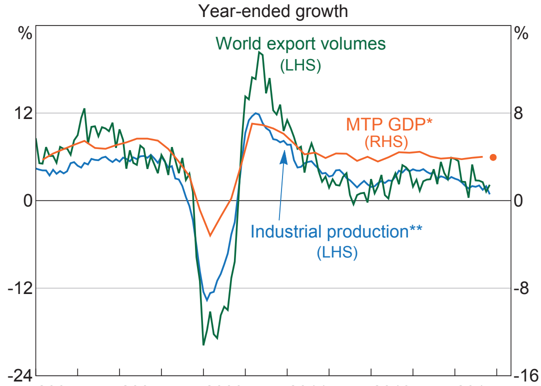
1. International Economic Developments

Overall growth in Australia's major trading partners (MTPs) was little changed in 2015 at a bit below its decade average (Graph 1.1). The US and euro area economies grew at or above trend rates over 2015, supported by very expansionary monetary policies. Growth has slowed in China and this has had flow-on effects to other economies in the region. Lower growth in Asia has been associated with a decline in growth in global industrial production and trade volumes, which has been offset by relatively strong growth in services globally. There has been a further broad-based decline in commodity prices in recent months, reflecting strong supply of some commodities as well as weaker demand growth of late. Lower oil prices should support growth in Australia's MTPs, which are generally net oil importers.

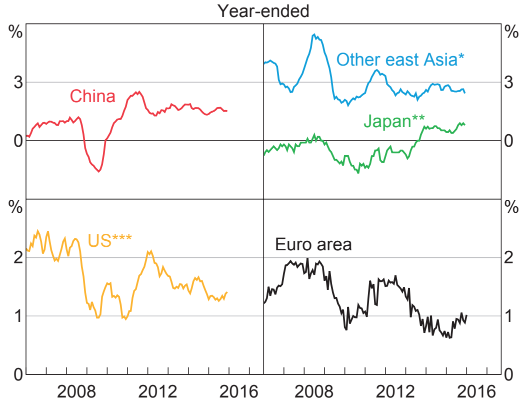
Graph 1.1
Global Economic Activity
Year-ended growth



* Weighted using Australia's export shares; dot indicates RBA estimate
** Weighted by share of world industrial production at market exchange rates
Sources: CEIC Data; CPB Netherlands Bureau for Economic Policy Analysis; RBA; Thomson Reuters

Inflation remains well below most central banks' targets, in part reflecting spare capacity in many labour and product markets as well as the substantial declines in oil prices since mid 2014 (Graph 1.2). Based on the most recent forecasts from the respective central banks, inflation is not expected to reach targets until at least 2017 in the United States, the euro area and Japan. Monetary policy is accommodative in all the large economies.

Graph 1.2
Core Inflation – Selected Economies
Year-ended

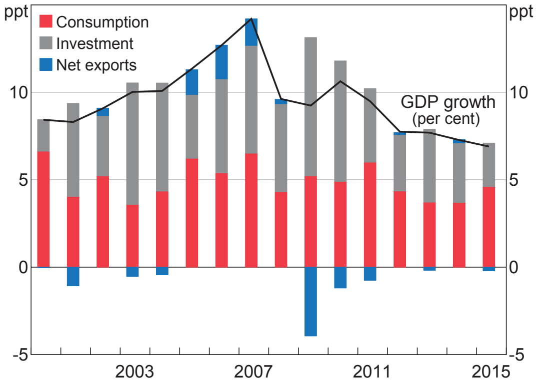


* Selected economies in east Asia excluding China and Japan; weighted by GDP at PPP exchange rates; excluding the estimated effect of the Malaysian goods and services tax implemented in April 2015
** Excluding the effects of the consumption tax increase in April 2014
*** Price index for personal consumption expenditures
Sources: CEIC Data; IMF; RBA; Thomson Reuters

Asia-Pacific

In China, economic growth moderated in 2015 (Graph 1.3). In part, this reflected excess capacity in heavy industry and the large stock of unsold housing, although a range of longer-term structural factors – such as falling productivity growth and a

Graph 1.3
China – Contributions to GDP Growth

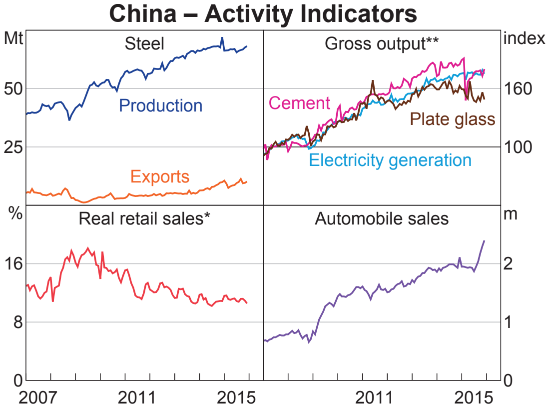


Sources: CEIC Data; RBA

decline in the growth of the urban workforce – may also have contributed. Weakness in the real estate and industrial sectors led to a decline in aggregate investment growth over the year. Infrastructure investment growth also slowed but remained relatively rapid, supported by numerous project approvals and strong growth in government expenditure. Growth in consumption picked up over the year and automobile sales have risen particularly strongly in recent quarters, supported by a reduction in the sales tax on motor vehicles (Graph 1.4).

There continues to be a significant divergence between conditions in the services sector, which were relatively strong in 2015, and those in the

Graph 1.4
China – Activity Indicators



* Year-ended growth

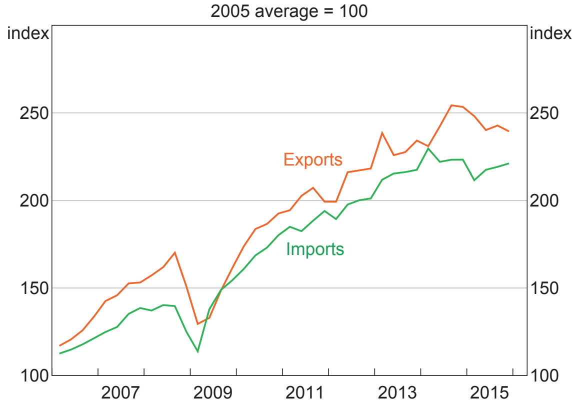
** 2007 average = 100

Sources: CEIC Data; RBA

industrial sector, which remained weak. Evidence of weakness in the industrial sector can be seen across a range of indicators such as industrial value added, profits, indicators of gross output and PMIs. Production of crude steel declined modestly over 2015, as falls in domestic steel consumption were partly offset by growth in steel exports. Profits of Chinese steel producers fell over the second half of 2015. More generally, Chinese trade was weak in 2015, with export and import volumes below the levels seen in the second half of 2014 (Graph 1.5). The weakness was broad based by trading partner, although the volume of iron ore imports from Australia increased in 2015.

Graph 1.5
China – Merchandise Trade Volumes*

2005 average = 100

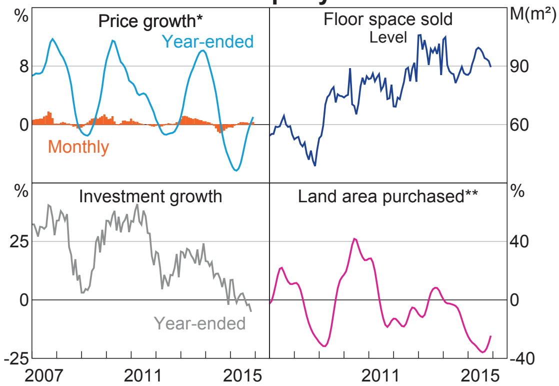


* Seasonally adjusted by RBA

Sources: CEIC Data; RBA

The Chinese residential property market remains subdued overall, notwithstanding some improvement in conditions in some of the larger cities. After picking up in the first half of 2015, the volume of floor space sold has declined (Graph 1.6). Average housing prices nationwide were up slightly over the year, driven by growth in the larger cities; prices in smaller cities are yet to pick up. Also, inventory-to-sales ratios have eased in many cities, but the stock of unsold housing is high and real estate investment has declined. Authorities have emphasised the need to run down the stock of unsold housing, and some local governments have introduced subsidies to home buyers who meet certain conditions.

Graph 1.6
China – Residential Property Market Indicators

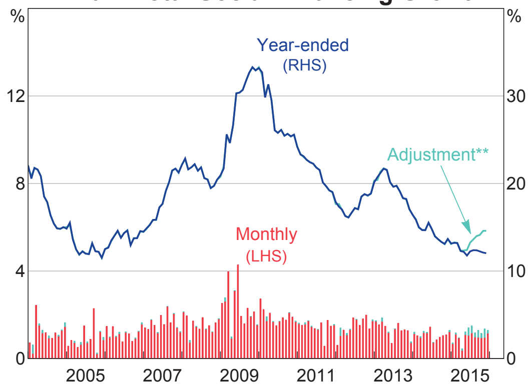


* Newly constructed property in 69 large and medium-sized cities

** Year-ended growth of trend series, includes non-residential land

Sources: CEIC Data; RBA; WIND Information

Graph 1.7
China – Total Social Financing Growth*



* Seasonally adjusted by RBA

** Upper bound estimate adjusting for impact of local government debt swap program

Sources: CEIC Data; People's Bank of China; RBA; WIND Information

Consumer price inflation was below the authorities' objective of 3 per cent in 2015, and disinflationary pressures have persisted. Producer prices continue to decline in response to excess capacity in a number of industries in the economy (see 'Box A: Recent Trends in Inflation in China').

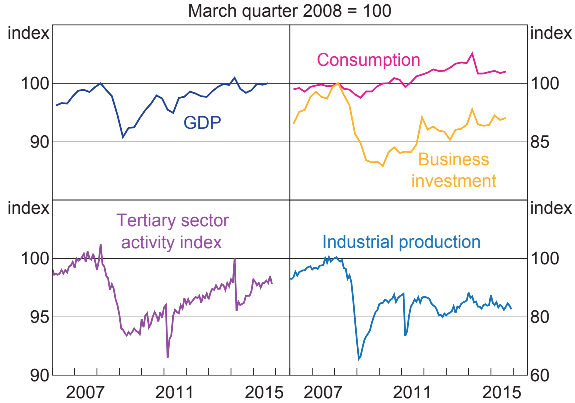
In response to the easing in growth in economic activity and low inflation, the People's Bank of China lowered benchmark interest rates five times and cut the reserve requirement ratio four times in 2015. Growth in total social financing (TSF) increased over the year when adjusted for the impact of the local government debt restructuring program (Graph 1.7). This program resulted in CNY3.2 trillion in local government debt being issued in 2015 to replace other sources of finance that are included in TSF. More generally, bank credit and corporate bond issuance were strong in 2015, offsetting weakness in other off-bank balance sheet components. Funding by government-directed 'policy banks' was especially strong, contributing almost 20 per cent of total growth of TSF in 2015. Equity issuance grew rapidly despite the stock market volatility and the temporary ban on initial public offerings, but remains a small share of TSF.

In early November, China's Communist Party issued a proposal for the 13th Five Year Plan, which articulates goals for the economy, social development and environmental protection. The plan and associated speeches by Chinese officials suggest that the goal for minimum average annual economic growth is 6.5 per cent over 2016–20. Reforms outlined in the plan include: ongoing financial sector reform; improvements to social welfare; environmental reform; industrial and agricultural reform; and continued efforts against corruption.

In Japan, GDP looks to have grown at a moderate rate over 2015, following the slight contraction in 2014 that was largely due to the increase in the consumption tax (Graph 1.8). Growth in the second half of 2015 appeared to have picked up, supported

Graph 1.8
Japan – Economic Activity

March quarter 2008 = 100



Sources: RBA; Thomson Reuters

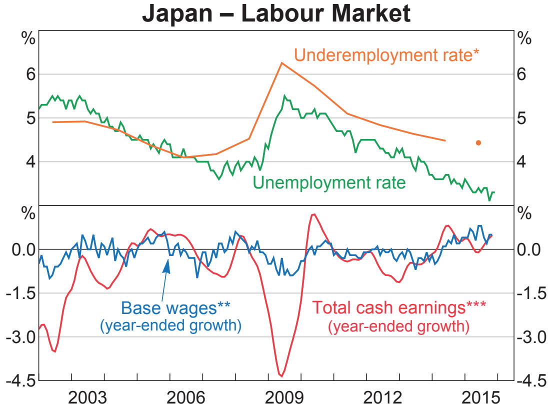
by expansionary monetary policy, the depreciation of the exchange rate over recent years, lower oil prices and the gradual improvement in labour market conditions.

Modest growth in consumption, business investment and public demand has contributed to GDP growth in recent quarters. Residential investment has rebounded following substantial weakness in 2014. Net exports made a positive contribution to growth in 2015, reflecting a strong increase in service exports in response to the earlier yen depreciation. Merchandise exports have been weak; while exports to Europe have increased moderately, exports to the Asian region have been flat in recent months. Overall, conditions in the services sector have been substantially stronger than in the manufacturing and other industrial sectors, as noted by the divergence in surveyed business conditions, stagnant industrial production and the pick-up in the tertiary sector activity index.

Conditions in the Japanese labour market remain tight. The unemployment rate has declined to a two-decade low and the number of job offers relative to applicants has increased steadily (Graph 1.9). The underemployment rate – based on part-time employees who would prefer to work more hours – has also declined from its peak in 2009, notwithstanding a shift towards more part-time work. This is consistent with an increase in the participation rates of older cohorts and females who may be less likely to want extra hours of work. Employment has increased gradually over the past three years. The overall participation rate has also increased over this period, despite the decline in the working-age population since 2012. Consistent with the tightening in labour market conditions, wage growth has picked up a little over the past couple of years. Inflationary pressures, however, remain subdued. Headline inflation is low, in part reflecting the decline in energy prices. Core inflation increased a little over 2015, but remains well below the Bank of Japan's 2 per cent target for headline inflation. In response to the weaker inflation outlook, the Bank of Japan announced further easing of monetary policy in January (see 'International and Foreign Exchange Markets' chapter).

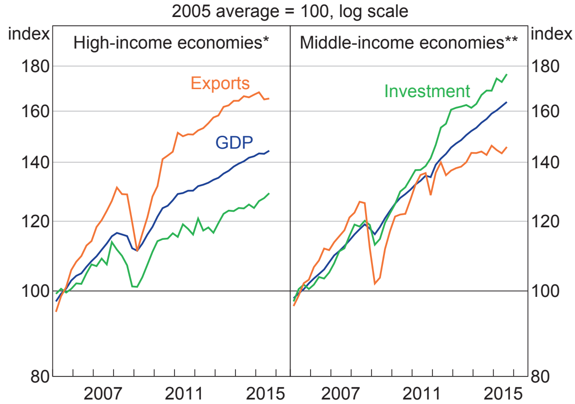
The rest of east Asia experienced below-average growth in 2015 (Graph 1.10). While GDP growth in the middle-income economies was little changed, growth in the high-income economies slowed, in part reflecting the fact that these economies are more exposed to trade, especially with China. Exports have been particularly subdued in the high-income economies in recent quarters,

Graph 1.9
Japan – Labour Market



* Part-time workers who would prefer to work more hours as per cent of the labour force; dot represents 2015 RBA estimate using data for the first three quarters of the year
** Full-time workers only
*** 13-period Henderson trend
Sources: CEIC Data; OECD; RBA; Statistics Bureau; Thomson Reuters

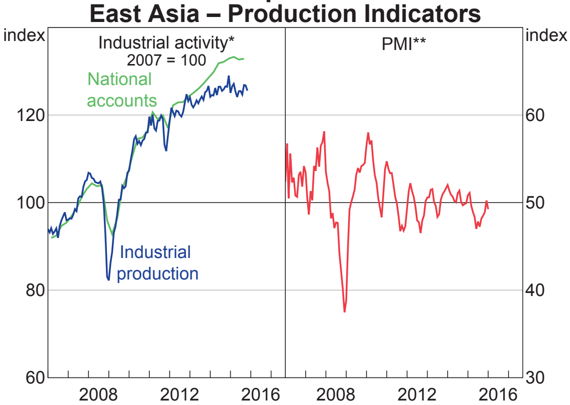
Graph 1.10
East Asia – GDP and Components
2005 average = 100, log scale



* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC Data; RBA

although the recent depreciation of a number of east Asian currencies is likely to provide some support to export growth in the period ahead. Business investment has also been generally weaker in the high-income economies, while industrial production has been a key source of weakness for the region overall; industrial output fell, or was flat, in most economies in the region over 2015 and the manufacturing PMIs have been below average (Graph 1.11). Several governments in the high-income economies provided fiscal stimulus in the latter part of 2015. While much of the direct benefit has flowed through to domestic demand already – most notably the sizeable boost to September quarter growth in Korea – fiscal stimulus should continue to provide some support in 2016. Monetary policy was also eased over 2015 in Korea, Singapore, Taiwan and Thailand. In contrast, the Hong Kong Monetary Authority raised its policy rate in response to the tightening of monetary policy in the United States.

Graph 1.11
East Asia – Production Indicators

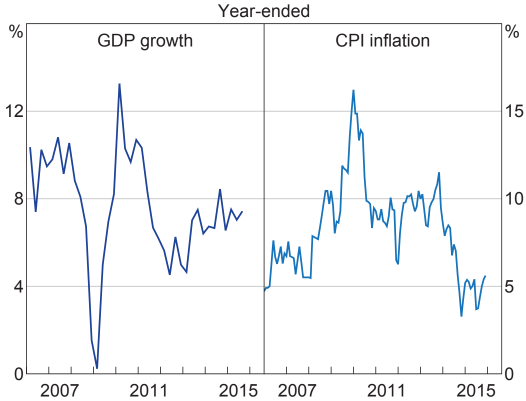


* Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand
** Hong Kong, Singapore, South Korea and Taiwan
Sources: CEIC Data; Markit Economics; RBA; United Nations

Consistent with the moderation in growth in economic activity, employment growth in most high-income east Asian economies has eased over 2015, although unemployment rates have remained mostly low and stable. For the region overall, headline and core inflation remain subdued in most economies. The recent depreciation of several east Asian currencies may provide a boost to inflation in the period ahead. In Malaysia, the introduction of a goods and services tax in April 2015 has also put upward pressure on inflation.

In India, economic growth has picked up over the past couple of years (Graph 1.12). This has reflected stronger private consumption and an increase in gross fixed capital formation, particularly by the public sector. The services sector continues to grow strongly and, recently, there has been a pick-up in growth in the manufacturing sector. Inflation was little changed in 2015 and remains below the Reserve Bank of India's (RBI) interim target of 6 per cent by January 2016. The RBI eased the policy rate by 125 basis points over 2015, citing weakness in global and domestic demand and capacity underutilisation.

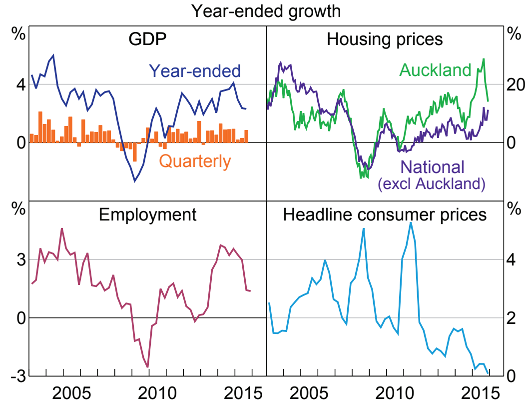
Graph 1.12
India – GDP Growth and Inflation
Year-ended



Source: CEIC Data

In New Zealand, GDP growth in the September quarter picked up from the modest outcomes earlier in 2015 (Graph 1.13). Investment and a recovery in net exports made the most significant contributions to growth in the quarter. However, dairy prices are around their lowest level in a decade and the prices of New Zealand's commodity exports more broadly have declined to below their decade average. With inflation remaining low and a moderation in the pace of employment growth, the Reserve Bank of New Zealand cut its policy rate by a cumulative 100 basis

Graph 1.13
New Zealand – Economic Indicators
Year-ended growth



Sources: RBA; RBNZ; REINZ; Thomson Reuters

points over 2015. Housing price growth in Auckland declined in late 2015, possibly reflecting recent changes to taxation and the tightening of lending regulations to investors in Auckland. Excluding Auckland, housing price growth has increased.

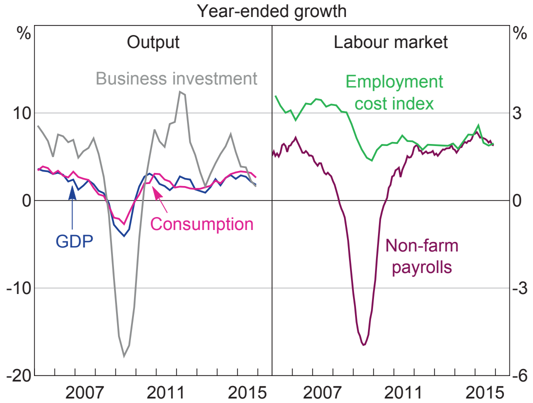
United States

The US economy expanded over 2015 at a rate that was close to trend, notwithstanding lower growth in the December quarter (Graph 1.14). Private consumption remained the key driver of growth in expenditure over the year, supported by further improvement in the labour market, the boost to household incomes from low fuel prices, accommodative monetary policy and rising household wealth. A range of indicators suggest that private consumption will continue to be a key driver of expenditure growth in the near term, with consumer confidence remaining around its long-run average, strong spending on larger-ticket items and motor vehicle sales around their pre-crisis peak.

Private investment growth has declined over the past year, owing in part to the decline in investment in the oil & gas sector (Graph 1.15). Industrial output has been little changed over the past year, in part reflecting subdued conditions in the manufacturing sector as a result of the US dollar appreciation and weaker external demand from emerging economies. However, business conditions in the services sector, which accounts for the majority of economic output, have been generally positive, with survey measures around or above their average levels.

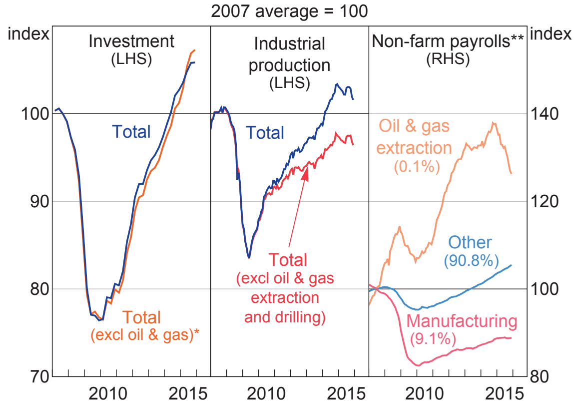
Meanwhile, residential investment and construction activity have grown strongly over the past year, owing in part to the further improvement in housing market conditions. Nominal housing prices are close to their pre-crisis levels (Graph 1.16). Mortgage applications for purchases are around a five-year

Graph 1.14
United States – GDP and Labour Market
Year-ended growth



Source: Thomson Reuters

Graph 1.15
United States – Oil and Gas Sector Relative to Total
2007 average = 100

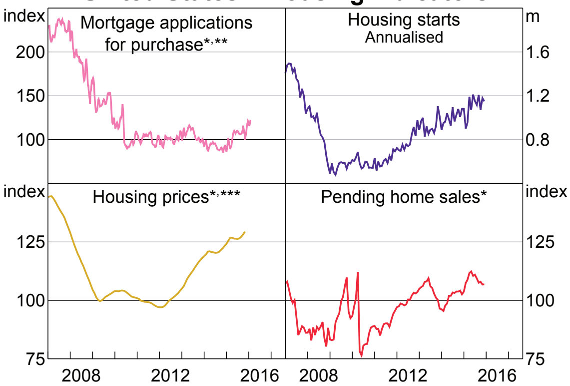


* Excludes structures investment in mining exploration, shafts and wells

** Numbers in parentheses show 2007–2015 average shares of total

Sources: RBA; Thomson Reuters

Graph 1.16
United States – Housing Indicators



* 2012 average = 100
** Four-week moving average
*** S&P/Case-Shiller 20-city composite index
Source: Thomson Reuters

high. Pending home sales and housing starts are also around their post-crisis highs, although both slowed somewhat over the second half of 2015.

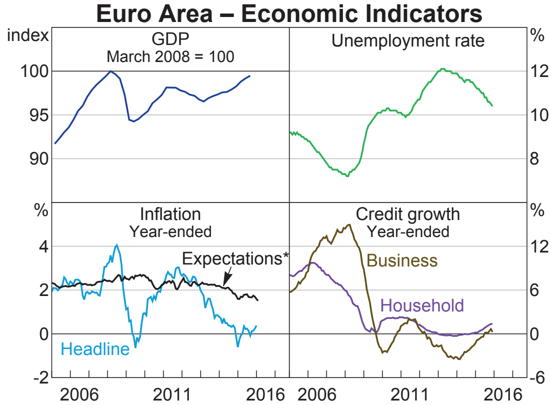
US labour market conditions improved further through 2015. The unemployment rate and other measures of labour market underutilisation declined and most are close to their pre-crisis long-run averages. There has not been a significant pick-up in wage growth to date; growth in the employment cost index remained around its post-crisis average over 2015. One possible explanation is that relatively weak productivity growth – which has kept unit labour cost growth in recent years well above its historical average, despite low growth of nominal wages – may be affecting the ability of firms to raise wages. Moreover, while the unemployment rate has declined, it has yet to fall below most estimates of its long-term level.

Headline inflation has been low since late 2014, reflecting the effects of lower oil prices. Core inflation has also been low, in part reflecting the impact of the stronger US dollar and the second-round effects of low oil prices, although it ticked up over 2015 to around 1½ per cent. The FOMC raised the federal funds rate target at its December meeting, in response to labour market strength and with the expectation that inflation would increase in the period ahead.

Europe

Economic activity in the euro area continued its gradual recovery in 2015. GDP has been increasing since early 2013 and has been growing at an above-trend rate over the past few quarters; however, the level of GDP is only now returning to its pre-crisis peak (Graph 1.17). Household and government consumption continued to be the main contributors to growth of expenditure over much of 2015, while investment has been little changed. Net exports have made almost no contribution to growth for the past two years despite the depreciation of the euro.

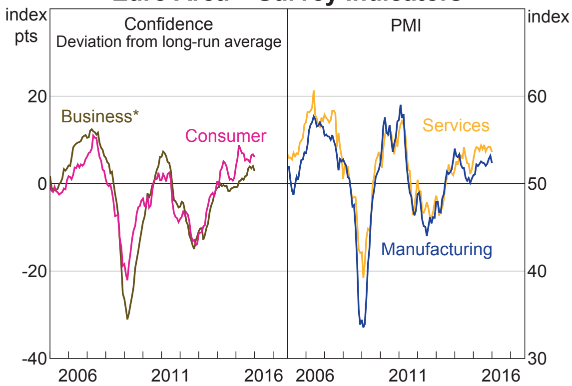
Graph 1.17
Euro Area – Economic Indicators



* 5-year, 5-year forward expectations; calculated from 5- and 10- year inflation swaps; latest month is an average in the month-to-date
Sources: Bloomberg; RBA; Thomson Reuters

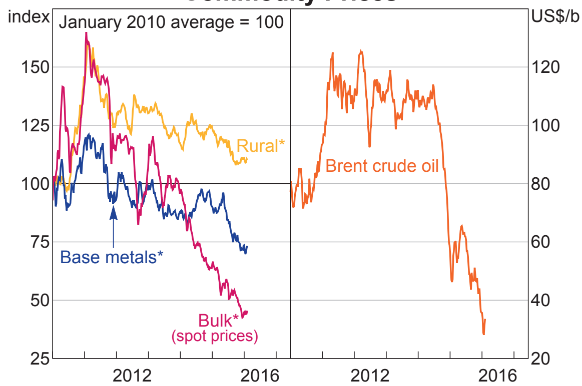
Timely indicators for the December quarter suggest that economic activity continued to grow at a similar rate to recent quarters. Consumption is likely to remain the key driver of growth of expenditure, while investment growth is likely to be subdued. Consumer sentiment remains moderately above its long-run average level and retail sales volumes are growing relatively strongly (Graph 1.18). The PMI surveys of manufacturing and services activity have remained around their recent highs, and business sentiment continues to be above average. Household and business credit growth rates have mostly picked up in recent months but remain relatively low. Construction output volumes and industrial production remain little changed over the past year.

Graph 1.18
Euro Area – Survey Indicators



* Includes industrial, services, retail and construction sector confidence
Sources: Markit Economics; RBA; Thomson Reuters

Graph 1.19
Commodity Prices



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

The euro area unemployment rate has continued its gradual decline and employment growth has increased steadily. Nonetheless, there remains considerable spare capacity in the labour market; the unemployment rate remains high, having declined by just 1.7 percentage points since its mid-2013 peak, and the employment-to-population ratio has only recovered a little from its 2013 low.

Headline inflation remains low, owing in part to the decline in oil prices. Core inflation has increased slightly, but remains well below the European Central Bank's target for headline inflation of below but close to 2 per cent. Financial market measures of long-term inflation expectations have been largely unchanged over 2015 at historically low levels.

Commodity Prices

The RBA Index of Commodity Prices (ICP) has fallen further in recent months, led by declines in the prices of oil and the bulk commodities, particularly iron ore (Graph 1.19; Table 1.1). Since the peak in 2011, commodity prices have fallen by around 55 per cent. A combination of a substantial increase in supply as resource projects have started production and weakness in demand more recently, especially from the Asian region, has driven the fall. Nonetheless, commodity prices remain around 60 per cent above the levels seen in the early 2000s. The decline in bulk commodity prices contributed to a fall in the terms of trade of 10 per cent over the year to September. In the near term, lower oil prices imply an increase in the terms of trade because Australia is a net importer of oil. However, this effect will be offset as exports of liquefied natural gas (LNG) ramp up in the years ahead, since the price of LNG is linked to the price of oil.[1]

The spot price of iron ore fell in 2015, in part reflecting lower demand for Chinese steel products, although it has been little changed more recently (Graph 1.20). At the same time, expansions in the supply of iron ore in Australia and elsewhere have continued (albeit at a slower pace than in the recent past). Reductions in production costs over recent years have also contributed to the decline in iron ore prices and are expected to continue, although the scope for further large cost reductions is likely to be more limited than in the past. Some smaller, higher-cost producers remain under pressure and some have cut production, including in China, although most Australian iron ore production appears to be profitable even at current prices.

Prices of thermal and coking coal have continued to decline in recent months, reflecting concerns about demand from China, particularly in the

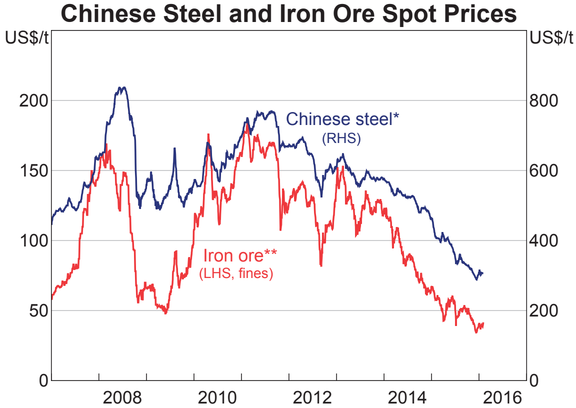
1 For further details on the effect of oil prices on the terms of trade, see RBA (2015), 'Box A: The Effect of Oil Price Movements on the Terms of Trade', *Statement on Monetary Policy*, May, pp 14–15.

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

	Since previous *Statement*	Over the past year
Bulk commodities	–14	–30
– Iron ore	–20	–36
– Coking coal	–5	–29
– Thermal coal	–7	–15
Rural	0	–11
Base metals	–6	–22
Gold	–3	–7
Brent oil[(b)]	–22	–40
RBA ICP	–8	–24
– using spot prices for bulk commodities	–9	–25

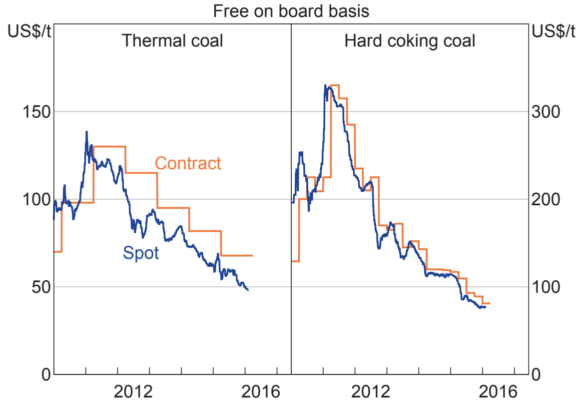
(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodities prices are spot prices
(b) In US dollars
Sources: Bloomberg; IHS; RBA

Graph 1.20
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 1.21
Coal Prices
Free on board basis



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

case of coking coal (Graph 1.21). At current prices, a substantial share of global coal production, including in Australia, is estimated to be unprofitable. Concerns about global demand, particularly more subdued growth of global industrial production, led to declines in the prices of base metals through 2015, although they have been little changed more recently. The declines in prices have prompted reductions in the production of some of these commodities globally.

The Brent crude oil price fell to its lowest level in over a decade in recent months (see Graph 1.19). This largely reflects the combination of rising production (and inventories) in the United States, increased supply from Iraq and expectations of increased supply from Iran, although concerns about demand growth have also been a factor more recently. The decline in oil prices continues to be reflected in weaker LNG prices in the Asian region. Moreover, increased supply from Australian LNG exporters is likely to place further downward pressure on the regional LNG spot price over the next couple of years.