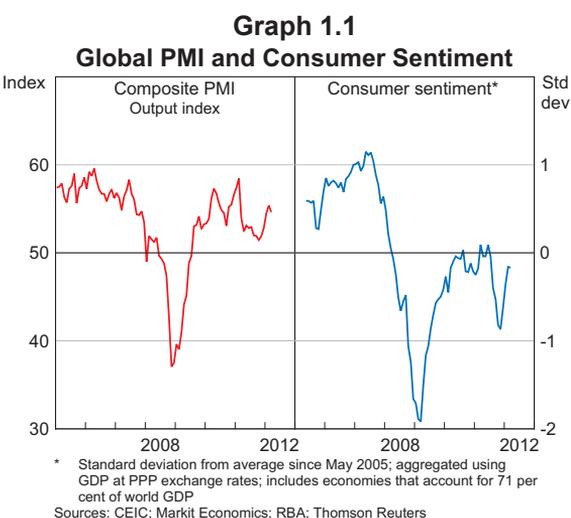


# 1. International Economic Developments

Global growth slowed in late 2011. At that time, heightened concerns about sovereign debt problems in Europe and global growth prospects more generally led to some deterioration in confidence and activity. Most indicators suggest that the slowdown was mild, and it was certainly nowhere near as severe as the downturn in 2008–2009 (Graph 1.1). Following further action by the European Central Bank (ECB), the restructure of Greek government debt held by the private sector and further evidence of continued growth in the United States, global business and consumer confidence has recovered somewhat and business activity indicators have generally improved. In the euro area, however, confidence and activity remain weak and recent indicators suggest that conditions have deteriorated again in April. In response to tighter policy, growth in China has slowed to a more sustainable pace, while activity in the rest of east Asia is recovering from the natural disasters in 2011.

Forecasts of global growth in 2012 have been revised up a little in recent months, the first upward revisions since around mid 2011. The International Monetary Fund expects global output to grow by 3.5 per cent in 2012 and by 4.1 per cent in 2013, with the forecasts for each year revised up by 0.1–0.2 percentage points from three months ago, but with the risks still skewed to the downside. Although many economies are forecast to grow at a below-trend pace, particularly in 2012, the increasing weight of the faster growing Asian economies means that global growth is expected to be at or above long-run average levels.

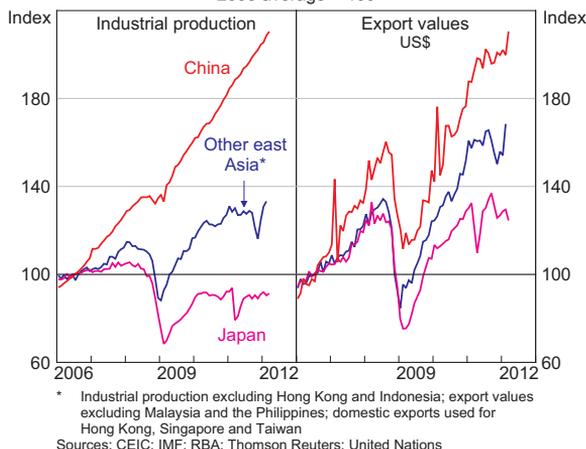


Although global economic conditions overall have improved, the recovery remains fragile. Public and, to a lesser extent, private debt remain elevated in the advanced economies, and continued deleveraging will weigh on growth for the foreseeable future. Although European leaders have made significant efforts to improve public finances and, in a number of countries, to enhance competitiveness, more progress is needed and securing public support for ongoing reform is proving difficult. Hence, Europe is likely to be a source of global uncertainty and financial market volatility for some time to come. Persistently high oil prices, if they reflect concerns about supply, could also slow the recovery in global activity.

## Asia

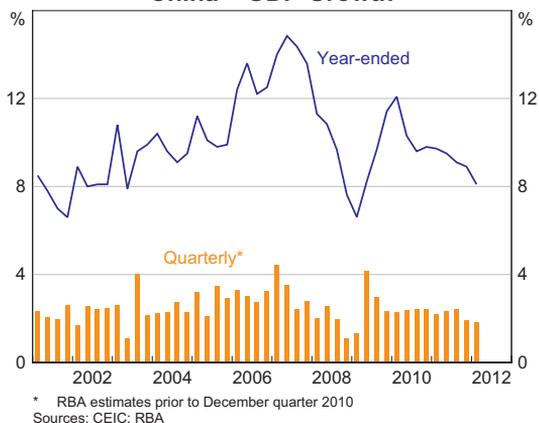
Growth in China moderated further in early 2012, while growth in the rest of east Asia has started to pick up after a noticeable slowing at the end of 2011. This pick-up reflects the beginning of the reconstruction effort in Japan and a partial recovery in regional supply chains that were disrupted by flooding in Thailand in late 2011 (Graph 1.2). Exports have also picked up from the lows seen in late 2011, in part supported by demand from the United States. Business and consumer confidence have generally increased, in line with the improving global outlook.

**Graph 1.2**  
East Asia – Production and Exports  
2006 average = 100



In China, economic growth continued to moderate in the March quarter. GDP grew by 1.8 per cent to be 8.1 per cent higher over the year (Graph 1.3). The recent slowing in Chinese GDP growth has mainly resulted from tighter domestic policies, although weaker external demand has also weighed on growth. Exports to the European Union have contracted over the past year and those to Japan have been subdued. However, this has been partially offset by the ongoing modest expansion in exports to the United States, where economic conditions continue to improve. Exports to the rest of east Asia have strengthened in recent months, reflecting the ongoing recovery in the region from recent production disruptions.

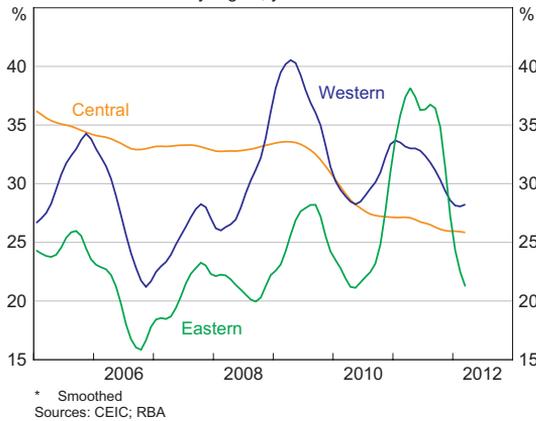
**Graph 1.3**  
China – GDP Growth



Growth in domestic demand in China has eased, but there are tentative signs that conditions are stabilising. Growth in retail sales volumes has risen, supported by subsidies for rural residents and strong growth in urban disposable incomes. Notwithstanding weaker growth in external demand, investment by the manufacturing sector has continued its strong expansion, in part reflecting the increasing domestic orientation of manufacturing in recent years. In contrast, real estate investment has slowed and conditions in the property market are weaker. Nevertheless, construction growth remains relatively robust. The strength in real estate investment is, in part, owing to support from the Chinese Government's affordable housing program. Ongoing controls have weighed on residential property turnover and resulted in a modest fall in apartment prices. Much of the weakness in sales volumes has been recorded in coastal provinces, where the property controls have been more pervasive; turnover in inland provinces has remained broadly unchanged at a high level. The regional differences in conditions across property markets are also evident in relatively stronger growth in construction activity in central and western provinces (Graph 1.4).

Industrial production growth has slowed over the past year, consistent with the broad trends in the manufacturing PMIs for China. The HSBC PMI, which

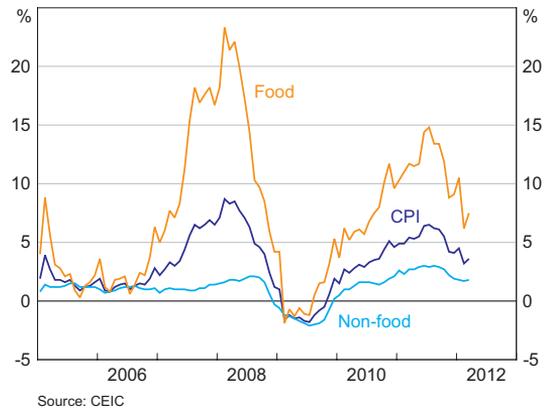
**Graph 1.4**  
**China – Construction Investment Growth\***  
 By region, year-ended



is currently lower than the official PMI and includes a higher share of smaller firms, has stabilised at a level just below 50. This level suggests that manufacturing activity has continued to grow, though slightly below its trend growth rate; the official PMI suggests that growth is somewhat stronger. Manufacturing of machinery and equipment, which accounts for a significant share of Chinese exports, is growing less rapidly than in 2011, although this is also the result of a significant slowing in domestic equipment investment. However, there are tentative signs that growth in industrial production has stabilised more recently. There has been a recovery in the production of key construction materials, including cement, steel and plate glass, after production fell towards the end of 2011.

There has been a clear moderation in inflationary pressures in China since mid 2011, in line with the slowing growth of activity (Graph 1.5). Food prices have contributed significantly to the lower inflation outcomes. Meat prices have eased, particularly for pork, although this has been offset somewhat by rapid increases in fresh vegetable prices, with adverse weather conditions having affected vegetable production earlier in 2012. Non-food price inflation has also fallen, with housing cost inflation falling largely as the result of the moderation in rents and property prices from weaker conditions in the

**Graph 1.5**  
**China – Consumer Price Inflation**  
 Year-ended

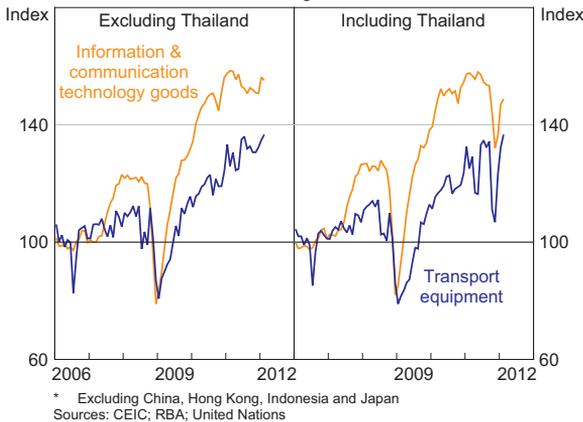


housing market. Earlier falls in commodity prices have been reflected in the prices of some household items and have resulted in a fall in producer prices.

Credit conditions appear to have eased recently. This follows a period of tighter liquidity between the end of January and mid February when market interest rates had increased. To ease liquidity conditions, the People's Bank of China (PBC) cut banks' reserve requirement ratios by 50 basis points. Further, to stimulate the supply of credit, the banking regulators increased the maximum loan-to-deposit ratio for two of China's five largest banks and cut reserve requirements for a large number of branches of the Agricultural Bank of China. Also, from 1 April, reserve requirements for some localised financial institutions were lowered by 100 basis points for one year. The PBC recently encouraged banks to offer lower loan rates for first home buyers to provide some support to housing demand. Overall then, financial policy settings are expected to be more supportive of growth in 2012. This is expected to be accompanied by an easing of fiscal policy, with growth in government spending projected to be strong, and the recent moderation in inflationary pressures has provided scope for an easing in monetary policy should there be a marked deterioration in economic conditions.

The easing of supply-chain disruptions from recent natural disasters, and some recovery in activity in the advanced economies, are starting to support activity in other parts of east Asia. The production of information and communication technology goods and motor vehicles has increased, particularly in Thailand where these industries were greatly affected by recent flooding (Graph 1.6). Exports of motor vehicles have also picked up, especially to the United States where motor vehicle sales have been strong recently. These factors have supported a pick-up in business and consumer confidence in most economies in the region, most notably in the higher-income economies that are more exposed to activity in the advanced economies and to regional supply chains. Indicators of domestic demand have been somewhat mixed; retail sales are likely to have fallen in the March quarter, while indicators of investment have picked up and credit growth has remained relatively firm.

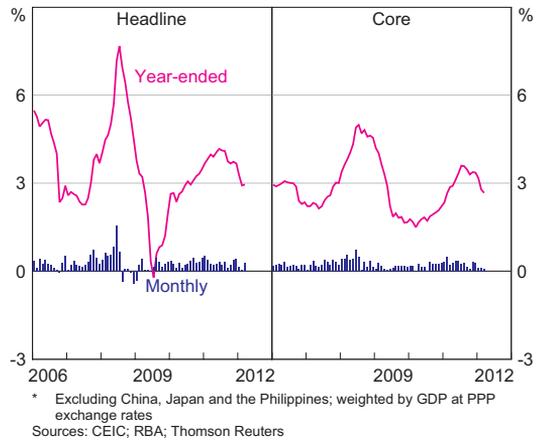
**Graph 1.6**  
**East Asia\* – Production**  
2006 average = 100



In line with the step down in the rate of growth in the region, and consistent with an earlier tightening in monetary conditions, inflation pressures have eased since 2011. Core inflation has moderated noticeably, to be below 3 per cent over the year (Graph 1.7). Oil price rises have not yet flowed through to retail prices, partly reflecting the slow adjustment of administered prices in some economies.

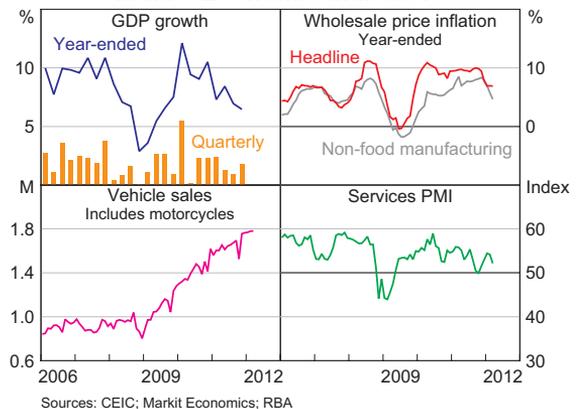
**Graph 1.7**

**East Asia\* – Consumer Price Inflation**



In India, GDP growth slowed in the December quarter to a year-ended rate of 6½ per cent, but conditions have stabilised in recent months (Graph 1.8). While private and public consumption continued to expand at a strong pace towards the end of 2011, investment contracted over the year, weighed down by tighter monetary conditions and greater uncertainty. More recently, growth in industrial production has lifted, supported by a recovery in coal production and strength in motor vehicle production. Cement production has continued to grow at a firm pace, underpinned by construction activity. Reflecting the recent improvement in production and demand, freight volumes and imports have also picked up. Conditions in the

**Graph 1.8**  
**India – Economic Indicators**



services sector remain firm, with the services PMI at a level suggesting above-trend growth.

As domestic demand in India has slowed, inflationary pressures have eased. Inflation in non-food manufactured goods prices (an indicator of core inflation for India) is now at its lowest level since early 2010. The moderation in core inflation has been broad based, with electrical and transport equipment prices falling. The recent fall in food price inflation, however, appears to have been short-lived, with food price inflation surging in March, driven in part by supply-side constraints. With growth in activity having slowed and inflationary pressures having abated, the Reserve Bank of India (RBI) cut its policy rate by 50 basis points at its recent meeting. However, the RBI has suggested that the extent of the easing of policy will be limited by inflationary pressures coming from the recent depreciation of the rupee and the rising cost of fuel.

Activity in Japan has recovered from natural disasters that affected the region in 2011, with industrial production and exports both back to around their levels prior to the Japanese earthquake and tsunami in March (Graph 1.9). Indicators of household consumption have also picked up, consistent with a rise in consumer confidence. Although indicators of equipment investment have tracked sideways, there are signs that the boost to investment from the reconstruction effort has commenced, with

housing starts growing strongly in the earthquake-affected regions in recent months. However, the risk of much more subdued output growth in the summer months remains, with the reluctance of local authorities to restart nuclear power stations likely to contribute to electricity supply shortages (see 'Box A: Electricity Supply in Japan').

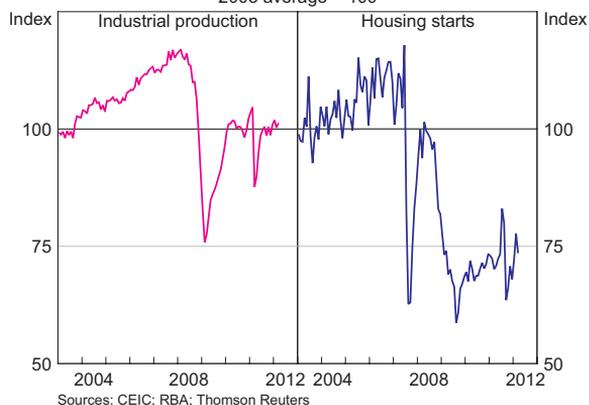
## Europe

Economic activity in the euro area continues to be affected by ongoing concerns about sovereign debt and the competitiveness of a number of European economies. Over recent months, measures of activity, confidence and sentiment in financial markets have tended to move together, with early signs of conditions having deteriorated again in April after some improvement in the first few months of the year. With financial market sentiment fragile and fiscal consolidation ongoing, economic activity will remain weak in the euro area for some time.

In the March quarter, euro area exports picked up, retail sales and indicators of investment stopped falling, and there was a slight improvement in sentiment (Graph 1.10). Activity in Germany and France continues to be a little stronger than conditions in the troubled euro area economies, though growth remains weak overall. Industrial production and orders stopped falling in Germany in January and February, although retail sales have fallen a little further since the beginning of the year. In contrast with other German economic indicators, the labour market continues to strengthen, with the unemployment rate at its lowest level since Germany's reunification in the early 1990s. In France, domestic demand picked up modestly, abstracting from volatility in motor vehicle sales related to tax changes; retail sales increased and indicators of investment improved in recent months. The unemployment rate in France remains elevated. Although these two larger economies are performing better than others in the euro area, they continue to be affected by concerns about other euro area countries, with the composite PMIs falling in France and Germany in April.

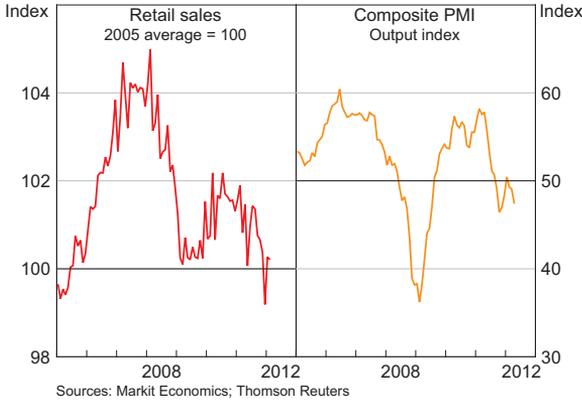
**Graph 1.9**  
**Japan – Economic Indicators**

2003 average = 100



**Graph 1.10**

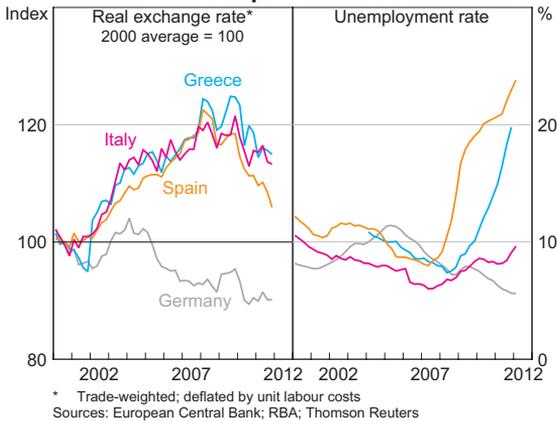
**Euro Area – Economic Indicators**



Conditions in euro area economies with significant competitiveness and sovereign debt issues remain difficult, with the negative feedback loop between fiscal consolidation and growth clearly evident. Domestic demand continues to fall and labour markets are very weak. Unemployment rates are very high and still rising (Graph 1.11). Some of these economies are progressing with structural reforms, but it will be some time before these translate into improved economic performance. Although competitiveness has improved somewhat over the past year, reflecting both the depreciation of the euro and declines in unit labour costs, most of these economies remain less competitive than they were a decade ago.

**Graph 1.11**

**Euro Area – Competitiveness and Labour**



Consistent with the substantial spare capacity in the euro area, core inflation remains contained. However, recent rises in oil prices are resulting in elevated rates of headline inflation and, if oil prices remain high, may create more generalised inflationary pressures.

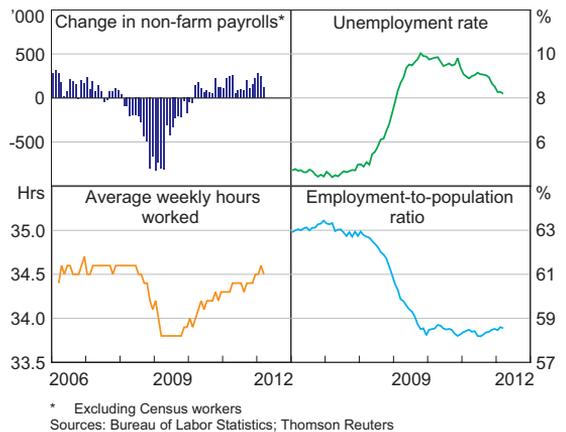
**United States**

The United States has continued to grow at a moderate pace so far in 2012. Payrolls data suggest that employment increased by an average of over 210 000 in the first three months of the year (Graph 1.12). The unemployment rate has declined by 0.8 percentage points over the past six months, although this partly reflects some decline in the participation rate; the employment-to-population ratio has increased only slightly over the same period. Average hours worked have also picked up and are around their early 2008 levels. Forward-looking indicators of employment continue to improve with initial jobless claims trending lower, despite some recent volatility, and survey measures of employment still positive. Nonetheless, employment remains well below its previous peak, and the long-term unemployment rate is still very high.

The improvements in the labour market have helped to support consumption. Household consumption increased by 2½ per cent in annualised terms over the six months to March, slightly below its long-run

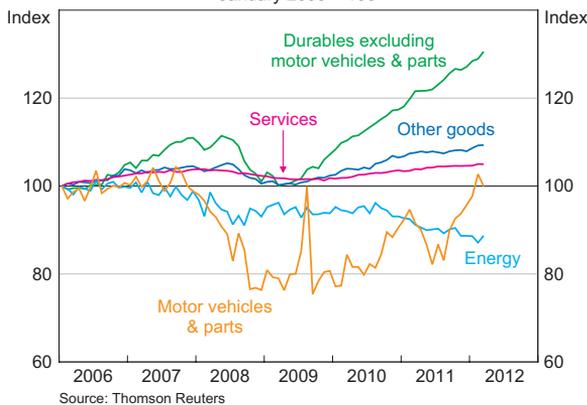
**Graph 1.12**

**United States – Labour Market Indicators**



average pace. Purchases of motor vehicles have accounted for more than one-third of this increase, reflecting a catch up from very low motor vehicle sales over the past four years and the easing of supply-chain disruptions in east Asia (Graph 1.13). Spending on other durables has been increasing at around its average pace. However, the large contraction in the budget deficit legislated for early 2013 is likely to reduce household disposable income, and the uncertainty about its size and composition may weigh on household expenditure this year and next.

**Graph 1.13**  
**United States – Real Personal Consumption**  
 January 2006 = 100



Although indicators of housing market activity have picked up a little in recent months, including some signs of stabilisation in house prices, they remain very weak. There is considerable uncertainty about the outlook for the housing market. Even though construction remains at low levels, the large number of mortgages in foreclosure will make a substantial contribution to the stock of homes for sale over the next couple of years. At the same time, the population continues to grow steadily, the labour market is improving and rents are rising, all of which will help to support demand for housing. Nonetheless, with many households still owing more on their houses than they are worth, the housing market will continue to weigh on economic activity for some time.

In contrast to the generally improving household indicators, business sector indicators have been less positive in the first few months of 2012. After increasing rapidly through the first two years of the recovery, growth in business investment appears to have slowed, with core capital goods orders only modestly higher over the six months to March. Industrial production has been broadly flat over the first few months of 2012, although the ISM manufacturing index is a little above its December level.

Consumer price inflation in the United States remains contained, with core inflation at 2 per cent over the year to March (based on personal consumption expenditure). However, headline inflation has picked up again in recent months, reflecting the flow-through of higher oil prices to petrol prices.

## Commodity Prices

The RBA's Index of Commodity Prices (in SDR terms) is broadly unchanged since the February *Statement* (Table 1.1). The index remains at a historically high level, but is around 9 per cent lower than its peak in mid 2011. In general, commodity prices have been supported by the gradual pick-up in global economic activity since the start of the year, though increases in some prices have been partially retraced over April (Graph 1.14). Spot prices for iron ore and base metals have all increased, while spot prices for both thermal and coking coal have declined in recent months, largely reflecting increased supply. Australia's terms of trade are estimated to have declined further in the March quarter, as average export prices for bulk commodities continue to decline gradually from their September 2011 peak.

Global oil prices have increased sharply over recent months. The price of Brent crude oil rose to its highest level in US dollar terms since mid 2008 but has since fallen a little (Graph 1.15). The increase in oil prices reflects, in large part, supply-side constraints, with a tightening of sanctions on the Iranian oil trade and political tensions in South Sudan, Syria and Yemen. There has been a shift towards using Brent as the

**Table 1.1: Commodity Price Growth<sup>(a)</sup>**  
SDR, per cent

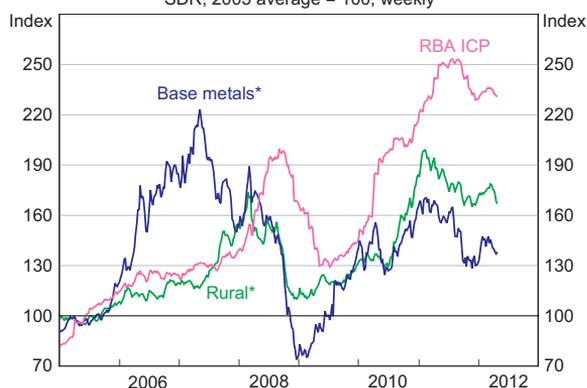
	Change since previous <i>Statement</i>	Change over the past year
Bulk commodities		
– Iron ore	1	–18
– Coking coal	–1	–31
– Thermal coal	–16	–16
Rural	–5	–9
– Beef	1	7
– Cotton	–5	–41
– Wheat	–10	–21
– Wool	–8	–13
Base metals	–6	–15
– Aluminium	–7	–22
– Copper	–2	–6
– Lead	–1	–11
– Nickel	–20	–33
– Zinc	–5	–6
Gold	–5	12
Oil <sup>(b)</sup>		
– US\$ terms	2	–4
RBA ICP	–1	–8

(a) RBA Index of Commodity Prices (ICP) components except oil and bulk commodities, which are spot prices; latest available

(b) Average of Brent and Tapis crude oil prices

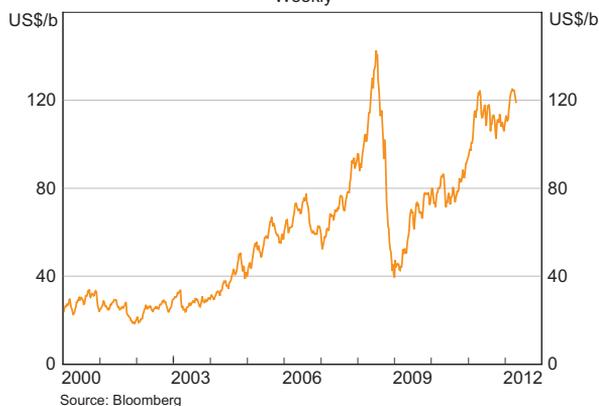
Sources: Bloomberg; RBA

**Graph 1.14**  
**Commodity Prices**  
SDR, 2005 average = 100, weekly



\* RBA Index of Commodity Prices (ICP) sub-indices  
Source: RBA

**Graph 1.15**  
**Brent Crude Oil Price**  
Weekly



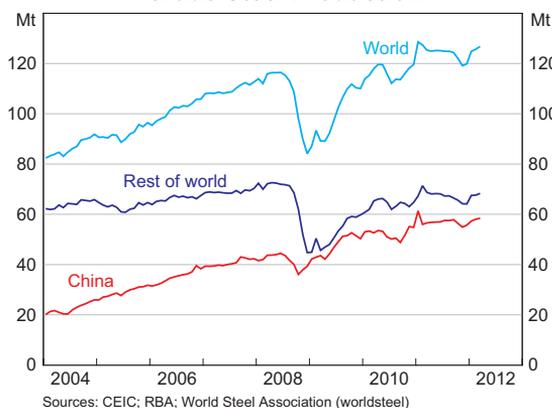
Source: Bloomberg

global benchmark for oil, with two-thirds of traded crude oil varieties now reportedly benchmarked to Brent. Other oil price benchmarks have also risen strongly over recent months.

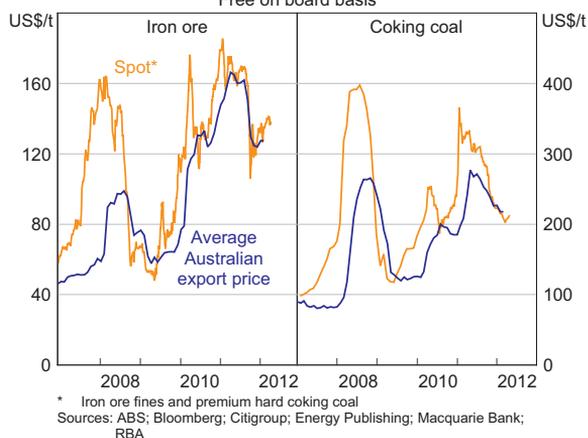
The spot price for thermal coal has fallen by around 16 per cent since the February *Statement*. The contract price for the Japanese Fiscal Year 2012 has recently been finalised by producers and Japanese utilities at around US\$115 per tonne, which is higher than the current spot price and is around 12 per cent below the previous year's contract price.

World steel production edged higher over the March quarter, with steel production in China increasing following a small drop in production in late 2011 (Graph 1.16). This, together with weather-related supply disruptions in Australia and Brazil, is likely to have provided some support to spot prices for iron ore in recent months. Since the beginning of the year, the spot price has increased by around 8 per cent but remains below the peak reached in September last year (Graph 1.17). The average Australian export price will be more closely aligned with the spot price (and less dependent on quarterly contract prices) than in previous years, reflecting the larger share of coal being sold at spot prices. Spot prices for coking coal appear to have stabilised in recent months but are around 5 per cent lower since the end of last year, which is largely the result of production in Queensland returning to around

**Graph 1.16**  
**Crude Steel Production**



**Graph 1.17**  
**Bulk Commodity Prices**  
Free on board basis



its levels prior to the flooding in early 2011. The benchmark quarterly contract price was recently settled at around US\$210 per tonne, 11 per cent below the previous quarter, which is broadly in line with the current spot price.

Base metal prices have drifted lower since February but are still higher than they were at the start of the year. Prices have generally been supported by the pick-up in global economic activity, while supply disruptions may have provided some support to the price of copper. In contrast, the aluminium spot price is currently at a level that is low enough to induce further reductions in aluminium production outside of China. The spot price of nickel has declined substantially, in part reflecting strong growth in supply. The price of gold and silver has increased over 2012 to date.

Global food prices have remained at high levels since the start of 2012. Nevertheless, they are considerably lower than the peaks in late 2010/early 2011 that were associated with supply disruptions. Recent trends among agricultural commodities have been divergent, with favourable supply conditions in the United States lowering prices for wheat, whereas canola and barley prices have risen.