

1. International Economic Developments

The global economy is continuing to expand, but the pace of growth has slowed recently, partly reflecting supply-chain problems from the earthquake in Japan. Conditions continue to vary significantly across regions, but the International Monetary Fund's central forecast for 2011 and 2012 is still for above-average global growth and for growth to be well above average in Australia's major trading partners (Table 1.1). However, the downside risks to growth remain prominent. Despite the recent financial assistance package for Greece and the agreement to lift the debt ceiling in the United States, sovereign debt concerns continue to weigh on global sentiment and a disorderly resolution of the current problems would lead to a considerably worse outcome for the global economy than suggested by the central forecast.

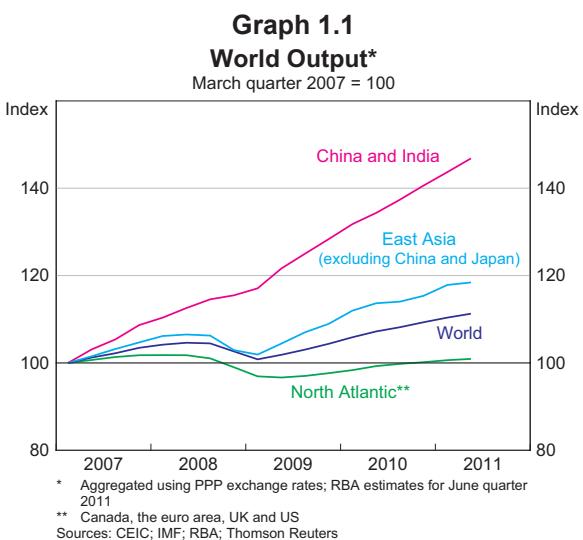


Table 1.1: World GDP Growth
 Year-average, per cent^(a)

	2009	2010	2011	2012
				IMF forecasts ^(b)
United States	-3.5	3.0	2.5	2.7
Euro area	-4.2	1.8	2.0	1.7
Japan	-6.3	4.0	-0.7	2.9
China	9.2	10.3	9.6	9.5
East Asia (excl China and Japan) ^(c)	0.1	7.7	5.2	5.0
India	6.8	10.1	8.2	7.8
World	-0.8	5.1	4.3	4.5
Australia's trading partners ^(d)	-0.2	6.8	4.7	5.5

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified

(b) Forecasts from the June *World Economic Outlook Update*

(c) Weighted using GDP at market exchange rates

(d) Weighted using merchandise export shares

Sources: CEIC; IMF; RBA; Thomson Reuters

Growth in Asia remains robust, particularly in China where GDP has continued to increase at around the same solid pace as seen over the past year and a half (Graph 1.1). Underlying growth in the rest of Asia (excluding Japan) also remains solid, with strong growth in domestic demand supported by expansionary macroeconomic policies, although production has been dampened by supply-chain disruptions from the Japanese earthquake (see 'Box A: The Japanese Earthquake and Global Supply Chains' for further details). Following a larger-than-expected reduction in activity in Japan following the earthquake, economic activity has rebounded relatively quickly and output will be boosted by the rebuilding effort in the second half of 2011 and throughout 2012.

In most of the North Atlantic economies, conditions are softer compared with three months ago. In addition to the adverse effects on confidence from sovereign debt concerns on both sides of the Atlantic, high commodity prices have reduced the purchasing power of household incomes, households continue to repair balance sheets weakened by depressed housing markets and, in recent months, hiring by businesses in the United States has slowed. There has also been some effect on manufacturing production and consumption from the Japanese supply-chain disruptions.

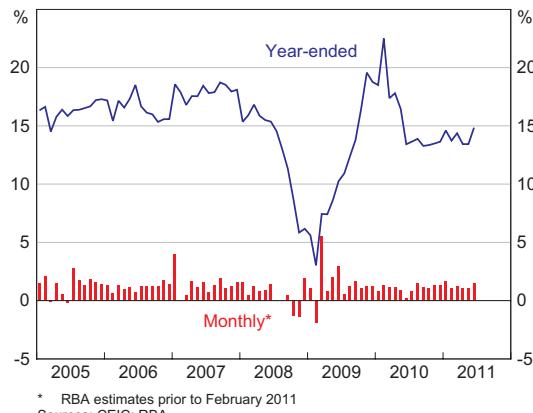
Robust rates of global growth, particularly in Asia, have kept commodity prices high, despite a modest easing in some prices in recent months. The increase in commodity prices last year and earlier this year has pushed up headline rates of inflation in many countries and is flowing through to higher rates of core inflation. This is especially so in Asia where domestic demand is robust, but core inflation in the G7 economies has also picked up from low levels. With monetary policies globally still accommodative and many economies in Asia coming up against capacity constraints, the risks to inflation remain to the upside.

Asia

China's economy grew at a solid pace in the June quarter, with GDP expanding by 2.2 per cent to be 9½ per cent higher over the year. Exports growth has been weaker over the past few months after having picked up strongly in March, while domestic demand has continued to grow at a firm pace. Both fixed asset investment and real retail sales have grown solidly in recent months, despite the tightening of monetary policy that has occurred over the past year.

Notwithstanding recent volatility in the seasonally adjusted estimates, fixed asset investment has continued to grow strongly in recent months, albeit at a slower pace than recorded at the beginning of the year. Growth has been driven by real estate investment, which has been supported by the Government's efforts to boost the construction of affordable housing. Manufacturing investment has also expanded at a robust pace recently, consistent with the recent pick-up in industrial production, while growth in infrastructure investment has softened as spending related to the earlier fiscal stimulus package is phased out (Graph 1.2).

Graph 1.2
China – Industrial Production Growth

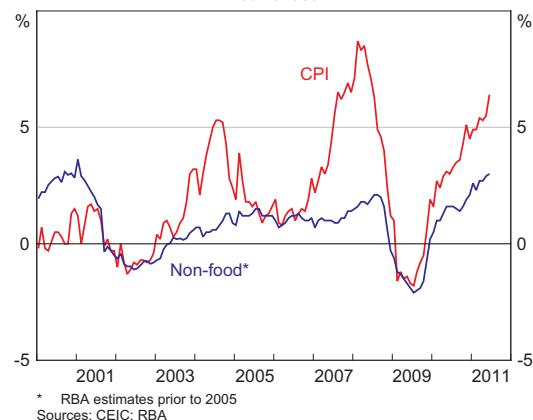


Growth in real retail sales picked up slightly in the June quarter, with urban and rural surveys of household expenditure suggesting that real consumption expanded by around 3 per cent in the quarter. Rural consumption, in particular, was supported by an ongoing subsidy provided by the Government for the purchase of home appliances and the boost to rural incomes from higher food prices. Household consumption is also likely to receive a boost in the second half of the year from changes to personal income taxes. The most important change is an increase in the monthly tax-free threshold from CNY 2 000 to CNY 3 500, which is estimated to reduce the number of wage earners paying income tax from 28 per cent to about 8 per cent. While there have also been increases in income taxes payable by very high income earners, the changes are expected to lower the Government's annual tax revenues by CNY 160 billion (0.4 per cent of GDP).

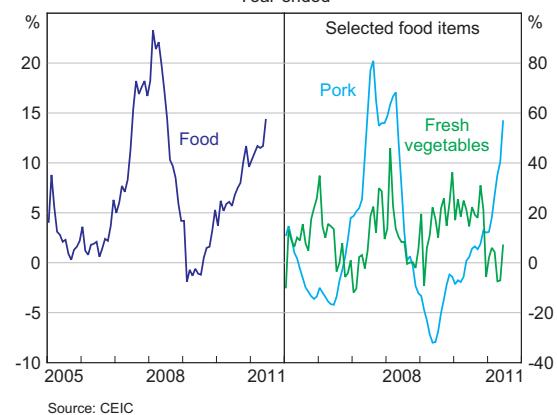
Growth in merchandise exports has softened in the past few months after having increased significantly in March. Exports to the rest of east Asia have contracted, although they have increased to Japan, while exports to the European Union and the United States have been broadly flat, reflecting weaker domestic demand in those economies. Weaker demand in the North Atlantic economies has also contributed to the weak growth in intra-regional trade, with China's imports of goods for processing and assembly broadly unchanged since January. The strength in merchandise import values recorded over recent months has reflected higher commodity prices, with import volumes having not grown in the past nine months, over which time crude oil imports have fallen.

Year-ended consumer price inflation reached 6.4 per cent in June, its fastest rate in nearly three years (Graph 1.3). Food price inflation picked up noticeably to 14.4 per cent, driven mainly by a 57 per cent increase in pork prices over the year (Graph 1.4). Pork prices have been driven higher by tight supply, with pork production falling in the first

Graph 1.3
China – Consumer Price Inflation
Year-ended



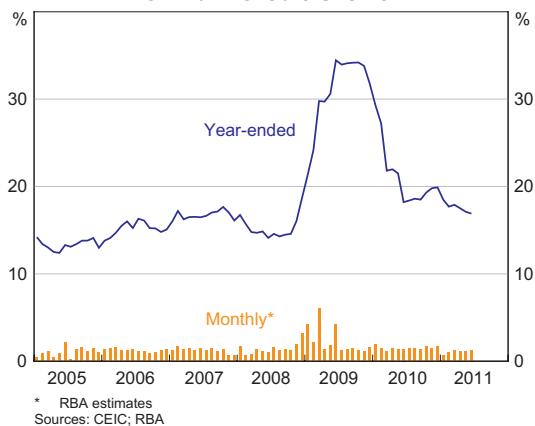
Graph 1.4
China – Consumer Price Inflation
Year-ended



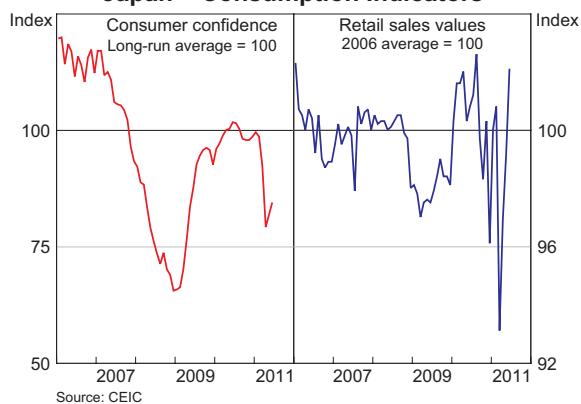
half of the year, and higher feed grain costs driven by higher corn prices. Grain and fresh vegetable prices have been affected by extreme weather, with flooding in southern and eastern China damaging crops.

Non-food inflation has continued to increase, reaching 3 per cent over the year to June. This increase has been reasonably broad based reflecting second-round effects from higher commodity prices. For example, prices for building materials and furniture have increased as the cost of raw materials has risen, and utilities prices have been allowed to increase in some regions in response to higher thermal coal prices. Earlier increases in cotton prices

Graph 1.5
China – Credit Growth



Graph 1.6
Japan – Consumption Indicators



have contributed to a 2 per cent rise in clothing prices over the past year; this compares with an average fall of around 1.5 per cent per year over the past decade.

The People's Bank of China (PBC) increased its benchmark deposit and lending rates by a further 25 basis points in early July, with 1-year benchmark rates now having been raised by a cumulative 125 basis points since October. In addition, the PBC has raised banks' reserve requirement ratios by a further 100 basis points since the May Statement reflecting its efforts to manage liquidity, particularly from the ongoing accumulation of foreign exchange reserves. Combined with direct controls on lending,

higher interest rates and reserve ratios have led to a moderation in credit growth, with credit expanding at an annualised rate of 13½ per cent over the first six months of 2011, which is significantly slower than the 20 per cent growth recorded over 2010 (Graph 1.5). The slowing in credit may, however, overstate the extent to which total funding has slowed; 'trusted' loans (where deposits are made for lending to a specific borrower), which are not included in the credit statistics, have expanded over the past two years, while the issuance of bank accepted bills has become an increasingly important source of funding in China.

In Japan, activity is recovering more quickly than anticipated from a greater-than-expected contraction following the mid-March earthquake and tsunami. After falling sharply in March and April, many economic indicators picked up in May and June; business surveys and industrial production are now only moderately below their February levels. After falling sharply in March, retail sales have picked up rapidly, supported by purchases of replacement household goods in the affected regions (Graph 1.6). In contrast, consumer sentiment has risen only modestly, with ongoing nuclear contamination concerns, uncertainty about employment and pressure to reduce electricity usage all weighing on confidence. With electricity supply still constrained, only relatively small further increases in activity are expected until the December quarter.

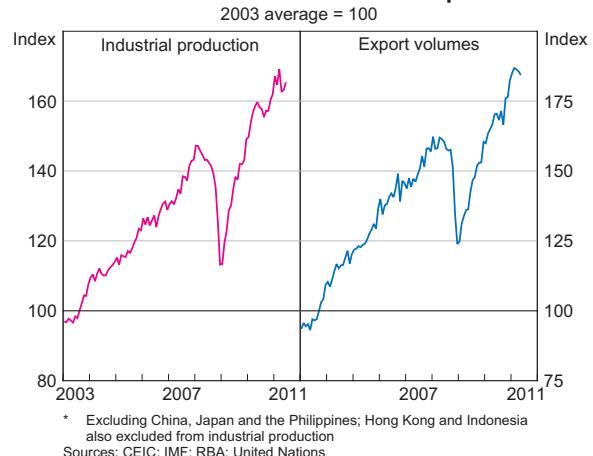
The Government has so far approved expenditures of ¥6 trillion for rehabilitating the earthquake-affected prefectures, which it can fit within its current budget without needing to raise additional funds. Around one-half of the expenditures have been allocated to reconstruction – the remainder has been for clean-up, payments to households, temporary accommodation, etc – with the funding approved to date only covering a fraction of the ¥16.9 trillion (3½ per cent of annual GDP) in estimated total damages. Reconstruction efforts are expected to begin in earnest in the December quarter.

Outside of Japan, the global effects of the supply-chain disruptions from the Japanese earthquake have been most evident in east Asia (excluding China). Industrial production in the region fell sharply in April, leading to falls in export volumes in April and May (Graph 1.7). The motor vehicle sector has been most affected, with Japanese firms making up a large share of producers in the region (see 'Box A: The Japanese Earthquake and Global Supply Chains' for further details). In contrast, some particular segments of the electronics sector have benefited from substitution away from their Japanese competitors. The supply-chain effects, however, appear to have been relatively short-lived, with industrial production rising in May and June.

Notwithstanding the temporary softness associated with the supply-chain disruptions, the robust pace of economic growth in east Asia over the past year has led to an increase in inflationary pressures. The high level of global commodity prices partly reflects the strong growth in the region and has contributed to the pick-up in inflation in these countries over the past year or so (Graph 1.8). Notwithstanding some recent easing in monthly headline rates of inflation, core inflation rates have continued to rise, as high commodity prices have been feeding through to higher prices of other goods and services, unemployment rates have continued to fall and other measures of capacity utilisation have remained elevated. Monetary authorities in some countries have tightened policy significantly, but policy is generally still accommodative across the region.

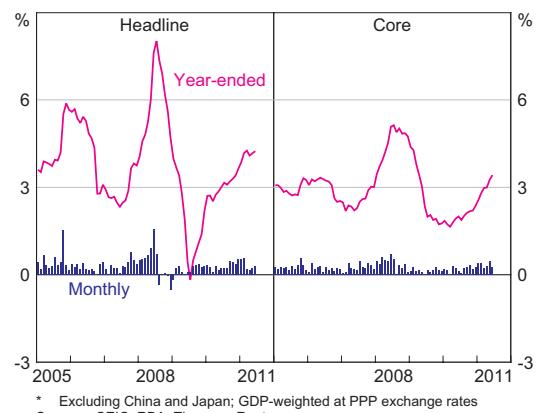
Conditions in the Indian economy have softened over recent months. Timely indicators suggest that output growth has begun to slow from the rapid pace that saw GDP growing at an annualised rate of 9½ per cent over the three quarters to March (Graph 1.9). Industrial production contracted in both April and May. Although merchandise trade values continued to grow strongly in the June quarter, much of this reflected higher commodity prices.

Graph 1.7
East Asia* – Production and Exports



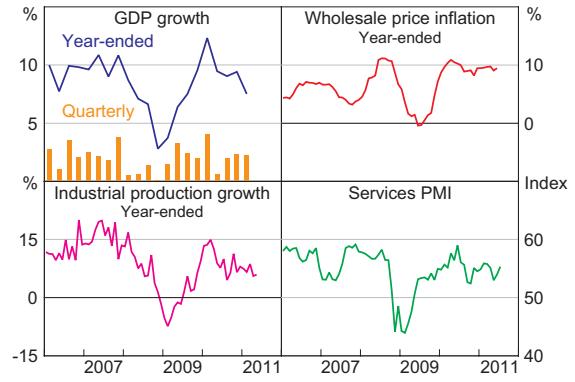
* Excluding China, Japan and the Philippines; Hong Kong and Indonesia also excluded from industrial production
Sources: CEIC; IMF; RBA; United Nations

Graph 1.8
East Asia* – Consumer Price Inflation



* Excluding China and Japan; GDP-weighted at PPP exchange rates
Sources: CEIC; RBA; Thomson Reuters

Graph 1.9
India – Economic Indicators



Sources: CEIC; Markit Economics; RBA

The services PMI suggests solid growth in activity in that sector. Conditions in the agricultural sector remain healthy, with rainfall in the first two months of the summer monsoon season around long-run average levels.

Inflation in India remains elevated, with the wholesale price index increasing by 9½ per cent over the year to June. In recent months, an easing in primary food inflation has been offset by higher inflation in non-food manufacturing and fuel & power prices. In response to persistently high inflation, the Reserve Bank of India has raised its policy rate by 325 basis points since March 2010 to 8 per cent.

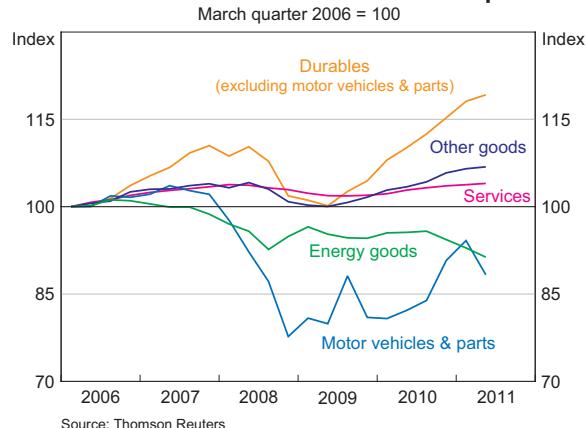
North Atlantic

The pace of growth in the United States has eased significantly in 2011. Consumption growth has slowed noticeably, with higher oil prices, the reduced availability of motor vehicles as a result of supply-chain disruptions from the Japanese earthquake, and increased uncertainty about public finances all playing a role (Graph 1.10). Consumer confidence has fallen further in recent months and remains well below average levels.

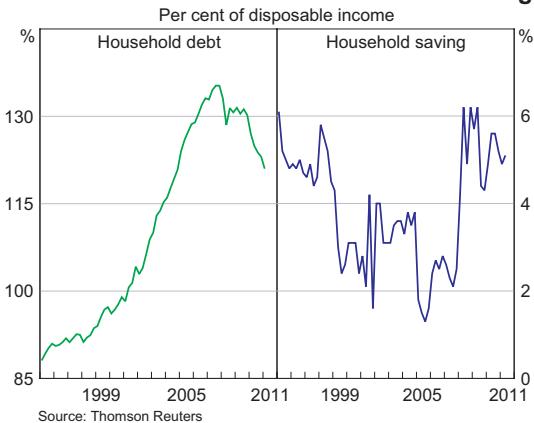
The weakness in the housing market also continues to weigh on household consumption. The stock of unsold homes remains high, house prices have continued to fall and house-building activity remains around historic lows. Household debt relative to income has continued to decline and the saving rate remains high compared with the past decade or so (Graph 1.11).

After picking up in the March quarter, the labour market recovery slowed in the June quarter. Non-farm payrolls rose by an average of around 20 000 in May and June; public payrolls continued to fall and growth in private payrolls eased back to the levels of a year earlier (Graph 1.12). The unemployment rate rose in June for the third consecutive month and initial jobless claims remain above their March quarter average.

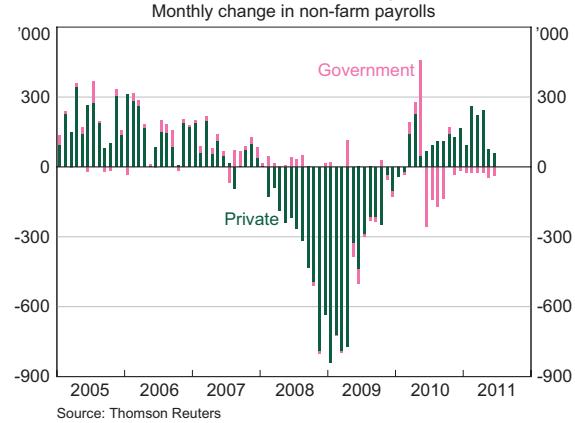
Graph 1.10
United States – Real Private Consumption



Graph 1.11
United States – Household Debt and Saving



Graph 1.12
United States – Employment



Conditions remain more positive in the business sector than in the household sector. Survey measures of business conditions are around their average levels, even with the manufacturing and non-manufacturing ISM indices having declined in recent months. High corporate profits, combined with government incentives, have led to a continued expansion in business investment, particularly in machinery & equipment. Non-residential construction has grown modestly over the past year, although it remains low as a share of GDP.

Net government debt, at around 55 per cent of GDP, is at its highest level since 1955. Notwithstanding the recent agreement to reduce government spending in conjunction with raising the debt ceiling, public debt in the United States is forecast to continue to rise as a ratio to GDP for some time yet. Over the medium term, major reforms to health care and social security entitlements are likely to be required to put public finances on a sounder footing.

Economic conditions remain very different across countries in Europe. The economic recovery continues in the larger euro area countries, especially in Germany where output is now above its pre-crisis peak (Graph 1.13). Activity has also largely recovered in France and the Netherlands. Growth continues to be supported by the external sector and firms in these countries are expanding investment, particularly in machinery & equipment. In contrast, consumption growth appears to have slowed in the June quarter after expanding solidly in the March quarter, despite these countries having experienced a decline in unemployment rates and relatively high levels of consumer confidence over the first half of the year. In the United Kingdom, growth is expected to strengthen somewhat after a period of subdued growth.

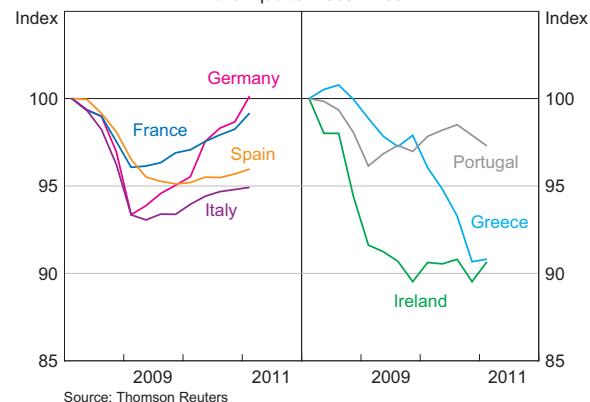
In contrast to developments in the countries to the north, the recovery in Italy and Spain is much less advanced, while economic activity remains depressed in Greece, Ireland and, to a lesser extent, Portugal. These latter economies face significant structural adjustment following a loss of

competitiveness over the past decade and a build-up of public and private debt. Government debt levels were already elevated when public finances deteriorated sharply following the global economic downturn, in some countries partly in response to the costs of supporting their banking sector (Graph 1.14). This has led to a self-reinforcing cycle of concerns about the ability of these economies to service their debts, higher borrowing costs, and further increases in projected deficits. In response, governments have committed to substantial programs of fiscal consolidation as part of support

Graph 1.13

Euro Area – GDP

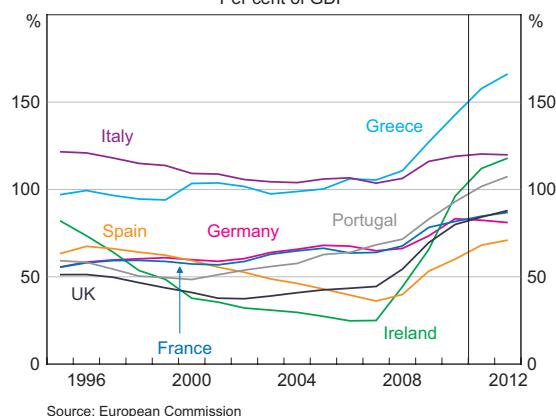
March quarter 2008 = 100



Graph 1.14

Europe – Gross Government Debt

Per cent of GDP

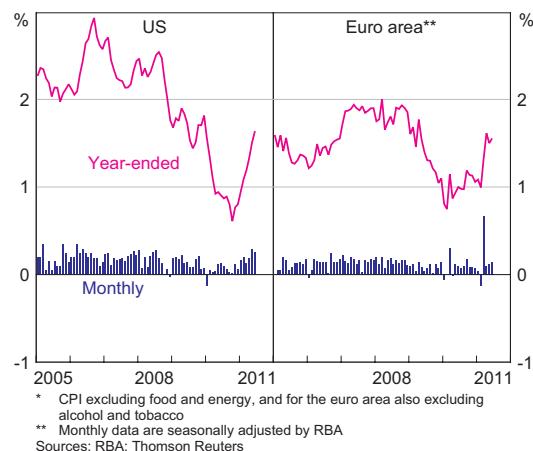


packages from international institutions. Although many of these programs were intended to address some of the structural problems hampering growth, in the short run, at least, there has been a further dampening in economic activity.

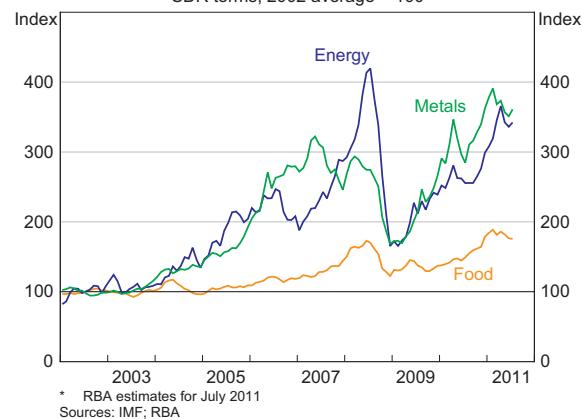
In the case of Greece, there have been two major developments since the May Statement. In late June, Greece's Parliament approved further fiscal consolidation efforts, securing the fifth disbursement of funds from the International Monetary Fund and European institutions under the initial bailout package. Then, in mid July the European Union agreed on the terms of a second financial assistance package for Greece, in response to widespread concerns about the sustainability of sovereign finances. The package also provides more favourable financing to Ireland and Portugal and will allow a greater role for the European Financial Stability Facility. With substantial fiscal consolidation efforts still required over many years, both in Greece and elsewhere, the outlook for these economies remains uncertain.

Core inflation rates in a number of the North Atlantic economies have picked up over the past six months (Graph 1.15), despite considerable excess capacity in these economies. This partly reflects the indirect effects of higher commodity prices, which are evident in large increases in public transport prices earlier in the year and in clothing prices more recently, as well as some temporary effects on motor vehicle prices from the earthquake in Japan. The recent stabilisation in commodity prices should reduce some input price pressures in the period ahead, but the European Central Bank and the Federal Reserve Board both expect a gradual pick-up in core inflation over the next few years.

Graph 1.15
Core Consumer Price Inflation*



Graph 1.16
Global Commodity Prices*
SDR terms, 2002 average = 100



Commodity Prices

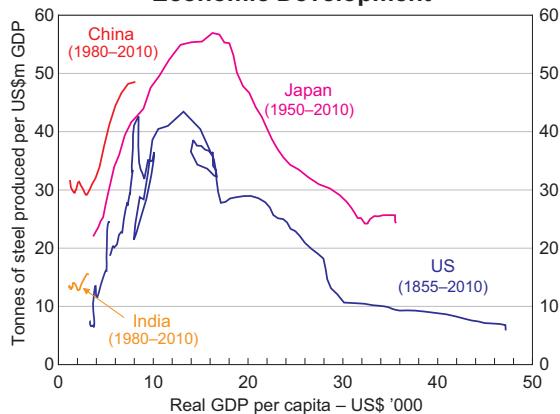
After rising earlier in the year, global commodity prices are a little off their recent peaks, in line with some moderation in the pace of global growth and improved supply for some commodities (Graph 1.16). Nonetheless, prices remain significantly higher than a year ago, with the IMF All Primary Commodities Index increasing by around 25 per cent since mid 2010. Prices have been supported by strong growth in emerging economies in Asia

and elsewhere, which are currently in a particularly resource-intensive stage of their development (Graph 1.17). Contract prices for iron ore and coal increased sharply in the first half of 2011, driven in part by supply disruptions in Australia and elsewhere, combined with ongoing growth in global steel production (Graph 1.18). The spot price for iron ore has eased slightly over recent months, but remains significantly higher than a year ago.

Similarly, the coking coal spot price remains very high as the recovery in Australian coal production from the recent floods has proceeded more slowly than initially expected. As a result, contract prices for iron ore and coking coal in the September quarter are estimated to have been set only a little lower than the very high June quarter levels. Spot prices for thermal coal have also declined over recent months, in line with other energy prices, and remain below the current annual contract price; prices nevertheless remain significantly higher than in mid 2010.

Global food prices, as measured by the IMF Food Price Index, have fallen slightly over recent months, but remain higher than their peak in 2008 following strong growth through 2010. The high level of prices reflects strong income growth in emerging and developing countries, particularly as they switch towards higher protein food. Prices for some rural commodities have eased, with improved climatic conditions underpinning higher forecast wheat crops in the Black Sea region, and an expected large increase in global cotton production. In contrast, Australian wool prices have increased further, to be around 75 per cent higher than a year ago, owing to strong Chinese demand and the Australian sheep flock being around its lowest level since early last century.

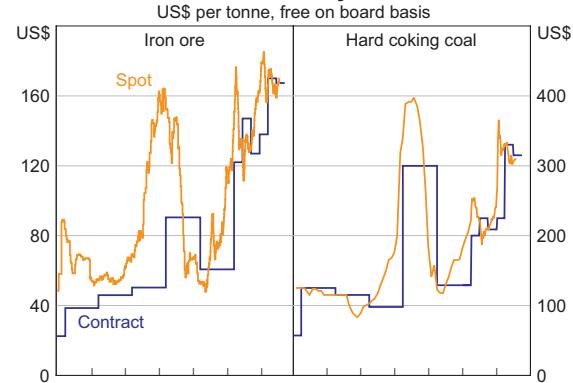
Graph 1.17
Steel Production Intensity and Economic Development*



* 2010 prices converted at 2005 PPP exchange rates; 5 year-moving-averages; US iron production intensity prior to 1897; Japanese steel production is by fiscal year prior to 1980

Sources: The Conference Board Total Economy Database (January 2011); IMF; Japan Iron and Steel Federation; Johnston L and SH Williamson (2010), 'What was the U.S. GDP Then?', MeasuringWorth; Maddison A (2009), 'Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD'; RBA; US Bureau of Mines; US Geological Survey; World Steel Association (worldsteel)

Graph 1.18
Bulk Commodity Prices



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

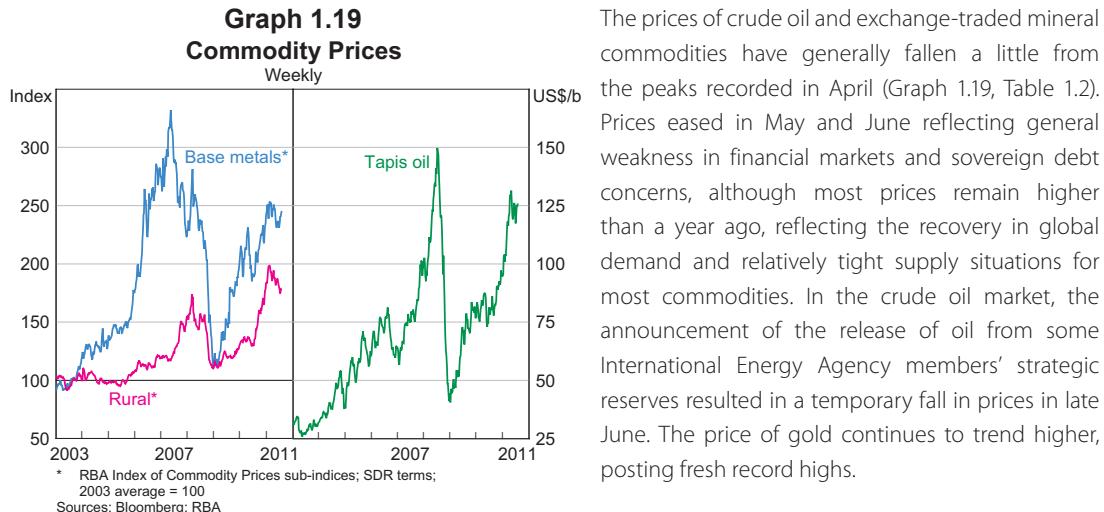


Table 1.2: Commodity Price Growth^(a)
 SDR terms, per cent

	Change since previous Statement	Change over the past year
Bulk commodities ^(b)	2	24
– Iron ore	-2	19
– Coking coal	5	32
– Thermal coal	12	26
Rural	0	25
– Beef	-3	14
– Cotton	-30	27
– Wheat	-2	21
– Wool	6	76
Base metals	3	12
– Aluminium	-4	8
– Copper	10	22
– Lead	9	8
– Nickel	-2	4
– Zinc	13	8
Gold	14	33
Oil ^(c)	-3	22
– US\$ terms	-5	27

(a) RBA Index of Commodity Prices components except oil; latest available

(b) RBA estimates for recent months

(c) Average of WTI and Tapis crude oil prices

Sources: Bloomberg; RBA