

Overview

Over recent months the sovereign debt and banking problems in Europe have again taken centre stage. These problems have led to high levels of volatility in financial markets and an increased focus on the downside risks to global growth. While the recent announcements by European leaders initially led to some improvement in confidence, difficult decisions still lie ahead, with many European governments facing a major challenge in putting their public finances on a sounder footing. The governments in the United States and Japan also face major medium-term fiscal challenges.

These fiscal issues, together with the ongoing consolidation of private-sector balance sheets following the financial crisis, mean that the outlook for growth in many advanced economies remains subdued. Recent data in the United States, however, have been more positive than earlier in the year and are consistent with an economy that is experiencing a modest expansion, but with little inroad being made into the high level of unemployment. While the market turbulence has dented business and consumer confidence in the advanced economies, fears of a major downturn have not been borne out so far. At this stage, there are few signs of the widespread deferral of capital spending and disruptions to trade finance that caused so much damage to the world economy in 2008/09.

In Asia, including China, growth remains solid, although below the pace in 2010. This moderation in growth partly reflects a general tightening of macroeconomic policy over the past year or so in response to a pick-up in inflation in the region.

There are also some indications that the troubles in the North Atlantic economies are having an effect, with growth in exports and industrial production in the region slowing over recent months. Inflation remains relatively high, although there are signs of it moderating in some countries.

The Bank's central scenario for global growth over the next couple of years has been revised lower since the previous *Statement* to around 4 per cent. Around three-quarters of this growth is expected to come from the emerging and developing economies; in comparison, these economies accounted for less than half of global growth during the period from 1990 to 2005. The risks to this central scenario continue to be tilted to the downside, with a very disruptive outcome in Europe still possible. If such an outcome did occur, the world economy would be considerably weaker than the central scenario, notwithstanding the ability of policymakers in Asia to respond to a slowdown in their own economies.

Commodity prices are lower than they were three months ago, although they have mostly risen over the past month. In contrast to the pattern for most other commodities, the price of iron ore, after being largely unchanged in August and September, fell sharply in October. This fall reflects, in part, increased global supply of iron ore and a slowdown in global steel production, including in China. Overall though, commodity prices are still at high levels.

The sovereign debt issues have contributed to large swings in financial markets over recent months. Both global equity prices and currencies, including the euro and the Australian dollar, have traded in

unusually wide ranges. In bond markets, yields on long-term government securities in the major economies have moved lower and are at historically low levels. In contrast, yields on government securities in several countries in Europe, particularly Italy, have increased over recent months.

Central banks in a number of countries have responded to these recent economic and financial developments with further policy measures. The US Federal Reserve, the European Central Bank and the Bank of England have all announced further non-conventional policy easing, and the Swiss National Bank and the Bank of Japan have taken actions to limit the appreciation of their currencies. Policy rates have also been reduced in some emerging market economies.

Conditions in global credit markets are tighter than earlier in the year, but markets are open to good-quality borrowers. The Australian banks have successfully issued securities in a range of markets over recent months and continue to experience strong growth in deposits. In the euro area, banks' borrowing costs have risen and, globally, corporate bond spreads, particularly for lower-grade issuers, have increased.

The Australian economy is growing at a moderate pace, with conditions varying significantly across sectors. The terms of trade in the September quarter are estimated to have been at their highest level in at least 140 years, and this is boosting both national income and investment. The mining-related parts of the economy are growing strongly and are expected to continue to do so, notwithstanding the recent decline in commodity prices. In contrast, in a number of other industries, the high exchange rate, the fading injections from the earlier fiscal stimulus and changes in household spending and borrowing behaviour are contributing to subdued conditions. Domestic demand continues to grow at around average pace, though an increased share of demand is being met by imports due to the high exchange rate and the import-intensive nature of the mining investment.

Consistent with moderate growth in the economy, survey-based measures of business conditions are mostly around long-run average levels. Business confidence has, however, fallen noticeably since mid year, to be well below its average level, although there has been some improvement recently. Growth in business credit remains subdued, and credit conditions are still fairly tight, particularly in the commercial property sector.

The published GDP outcomes for 2011 continue to be affected by the weather-related disruptions earlier in the year. In the June quarter, GDP increased by 1.2 per cent, after a decline of 0.9 per cent in the March quarter as extreme weather events affected exports of iron ore and coal. Over recent months, there has been a strong recovery in exports of iron ore, but the recovery in coal production in Queensland is continuing to take longer than earlier expected due to the difficulties in removing water from flooded coal pits. However, an increase in coal production is still expected to boost the outcomes for GDP over the second half of 2011.

Over the past year, consumption growth has been broadly in line with growth in household incomes, with the household saving ratio steady at around 10 per cent. Many households appear to be increasing their expenditure on services, rather than goods, and this is contributing to the weak conditions in parts of the retail sector. Household confidence has fallen over the past six months, although there are some signs of an improvement recently, and measures of household wealth have declined this year.

The housing market remains subdued, with nationwide measures of housing prices declining over 2011. Perhaps not surprisingly, the weakest markets have been those that had the largest run up over the preceding few years. At the aggregate level, the ratio of housing prices to income has been broadly steady for almost a decade now after its earlier large increase. Growth in housing credit is noticeably slower than in earlier years and is running

at a little below that in household disposable income.

Reflecting the moderation in overall economic growth, the unemployment rate has increased slightly from 5 to 5¼ per cent over recent months and employment growth has slowed from the rapid pace of last year. The Bank's liaison suggests that the general increase in economic uncertainty has led some firms to wait for evidence of stronger demand before hiring additional workers. Notwithstanding this, the forward-looking indicators of labour demand continue to suggest ongoing employment growth, with the ratio of job vacancies to the total labour force still at a high level.

Aggregate wage growth has been relatively firm, although the Bank's liaison suggests that the likelihood of a significant acceleration of aggregate labour costs in the near term has lessened. Outside of the mining sector and some related industries, most firms are not reporting unusual difficulty in finding suitable workers, and there has been a rise in households' concerns about higher unemployment. Unit labour costs, however, continue to increase at an above-average rate, with productivity growth remaining below average.

The recent CPI data indicate a moderation in underlying inflation in the September quarter, after it had picked up in the first half of 2011. On a year-ended basis, underlying inflation is running at a little below 2½ per cent, the midpoint of the target band. For the quarter, the various measures of underlying inflation were in the range of 0.3 to 0.5 per cent, after above-average outcomes in the first half of the year. While the quarter-to-quarter movements in inflation need to be interpreted with care, this moderation is consistent with the softer growth in the non-mining economy and liaison reports that many firms feel that they have limited pricing power.

Over the year to the September quarter, CPI inflation was 3.5 per cent, with the outcome boosted by the increase in fruit and vegetable prices (particularly

the price of bananas) that occurred earlier in the year due to the Queensland floods. The quarterly outcome (on a seasonally adjusted basis) was 0.4 per cent, similar to that for the measures of underlying inflation. In the quarter, there was a large increase in the price of utilities, partly offset by a decline in new dwelling costs. The effects of the earlier exchange rate appreciation also continue to be evident, with the prices of tradable goods falling slightly in the quarter, although these effects appear to be waning.

Reflecting recent developments in both the domestic and global economies, the Bank's forecasts for Australian GDP growth over the next couple of years have been lowered. In 2011, growth is now expected to be around 2¾ per cent, with the slow recovery in coal production accounting for a significant part of the downward revision since earlier in the year. In 2012, growth is expected to be around 3–3½ per cent and to be a little stronger in 2013. Over most of the forecast period, domestic demand is expected to grow at an annual rate of around 4 per cent, with growth in imports running substantially faster than this. In the central scenario, the unemployment rate is expected to increase a little before moving lower again, to around its current level.

The mining boom remains a central element in these forecasts, with mining investment expected to increase very strongly over the next few years, particularly in the LNG sector. In contrast, growth in the non-mining economy is expected to remain below average. The household saving ratio is forecast to remain around its current level and growth in public demand is expected to remain subdued, given ongoing fiscal consolidation.

The inflation forecasts have also been lowered, reflecting both the lower starting point and the revisions to the growth forecasts. In underlying terms, inflation (excluding the effect of the carbon price) is expected to be around 2½ per cent in 2012, ½ percentage point lower than forecast at the time of the *August Statement*. In 2013, inflation is

expected to pick up a little, but still be consistent with the inflation target. The year-ended rate of CPI inflation is expected to fall below underlying inflation in early 2012 as banana prices return to more normal levels. It is then expected to increase to around 3¼ per cent following the introduction of the price on carbon in mid 2012, before again easing back.

This general outlook for inflation is conditional on aggregate wage growth remaining at around its current pace. It is also conditional on a pick-up in productivity growth as firms respond to competitive pressures and take advantage of lower prices for capital goods.

The largest risk to these forecasts is the sovereign debt and banking problems in the euro area, as discussed above. The Bank's central scenario continues to be one in which the European authorities do enough to avert a disaster, but are not able to avoid periodic bouts of considerable uncertainty and volatility. A worse outcome in Europe would adversely affect the Australian economy, and underlying inflation would be likely to decline. The main upside risk to inflation comes from growth in unit costs turning out to be faster than is currently expected due to either a continuation of low productivity growth or a pick-up in wage growth.

Given the very high commodity prices, the strong growth in investment and the relatively limited spare capacity in the Australian economy, the Board has been concerned, for most of the past year, about the potential for inflation to be above the target band over the period ahead. Given these concerns, it has maintained a mildly restrictive stance of monetary policy, with most lending rates in the economy a little above their medium-term averages. Broader financial conditions have also been tighter than normal, with credit growth subdued, the exchange rate at a high level and asset prices lower than earlier in the year. These financial conditions have helped contain the inflationary pressures in the economy, with underlying inflation a little below the midpoint of the target band.

At its meetings over recent months, the Board has reviewed the improving outlook for inflation and ongoing moderate growth in the overall economy. At its November meeting, the Board judged that a more neutral stance of monetary policy was now appropriate given that, over the period ahead, inflation was likely to be consistent with the medium-term target and that economic growth remained moderate. As a result, after holding the cash rate steady at 4.75 per cent since last November, the Board reduced the cash rate by ¼ percentage point to 4.5 per cent. At its future meetings the Board will continue to set monetary policy so that it is consistent with achieving sustainable growth and 2–3 per cent inflation over time. ✎