GDP growing by 2 per cent in the December quarter to be 8.9 per cent higher over the year (Graph 1.3). In part, the moderation in Chinese growth is due to domestic economic policies, including the continuing unwinding of the late 2008 fiscal stimulus, tighter monetary policy and measures to contain the property market. Weaker global demand has also weighed on growth. Similar to other economies in the region, growth in the value of Chinese exports slowed in the second half of 2011. In contrast, imports have grown solidly in recent months, with imports of crude oil, coal and copper expanding at a robust pace and imports of iron ore remaining high (Graph 1.4).

Growth in domestic demand remains firm, although below the pace of 2010. Retail sales have continued to expand at a solid pace and passenger vehicle sales have increased further to be just below the policy-affected peak level of late 2010. Manufacturing investment has continued to grow, notwithstanding weaker external demand, and industrial production growth has remained firm, albeit below the pace recorded earlier in 2011. Although power generation and automobile production have been growing strongly over recent months, other components of

**Graph 1.3**  
**China – GDP Growth**



**Graph 1.4**  
**China – Steel and Iron Ore**



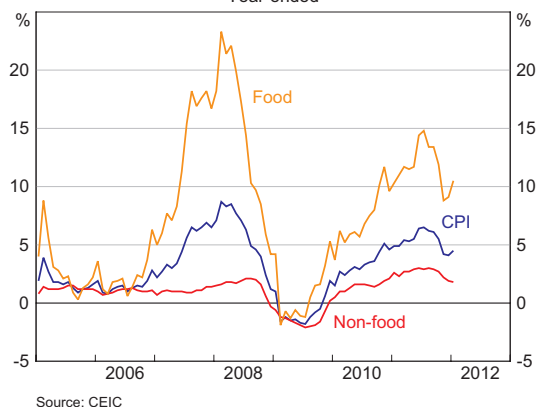
industrial production have been softer, particularly those more closely related to the construction sector. Output of crude steel, steel products and cement all fell towards the end of 2011, reflecting both the slowing in infrastructure investment due to the withdrawal of fiscal stimulus and softer growth in real estate investment. The gradual extension of property controls to more cities over time and the restricted availability of credit to property developers have had the desired effect of slowing activity in the property market (for more details, see 'Box A: China's Residential Property Market').

Inflationary pressures eased significantly towards the end of 2011, reflecting falls in agricultural prices and lower commodity prices. Consumer prices increased

by 4.5 per cent over the year to January after having peaked at 6.5 per cent in July (Graph 1.5). This disinflation largely reflects lower food price inflation, though year-ended non-food inflation has also eased, to be below 2 per cent after having reached 3 per cent in mid 2011. Housing has been the main driver of lower non-food inflation, reflecting lower growth in rents for public housing. Year-ended inflation is expected to moderate further in coming months as lower commodity prices, including for cotton and grains, feed through into retail prices of products such as clothing and alcohol.

Monetary policy settings have remained mostly unchanged since the November *Statement*, although the People's Bank of China (PBC) has lowered banks' reserve requirements by 50 basis points as the pace of foreign exchange reserve accumulation has slowed. While credit growth moderated to around 16 per cent over 2011, the monthly pace of credit growth increased towards the end of the year. This possibly reflects a switch in how financing was being provided following regulations introduced in September requiring banks to hold reserves against margin deposits used to secure bank acceptances, which is likely to have caused banks to shift some lending activity back onto their balance sheets. There was also a slowing in a broader measure of financing, with the flow of total social financing in 2011 below the target set by the PBC earlier in the year.

**Graph 1.5**  
**China – Consumer Price Inflation**  
Year-ended



Consistent with the falls in exports, industrial production in east Asia (excluding China and Japan) has been weak. Excluding Thailand, where manufacturing production halved over October and November due to severe flooding and is yet to fully recover, industrial production was broadly flat over the year to December with growth in electronics production softening (Graph 1.6). Uncertainty about the global outlook also appears to have dampened domestic demand. Retail sales fell by ½ per cent in the December quarter and consumer confidence declined, though it remains at above-average levels (Graph 1.7). Indicators of investment have also weakened. Nonetheless, credit growth remains relatively firm and the PMI surveys of manufacturing activity picked up noticeably in January.

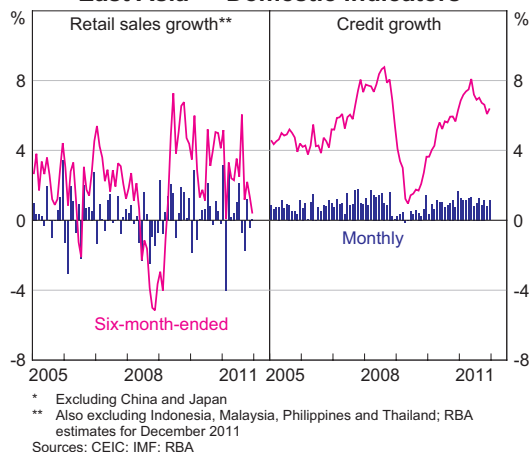
Labour market indicators were mixed in the December quarter. Average hours worked in South Korea and Taiwan declined and wage growth in the higher-income economies slowed sharply. Unemployment rates, however, declined a little further. Price pressures have started to ease and a number of monetary authorities in the region have loosened policy. The region has ample scope to pursue more stimulatory macroeconomic policies if required, with low government debt ratios and the ability to cut nominal interest rates following policy tightening over the first half of 2011.

Indicators of activity in Japan softened in the December quarter. Export volumes fell by more than 7 per cent over October and November (partly due to the Thai floods disrupting supply chains) and recovered only slightly in December. Machinery orders and indicators of production also fell in the quarter, as did household expenditure (Graph 1.8). In contrast, activity in the services sector appears to have improved modestly in the quarter. The rebuilding of earthquake-damaged houses and infrastructure is now expected to begin in the March quarter, which will boost growth in 2012; land clearing has been completed and in November the Diet passed a third supplementary budget to finance the rebuild.

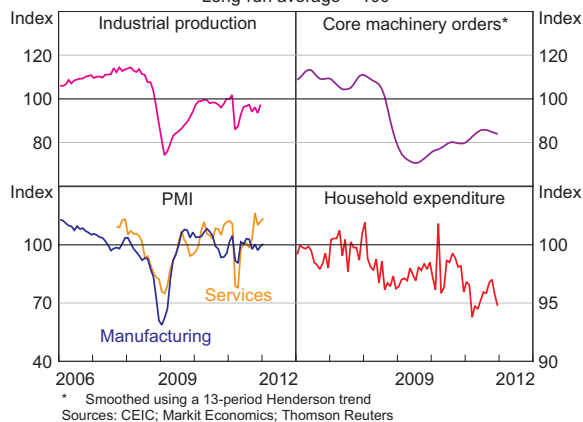
**Graph 1.6**  
**East Asia – Production and PMI**



**Graph 1.7**  
**East Asia\* – Domestic Indicators**



**Graph 1.8**  
**Japan – Economic Indicators**  
Long-run average = 100



In India, GDP grew by 7 per cent, down from the rates of around 10 per cent that were recorded during 2010. The slowing in growth follows a significant tightening in monetary policy, and recent data suggest that growth eased further in the December quarter (Graph 1.9). Growth in industrial production remains subdued; in the final months of 2011, average manufacturing output remained around 5 per cent below its peak in early 2011. In addition to the effect of monetary policy, industrial production has also been affected by problems at a number of coal mines, which have lowered mining output and disrupted the supply from thermal power stations. The value of merchandise exports fell in the December quarter, reflecting weaker external demand and lower commodity prices, particularly for iron ore. In contrast, conditions in India's services sector appear to have improved, with the services PMI rising to its highest level in six months in January.

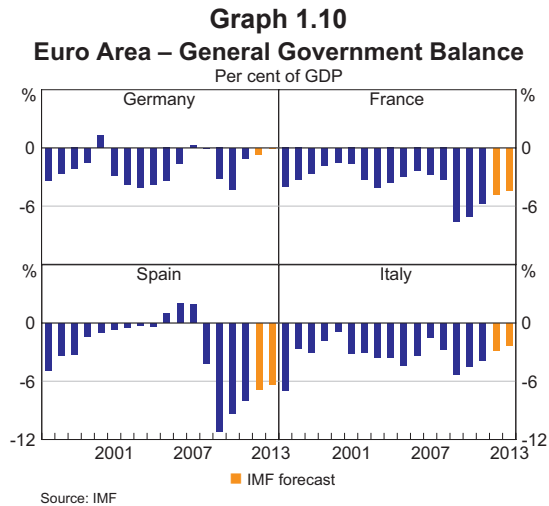
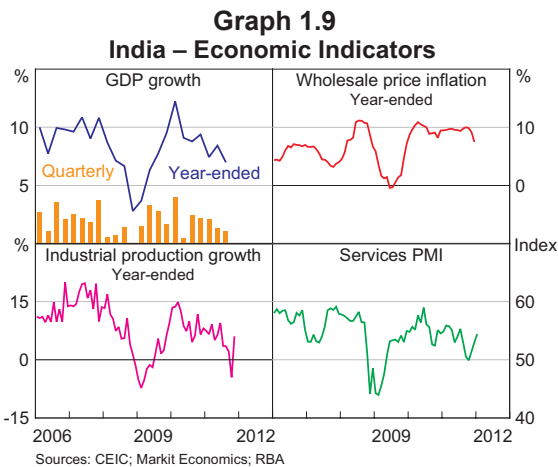
Despite some moderation, inflation in India remains high. The wholesale price index rose by 7½ per cent over the year to December. While inflation in prices of food and other primary products has eased in recent months, this has been partly offset by a pick-up in inflation for fuel and power; non-food manufacturing inflation has remained elevated. After increasing its policy rate by a cumulative 375 basis points starting in early 2010, the Reserve Bank of India has left rates on hold at its past three policy reviews, although it has recently reduced the

cash reserve ratio by 50 basis points in order to ease liquidity conditions.

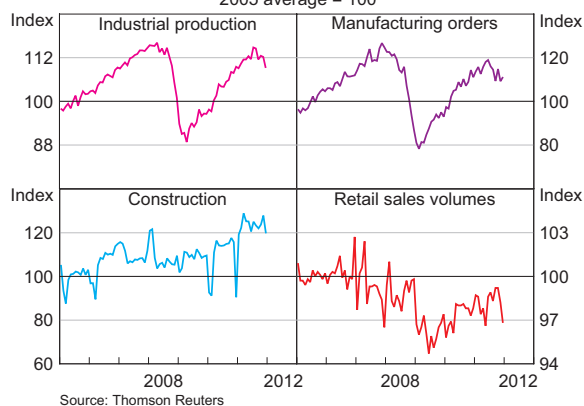
## Europe

Conditions in the euro area have deteriorated since mid 2011. Over this period, fiscal consolidation measures have slowed growth and sentiment has been dampened by concerns about the sustainability of sovereign debt positions (Graph 1.10). Business and consumer sentiment are well below their July levels, notwithstanding some improvement over the past two months in some countries.

Reflecting these developments, activity indicators for the euro area were weak in the December quarter, including in Germany which had led the modest expansion seen in the euro area over the previous two years. In Germany, industrial production has fallen by almost 5 per cent from its peak in July and retail sales volumes have fallen by 2½ per cent since September (Graph 1.11). Forward-looking indicators of equipment investment and exports, the two strongest sectors in the German recovery, have also declined. In contrast, construction activity in Germany has generally remained firm in recent months, the unemployment rate has continued to fall and the most recent readings of business and consumer confidence have strengthened somewhat.

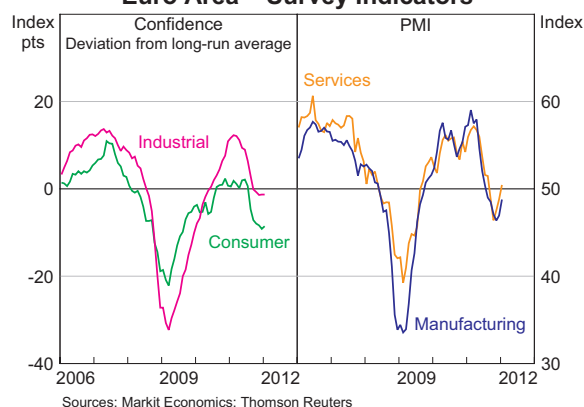


**Graph 1.11**  
**Germany – Activity Indicators**  
2005 average = 100



Outside of Germany and the northern economies, conditions remain fragile. The Greek economy continues to contract sharply, while activity is weak in Italy and Spain; further fiscal consolidation is expected to weigh on growth in these economies in the next couple of years (see 'Box B: Fiscal Consolidation and Economic Growth in the Advanced Economies' for more details). Unemployment in the euro area as a whole has risen in recent months to a rate of 10.4 per cent, the stock of outstanding credit has fallen recently, while consumer and business confidence remain at low levels, notwithstanding some improvement in the manufacturing and services PMIs in recent months (Graph 1.12).

**Graph 1.12**  
**Euro Area – Survey Indicators**



## United States

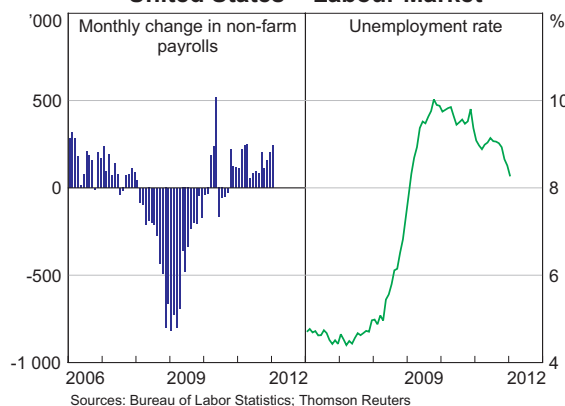
In contrast to the deterioration in economic conditions seen in a number of other parts of the world, economic activity in the United States has continued to improve, following a soft patch in mid 2011. The labour market has picked up, consumption growth has been solid, and house sales and housing starts have increased a little in recent months. However, the stock of unsold homes is still high and some measures of house prices have continued to fall in recent months. Further, the boost to spending from lower saving in the second half of 2011 is unlikely to be sustained, with household balance sheets still weak and many household mortgages still in negative equity. As in many other advanced economies, the ratio of government debt to GDP is high and fiscal consolidation is likely to weigh on growth in the medium term.

After softening in the middle of the year, the labour market picked up towards the end of 2011. Non-farm payrolls employment increased by an average of around 200 000 per month in the three months to January, up from an average of 78 000 in the three months to July 2011, and the unemployment rate fell to 8.3 per cent in January after having been broadly steady at around 9 per cent for much of 2011 (Graph 1.13). Other timely indicators, such as initial jobless claims, have also continued to improve.

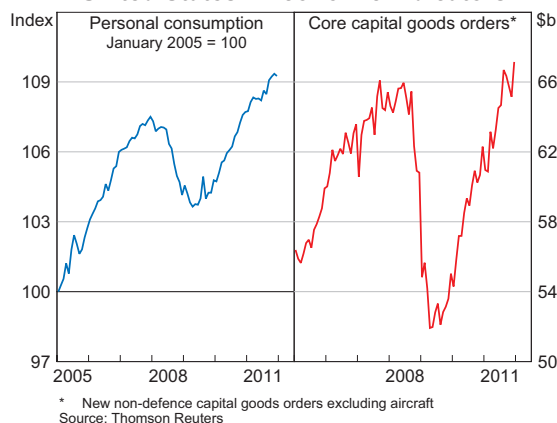
In line with the labour market improvement, consumer spending growth strengthened in the second half of 2011 (Graph 1.14). This pick-up in consumption partly reflects the recovery in purchases of motor vehicles following supply problems stemming from the Japanese earthquake, but purchases of other goods have also increased. Household consumption grew by ½ per cent in the December quarter and the continued improvement in the labour market and a recovery in consumer confidence from low levels should support consumer spending in the period ahead.

Business equipment investment continued to grow in the December quarter, although there

**Graph 1.13**  
**United States – Labour Market**



**Graph 1.14**  
**United States – Economic Indicators**

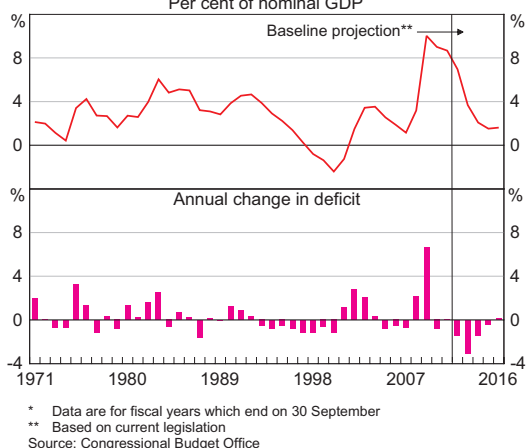


has been some slowing. Manufacturing activity, however, looks to have remained firm, with industrial production continuing to trend higher and the manufacturing ISM picking up from its recent lows. Growth in business credit (outside of commercial real estate) has also picked up.

Inflationary pressures in the United States eased markedly in late 2011, largely reflecting falls in global commodity prices and the reversal of some temporary factors that were boosting prices earlier in the year. Headline measures of consumer prices were broadly flat over the three months to December and the monthly pace of core inflation has moderated since mid 2011.

The Joint Select Committee on Deficit Reduction did not reach any agreement about cuts to spending or increases in taxes, while Congress has not passed key components of President Obama's proposed American Jobs Act. As a result, on current legislation a large fiscal contraction is scheduled to occur in 2013. The Congressional Budget Office estimates that this contraction could be around 3 per cent of GDP in fiscal year 2013, although there is some uncertainty about how much of this contraction will ultimately occur (Graph 1.15).

**Graph 1.15**  
**United States – Federal Budget Deficit\***  
Per cent of nominal GDP

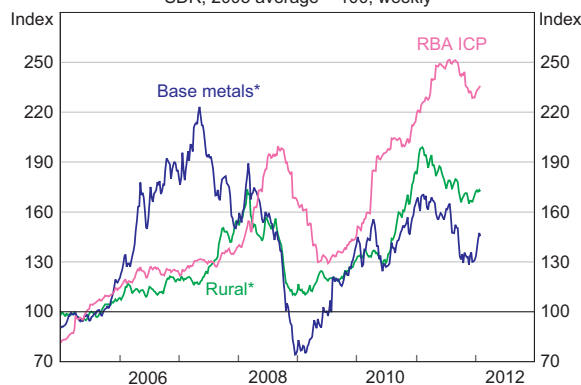


## Commodity Prices

Global commodity prices have remained at relatively high levels over the past three months, despite ongoing sovereign debt problems in Europe and some slowing in economic growth in China (Graph 1.16 and Table 1.2). While spot prices for coking coal and some rural commodities have edged lower since early November, spot prices for base metals and iron ore have increased, and oil prices have also risen. The terms of trade are estimated to have fallen in the December quarter reflecting the earlier weakening in iron ore prices, but the forecast profile has been revised up slightly.

**Graph 1.16**  
**Commodity Prices**

SDR, 2005 average = 100, weekly



\* RBA Index of Commodity Prices (ICP) sub-indices  
Source: RBA

The iron ore spot price has retraced almost half of the sharp fall recorded over September and October, rising by around 30 per cent from the low recorded in late October to be around US\$136 per tonne (free on board basis; Graph 1.17). Global steel production has declined over recent months, though Chinese iron ore demand has remained strong, with mills and traders reportedly rebuilding inventories. While global iron ore production capacity expanded in the second half of 2011, an increase in duty on iron ore exports from India – the world's third-largest iron ore exporter – and some weather-related disruptions in Brazil have restrained supply more recently. Coking coal spot prices have edged lower over the past three months, and are now around the levels seen prior to the significant flood-related disruptions to Queensland coal production early in 2011. Contract prices for hard coking coal look to have moved sharply lower in the March quarter, in line with the earlier falls in the spot price.

Quarterly contracts emerged almost two years ago as a dominant price-setting mechanism for Australian iron ore and coking coal exports, largely replacing annual benchmark prices. More recently, price-setting mechanisms have continued to shift towards shorter-term index-based approaches. In the case of iron ore, this evolution appears to have been accelerated by the sharp decline in spot prices

**Table 1.2: Commodity Price Growth<sup>(a)</sup>**  
SDR, per cent

|                                 | Change since previous Statement | Change over the past year |
|---------------------------------|---------------------------------|---------------------------|
| Bulk commodities <sup>(b)</sup> |                                 |                           |
| – Iron ore                      | 24                              | –24                       |
| – Coking coal                   | –11                             | –35                       |
| – Thermal coal                  | 3                               | –3                        |
| Rural                           | 1                               | –12                       |
| – Beef                          | 2                               | 2                         |
| – Cotton                        | –4                              | –49                       |
| – Wheat                         | 0                               | –23                       |
| – Wool                          | 5                               | 4                         |
| Base metals                     | 10                              | –14                       |
| – Aluminium                     | 9                               | –11                       |
| – Copper                        | 11                              | –14                       |
| – Lead                          | 11                              | –16                       |
| – Nickel                        | 18                              | –24                       |
| – Zinc                          | 12                              | –14                       |
| Gold                            | 1                               | 28                        |
| Oil <sup>(c)</sup>              | 6                               | 20                        |
| – US\$ terms                    | 4                               | 19                        |
| RBA ICP                         | 1                               | 5                         |

(a) RBA Index of Commodity Prices (ICP) components except oil and bulk commodities; latest available

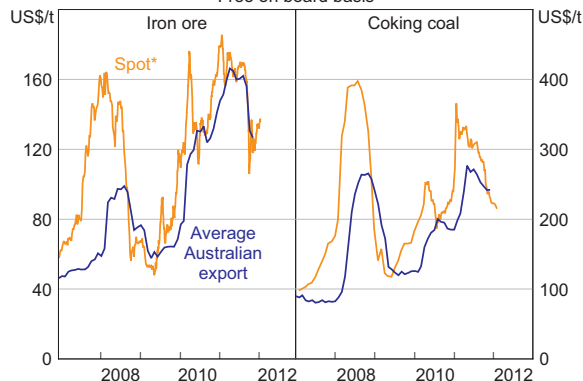
(b) Spot prices

(c) Average of WTI and Tapis crude oil prices

Sources: Bloomberg; RBA

**Graph 1.17**  
**Bulk Commodity Prices**

Free on board basis



\* Iron ore fines and premium hard coking coal

Sources: ABS; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA



in October, as customers shifted from backward-looking (and therefore higher) quarterly contract prices to arrangements based on more timely (and therefore lower) monthly or quarterly averages of spot price indices. Looking ahead, company announcements suggest that over half of Australian iron ore exports will be sold on either spot or monthly contract price terms, while one major producer has indicated that it expects to sell almost two-thirds of its coking coal on such terms in 2012.

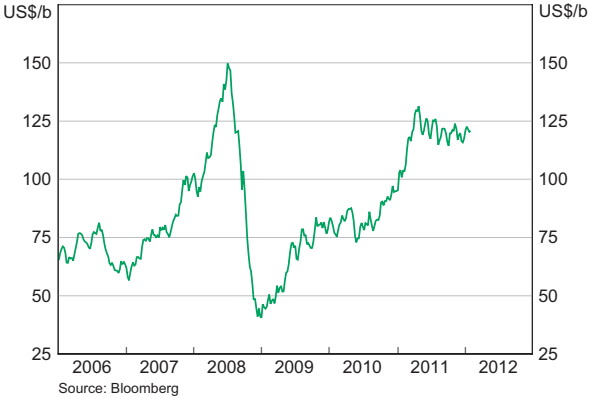
The prices of energy-related commodities have tended to rise over recent months. Thermal coal spot prices have increased since the November *Statement*, but they remain around 9 per cent below the 2011/12 Japanese fiscal year contract price of US\$130 per tonne. Global crude oil prices have risen over recent months, despite a weakening in the outlook for global economic activity (Graph 1.18). Geopolitical factors are affecting global oil markets, with the EU imposing an embargo on Iranian oil exports from mid 2012, and US sanctions also weighing on Iranian oil trade. Oil production also continues to be disrupted in Syria, Libya and South Sudan due to political tensions.

Base metals prices have strengthened over the past three months, after falling through much of 2011 in response to softer growth in global industrial production and weaker prospects for demand (Graph 1.19). Market reports suggest that the prices of aluminium, and some other base metals, are close to marginal costs of production, and there has been some mothballing of global aluminium production capacity. The gold price has risen by 1 per cent since November to around US\$1 730 per troy ounce, but it remains well below the peak reached in early September.

Global food prices tended to ease further in the latter stages of 2011, contributing to the moderation in global consumer price inflation. The prices of rural commodities most important to Australia's exports have been mixed over the past three months, after falling significantly over the first half of 2011. Strong global production of wheat, cotton and sugar has

led to price declines for these commodities over the past year, although prices remain at relatively high levels. Global beef prices have also remained at high levels, in line with rising production costs and growing demand in emerging economies.

**Graph 1.18**  
**Tapis Crude Oil Price**  
Weekly



**Graph 1.19**  
**Base Metals Prices and Industrial Production**  
Year-ended change

