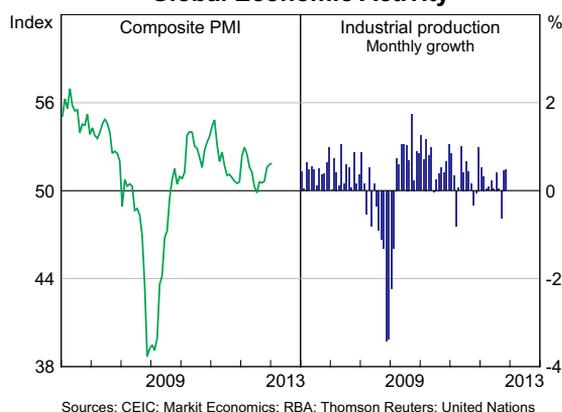


1. International Economic Developments

Global economic conditions improved a little in the last few months of 2012 (Graph 1.1). There have been further signs that the Chinese economy has stabilised, and economic activity has also shown signs of improvement elsewhere in Asia, with the notable exception of Japan. Overall, economic conditions in the advanced economies also improved a little toward the end of 2012, although growth remains subdued. Recent developments in the United States have been fairly positive, but economic activity in the euro area has continued to contract and conditions in Japan remain weak. Many commodity prices have increased, coinciding with a pick-up in the growth rate of global industrial production.

Graph 1.1
Global Economic Activity



Forecasts of global growth are broadly unchanged since the November *Statement*; after slowing to 3¼ per cent in 2012, global economic growth is expected to pick up gradually to be around 3½ per cent in 2013, before increasing to an above-average

pace in 2014. Growth is expected to remain relatively strong in the developing Asian economies. Reflecting Australia's increasing trade with these faster-growing economies, growth in Australia's major trading partners is forecast to be at, or a little above, its long-run average in each of the next two years. In most countries, inflation is well contained, and monetary policy has remained accommodative, especially so in a number of advanced economies.

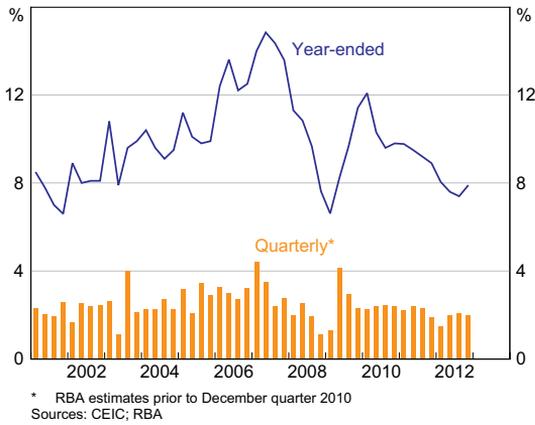
Asia

Economic conditions in China continued to improve in the second half of 2012, with GDP growing at 2.0 per cent in the December quarter to be 7.9 per cent higher over the year (Graph 1.2). The pick-up has been driven by faster growth in investment following a modest expansion in fiscal spending and improvements in the property market (Graph 1.3). Monetary conditions have generally remained accommodative.

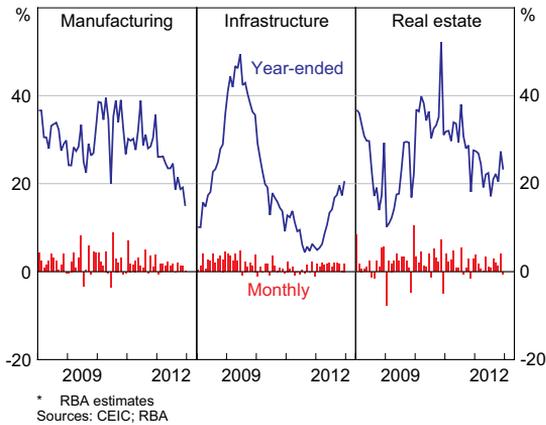
Conditions in the real estate sector have continued to recover. Residential property prices have risen at a modest pace since the trough in May 2012. The pick-up in residential sales activity has continued, with sales in the December quarter around 20 per cent higher than in the March quarter 2012, and this has supported a recovery in real estate investment. The government's affordable housing program is also providing support to activity, with a target of 4.6 million completions for 2013 following 6 million units completed in 2012.

The increase in public spending has supported a strong pick-up in infrastructure investment, including

Graph 1.2
China – GDP Growth



Graph 1.3
China – Growth in Nominal Investment*

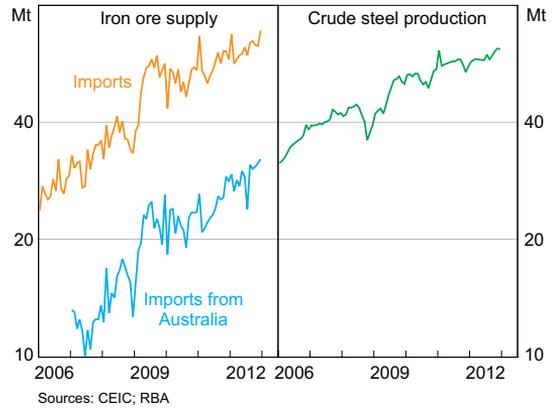


for railways between and within cities. The sizeable pipeline of projects suggests that infrastructure investment will continue to support growth in 2013. However, investment growth in the manufacturing sector has remained lower than in the past few years in line with only moderate growth in external demand.

Industrial production has been boosted by the recovery in the real estate sector and the expansion of infrastructure investment, particularly in heavy industries including steel production (Graph 1.4). This has also seen an improvement in industrial profits in late 2012. Electricity generation has recovered after a period of weak growth in mid 2012. A target of 10 per cent annual growth in industrial production has been announced for 2013, which is

consistent with the recovery currently underway, although significantly lower than the average of the past decade. Growth in imports has also accelerated somewhat alongside the pick-up in domestic demand. Iron ore and other resource imports have shown particular strength in line with the recovery in heavy industry.

Graph 1.4
China – Iron Ore Supply and Steel
Log scale



Chinese exports had been fairly subdued over the second half of 2012, but rose sharply in the month of December, partly due to some exports being pulled forward to avoid a scheduled increase in customs inspection fees at the end of 2012. Growth in exports to emerging economies has been substantially stronger than in exports to advanced economies.

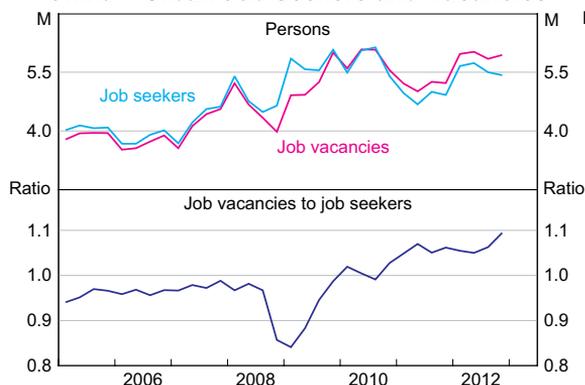
Labour market indicators for the Chinese economy suggest that the lower growth of economic activity in 2012 has not translated to a softening in labour market conditions, with the ratio of urban job vacancies to urban job seekers continuing to rise (Graph 1.5).

Inflationary pressures in China remain contained despite a noticeable pick-up in fresh food prices in recent months owing to the effects of harsh weather on supply. Producer prices have stabilised after falling substantially through most of 2012, which suggests that the inflation cycle has passed its trough.

In terms of monetary policy, the People's Bank of China has not adjusted reserve requirements

Graph 1.5

China – Urban Job Seekers and Vacancies



Sources: CEIC; RBA

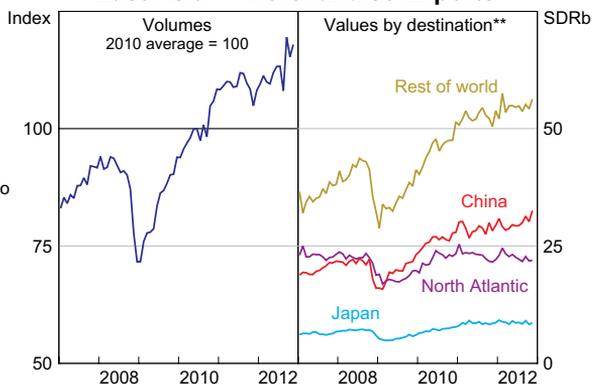
or benchmark interest rates since the previous *Statement*. There has been a modest increase in household credit growth consistent with improved conditions in the residential property market. Growth in business credit has moderated slightly, but strong growth in non-credit finance has meant that overall financing conditions in the business sector remain positive. As a result of the pick-up in non-intermediated finance – especially in off-balance sheet lending and corporate bond issuance – the government’s target for total social financing for 2012 was exceeded.

While the slowdown in the advanced economies weighed on growth in east Asia in 2012, the pick-up in activity in China appears to have supported export growth in a number of east Asian economies (Graph 1.6). Growth in industrial production increased in the region during the December quarter after easing earlier in the year. Some of that recovery has been in the electronics and transport industries, which had been particularly weak around the middle of the year.

Domestic demand conditions continue to be weaker in the higher-income economies of the region than in the lower-income economies. The difference is particularly pronounced for investment, which contracted in some higher-income economies in the second half of 2012 but continued to expand in the lower-income economies. Consumption

Graph 1.6

East Asia* – Merchandise Exports



* Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand

** North Atlantic includes the European Union and US; 'Rest of world' includes intra-regional exports

Sources: CEIC; IMF; RBA; Thomson Reuters

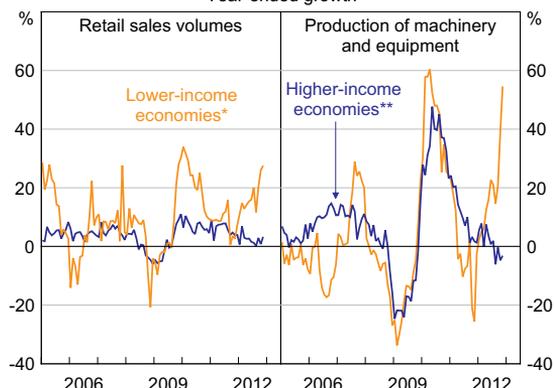
growth also slowed over the year in the higher-income economies, where growth in retail sales has been modest, consumer confidence has remained at relatively low levels, and softer employment growth appears to be weighing on income growth (Graph 1.7).

In Japan, growth has declined over the year with waning impetus from the reconstruction effort following the March 2011 earthquake (Graph 1.8). Exports also declined, with the territorial dispute with China a contributing factor to export weakness more recently. Private demand appears to have

Graph 1.7

East Asia – Domestic Activity Indicators

Year-ended growth

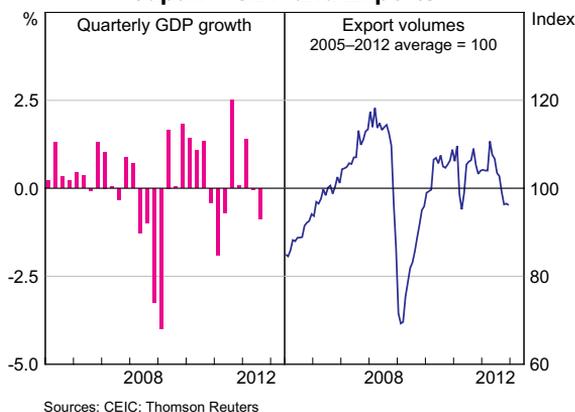


* Indonesia and Thailand for retail sales; Malaysia, Philippines and Thailand for production

** Hong Kong, Singapore, South Korea and Taiwan; excluding Hong Kong for production

Sources: CEIC; IMF; RBA

Graph 1.8
Japan – GDP and Exports



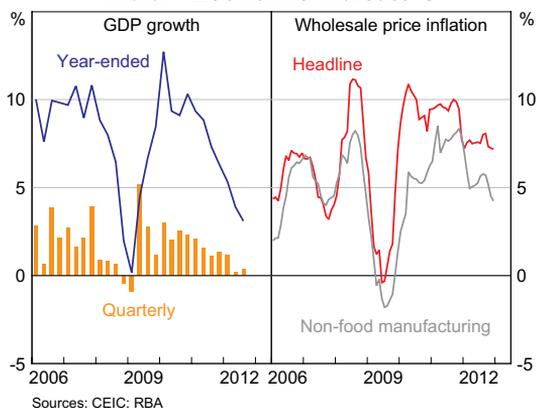
contracted further in the December quarter, with some indicators suggesting that there was no growth in consumption and a further contraction in business investment. However, the core measure of machinery orders has rebounded more recently, pointing to some improvement in investment in early 2013. Rebuilding efforts continued to support activity in some sectors in the second half of 2012 and public investment remained at a high level.

In January, the new Japanese Government announced a large supplementary budget aimed at stimulating economic growth. The package includes new expenditure on earthquake reconstruction and measures to support small businesses. The Bank of Japan also announced that it was adopting a 2 per cent inflation target and would implement some additional asset purchases from 2014 (see the 'International and Foreign Exchange Markets' chapter for more detail).

As in China, inflationary pressures in east Asia, including Japan, eased during the year. Notwithstanding this, recent cold weather is likely to see higher food prices in coming months.

In India, GDP growth slowed over the past year (Graph 1.9). The soft growth reflected ongoing weakness in investment, stagnant exports and slower household consumption growth. However, indicators point to a modest pick-up in growth in the December quarter; industrial production rose

Graph 1.9
India – Economic Indicators



over October and November, and conditions in the services sector remain relatively favourable with the services PMI pointing to continued expansion. Exports and production of iron ore are still affected by legal and environmental constraints in some states.

Wholesale price inflation in India has eased slightly over the three months to December, although inflation over the year remained high. Core (non-food manufacturing) wholesale price inflation has eased somewhat but food price inflation has remained elevated with higher rice, corn and tea prices driving an increase in food inflation in December. The slight easing of inflation provided space for the Reserve Bank of India to assist weak growth by cutting both the policy rate and the cash reserve ratio by 25 basis points at its January meeting.

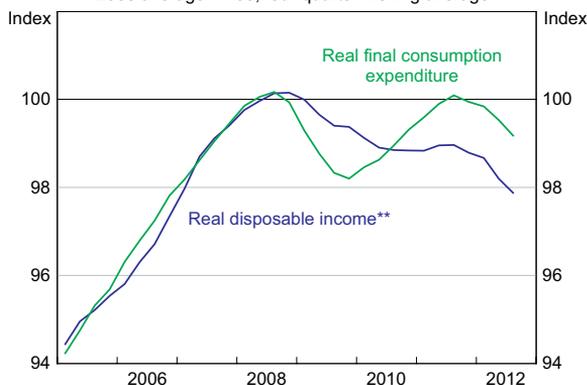
Europe

The euro area economy contracted further over 2012. Although economic conditions remain weakest in southern Europe, growth in Germany, France and other non-crisis economies has also moderated. Timely survey indicators suggest that economic activity in the December quarter remained weak. Fiscal consolidation in a number of countries is continuing to weigh on economic activity, and the underlying structural problems in several euro area economies will take time to resolve. Nonetheless,

measures taken by policymakers in the region have led to improved sentiment in financial markets and some indicators, such as survey indicators of export orders, have increased from low levels.

Consumption in the euro area has declined, in part reflecting lower real household disposable income as employment has fallen (Graph 1.10). Both retail sales and survey data suggest that consumption has remained weak in recent months. Consumer sentiment has remained below its long-term average, albeit improving in some countries more recently.

Graph 1.10
Euro Area – Household Sector
 2008 average = 100, four-quarter moving average*

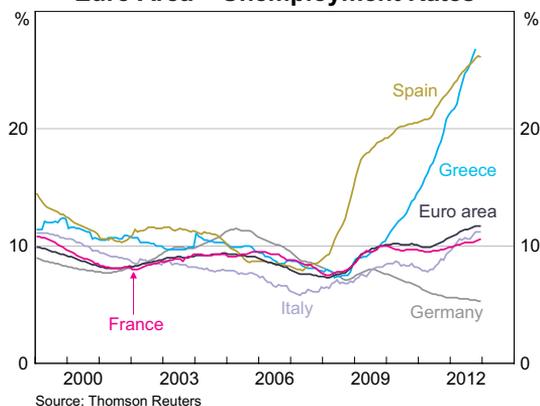


* Deflated using the final consumption expenditure deflator
 ** Gross, adjusted for the change in net equity of households and pension funds
 Sources: European Central Bank; Eurostat; RBA

Labour market conditions have continued to deteriorate in most of the euro area; employment has contracted further and the unemployment rate has increased to historically high levels, reflecting the weak domestic demand and slower growth in world trade (Graph 1.11). There are, however, substantial differences between countries; unemployment remains low in Germany, while it is very high in the crisis economies.

Euro area inflation moderated toward the end of 2012 as energy price pressures eased. In an environment of weak economic activity in the region and well-anchored long-term inflation expectations, price pressures are expected to remain subdued.

Graph 1.11
Euro Area – Unemployment Rates



United States

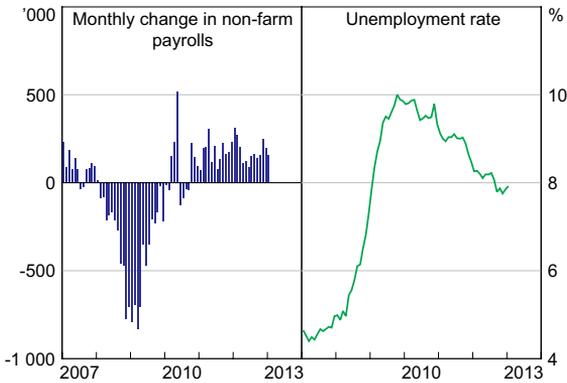
Economic conditions in the United States have generally improved in recent months. While GDP was unchanged in the December quarter, private demand grew strongly; temporary factors such as a large fall in defence spending, a run-down of inventories and Hurricane Sandy subtracted from growth in the quarter. Although private non-farm employment has increased at a slightly stronger pace over recent months, the unemployment rate has remained elevated (Graph 1.12). Furthermore, the labour force participation rate has remained near its lowest level in three decades, although this partly reflects the effects of population ageing on participation.

In December, the Federal Open Market Committee (FOMC) indicated that the highly accommodative level of interest rates would continue to be appropriate as long as the unemployment rate remained above 6½ per cent and inflation was projected to be no more than ½ percentage point above the Committee’s 2 per cent goal (see the ‘International and Foreign Exchange Markets’ chapter for more detail).

In early January, legislation was passed to avoid the full effects of the large legislated fiscal contraction known as the ‘fiscal cliff’. However, there has not been complete resolution of fiscal issues, with decisions about expenditure cuts and changes to the debt ceiling delayed for several months.

Graph 1.12

United States – Labour Market



Source: Thomson Reuters

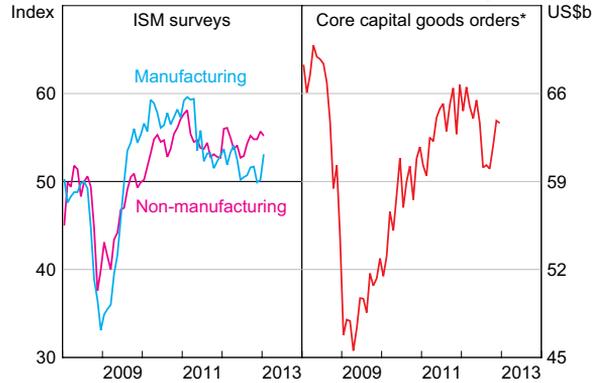
Industrial activity rebounded sharply in November and December following the disruptions caused by Hurricane Sandy in October along the US east coast. Broad indicators of factory output, such as the manufacturing and non-manufacturing ISM surveys and core capital goods orders, have improved after slowing through the middle of 2012 (Graph 1.13).

Household consumption has remained resilient and growth has picked up since the first half of 2012 (Graph 1.14). Purchases of motor vehicles and other durables have remained relatively strong. While real disposable income increased, the strong rise in the December quarter was partly due to payments being brought forward ahead of impending tax changes and growth in nominal wages remained low. The recent increase in the payroll tax rate may weigh on consumption in the months ahead. Household net worth has increased as a result of higher equity and housing values; nominal household net worth is now approaching levels seen before the financial crisis.

Conditions in the housing market have continued to improve gradually, with housing starts increasing since mid 2012 and house prices also rising (Graph 1.15). However, construction activity is still at a low level, with the stock of foreclosed and distressed homes still high and credit standards for mortgages remaining tight, particularly for borrowers with low credit ratings.

Graph 1.13

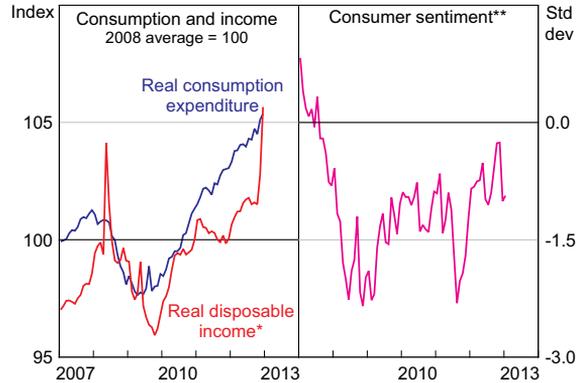
United States – Business Activity



* Non-defence capital goods orders excluding aircraft
Source: Thomson Reuters

Graph 1.14

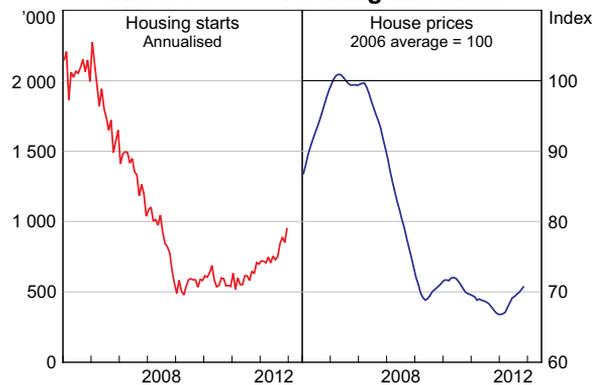
United States – Household Indicators



* After tax, before the deduction of interest payments
** Standard deviation from long-run average
Source: Thomson Reuters

Graph 1.15

United States – Housing Indicators



Sources: Standard & Poor's; Thomson Reuters

Inflation has slowed over the past six months as consumer energy costs fell, while measures of longer-run inflation expectations have remained stable. Core measures of inflation have also remained modest. In year-ended terms, both core and headline inflation remain well below the FOMC's 2 per cent goal.

Commodity Prices

Commodity prices have generally increased since the November *Statement*. The RBA Index of Commodity Prices, based on spot prices for the bulk commodities, has increased by 10 per cent in SDR terms. The rise was broadly based, with the exception of rural commodities (Table 1.1, Graph 1.16).

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

	Change since previous <i>Statement</i>	Change over the past year
Bulk commodities		
– Iron ore	31	7
– Coking coal	7	–22
– Thermal coal	14	–18
Rural	–2	1
– Beef	–1	0
– Cotton	11	–14
– Wheat	–11	15
– Wool	11	–8
Base metals	10	–2
– Aluminium	8	–4
– Copper	8	–2
– Lead	12	15
– Nickel	16	–13
– Zinc	15	3
Gold	–4	–2
Brent oil ^(b)	6	1
RBA ICP	7	–6
– using spot prices for bulk commodities	10	–4

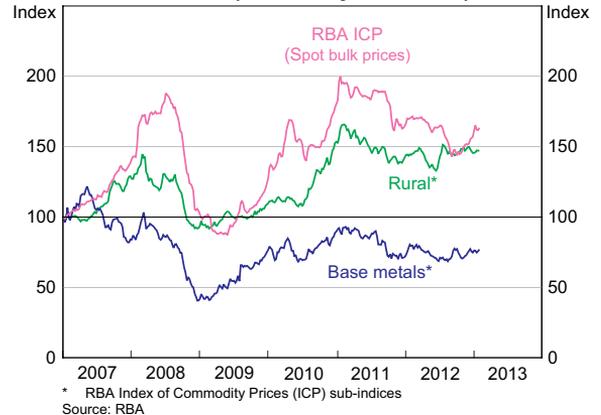
(a) Components of RBA Index of Commodity Prices (ICP), except oil and bulk commodities prices, which are spot prices; latest available

(b) US dollar terms

Sources: Bloomberg; RBA

Graph 1.16
Commodity Prices

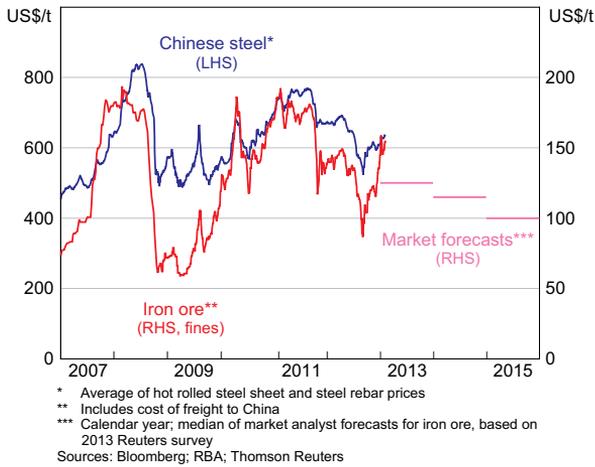
SDR, January 2007 average = 100, weekly



The spot price for iron ore continues to be volatile, and the average price in the past two months has been 25 per cent higher than the average price in the preceding two months. This increase has more than unwound the sharp falls in July and August, with the price currently around 86 per cent higher than its trough in September last year (Graph 1.17). The recent rise appears to have partly reflected an effort by Chinese iron ore users to restock inventories, which had fallen to a low level relative to steel production (Graph 1.18).¹ Chinese steel prices have also increased, consistent with some pick-up in steel demand. However, growth in steel prices has been more modest than the rise in spot prices for iron ore, suggesting that iron ore prices may not be sustained at current high levels. Indeed, most forecasters are expecting the iron ore price to drop back over 2013, to levels more in line with estimates of the marginal cost of global supply. The spot price for coking coal – which is predominantly used in steel production – has increased a little since the November *Statement*, but remains more than 20 per cent lower than a year ago. The March quarter benchmark contract price for premium hard coking coal has reportedly been settled at US\$165 per tonne, US\$5 lower than the December quarter contract.

¹ See RBA (2012), 'Box A: China's Steel and Iron Ore Sector', *Statement on Monetary Policy*, November, pp 14–16.

Graph 1.17
Chinese Steel and Iron Ore Spot Prices

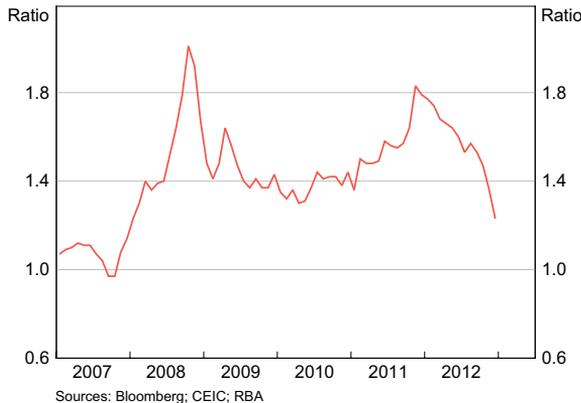


current level of the spot price for Newcastle thermal coal, however, remains lower than the existing Japanese financial year contract price of US\$115 per tonne, which is typically renegotiated in the March quarter. This is likely to lead to lower contract prices in 2013.

Base metals prices have risen in recent months in line with more encouraging signs that infrastructure and real estate investment in China is picking up and tentative signs of improvement in industrial production in other Asian economies. Despite a recent increase in aluminium prices, they remain low by historical standards, with inventories at a high level and continued growth in Chinese capacity expected to outweigh production cuts elsewhere.

Graph 1.18
Chinese Iron Ore Inventories

At ports, relative to Chinese crude steel production



Rural prices overall have remained broadly unchanged over recent months, with rising wool and cotton prices offset by falling wheat prices. Although drought conditions in the United States have persisted, wheat prices have been weighed down by expectations of increased production in Canada and China, and by India becoming a significant exporter of wheat for the first time in five years. Nevertheless, wheat prices remain high relative to their decade average. Prices of some other crops, such as soya beans and corn, have also fallen. The strengthening in wool prices unwinds the fall in the September quarter, reflecting stronger demand from China.

Energy prices have generally increased since the November *Statement*. Crude oil prices are higher and global spot prices for thermal coal have also risen, after falling over much of 2012. As discussed in 'Box A: Thermal Coal Prices', the fall in thermal coal prices in 2012 in part reflected increased coal exports from the United States as it shifted to using cheaper natural gas. The announcement of cuts to coal production in the United States, together with US natural gas prices rising since their trough in April last year, may have contributed to the stabilisation in thermal coal prices toward the end of 2012. The