1. The International Environment

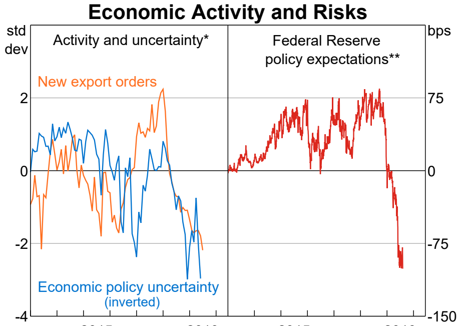
Growth in Australia's major trading partners remains reasonable. The growth outlook is a little lower than was expected three months ago because there have been further signs of slowing in activity indicators that are related to trade, such as exports, manufacturing and investment, and the US–China trade and technology disputes have escalated further (Graph 1.1). In contrast, consumption growth has been relatively resilient. Labour markets are tight but global inflation continues to be subdued. Downside risks to the outlook have increased: policy uncertainty remains high and the potential for the US–China dispute to escalate further has risen, which would adversely affect business investment.

Financial market conditions remain accommodative. Several major central banks have either eased policy or signalled a greater willingness to do so in response to subdued inflation and persistent downside risks to growth. The more accommodative outlook for policy in major economies, as well as subdued domestic inflation outcomes, has also provided space for a growing number of emerging market central banks to ease monetary policy in support of growth.

The shift in the expected path for policy rates has contributed to sharp declines in government and corporate bond yields and provided some support to equity prices. This constellation of lower interest rates and elevated prices for riskier assets over much of this year suggest that market participants believe that central banks will respond to downside risks and thereby sustain the economic expansion. However, risky asset prices fell sharply following the recent escalation in the US–China dispute, highlighting the potential for financial market conditions to tighten quickly if market participants become more concerned about the outlook for global growth.

Graph 1.1

Economic Activity and Risks



* Average between 2014 and 2018

** Cumulative expected change in the Federal Reserve policy rate target over the proceeding 12 months implied by futures

Sources: Bloomberg; Economic Policy Uncertainty; Markit; RBA

Trade and technology disputes have escalated …

The US–China trade dispute has escalated over recent months after negotiations between the two countries stalled. In June, the United States increased tariffs from 10 to 25 per cent on US$200 billion of imports from China and China retaliated with higher tariffs on US$60 billion of imports from the United States. About half of US imports from China are now covered by a 25 per cent tariff rate and most Chinese imports from the United States are covered by 5–25 per cent tariffs (Graph 1.2); average US tariff rates on Chinese imports are now 12 per cent, which is substantially above those on other US trading partners at around 1 per cent. More recently, the US administration announced it will impose a 10 per cent tariff on almost all remaining imports from China from 1 September and further tariff increases have been threatened. A decision by the US administration on increasing tariffs on automotive imports from a number of countries has been delayed to November. Trade tensions have broadened in recent months, with some countries using them to address political disputes. For example, the United States threatened, but then suspended, higher tariffs on imports from Mexico in response to a dispute over immigration flows.

The escalation in the trade dispute is weighing on global economic activity. The direct impact of the measures currently in place is relatively small, but the indirect effects of uncertainty on investment have been more significant. The risk of further escalation also poses a major downside risk to global growth, particularly through adverse effects on business investment and confidence more generally, and the potential for amplification through highly integrated global supply chains. Nonetheless, some economies that provide a competitive production alternative to China, such as Vietnam, appear to be benefiting from trade diversion due to the trade dispute.

The US–China technology dispute has also escalated in recent months. The United States imposed export and transfer controls that restricted access to key US technologies for certain Chinese entities, particularly targeting advanced semiconductor integrated circuits; the United States is the dominant global producer of advanced circuits (Graph 1.3). The Chinese Government is reportedly considering controlling exports of rare earth minerals; China is the largest global producer of these minerals, which have various uses in high-technology processes. The economic effects of the technology disputes are uncertain and are likely to play out over a long period.

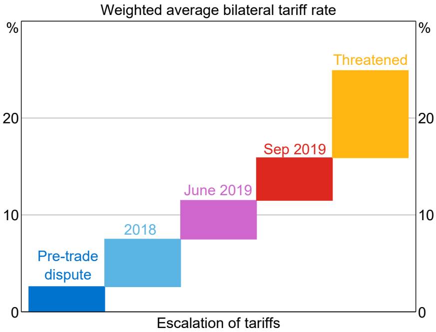
… creating downside risks to the outlook for trading partner growth

Major trading partner growth is expected to be around 3.7 per cent in 2019 and 2020 and pick up a little to 3.8 per cent in 2021 (Graph 1.4). This is a little lower than forecast in the May *Statement on Monetary Policy* because of the escalation in the US–China disputes and weak investment indicators. While this outlook is still reasonable, the downside risks have increased substantially, given the potential for further

Graph 1.2

US Tariff Rates on China*

Weighted average bilateral tariff rate



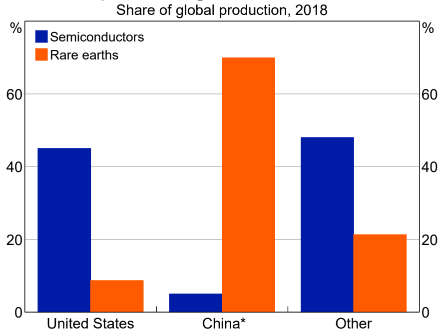
* Excludes steel and aluminium tariffs introduced in 2018

Sources: RBA; World Integrated Trade Solution

Graph 1.3

Inputs to High-tech Products

Share of global production, 2018



* Rare earths production based on production quotas; estimate of actual production (including illegal and undocumented) based on magnet production indicates a share closer to 80 per cent

Sources: SIA; USGS

escalation in US disputes with China and other economies. At the same time, however, monetary policy is expected to become more accommodative across a range of economies, in part because of the easing in global growth, but also in response to the rise in downside risks and subdued inflation.

In China, activity indicators have moderated

In China, economic conditions have softened since last year and GDP growth is expected to slow over the next two years. The direct effect of the US–China trade and technology disputes on Chinese activity has been limited to date; however, the impact of the associated uncertainty on investment decisions is expected to add to medium-term downward pressures on growth, which had already been slowing as a result of tighter financial regulations and longer-term structural factors. Various government measures have been introduced to support the domestic economy.

In the June quarter, growth moderated for a range of official activity indicators despite some supportive temporary factors (Graph 1.5). Growth in real retail sales eased despite a temporary boost from retailers attempting to reduce stocks of vehicles that were not compliant with tighter emission standards effective from early July. Fixed asset investment has been supported by continued growth in real estate investment, as well as policy measures to facilitate public spending on infrastructure, although the pace of growth in both sectors eased in the June quarter. Falling exports subtracted a little from GDP growth in the quarter.

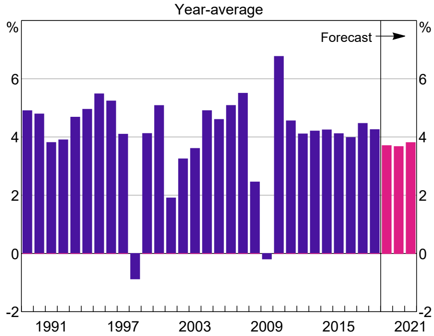
Many industrial sector indicators remain weak: growth in the output of industrial products remains subdued, manufacturing purchasing managers indices (PMIs) have trended lower and industrial sector profits have been weak. Nonetheless, the production of some items, such as steel and plate glass, have continued to rise, supported by high construction-related demand (Graph 1.6). This demand has also underpinned high margins for steel production, although increases in bulk commodity prices over the past year have eaten into these margins.

Conditions in Chinese property markets were mixed in the June quarter (Graph 1.7). While construction investment continued to grow relatively strongly, residential property sales declined. Property prices have continued to rise but, over the past year, growth in non-official measures of property prices compiled by the private sector firm China Index Academy have

Graph 1.4

Australia's Trading Partner Growth

Year-average

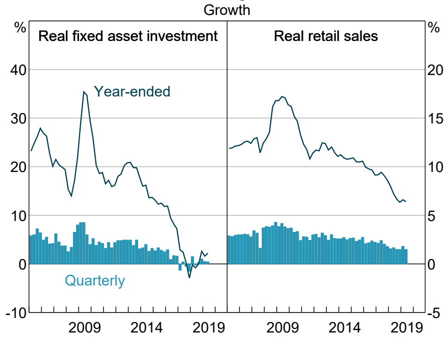


Sources: ABS; CEIC Data; RBA; Refinitiv

Graph 1.5

China – Activity Indicators*

Growth



* Seasonally adjusted by the RBA

Sources: CEIC Data; RBA

been notably weaker than official price indicators.

Core consumer price inflation in China has been little changed in recent months, after easing over the past two years, while headline inflation has risen further because of higher food price inflation stemming from supply disruptions in the rural sector (Graph 1.8). Producer price inflation has moderated further, partly driven by sharp falls in international oil prices in June.

Chinese authorities have eased policy further to support growth

Authorities have responded to slowing economic activity by announcing a further range of policies designed to support growth. The People's Bank of China (PBC) has lowered reserve requirements for some county-level banks over the past few months. PBC officials have reiterated that the central bank has significant room to adjust policies if further downside risks were to materialise, and market participants expect that it will do so.

Authorities have also taken further measures to ease fiscal policy. The general government fiscal deficit has continued to widen in recent months (Graph 1.9). Moreover, central authorities have authorised local governments to use proceeds from special bonds as project capital for some infrastructure projects, including large railway, highway, power supply and gas supply projects. Measures to support consumption have also been announced.

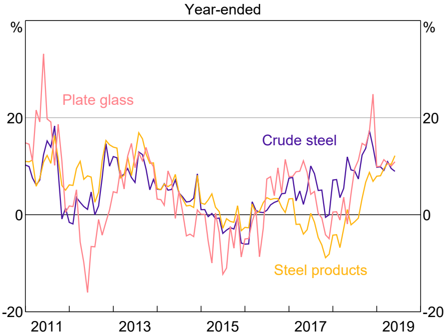
Economic activity overall has slowed in the major advanced economies

Year-ended growth has slowed in the major advanced economies. Policy uncertainty and weaker external demand, particularly from China, has weighed on investment. Conditions in manufacturing have eased, as have new export orders; the deterioration has been especially sharp in the United States after the escalation in US–China trade and technology disputes in recent months (Graph 1.10). Surveys

Graph 1.6

China – Industrial Production Growth

Year-ended

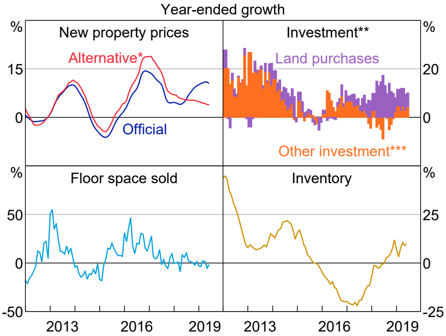


Sources: CEIC Data; RBA

Graph 1.7

China – Residential Property Indicators

Year-ended growth



* China Index Academy

** Contributions of residential and non-residential investment

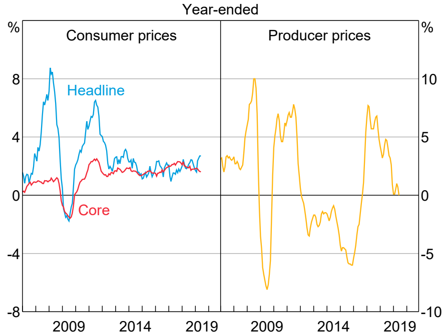
*** Construction, installation, equipment purchases and other

Sources: CEIC Data; CIA; CRIC; RBA

Graph 1.8

China – Inflation*

Year-ended



* Seasonally adjusted by the RBA

Sources: CEIC Data; RBA

of conditions in the services sector have been relatively resilient in Japan and the euro area, but have deteriorated in the United States since May. In marked contrast, consumption growth has been robust in the major advanced economies, supported by strong labour markets and rising wages growth.

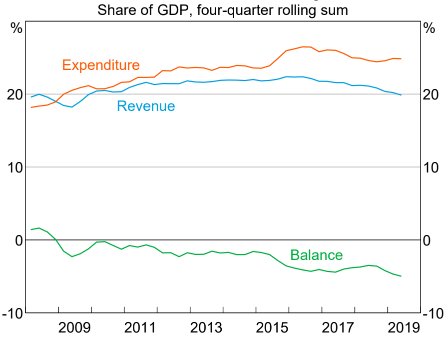
In the United States, consumption growth has recovered in recent months from its temporary weakness at the start of the year, supported by the strong labour market (Graph 1.11). However, GDP growth overall slowed in the June quarter because business investment growth slowed; net exports and inventories also subtracted from growth. A recovery in investment is unlikely in the near term, given that investment intentions, capital goods orders growth and business conditions have declined sharply over the past six months (Graph 1.12). This is, at least in part, due to the sharp rise in uncertainty associated with US trade and technology policies. Together with the effect of higher import tariffs on trade and the diminishing boost from earlier fiscal stimulus, the weaker outlook for investment is expected to lead to slightly slower growth in 2019 and 2020 than was previously thought.

In the euro area, GDP growth eased in the June quarter, which is likely to have been driven by a fall in exports. Indicators of investment

Graph 1.9

China – Fiscal Policy

Share of GDP, four-quarter rolling sum

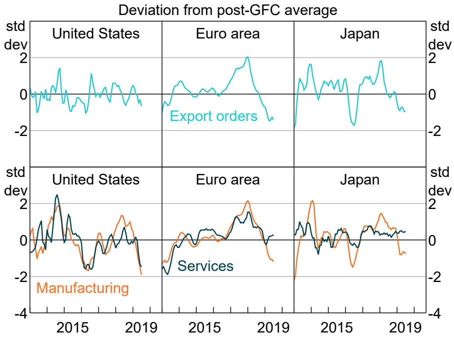


Sources: CEIC Data; RBA

Graph 1.10

Major Advanced Economies – Business Conditions*

Deviation from post-GFC average

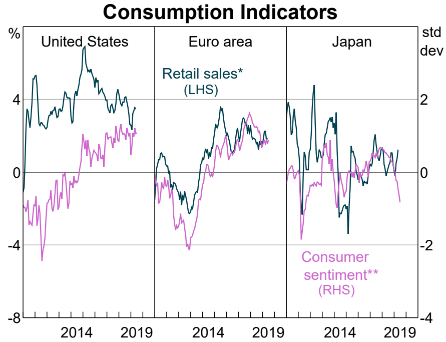


* PMIs; smoothed

Sources: Markit; RBA

Graph 1.11

Major Advanced Economies – Consumption Indicators



* Year-ended growth; smoothed; consumption index for Japan

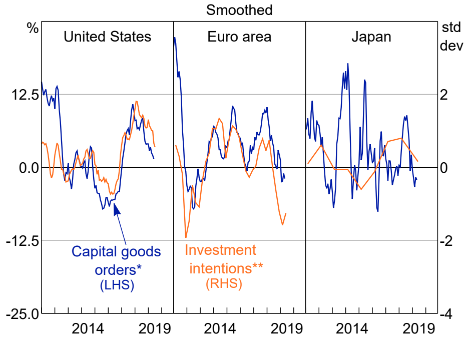
** Deviation from long-run average

Sources: CEIC Data; RBA; Refinitiv

Graph 1.12

Major Advanced Economies – Investment Indicators

Smoothed



* Year-ended growth; machinery orders for Japan

** Deviation from post-2000 average

Sources: Bank of Japan; RBA; Refinitiv

intentions and manufacturing conditions have remained weak while, in contrast, growth in household consumption has been strong, supported by strong labour markets. Growth has slowed because of the slowdown in global trade, moderating growth in China, and country-specific factors in some of its important trading partners (including in the United Kingdom and Turkey). Subdued external demand is expected to continue to weigh on growth in the near term. The potential for a disorderly exit of the United Kingdom from the European Union is an additional source of uncertainty for the euro area outlook.

In Japan, growth in domestic demand and exports slowed sharply early in 2019. External demand, particularly from China and the rest of Asia, has weakened since late 2018 and is weighing on the manufacturing sector. However, investment intentions remain relatively strong and have been supported by the need to address severe labour shortages. While consumer sentiment has eased, partial indicators suggest that consumption growth picked up strongly in the June quarter ahead of the consumption tax increase in October. Growth is expected to slow in late 2019 and early 2020 because fiscal policy will tighten following the consumption tax increase.

Labour market conditions in advanced economies remain tight

Employment growth in many advanced economies has slowed, but remains well above working-age population growth and, thus, strong enough to continue absorbing spare capacity in the labour market. The slowing in employment growth has been most pronounced in Japan and in the global manufacturing sector (Graph 1.13). Nevertheless labour markets remain tight, unemployment rates are at multi-decade lows and firms continue to report widespread difficulties in filling jobs.

Wages growth increased notably over 2018 in the major advanced economies and remains around the highest levels since 2010. Wages growth has slowed a little in the United States and the euro area this year. In Japan, full-time wages growth has stepped up to around the highest rate since late 2000 and wages growth in the more cyclically sensitive part-time sector has also been high and continues to increase. Wages are also growing at around their fastest pace since the global financial crisis in the United Kingdom and New Zealand, where labour markets are also tight.

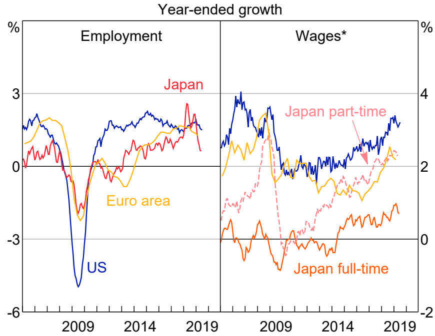
Inflation remains subdued in the major advanced economies

Inflation is below target in each of the major advanced economies, despite tight labour market conditions (Graph 1.14). Core inflation eased in the United States early this year after being close to the 2 per cent inflation target, although other underlying inflation measures, such as trimmed mean inflation, have remained close to the inflation target. Inflation is around target in several other advanced economies including the United Kingdom, Canada, Sweden and Norway. Oil prices have been volatile over the past few months after declining in late 2018;

Graph 1.13

Major Advanced Economies – Labour Market and Wages

Year-ended growth



* Average hourly earnings for the US; compensation per employee for the euro area; smoothed matched-sample average full-time scheduled wages and part-time hourly wages for Japan

Sources: CEIC Data; ECB; Eurostat; RBA; Refinitiv at current levels, oil prices will not exert upward pressure on headline inflation.

Persistently low inflation and slowing GDP growth have lowered some measures of inflation expectations. Market-implied measures of long-term inflation expectations have declined this year across all major advanced economies. The decline has been especially large in the euro area where market-implied measures are around their lowest levels in more than a decade (Graph 1.15). Economists' long-term inflation expectations have also eased but by much less. In contrast, in Japan, consumer inflation expectations have increased ahead of the consumption tax increase in October.

Major central banks have eased policy or are prepared to do so in coming months

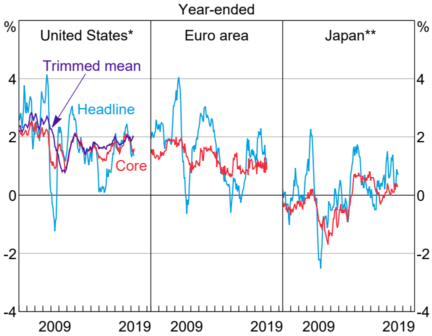
Major central banks have eased monetary policy pre-emptively or indicated a willingness to do so in response to downside risks to growth and subdued inflation outcomes and expectations. Consistent with this shift, market participants now expect most major central banks to ease policy by more than was the case a few months ago (Graph 1.16).

In the United States, the Federal Reserve (Fed) lowered its policy rate target by 25 basis points in July. The Fed noted that the US economy remains strong but there was room for some easing of monetary policy given the implications of global developments for the US economic outlook and subdued inflation pressures. This stands in contrast to Federal Open Market Committee (FOMC) projections earlier in the year, where most members envisaged one increase of 25 basis points in the policy rate over 2019. Market pricing implies that the Fed is expected to lower its policy rate by a further 100 basis points over the next 12 months. The Fed also announced that it would cease winding down its balance sheet in August, two months earlier than previously indicated.

Graph 1.14

Major Advanced Economies – Inflation

Year-ended



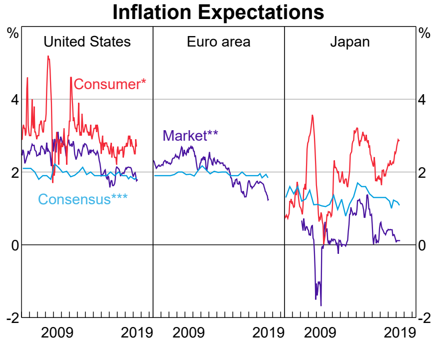
* Personal consumption expenditure inflation

** Excludes effect of the consumption tax increase in April 2014

Sources: RBA; Refinitiv

Graph 1.15

Major Advanced Economies – Inflation Expectations



* One-year-ahead

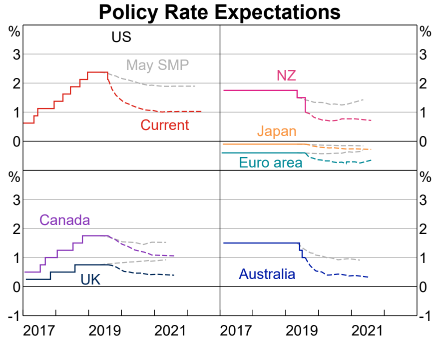
** Monthly average of five-years-ahead inflation expectations implied from inflation swaps; US adjusted for PCE

*** Long-run consensus; average of six-to-ten-years-ahead inflation expectations

Sources: Bloomberg; Consensus Economics; ECB; RBA; Refinitiv

Graph 1.16

Policy Rate Expectations



Source: Bloomberg

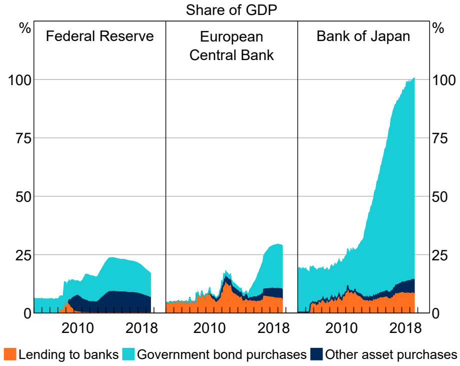
The European Central Bank (ECB) has emphasised that it will provide additional stimulus in the absence of a further improvement in the outlook for inflation. In particular, it has noted that this could involve a combination of lowering the policy rate, strengthening its guidance on the future path of the policy rate, and resuming the expansion of its balance sheet through the purchase of government and private-sector securities. Analysts expect a package of measures to be announced in September, with market pricing now implying that the ECB is expected to lower its policy rate by 30 basis points to –0.7 per cent over the next 12 months. The ECB has also provided more details on its upcoming 'Targeted Longer-term Refinancing Operations' (TLTRO-III), which are designed to provide continued support for bank lending to the real economy (Graph 1.17).

The Bank of Japan (BoJ) has continued to provide monetary stimulus by maintaining very low interest rates and expanding its balance sheet. The BoJ expects to maintain its current policy settings until at least the second quarter of 2020, although the BoJ has noted that policy could be eased further if necessary. Market pricing implies that the BoJ is expected to lower its policy rate by 10 basis points to –0.2 per cent by the end of the year.

Graph 1.17

Central Bank Balance Sheets

Share of GDP



Source: Refinitiv

Market pricing suggests that policy rates are expected to be lowered in a number of other advanced economies, or otherwise remain accommodative for an extended period. The Bank of Canada continues to assess that its current accommodative stance for monetary policy remains appropriate and future policy decisions will be data dependent; inflation has remained around the 2 per cent target and the Bank of Canada judges GDP growth to be nearing its potential rate. The Bank of England continues to point to the outcome of Brexit as a significant source of uncertainty, and notes that the next move in its policy rate could be up or down. The Reserve Bank of New Zealand (RBNZ) lowered its policy rate by 50 basis points at its August meeting to 1.0 per cent. The RBNZ noted that while employment is strong, inflation remains below the 2 per cent mid-point of the target range, growth in domestic and global activity has slowed, and risks remain titled to the downside. In contrast, some central banks, such as those in Sweden and Norway, expect to increase their policy rates in the coming year, reflecting solid domestic growth and inflation around target.

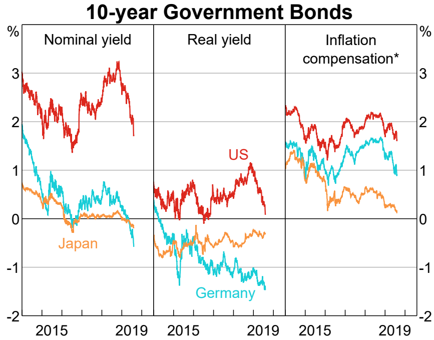
Government bond yields have fallen, in many cases to historical lows

Yields on long-term government bonds have fallen further to around record lows in some cases (Graph 1.18). Ten-year yields are at or below central bank policy rates in most major markets. In Japan, Germany, France, the Netherlands, Sweden and Switzerland, both 2- and 10-year yields are negative and around their lowest levels on record.

Part of the decline reflects lower real short-term interest rates, which is consistent with expectations that central banks will ease monetary policy and/or keep policy settings accommodative for an extended period. The declines also reflect a fall in inflation compensation, which suggests that market participants have lowered their expectations for future inflation, and/or that they believe that there is little if any risk that inflation will increase in the future. In addition, term premiums – the compensation that investors demand for holding long-term rather than short-term bonds – have declined to be around record low levels and, by some measures, are negative (Graph 1.19). This reflects unusually low perceived uncertainty about future interest rates and inflation outcomes, and demand for government securities from less price-sensitive buyers such as central banks, insurers and pension funds.[1]

Graph 1.18

10-year Government Bonds

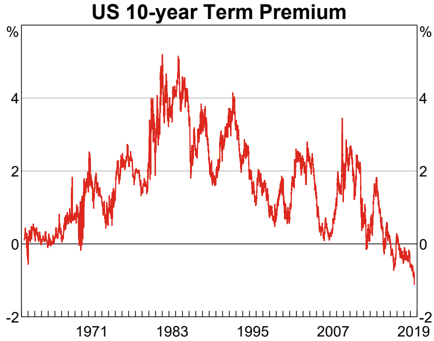


* Difference between nominal yield and real yield

Sources: Bloomberg; RBA

Graph 1.19

US 10-year Term Premium



Source: Refinitiv

The US dollar and the Japanese yen have appreciated, while the Chinese renminbi has depreciated

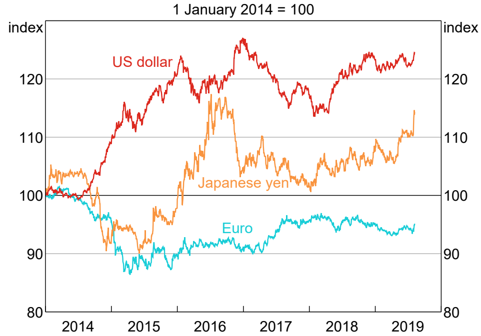
The US dollar has appreciated recently, but remains within its relatively narrow range following a sustained appreciation over 2018 (Graph 1.20). The Japanese yen has appreciated sharply, as it often does during periods of heightened uncertainty, and is around its highest level in several years on a trade-weighted (TWI) basis. The appreciation of the yen over the past few months is consistent with market participants expecting future monetary easing in Japan to be more modest than for other major markets. Japanese Ministry of Finance officials have signalled that they are closely monitoring for 'excessive movements' in foreign exchange markets. The euro is in the middle of its narrow range of recent years.

Following the recent escalation of US–China disputes, the Chinese renminbi has depreciated on a TWI basis and against the US dollar (Graph 1.21). The renminbi depreciated in early August, moving above 7 yuan per US dollar. Market participants had been widely of the view that the Chinese authorities would not want to see the exchange rate move through this level while trade negotiations were ongoing. The Chinese authorities attributed the depreciation to market forces, while the US government

Graph 1.20

Nominal Trade-weighted Exchange Rates

1 January 2014 = 100



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System formally labelled China a 'currency manipulator' and stated that it will engage with the International Monetary Fund over China's approach to exchange rate determination.

The cost of financing for corporations remains low

The cost of financing for corporations in bond markets has declined since the start of this year, reflecting both lower government bond yields and narrower credit spreads. This improvement in conditions has encouraged non-financial firms to issue more bonds, particularly firms with lower credit ratings (Graph 1.22). In China, the cost of financing for highly rated corporations has been stable in recent months, but it is lower than in the first half of 2018. In part, this reflects the effect of policy measures aimed at improving financing conditions for private enterprises.

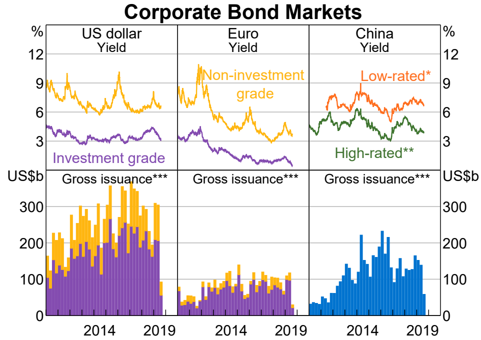
The cost of funding in short-term US dollar money markets has declined since earlier this year (Graph 1.23). Continued inflows into US dollar prime money market funds, a key source of US dollar supply in the market, have contributed to the easing in conditions. These favourable conditions have contributed to a pick-up in issuance of commercial paper by both US and non-US financial institutions.

In China, money market rates have generally remained low alongside efforts by the PBC to ensure there is ample liquidity in the banking system. However, there has been some tightening in funding conditions for small banks following the takeover of a small bank by regulators due to concerns about its solvency and reported misappropriation of funds (see 'Box A: Small Banks in China').

Despite the sharp declines seen since the beginning of August, global equity prices have risen strongly this year (Graph 1.24). Through much of this year, equity prices had been supported by lower sovereign bond yields, which increase the discounted value of future corporate earnings (equity risk premiums appear

Graph 1.22

Corporate Bond Markets



* Based on five-year AA- domestically rated bond

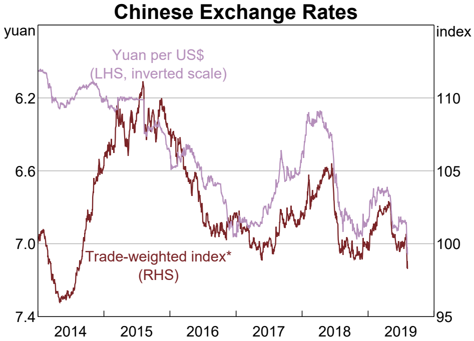
** Based on five-year AAA domestically rated bond

*** Non-financial corporations; September quarter-to-date

Sources: CEIC Data; Dealogic; ICE Data is used with permission

Graph 1.21

Chinese Exchange Rates

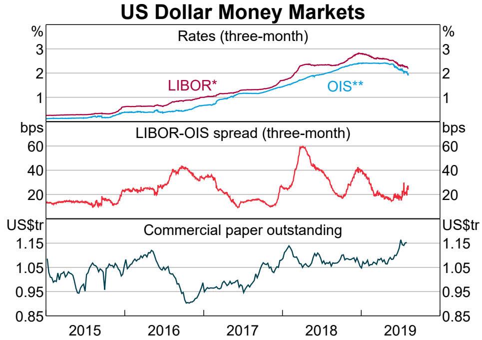


* Indexed to 1 January 2014=100

Sources: Bloomberg; China Foreign Exchange Trade System; RBA

Graph 1.23

US Dollar Money Markets



* London interbank offered rate

** Overnight index swap

Sources: Bloomberg; Refinitiv

little changed). At the same time, market analysts have maintained their forecasts for strong growth in earnings next year, despite some slowing in earnings growth this year (Graph 1.25). This suggests that participants have judged that downside risks to growth are either unlikely to affect corporate earnings materially, or that such risks will be offset by central bank policy accommodation if needed.

In east Asia, the decline in global trade has weighed on growth

Persistent weakness in external demand, especially from China, and intensification of the US–China trade dispute have weighed on the outlook for growth in east Asia. For most economies in the region, export growth has remained negative, new export orders are below average and industrial production has contracted (Graph 1.26). The ongoing weakness in global trade and the escalation in the US–China trade and technology disputes are likely to have a relatively more severe impact on these economies because of their integration in global supply chains.

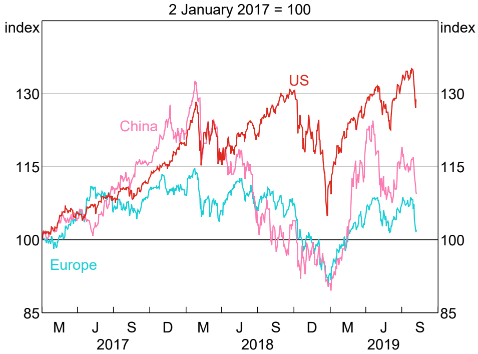
Overall, exports from east Asia to China have declined sharply since late 2018, partly as a result of weaker Chinese exports to the United States, which use significant inputs from the region's economies (Graph 1.27). An easing in Chinese domestic demand has also had an effect; for most economies in east Asia, their exposure to domestic Chinese demand is significantly larger than their exposure to Chinese exports to the United States. Intraregional trade has also declined because of the region's highly integrated production chains. However, in Vietnam and some of the high-income economies in the region, export growth to the United States has picked up, supported by the relocation from China of production of exports to the United States.

Weaker external demand is affecting domestic conditions in the region and growth has slowed

Graph 1.24

Equity Prices

2 January 2017 = 100

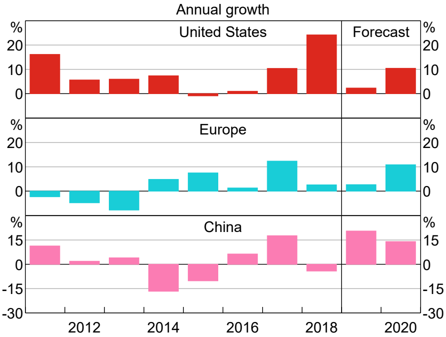


Source: Bloomberg

Graph 1.25

Corporate Earnings Growth*

Annual growth



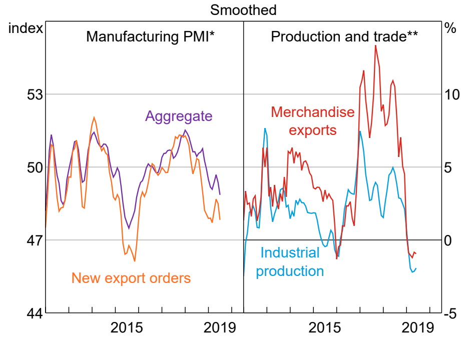
* Net income of financial and non-financial corporations adjusted for one-off items; earnings are for companies included in benchmark indices

Source: Refinitiv

Graph 1.26

East Asia – Economic Indicators

Smoothed



* Purchasing Managers' Index

** Year-ended growth

Sources: CEIC Data; IHS Markit; RBA

over the past year (Graph 1.28; Graph 1.29). Policy actions have muted some of the effects of weaker external demand more recently, including in South Korea, where GDP growth picked up in the June quarter, boosted by government spending. In most of the more trade-exposed east Asian economies, business investment has fallen sharply over the past year and consumption growth has slowed. In the less-trade-exposed economies, investment growth has also slowed but remains relatively high and consumption growth has remained resilient.

Inflation remains subdued in east Asia (Graph 1.30). Indonesian core inflation has increased, driven by higher durable goods and housing services inflation, but headline inflation remains in the bottom half of the inflation target band. Inflation in the Philippines has eased back to its target range, following tighter monetary policy in 2018. In Malaysia, inflation rose in June because of base effects from changes in consumption taxes a year ago.

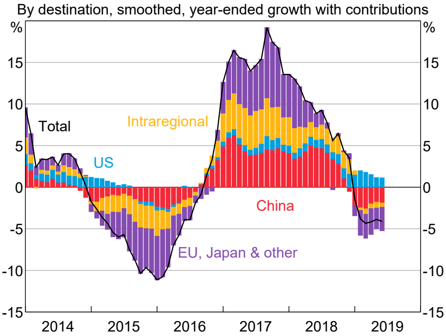
Accommodative global financial conditions have supported emerging financial markets

Expectations that major central banks will ease policy have supported financial market conditions in emerging market economies (Graph 1.31). Easier external financing conditions have provided space for many emerging market

Graph 1.27

East Asia – Merchandise Export Values

By destination, smoothed, year-ended growth with contributions

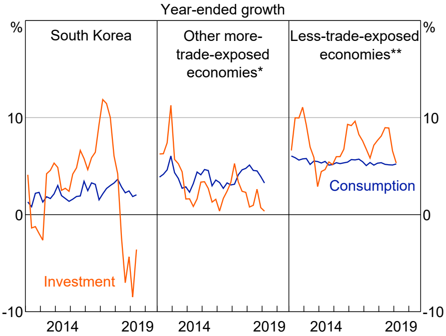


Sources: CEIC Data; RBA

Graph 1.28

East Asia – Investment and Consumption

Year-ended growth



* Hong Kong, Singapore, Taiwan, Thailand and Malaysia

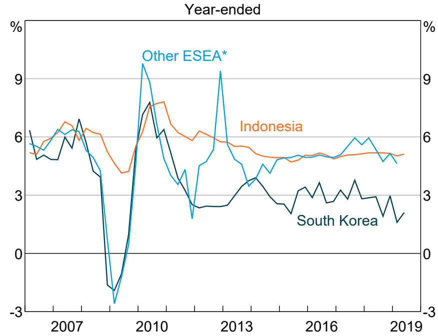
** Indonesia and Philippines

Sources: CEIC Data; RBA

Graph 1.29

East Asia – GDP Growth

Year-ended



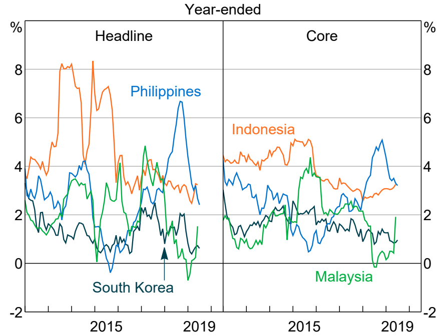
* Emerging South-East Asia; includes Thailand, Malaysia, Philippines and Vietnam

Sources: CEIC Data; IMF; RBA

Graph 1.30

East Asia – Inflation

Year-ended



Sources: CEIC Data; RBA

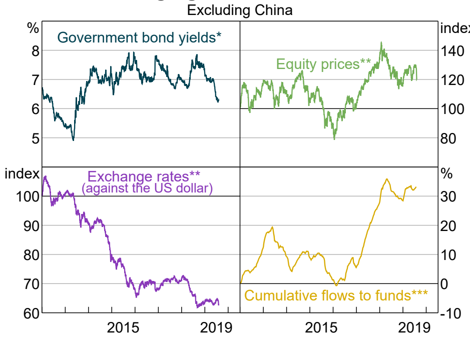
central banks to ease monetary policy in response to downward revisions to domestic growth forecasts, subdued domestic inflationary pressures and downside risks to growth. This has contributed to a sharp decline in yields on government bonds denominated in local currencies. Spreads for bonds denominated in US dollars have also tightened for sovereign and corporate issuers in emerging markets.

Since the start of the year, emerging markets have experienced steady inflows of foreign capital into their bond markets, while foreign flows to their equity markets have been more mixed. There were some capital outflows from mutual and exchange-traded funds that invest in equities in emerging markets, following the escalation of the US–China trade and technology disputes in early May (Graph 1.32). The economies that are most integrated into Chinese supply chains were the most affected. Meanwhile, inflows into emerging market bond funds have persisted in response to relatively higher yields (vis-à-vis advanced economies) and further expected policy easing by emerging market central banks. The recent escalation in trade and technology disputes presents a downside risk to capital flows into emerging markets.

Graph 1.31

Emerging Financial Markets

Excluding China



* Local currency bonds, weighted by market value
** 1 January 2012 = 100
*** Includes flows to exchange-traded funds and mutual funds
Sources: Bloomberg; EPFR Global; IMF; JP Morgan; RBA

Growth in India has slowed, and the central bank has responded

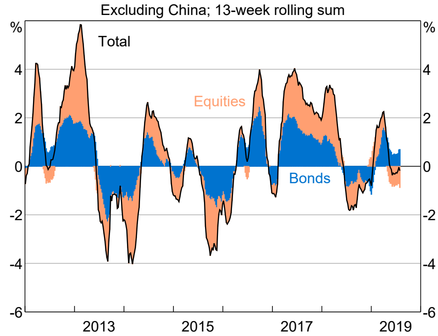
In India, GDP growth slowed in the March quarter, driven by a fall in the level of investment (Graph 1.33). More recent monthly activity indicators have been mixed. Steel output and industrial production have begun to pick up, but remain weak. A range of service sector indicators have also eased in recent quarters, after being elevated last year (Graph 1.34).

Future growth is expected to be weaker than previously forecast, partly because of slower growth in the industrial sector, lower-than-expected fiscal expenditure in 2019/20, weaker external demand and emerging trade tensions. In the recent budget, the Indian Government

Graph 1.32

Flows to Emerging Market Funds*

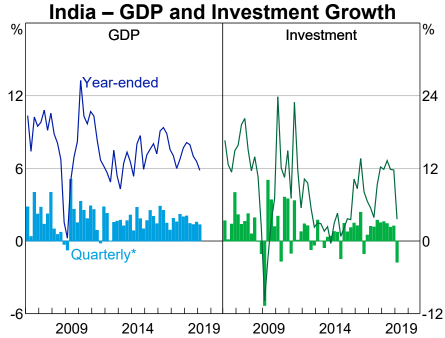
Excluding China; 13-week rolling sum



* Per cent of assets under management; includes bonds denominated in US dollars and local currencies
Source: EPFR Global

Graph 1.33

India – GDP and Investment Growth



* Seasonally adjusted by the RBA
Sources: CEIC Data; RBA

announced a slightly smaller fiscal deficit for 2019/20 than in 2018/19. The budget included an INR 700 billion recapitalisation of state-owned banks, which should support these institutions' lending activity. In May, the United States announced that India would no longer qualify as a 'beneficiary developing country', which had given India preferential access to the US market, prompting retaliatory tariffs from India.

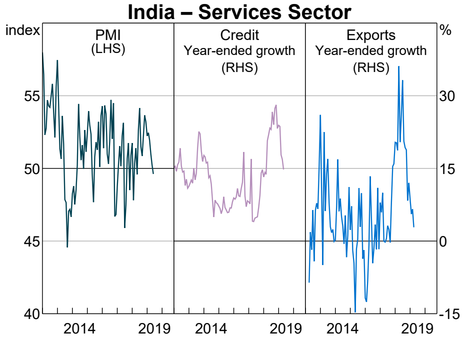
Meanwhile, rebounding food and fuel prices have boosted headline inflation but core inflation has continued to moderate; even so, headline inflation remains below the Reserve Bank of India's 4 per cent target (Graph 1.35). In response to slower growth and subdued inflation, the Reserve Bank of India lowered its policy rate by 35 basis points in August, following earlier cuts in February, April and June.

Iron ore prices have moved in a wide range in recent months …

The benchmark iron ore spot price has been volatile in recent months. For most of the period since the previous *Statement on Monetary Policy*, prices continued to strengthen and reached their highest level since early 2014 (Graph 1.36). Disruptions in Australia and Brazil have limited available supply in the seaborne market while, at the same time, Chinese demand for iron ore had been relatively resilient because steel production has increased strongly over recent months (see 'Box B: The Recent Increase in Iron Ore Prices and Implications for the Australian Economy'). However, in recent weeks, reports have been suggesting Chinese iron ore demand has moderated because of production curbs that are in place in some cities. The escalation in trade tensions has led to sharp falls in iron ore prices since the start of August. The outlook for iron ore seaborne supply and prices remains highly uncertain; although Chinese steel demand is expected to remain elevated in the near term, supply constraints should continue to ease following approval for some Brazilian production to resume.

Graph 1.34

India – Services Sector

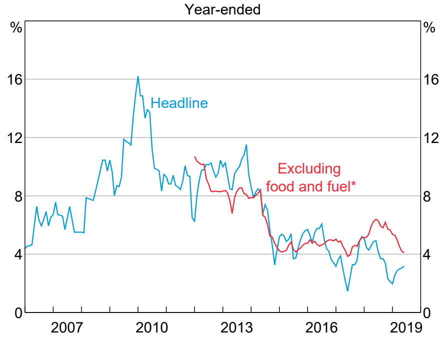


Sources: CEIC Data; IHS Markit; RBA

Graph 1.35

India – Inflation

Year-ended

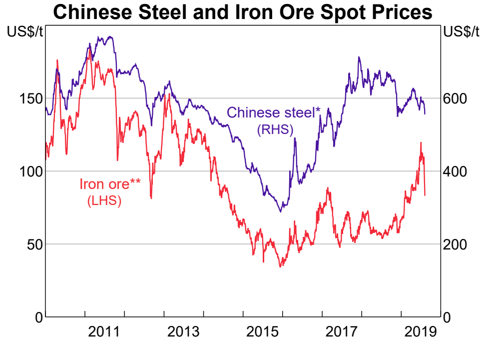


* RBA calculations

Sources: CEIC Data; RBA

Graph 1.36

Chinese Steel and Iron Ore Spot Prices



* Average of hot rolled steel sheet and steel rebar prices

** 62% Fe Fines index; free on board basis

Sources: Bloomberg; RBA

… while most other commodity prices have declined

Australian thermal coal prices have steadily declined over the past year (Graph 1.37; Table 1.1). Price declines in recent months have reflected ample supply from exporting countries, while Asian demand has declined because of a combination of elevated stockpiles, an increase in renewable generation and some substitution towards lower-cost LNG and cheaper Russian thermal coal. Coking coal prices have also declined since the previous *Statement* alongside an increase in global supply, notably from Australia, and because demand from some key steel-producing economies has eased.

Oil prices have declined since their peak in mid May because renewed trade disputes have raised concerns about the outlook for global oil demand (Graph 1.38). Some partially offsetting support for prices has come from OPEC members and a number of other oil-exporting countries agreeing to extend production cuts through to March 2020, as well as rising geopolitical tensions between major producers which have raised concerns around the outlook for global supply.

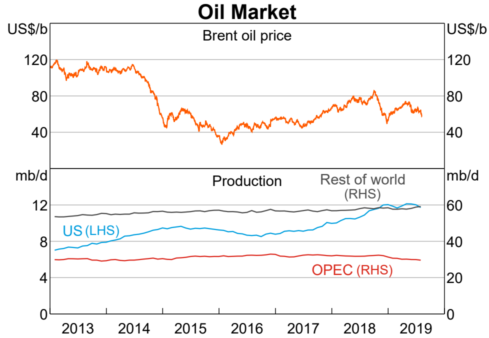
Base metal prices have generally declined in recent months as trade tensions escalated (Graph 1.39). Zinc prices have declined considerably alongside rising global supply, particularly from China, while lead prices have increased following supply disruptions in Australia and declining global inventories.

Prices for Australian rural exports have been mixed since the previous *Statement*. Lamb prices have increased, supported by strong demand from China and the United States. In contrast, wool prices have declined alongside subdued northern hemisphere demand, and wheat prices have declined recently as the outlook for global supply from some key producing regions has picked up.

Australian export prices (including the prices of non-commodity exports) are expected to have increased in the June quarter, largely reflecting higher iron ore prices, supporting an increase in Australia's terms of trade. Export prices are still

Graph 1.38

Oil Market

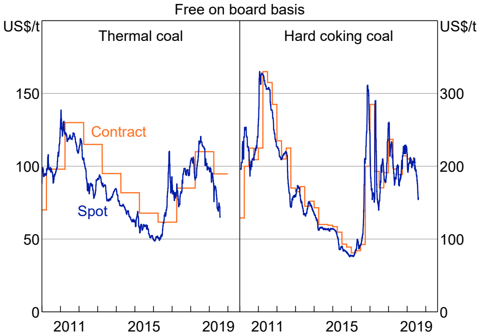


Sources: Bloomberg; EIA

Graph 1.37

Coal Prices

Free on board basis

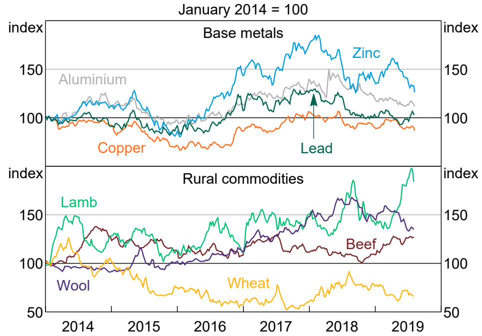


Sources: Department of Industry, Innovation and Science; IHS Markit; RBA

Graph 1.39

Base Metal and Rural Prices

January 2014 = 100



Sources: Bloomberg; Landmark; MLA; RBA

Table 1.1: Commodity Price Growth[(a)]

	Since previous *Statement*	Over the past year
Bulk commodities	12	7
– Iron ore	–5	40
– Coking coal	–23	–11
– Thermal coal	–23	–43
Rural	–1	–11
Base metals	–4	–10
Gold	18	26
Brent crude oil[(b)]	–19	–22
RBA ICP	5	14
– Using spot prices for bulk commodities	–6	1

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices

(b) In US dollars

Sources: Bloomberg; IHS Markit; RBA

likely to decline over the next few years as Chinese demand for bulk commodities moderates and low-cost global supply of these commodities increases. Even so, the outlook for the terms of trade over the next year or so has been revised higher compared to the May *Statement* (see 'Economic Outlook' chapter).

Endnotes

[1] RBA (2019), 'Box B: Why Are Bond Yields So Low?', *Statement on Monetary Policy*, May, pp 27–31. Available at <https://www.rba.gov.au/publications/smp/2019/may/box-b-why-are-long-term-bond-yields-so-low.html>