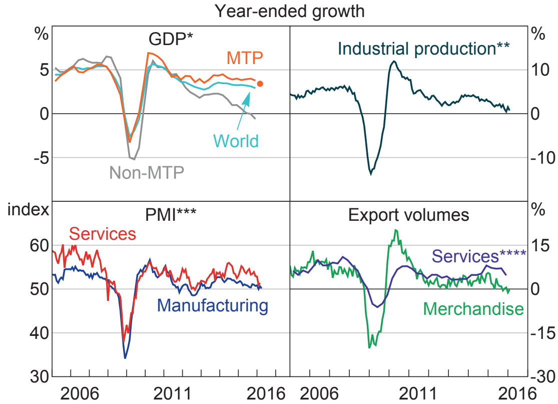
1. International Economic Developments

Growth in Australia's major trading partners moderated around the turn of the year to be below its decade average in early 2016 (Graph 1.1). Over the past year or so, growth eased in the United States and stalled in Japan, but continued at an above-trend rate in the euro area. Growth in China has moderated, although the Chinese authorities remain committed to supporting growth, announcing a growth target for 2016 of 6.5–7 per cent. The slowing in growth in China has had significant flow-on effects on Asian economies and emerging economies in other regions that have strong trade links with China. Commodity prices have increased in recent months, but still remain low relative to recent years. The low level of oil prices should support growth in Australia's major trading partners, which are generally net oil importers. Expansionary monetary policy in most economies is also supporting growth.

Growth in Australia's major trading partners has been higher than growth in the world as a whole over recent years. Lower growth has been most pronounced in commodity-exporting emerging market economies, such as Brazil, with which Australia has little direct trade. The resilience of Australia's major trading partners' growth also reflects the increase in the share of Australia's exports going to China, where GDP growth remains relatively strong despite some moderation.

The growth of global industrial production and merchandise trade (which accounts for around 80 per cent of total trade) has declined over the past couple of years. Although services sector conditions had been more positive and growth

Graph 1.1
Global Economic Activity
Year-ended growth



* Major trading partner (MTP) GDP weighted using Australia's export shares; dot indicates RBA estimate; other series are PPP-weighted

** Weighted by world industrial production shares at market exchange rates

*** Diffusion index

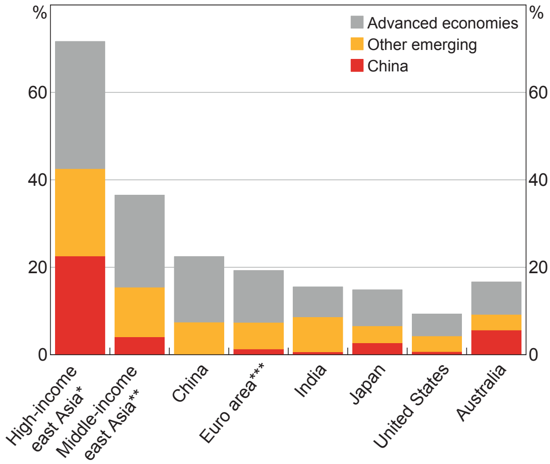
**** MTPs and Australia; excludes India, Malaysia and Singapore

Sources: ABS; Bloomberg; CEIC Data; CPB; IMF; Markit Economics; OECD; RBA; Thomson Reuters

in global service exports remains higher than it was a few years ago, surveys suggest that global services sector activity has weakened recently. The slowing growth in global trade has had a material impact on conditions in the high-income east Asian economies, which are significantly more trade exposed than the rest of Australia's major trading partners (Graph 1.2). In particular, a substantial share of these economies' exports goes to China and other emerging economies where growth has slowed noticeably. In contrast, the major advanced economies are less exposed to trade.

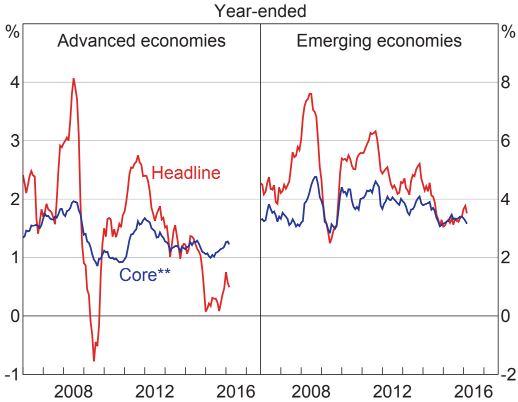
Globally, inflation remains low and is below central banks' targets in most advanced economies (Graph 1.3). Year-ended headline inflation has

Graph 1.2
Merchandise Export Values by Destination
Per cent of GDP, 2014



* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand
*** Excludes intra-euro area trade
Sources: IMF; United Nations

Graph 1.3
Global Inflation*
Year-ended



* PPP-weighted; sum of emerging and advanced economies accounts for around 80 per cent of world GDP
** Excluding food and fuel
Sources: CEIC Data; IMF; RBA; Thomson Reuters

picked up a little in recent months, as the direct effect of some of the earlier oil price decline has moved out of the year-ended calculations. Core inflation has also increased in advanced economies over the past year, most notably in the United States, but it has been little changed over the past two years in emerging economies.

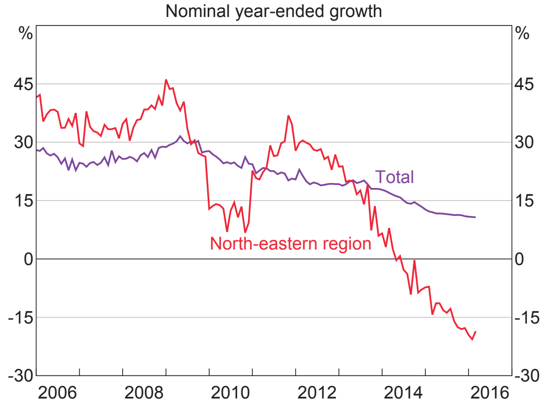
Asia-Pacific

In March, the Chinese Government announced a GDP growth target for 2016 of 6.5–7 per cent, down from 'around 7 per cent' in 2015. In related policy documents, the authorities acknowledged risks facing the domestic economy and financial system, including rising corporate debt, but placed considerable priority on meeting the new growth target. Consistent with this, the projected headline budget deficit for 2016 was increased to 3 per cent of GDP from 2.4 per cent and the authorities suggested that more fiscal and monetary support could be provided if required.

China's economic growth has moderated further in 2016, as excess capacity in the industrial sector has continued to weigh on growth in investment. Chinese GDP increased by 1.1 per cent in the March quarter, to be 6.7 per cent higher over the year. Longer-term structural factors, including an easing in growth in productivity and the urban workforce, may also be contributing to slower growth in China. Investment has fallen particularly sharply in the north-eastern region where there has been a substantial build-up of excess capacity in the mining and manufacturing industries (Graph 1.4).

The slowing in industrial activity during the past year has been accompanied by a decline in industrial profits, which has been most pronounced

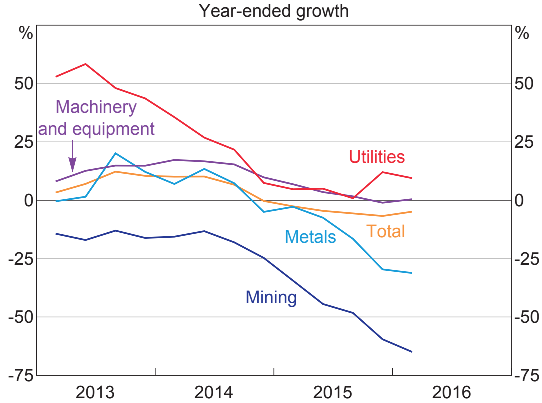
Graph 1.4
China – Fixed Asset Investment
Nominal year-ended growth



Sources: CEIC Data; RBA

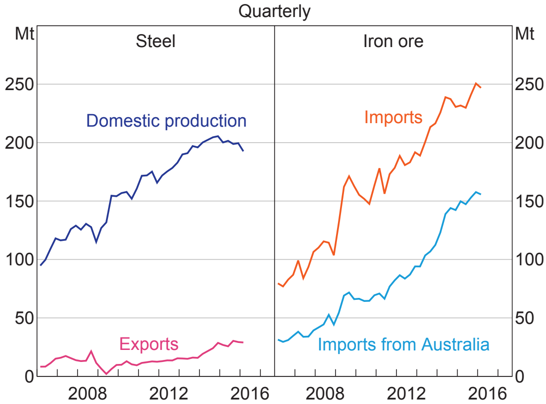
for the mining and metals manufacturing industries (Graph 1.5). Mining profits have been declining for several years now, in line with the falls in commodity prices, and profits in the metals industry have been declining over the past year or more. The domestic production of crude steel and iron ore declined in the March quarter in seasonally adjusted terms (Graph 1.6). Iron ore imports remain around record highs and imports from Australia have maintained their market share. Chinese trade overall has continued to decline in 2016 in response to weaker domestic and external demand.

Graph 1.5
China – Industrial Profits*
Year-ended growth



* Four-quarter moving average
Sources: CEIC Data; RBA

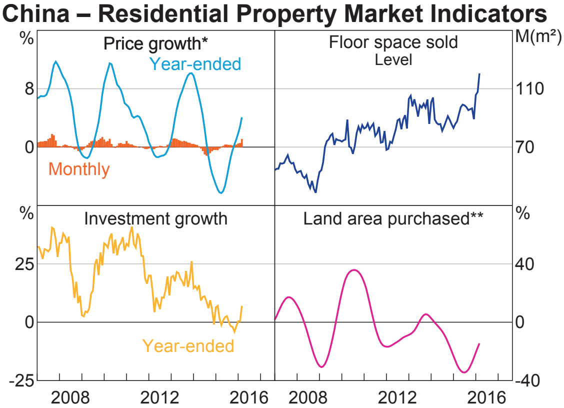
Graph 1.6
China – Steel and Iron Ore*
Quarterly



* Seasonally adjusted by RBA
Sources: CEIC Data; RBA

Conditions in the Chinese residential property market have improved noticeably in early 2016. The volume of floor space sold increased significantly in the first few months of the year, which has helped to reduce inventory-to-sales ratios. Real estate investment also picked up in the first quarter of 2016 (Graph 1.7). Property prices increased further in the larger cities and many smaller cities showed signs of price growth after a prolonged period of weakness. This follows a series of supportive measures introduced by the authorities over 2015 and early 2016, including lowering minimum mortgage down payments and benchmark lending rates. Stronger conditions in a few of the larger cities have prompted those local authorities to tighten borrowing requirements and restrictions on the number of properties people can purchase.

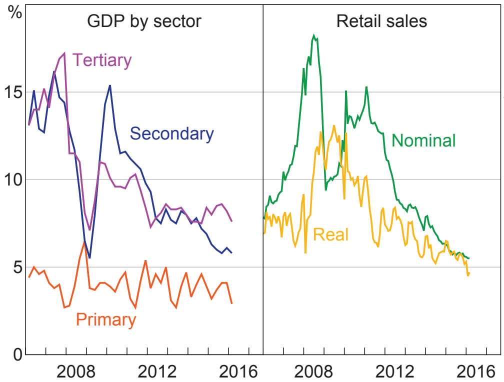
Graph 1.7
China – Residential Property Market Indicators



* Newly constructed property in 69 large and medium-sized cities
** Year-ended growth of trend series, includes non-residential land
Sources: CEIC Data; RBA; WIND Information

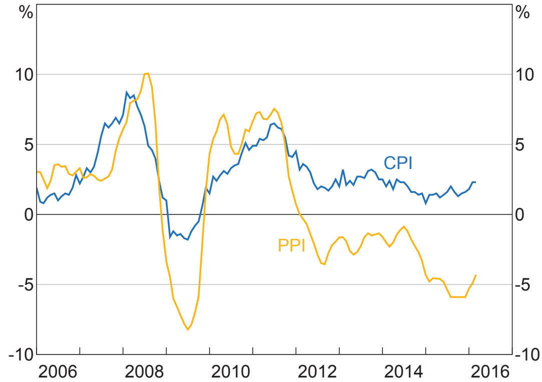
Growth in the services (tertiary) sector has been sustained at a relatively strong pace, which has helped to support overall growth in the face of lower growth in the industrial (secondary) sector (Graph 1.8). Financial services activity, which grew rapidly in the first half of 2015, has slowed in recent quarters, although a pick-up in real estate services activity in the March quarter has provided some offset to that. Growth in a number of indicators of household consumption has also eased, but remains relatively strong. Retail sales volumes

Graph 1.8
China – Activity Indicators
Year-ended growth



Sources: CEIC Data; RBA

Graph 1.9
China – Inflation
Year-ended



Sources: CEIC Data; RBA

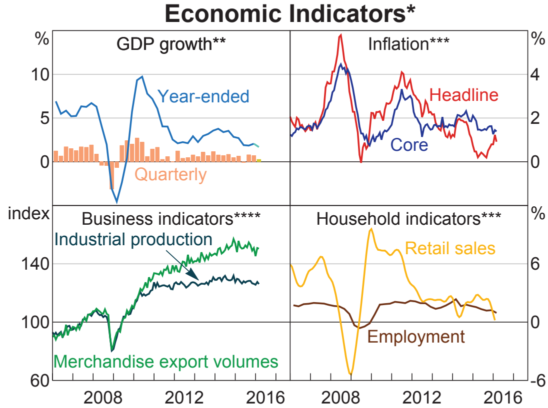
growth has moderated over the past year, while automobile sales declined in the March quarter after increasing strongly in late 2015, partly in response to earlier tax cuts.

Financial conditions remain very accommodative in China. Growth in total social financing (TSF) has increased strongly in 2016 to date, particularly when adjusted for the impact of the local government debt restructuring program. At the National People's Congress in March, a target for TSF growth in 2016 of 13 per cent was introduced. Although no specific quota of debt issuance was announced as part of the local government debt restructuring program, it is likely that local government bond issuance will make a sizeable contribution to growth of economy-wide financing in 2016. More generally, bank credit growth and corporate bond issuance have remained strong, offsetting weakness in a range of off-bank balance sheet components.

Inflationary pressures are subdued in China, consistent with excess capacity in a number of industries, although downward pressure on prices has moderated somewhat. CPI inflation has increased a little in recent months, driven by higher food prices (Graph 1.9). The rate of decline in the producer price index (PPI) has also eased, in part reflecting increases in commodity prices over recent months.

Economic growth in the high-income east Asian economies slowed in 2015 – driven by the softer demand from China and other emerging economies for the region's exports – and appears to have continued at a below-average rate in early 2016 (Graph 1.10). Merchandise export volumes have been little changed for around two years, despite substantial exchange rate depreciations in the region over the past year. Industrial production has not grown for two years. Investment was

Graph 1.10
High-income East Asia – Economic Indicators*

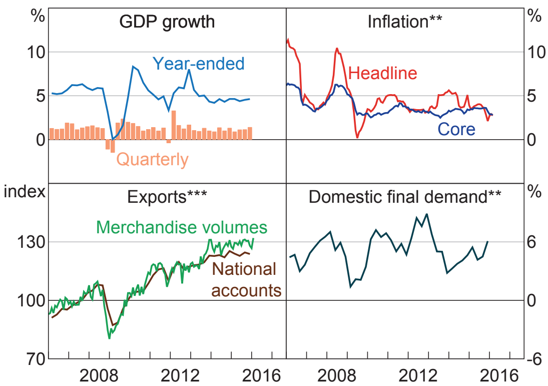


* Hong Kong, Singapore, South Korea and Taiwan
** March 2016 estimate based on advance releases from Singapore, South Korea and Taiwan
*** Year-ended growth; retail sales is a 13-term Henderson trend; employment is a quarter average.
**** 2007 average = 100
Sources: CEIC Data; RBA; Thomson Reuters; United Nations

subdued over 2015 and recent indicators across the region suggest that this remained the case in early 2016. Consumption growth had been resilient over 2015, but in recent months consumer confidence has declined and retail sales growth has slowed. This may reflect the moderation in employment growth over the past six months. Core inflation has eased since late 2014, and headline inflation remains low. A number of central banks in the region have reduced policy rates since mid 2014 and several governments have increased spending and implemented temporary tax reductions during the past year.

In the middle-income east Asian economies, growth has been more resilient and remains at around its average rate over recent years (Graph 1.11). While these economies are also facing subdued external demand, they are less exposed to international trade than the high-income east Asian economies. Domestic final demand has continued to expand due to moderate consumption growth and a marked increase in investment growth over the second half of 2015. Both headline and core inflation remain relatively low across the region and have eased in recent months.

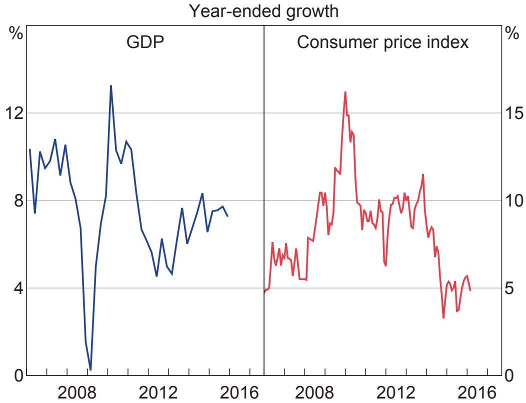
Graph 1.11
Middle-income East Asia – Economic Indicators*



* Indonesia, Malaysia, Philippines and Thailand
** Year-ended growth
*** 2007 average = 100
Sources: CEIC Data; RBA; Thomson Reuters; United Nations

In India, economic growth has picked up over recent years (Graph 1.12). Growth has been underpinned by household consumption and public sector investment, while private investment and external demand have been relatively weak. Subdued commodity prices have helped to contain inflation and support domestic demand. They have also assisted the process of fiscal consolidation by reducing government expenditure on energy subsidies. CPI inflation slowed to around 5 per cent in March 2016, driven by declining food price inflation. The Reserve Bank of India (RBI) eased the policy rate further in April, bringing the reduction over the past year to 100 basis points. The RBI cited weaker-than-expected inflationary pressures and downward pressure on growth stemming from the government's fiscal consolidation and muted global demand. The RBI is seeking to achieve CPI inflation of 5 per cent by March 2017.

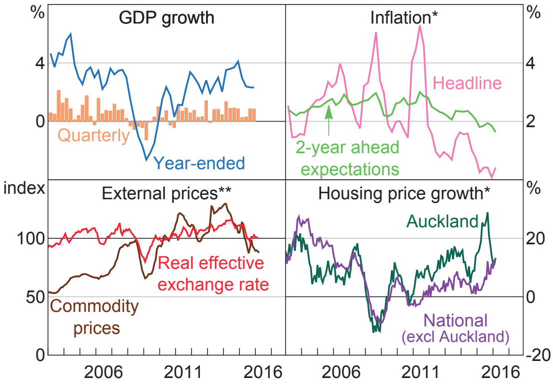
Graph 1.12
India – GDP Growth and Inflation
Year-ended growth



Source: CEIC Data

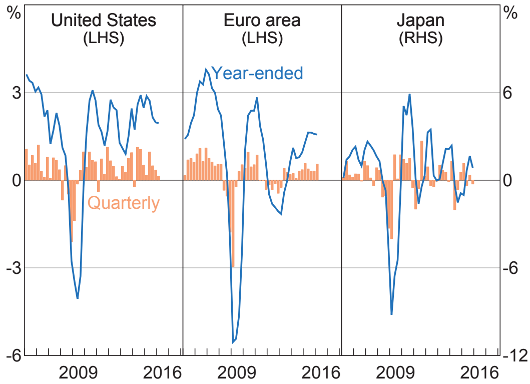
Growth in the New Zealand economy picked up in the second half of 2015, supported by accommodative monetary policy and the earlier exchange rate depreciation (Graph 1.13). Record high net immigration has boosted growth of the labour force, buoyed private consumption and added pressure to housing price growth. Tax and regulatory changes aimed at curtailing investor activity in the housing market have seen housing

Graph 1.13
New Zealand – Economic Indicators



* Year-ended
** 2010 average = 100
Sources: ANZ; BIS; RBA; RBNZ; REINZ; Thomson Reuters

Graph 1.14
Major Advanced Economies – GDP Growth

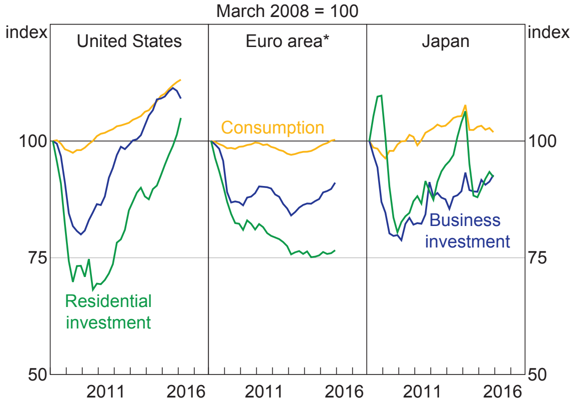


Source: Thomson Reuters

price growth moderate in Auckland since October last year, although it picked up in March. More generally, housing price growth remains relatively high across New Zealand and has picked up in recent months. Falling food and energy prices continue to exert downward pressure on inflation; headline inflation is around its lowest rate since 1999. Underlying inflationary pressures are also subdued. In early 2016, prices for New Zealand commodity exports declined, while the exchange rate was little changed. This, along with declining inflation expectations and low wage growth, led the Reserve Bank of New Zealand to reduce its policy rate by 25 basis points in March, following a cumulative 100 basis point reduction over 2015.

Graph 1.15
Major Advanced Economies – Economic Indicators

March 2008 = 100



* Business investment in the euro area includes both public and private investment
Source: Thomson Reuters

Major Advanced Economies

Growth in the major advanced economies over the past year has led to continued improvements in their labour markets. However, growth slowed over recent quarters in the United States and stalled part-way through 2015 in Japan (Graph 1.14). The euro area economy has continued to expand at above its trend growth rate.

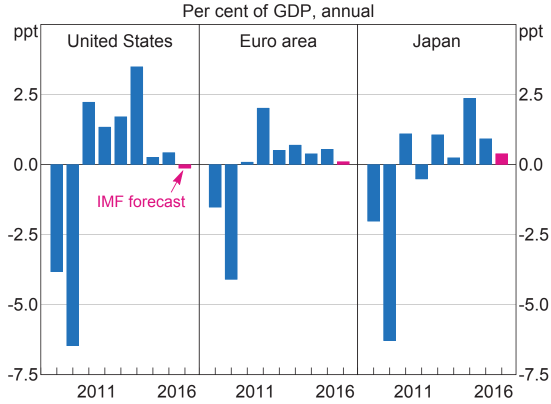
Over the past two years private consumption growth has been a key driver of growth in the United States and the euro area (Graph 1.15). In contrast, consumption in Japan has remained subdued since the consumption tax increase in early 2014, after growing over much of the preceding few years. Conditions in the major advanced economies generally remain supportive of consumption: employment growth has been strong; accommodative monetary policies are keeping borrowing rates low; household net wealth has been recovering, with housing prices approaching, or even exceeding, pre-crisis levels; and low fuel prices have been boosting real incomes. At the same time, however, nominal wage growth remains low and consumer confidence has declined recently, although it remains at or above long-run average levels.

A recovery in business investment has made an important contribution to growth in the major advanced economies over recent years. More recently, the strength in business investment waned in the United States, where declining investment in the oil & gas and manufacturing sectors, due to declining oil prices, weak external demand and the appreciation of the US dollar, subtracted from growth in recent quarters. In contrast, residential investment continued to grow strongly, supported by improvements in housing market conditions and low borrowing rates. In the euro area and Japan, investment has continued to grow, but remains well below its pre-crisis levels. Euro area investment growth, particularly in machinery and equipment, picked up in 2015 supported by above-average business confidence, and timely indicators suggest that this momentum has continued into early 2016. Similarly, timely indicators suggest that business investment has continued to grow in Japan, supported by strong corporate profit growth following the significant depreciation of the yen between 2012 and 2014. However, the recent appreciation of the yen and a decline in surveyed business conditions are less positive for the investment outlook.

After earlier fiscal tightenings, fiscal policy in the United States and Japan became less of a drag on economic activity recently and this is projected to continue this year (Graph 1.16). In the euro area, fiscal policy is also expected to be less contractionary in 2016.

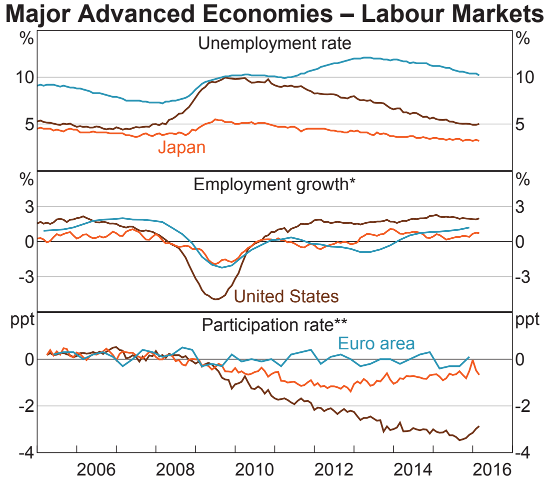
Labour markets have improved considerably in recent years across the major advanced economies (Graph 1.17). Employment growth has been robust in all three economies, resulting in declining unemployment rates. Unemployment rates in the United States and Japan are now at or below their long-run averages, indicating increasingly limited spare capacity. In contrast, the euro area unemployment rate remains well above its long-run average level. The strength in labour market conditions seems to have encouraged an increase

Graph 1.16
Major Advanced Economies – Change in Fiscal Balances



Sources: IMF; RBA

Graph 1.17
Major Advanced Economies – Labour Markets



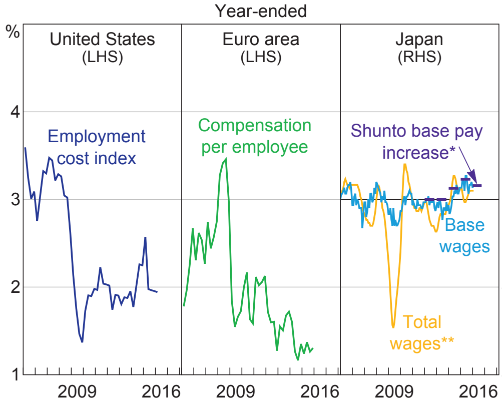
* Year-ended; three-month moving average growth rate for Japan
** Cumulative change since March 2005
Sources: Eurostat; RBA; Thomson Reuters

in workforce participation in Japan, and more recently in the United States, after earlier declines. Nonetheless, participation rates remain at or below their levels of a decade earlier, partly because of population ageing.

Nominal wage growth in the major advanced economies remains low despite the improvements in labour markets (Graph 1.18). In the United States, low productivity growth may be restraining wage growth in the face of the tightening labour market; unit labour costs have been growing at an above-average pace. Wage growth in Japan has been positive since 2014, consistent with the strengthening in the labour market. However, recent negotiations between labour unions and large employers (the so-called 'Shunto') point to some moderation in base-wage growth in the coming year. Growth in euro area compensation per employee remained close to its historic low during 2015, consistent with the relatively high level of unemployment.

Graph 1.18
Major Advanced Economies – Wage Growth

Year-ended



* Reported agreed base-wage increases in the annual Shunto negotiations between labour unions and large employers; 2016 estimate is based on a sample of negotiated wage agreements reported to date

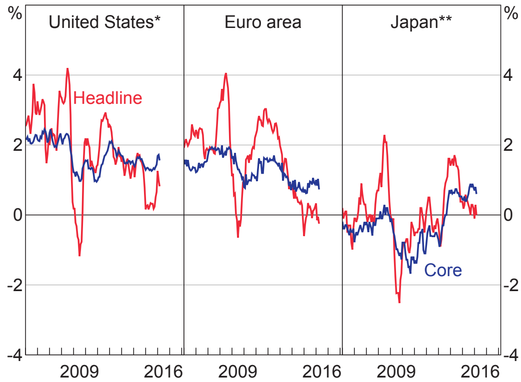
** 13-term Henderson trend

Sources: CEIC Data; Eurostat; Nomura; RBA; Thomson Reuters

Inflation in the major advanced economies remains below central banks' targets (Graph 1.19). Low nominal wage growth and the earlier decline in oil prices have contributed to the restrained price pressures. Even though core inflation has increased from its recent lows, most measures of inflation expectations in the major advanced economies have declined in recent years, and in the United States and euro area they are at around their lowest levels since the global financial crisis (Graph 1.20). To a large extent, the decline in inflation expectations has coincided with the decline in headline inflation. While long-term market-based measures of inflation expectations

Graph 1.19
Major Advanced Economies – Inflation

Year-ended

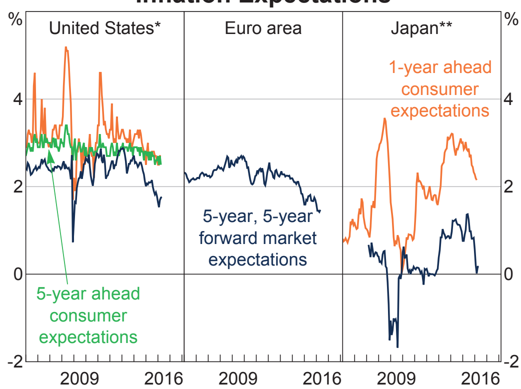


* Personal consumption expenditures (PCE) inflation

** Excluding the effects of the consumption tax increase in April 2014

Sources: RBA; Thomson Reuters

Graph 1.20
Major Advanced Economies – Inflation Expectations



* US expectations are for CPI inflation

** Calculated as a weighted average of responses to a monthly consumer survey; the survey asks respondents to indicate their price expectations over the next year within a given range

Sources: Bloomberg; RBA; Thomson Reuters

declined sharply in early 2016, especially in Japan, some caution should be applied in interpreting these measures because they can be affected by other developments in financial markets. Nevertheless, the European Central Bank (ECB) has noted its concern about the further decline in inflation expectations over recent months. In Japan, the anticipated effect of the scheduled increase in the consumption tax in April 2017 may be boosting consumers' short-term inflation expectations.

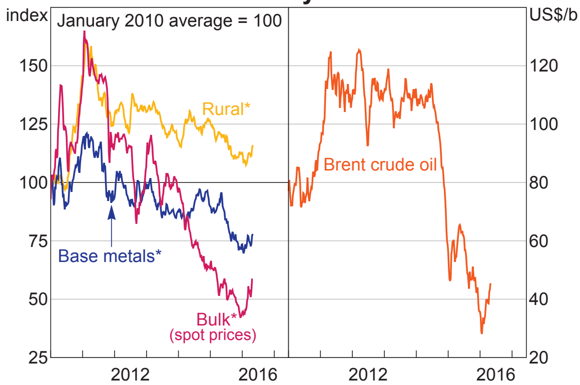
The persistence of low inflation (and the decline in oil prices up to early 2016) had prompted central banks in the major advanced economies to revise down their forecasts of inflation. The ECB undertook further monetary policy steps in March aimed at inflation reaching its target over an acceptable timeframe (see 'International and Foreign Exchange Markets' chapter).

Commodity Prices

The RBA Index of Commodity Prices (ICP) has increased in recent months, led by a large increase in the price of iron ore (Table 1.1; Graph 1.21). Nonetheless, commodity prices are around 50 per cent below their 2011 peak, reflecting both substantial increases in global supply as new resource projects have started production and weakness in global demand, especially from Asia. Lower bulk commodity prices contributed to a decline in Australia's terms of trade of 3 per cent in the December quarter and of 12 per cent over 2015.

The spot price of iron ore has increased significantly over recent months to be around 60 per cent above the low reached in December 2015, although it remains 70 per cent below its 2011 peak (Graph 1.22). The prices of iron ore and steel rose sharply after the Chinese Government announced its growth targets for 2016 in early March, which led to improvements in the near-term outlook for steel demand. Re-stocking of iron ore inventories and some production cuts from high-cost global iron ore producers, including in China, are also likely to have supported prices. Speculative activity in futures markets may also have played a role. At the same time, however, the expected increase in the global supply of iron ore, as capacity expansions come on line in Australia and Brazil, may exert downward pressure on prices, and Chinese steel production is expected to moderate over the year ahead.

Graph 1.21
Commodity Prices



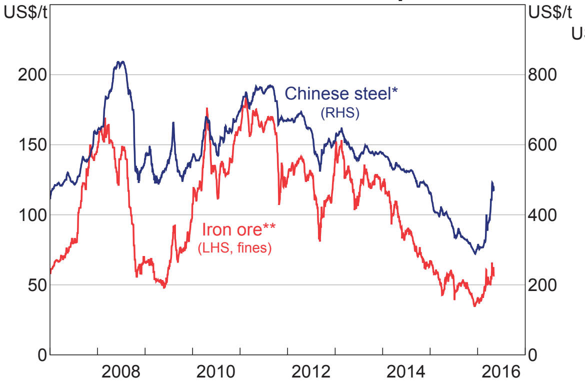
* RBA Index of Commodity Prices sub-indices, SDR
Sources: Bloomberg; RBA

Table 1.1: Commodity Price Growth(a)
SDR, three-month-average prices, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	18	–9
– Iron ore	31	–1
– Coking coal	9	–19
– Thermal coal	–1	–17
Rural	0	–7
Base metals	4	–17
Gold	13	3
Brent oil(b)	5	–33
RBA ICP	5	–15
– using spot prices for bulk commodities	9	–12

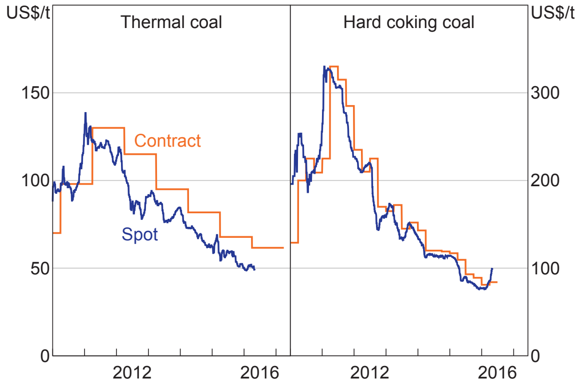
(a) Prices from the RBA ICP; bulk commodities prices are spot prices
(b) In US dollars
Sources: Bloomberg; IHS; RBA

Graph 1.22
Chinese Steel and Iron Ore Spot Prices



* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; RBA

Graph 1.23
Coal Prices
Free on board basis



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

After declining for much of the past five years, coking coal prices have been supported by improved sentiment surrounding Chinese steel demand of late (Graph 1.23). Thermal coal prices remain under pressure from weaker global demand, particularly from the Asian region. At current prices, a substantial share of global coal production, including in Australia, remains unprofitable. Concerns about global demand, particularly subdued growth of global industrial production, have also led to declines in the prices of base metals over the past year, although these are also a little above their lows around the turn of the year. Declines in the production of some of these commodities may have provided some support to prices of late.

The Brent crude oil price has risen noticeably over recent months, after falling to its lowest level in over a decade around the turn of the year (Graph 1.21). The recent increase has been supported by speculation about potential production freezes by some of the major producers, although global supply remains little changed at relatively high levels. Changes in oil prices tend to be reflected in regional liquefied natural gas (LNG) prices with a lag of a few quarters. Looking further ahead, increased supply from Australian LNG exporters is likely to place downward pressure on regional LNG spot prices over the next couple of years. ✠