

1. International Economic Developments

Growth in the global economy appears to have remained subdued in the September quarter, notwithstanding slightly better news more recently from some countries. The soft conditions over the year to date have led most forecasters – including the IMF – to again revise down their global outlook (Graph 1.1). In many advanced economies there continues to be an adverse feedback loop between private and public balance sheet consolidation and economic growth, particularly in the euro area. Despite some improvement in financial conditions in the euro area, consumer and business sentiment across the region has deteriorated further.

The problems in the euro area have affected activity and sentiment in the rest of the world. The effect on trade and activity in Asia has been increasingly evident and, combined with domestic factors in

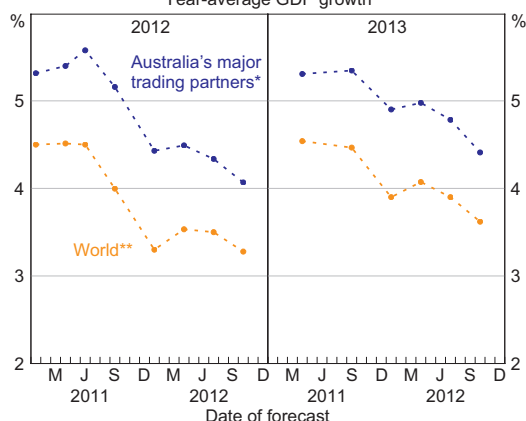
some economies, has led to downward revisions to growth in Australia’s major trading partners in recent months. While most economies are forecast to experience below-average growth in 2012 and 2013, with the contribution to growth from the faster-growing Asian economies continuing to increase, world and major trading partner growth are forecast to be only a little below their long-run averages in 2012 and around average in 2013.

In response to weaker-than-expected economic activity, many policymakers have announced additional stimulus to boost economic growth and improve financial market conditions. The European Central Bank (ECB) announced its Outright Monetary Transactions program and the US Federal Reserve and the Bank of Japan announced further quantitative easing (see the ‘International and Foreign Exchange Markets’ chapter for further details on these measures). There has been some easing of fiscal and monetary policies in China and South Korea. Other emerging market economies, such as Brazil, continue to put further stimulus in place.

Asia

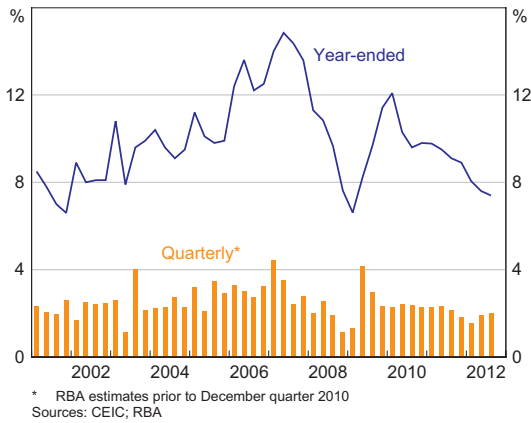
Overall, indicators suggest that economic conditions in China have improved in recent months, although growth is noticeably lower than it had been in early 2011. GDP expanded by 2.2 per cent in the September quarter, to be 7.4 per cent higher over the year, and has been supported by an easing in fiscal policy and a modest easing of monetary conditions (Graph 1.2).

Graph 1.1
IMF Forecast Revisions
Year-average GDP growth



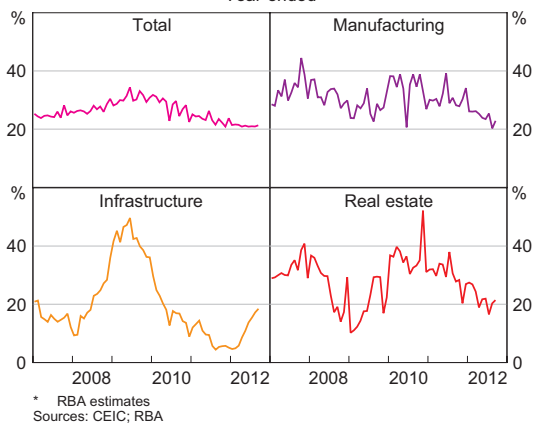
* Aggregated using Australia's export shares
** Aggregated using PPP exchange rates
Sources: ABS; IMF; RBA

Graph 1.2
China – GDP Growth



Growth in nominal fixed asset investment has stabilised during 2012 (Graph 1.3). Construction investment has been stronger in recent months despite a further slowing in residential building. Much of the acceleration in overall investment can be attributed to a pick-up in infrastructure spending. Looking ahead, the approval of a series of large transportation and utilities projects is expected to support infrastructure spending. However, the extent of new stimulus provided by these projects in the near term is unclear, as many of the announced projects have a relatively long construction phase and financing remains uncertain for some. Manufacturing investment has slowed a little during 2012 as production growth slows.

Graph 1.3
China – Growth in Nominal Investment*
Year-ended



Conditions in the real estate market have recovered modestly. Housing prices and the amount of floor space sold have generally turned up over recent months. While dwelling construction activity has remained subdued, recent trends in floor space completed suggest that the slowing in dwelling investment may have come to an end. The relative weakness in dwelling investment partly reflects the desire of developers to sell unsold stock, while administrative restrictions on house purchases continue to weigh on investor demand for property. Further, tight financing conditions for property developers have limited their ability to engage in new projects. Construction of affordable housing, however, has offset some of the weakness in private residential building. In the first three quarters of 2012, 4.8 million affordable housing units were completed. In the absence of comparable restrictions, office and commercial property construction has grown strongly, partly offsetting the weakness in residential building activity.

With recent strength in non-residential construction activity, growth in industrial production has shown signs of stabilising. The pace of growth of production of key construction materials such as cement and steel has increased slightly since the previous *Statement*. However, steel prices and production have been volatile, reflecting conditions that are specific to the steel industry (see 'Box A: China's Steel and Iron Ore Sector'). Growth in electricity production has been noticeably lower since early 2012, which may reflect the shift in the composition in industrial production, with a more protracted slowing in electricity-intensive heavy industry production occurring over the past year.

Chinese exports have continued to grow over recent months despite demand from the advanced economies – in particular the euro area – remaining soft. While there was also a softening in demand from the United States and Japan around the middle of the year, exports to these destinations have strengthened in recent months. By contrast, exports to east Asia (excluding Japan and Hong Kong)

continue to record strong growth. This has been especially the case for exports to lower-income economies in the region, where domestic demand has been relatively strong. Exports to Latin America and Africa, which now account for 10 per cent of China's exports, have also been growing at a fairly rapid pace.

Inflationary pressures in China have remained contained after easing through the first half of 2012. Consumer price inflation is currently around 2 per cent, reflecting generally lower food price inflation (Graph 1.4). However, upward pressure on food prices is likely to emerge over the coming months, with global grain prices rising due to production shortages and pork prices rising gradually after having fallen by 15 per cent since their peak in mid 2011. Non-food inflation remains muted, reflecting subdued outcomes across most non-food components, although prices have increased slightly in the past couple of months as regulated increases in electricity and fuel prices have come into effect. Upstream price pressures remain very weak, with producer prices falling further in line with softer demand and weakness in non-food commodity prices.

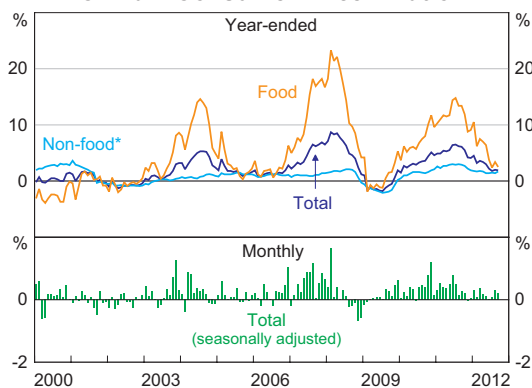
Monetary and credit conditions have been stable in recent months. Credit growth has been steady, with household credit growth rising in line with the pick-up in residential property sales and

non-household credit growth slowing marginally. The stability in overall credit growth has been accompanied by a noticeable rise in other forms of financing, especially in non-intermediated debt, mainly through the issuance of corporate bonds, as well as in non-bank loans. The People's Bank of China has not adjusted reserve requirements or benchmark interest rates since the previous *Statement*, although it has been more active in its use of open market operations to support liquidity in the banking system more generally.

Weaker demand from the advanced economies is also weighing on the other economies in east Asia (Graph 1.5). Export volumes have fallen by around 10 per cent in Japan, and by 3 per cent in the other east Asian economies over the past year, with the value of electronics and transport equipment exports especially weak. This has spilled over to weakness in industrial production, particularly in Japan where electronics production has fallen by 4 per cent over the three months to September and transport equipment has fallen by over 10 per cent, although this may have been exacerbated by the territorial dispute with China.

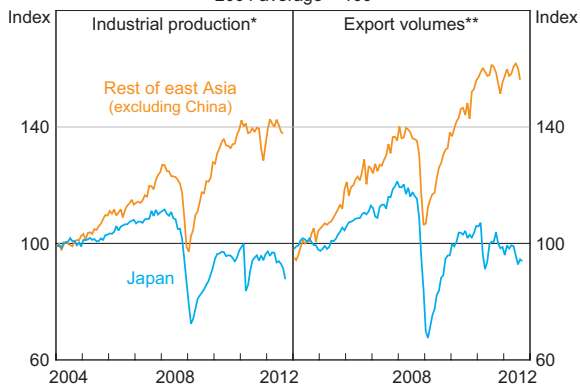
Domestic demand has also weakened a little in Japan in recent quarters. Car sales dropped significantly given the expiry of the tax incentives for purchasing fuel-efficient vehicles. The impetus to demand from

Graph 1.4
China – Consumer Price Inflation



* RBA estimates prior to January 2002
Sources: CEIC; RBA

Graph 1.5
East Asia – Production and Exports
2004 average = 100



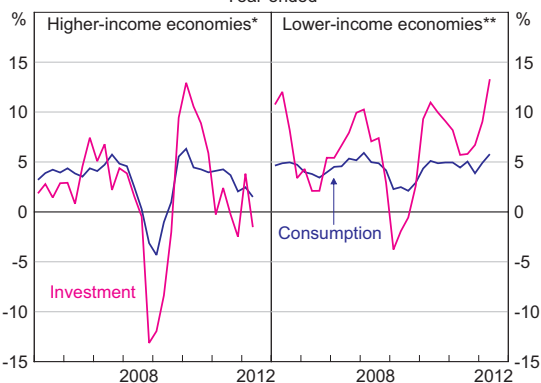
* Rest of east Asia also excludes Hong Kong and Indonesia
** Rest of east Asia also excludes Philippines
Sources: CEIC; IMF; RBA; Thomson Reuters; United Nations

reconstruction also appears to be waning; indicators of public investment, which had risen significantly over the first half of 2012, have softened recently.

Domestic demand conditions are relatively weak in the other higher-income east Asian economies but quite strong in the lower-income east Asian economies, with particularly pronounced differences in investment growth (Graph 1.6). The weakness in investment in the higher-income economies has been concentrated in South Korea and Taiwan, following a strong rebound in investment in 2010. Consumption growth has also eased, consistent with some softening in wage and employment growth. In South Korea, house price growth has slowed and the ratio of household debt to income has turned down after rising significantly over most of the past decade. The strength in investment in the lower-income economies partly reflects the larger role of government in investment spending as well as the expansion of productive capacity for commodities. Consumption in these economies continues to be supported by low unemployment rates and rising household wealth.

Inflation in east Asia has eased noticeably over the past year, and remains lower in the higher-income economies where domestic demand has been weaker.

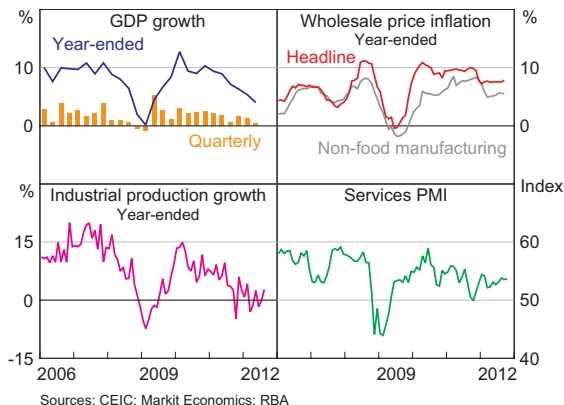
Graph 1.6
East Asia – Domestic Demand Growth
Year-ended



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

In India, GDP growth continued to slow in the June quarter (Graph 1.7). At 4 per cent over the year, GDP growth is well below the average of the past decade. Growth in both investment and household consumption has been subdued, while the depreciation of the rupee over the past year has supported growth in exports and contributed to a slowing in imports. Industrial production remains weak; production in the mining and manufacturing sectors has been flat for much of the past two years. Over that time, the production of electricity had been rising, but it has fallen significantly since June, in part reflecting the blackouts in northern India in late July. In contrast, conditions in the services sector have held up, with service exports growing strongly as a result of the weaker rupee.

Graph 1.7
India – Economic Indicators



Sources: CEIC; Markit Economics; RBA

While Indian inflation is lower than the double-digit rates recorded during 2011, wholesale price index inflation has increased a little over recent months. The depreciation of the rupee and higher oil prices have pushed up the cost of the government's subsidies for fuel. In response, fuel subsidies were reduced and fuel prices increased. Although this is not expected to raise the rate of inflation permanently, higher fuel prices may have second-round effects on inflation in the near term. With inflation remaining high despite the slowing in economic activity, the Reserve Bank of India has not lowered its policy rate further, although it has cut its cash reserve ratio by 50 basis points since the previous *Statement*.

Europe

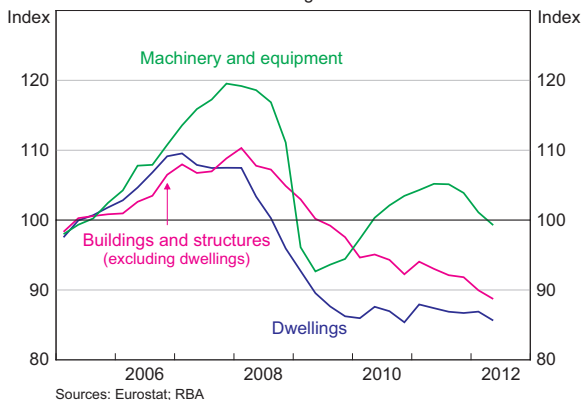
Timely indicators of activity and confidence in the euro area continue to deteriorate, despite some recent improvement in financial markets (Graph 1.8). Economic conditions remain weakest in Greece, Italy, Portugal and Spain, where activity has been contracting at average rates of up to 1½ per cent per quarter. Many of these economies continue to miss targeted reductions in their fiscal deficits and, in response, additional fiscal consolidation measures have been announced. Even the stronger economies in the region have shown signs of deterioration. The French economy has barely grown since March 2011, and there are signs that growth in the German economy is slowing further. In contrast, in the United Kingdom GDP grew in the September quarter, after contracting in the previous three quarters, although a number of one-off factors contributed to this outcome.

Graph 1.8
Euro Area – Confidence Indicators
Deviation from long-run average



Investment activity in the euro area remains very weak (Graph 1.9). Residential investment has been flat since the end of 2009 following a 20 per cent fall over the previous two years, consistent with the large correction in housing markets in a few countries. Although machinery and equipment investment had recovered somewhat from its 2009 trough, particularly in Germany, it has softened since mid 2011.

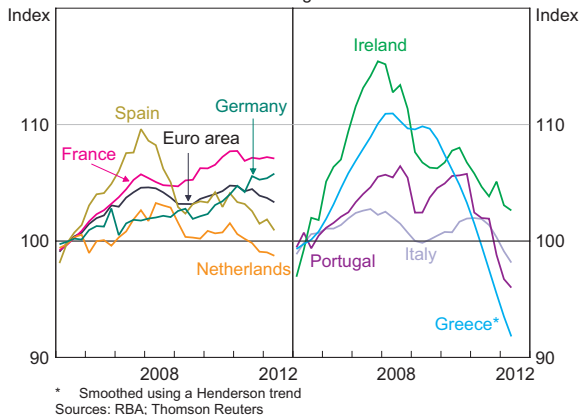
Graph 1.9
Euro Area – Investment
2005 average = 100



Consumption in the euro area has been in decline since the beginning of 2011, with indicators of consumption remaining weak into the September quarter (Graph 1.10). As with other indicators, consumption has been weakest in the crisis economies, consistent with the very low levels of consumer sentiment and high unemployment rates, which remain around 25 per cent in Greece and Spain. Reflecting its significantly stronger labour market, consumption in Germany has continued to grow.

The external sector remains the primary source of growth in the euro area. Export volumes rose by almost 4 per cent over the year to July, assisted by

Graph 1.10
Euro Area – Private Consumption
2005 average = 100



a significant real depreciation, and export values suggest that there was further growth in August. Exports from Germany continue to grow, and it appears that, with exports to China softening a little, exports of machinery and equipment to the Americas have become an important source of growth more recently. Reflecting weak domestic activity, euro area import volumes have been more subdued.

Annual headline inflation, at 2.5 per cent, is above the ECB's target, reflecting high rates of inflation in petrol and other energy prices. However, consistent with weak activity, core inflation in the euro area is much lower, at 1.5 per cent.

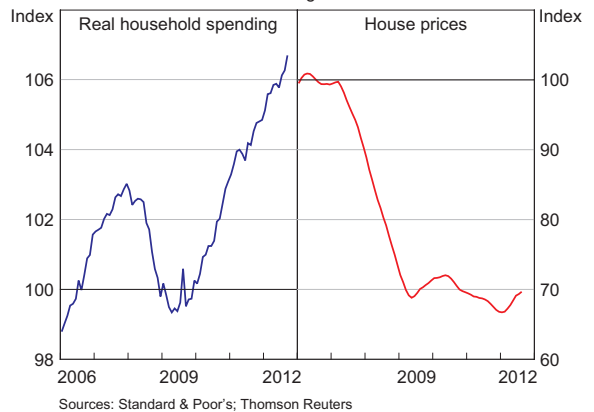
United States

The recovery in the United States has continued at a moderate pace, with GDP growing at an annualised rate of 2 per cent in the September quarter. Although indicators of activity have been a little more positive recently, including employment growth, the level of employment is still more than 3 per cent below its pre-crisis peak (Graph 1.11). The pace of growth is consistent with the more protracted recovery generally experienced after financial crises. The state of the labour market was a key reason behind the Federal Open Market Committee's

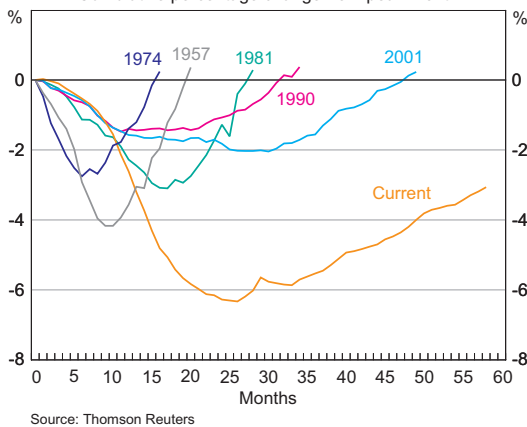
announcement of additional quantitative easing measures at its September meeting.

Household consumption growth has picked up recently after slowing through the first half of the year (Graph 1.12). Recent trends in consumption growth have largely reflected purchases of motor vehicles, which have recovered following earlier disruptions to supply chains in Asia. Purchases of other durable goods have also continued to grow at an above-trend pace. The recent turnaround in consumption growth is consistent with the improvement in employment growth and consumer sentiment over the past few months.

Graph 1.12
United States – Household Activity
 2006 average = 100

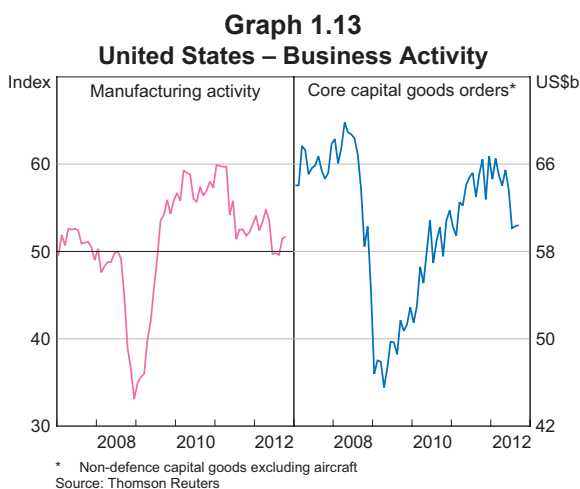


Graph 1.11
United States – Non-farm Payrolls
 Cumulative percentage change from peak month



Housing market developments have been reasonably positive and no longer appear to be weighing on growth in economic activity. House prices have risen steadily since the beginning of the year. Applications for mortgage refinancing have increased noticeably in recent months, though mortgage applications for new purchases remain at depressed levels, suggesting that households remain unwilling or unable to take on much additional debt. Builder confidence has risen to levels not seen since mid 2006, although this seems to have run somewhat ahead of housing-related activity, as indicated by the more moderate pick-up in housing starts.

Timely indicators of business activity have improved in recent months from weaker levels seen earlier in the year. Both the manufacturing and non-manufacturing ISM surveys show an improvement in conditions over September and October (Graph 1.13). Industrial production partly recovered in September from its large, hurricane-affected fall in the previous month; it is too early to tell the extent to which Hurricane Sandy in late October has affected activity. However, forward-looking indicators of investment remain weak. Core capital goods orders, which are a leading indicator of equipment and software investment, have fallen noticeably since the middle of the year and indicators of non-residential construction activity remain subdued.

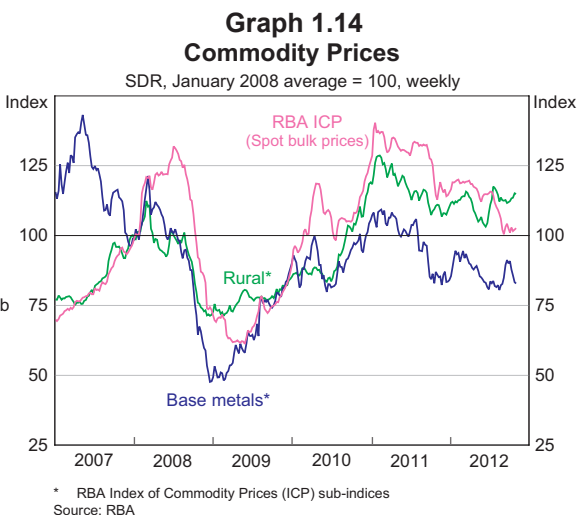


While the modest improvement in employment, consumption and the housing market bodes well for the pace of the recovery, the large fiscal consolidation legislated for the beginning of 2013 remains a significant risk (see 'Box B: Fiscal Consolidation in the United States' for a detailed discussion).

Spare capacity in the economy continues to place downward pressure on inflation. Year-ended rates of both headline and core inflation for personal consumption expenditures are below the Federal Reserve's stated 2 per cent goal. Core inflation has trended down since the beginning of the year.

Commodity Prices

Developments in global commodity markets have been mixed in recent months. The RBA Index of Commodity Prices (ICP) has fallen since the August *Statement*, as declines in prices for coking and thermal coal have only been partly offset by increases in the prices of rural commodities and gold (Graph 1.14; Table 1.1).



There has been significant volatility in the spot price of iron ore in recent months. After falling sharply over July and August, the spot price of iron ore has risen from its early September low, although it remains around 21 per cent lower than its recent peak in April (Graph 1.15). The spot price of premium hard coking coal has declined, and the benchmark contract in the December quarter has reportedly been settled at US\$170 per tonne, which is the lowest contract price settled since 2009/10. Lower prices of both iron ore and coking coal over recent months largely reflect developments in the Chinese steel sector, which is a major source of demand for both commodities (for more detail, see 'Box A: China's Steel and Iron Ore Sector'). The recent approval of infrastructure projects in China may have contributed to some of the unwinding of the sharp falls in the spot price of iron ore more recently, although the spot price of coking coal has not rebounded. The trend to

Table 1.1 Commodity Price Growth^(a)
SDR, per cent

	Change since previous Statement	Change over the past year
Bulk commodities		
– Iron ore	3	0
– Coking coal	–21	–33
– Thermal coal	–14	–29
Rural	1	4
– Beef	0	1
– Cotton	–8	–24
– Wheat	4	30
– Wool	1	–13
Base metals	2	–2
– Aluminium	1	–7
– Copper	1	1
– Lead	13	13
– Nickel	3	–12
– Zinc	0	–2
Gold	4	–1
Brent oil ^(b)	–6	–7
RBA ICP	–6	–14
– using spot prices for bulk commodities	–5	–10

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

(b) US dollar terms

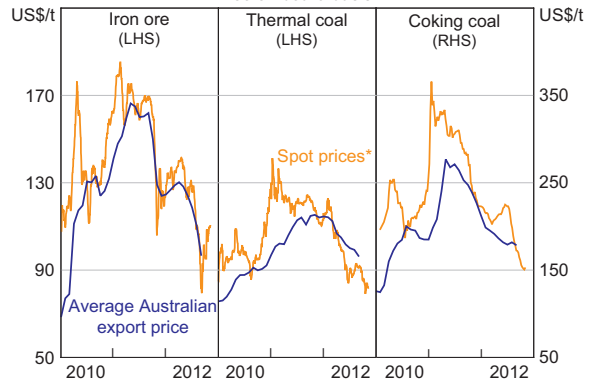
Sources: Bloomberg; RBA

shorter-term pricing arrangements in both the iron ore and coking coal markets means that recent changes in these spot markets have flowed through more quickly to prices received by producers.¹

In recent years, there has been a relatively close relationship between iron ore spot prices and base metals prices, reflecting the influence on both of Chinese demand (Graph 1.16). However, in contrast to iron ore, base metals prices were temporarily boosted by the approval of further infrastructure

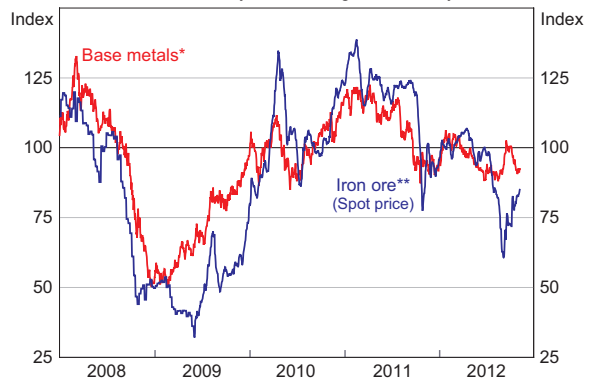
¹ See RBA (2012), 'Box B: Iron Ore Pricing', *Statement on Monetary Policy*, August, pp 15–16.

Graph 1.15
Bulk Commodity Prices
Free on board basis



* Iron ore fines, Newcastle thermal coal and premium hard coking coal
Sources: ABS; Bloomberg; Citigroup; Energy Publishing; globalCOAL; Macquarie Bank; RBA

Graph 1.16
Base Metals and Iron Ore Prices
SDR, January 2012 average = 100, daily



* RBA Index of Commodity Prices sub-index

** Iron ore fines; free on board basis
Sources: Bloomberg; RBA

projects in China and the announcement of quantitative easing in the United States, and are broadly unchanged since earlier in the year.

Energy price developments have been mixed since the August Statement. Spot prices of thermal coal – which is principally used in electricity generation – have continued to decline. In part, this reflects increased supply of thermal coal from Indonesia and Australia over the past year, but, perhaps more importantly, exports of thermal coal from North and South America have increased. There has been reduced demand for thermal coal in US electricity

generation in response to the increase in the supply, and hence reduction in the price, of natural gas in the United States. While there has been some increase in natural gas prices in the United States and high-cost American coal producers have started to cut production, the spot price for thermal coal has continued to decline. The price of Brent crude oil has drifted lower since the *August Statement*.

Prices of some rural commodities, such as wheat, soya beans and corn, have been at high levels since late June due to dry conditions in the Black Sea and US cropping regions. Recent rainfall in the United States has led to some moderation in the prices for soya beans and corn, although wheat prices remain elevated.