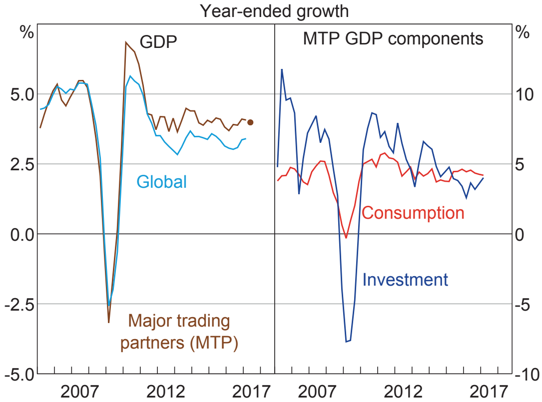
1. International Economic Developments

Global economic conditions have strengthened over the past year (Graph 1.1). Business investment growth has picked up, particularly in the advanced economies, and consumption growth has been resilient. A range of other indicators of global activity have also increased, including growth in industrial production and merchandise trade, surveyed business conditions, and consumer and business sentiment (Graph 1.2). Accommodative monetary policies and less contractionary fiscal policies have supported growth globally for a few years now.

Graph 1.1
Global Activity*
Year-ended growth

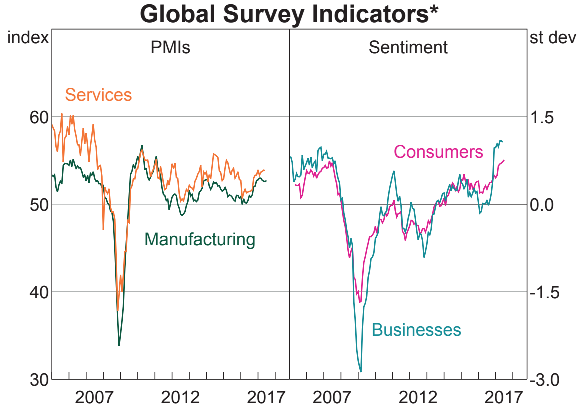


* Weighted by export shares, except for global GDP, which is PPP-weighted

Sources: CEIC Data; IMF; RBA; Thomson Reuters

By region, GDP growth has edged higher in China, while growth has been above potential in the major advanced economies. In the rest of east Asia, GDP growth has increased partly because of stronger growth in global merchandise trade (see 'Box A: The Recent Pick-up in Global Merchandise Trade').

Graph 1.2
Global Survey Indicators*



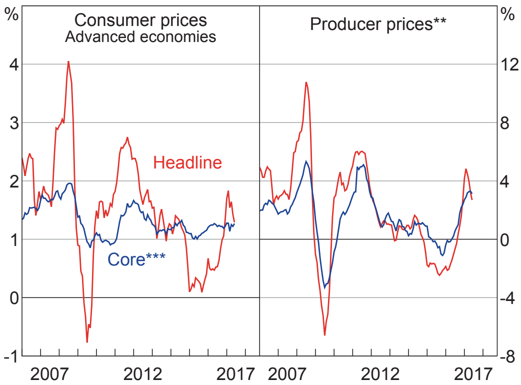
* PPP-weighted

Sources: CEIC Data; IMF; Markit Economics; RBA; Thomson Reuters

Major trading partner growth is forecast to ease slightly in 2018 and 2019. This is largely because of an expected gradual decline in Chinese growth as a result of structural factors, including the decline in the working age population, as well as policies designed to address rising debt. GDP growth in the major advanced economies is also expected to ease slightly, but remain above estimates of potential growth.

Core inflation remains low in many economies and it has declined in recent months in some large advanced economies, partly reflecting temporary idiosyncratic factors (Graph 1.3). Headline inflation has eased recently as the boost from earlier increases in oil and other commodity prices has started to dissipate. However, a range of factors should contribute to a gradual increase in underlying inflationary pressures over the next couple of years: producer price inflation has increased since late 2015; spare capacity in many advanced economies is expected to be absorbed

Graph 1.3
Global Inflation*
Year-ended



* Selected economies; PPP GDP-weighted
** Core series is an aggregate of selected advanced economies
*** Excludes food and fuel
Sources: CEIC Data; Eurostat; IMF; RBA; Thomson Reuters

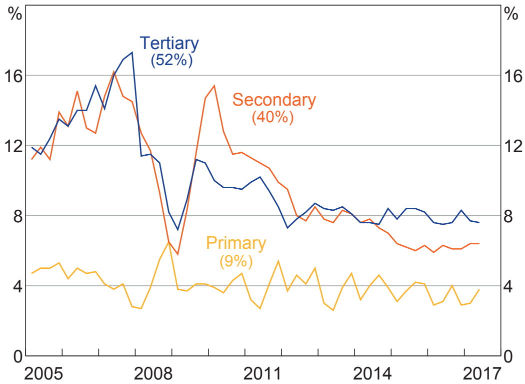
over the next year or so; and unit labour cost growth has been above average in a some large advanced economies.

China and Asia-Pacific

In China, GDP growth edged higher in the first half of 2017, supported by expansionary fiscal policy and accommodative financial conditions; this is consistent with the authorities' desire for stability ahead of the 19th National Congress of the Chinese Communist Party later in the year. The biggest driver of growth continues to be the services (tertiary) sector, although growth in the industrial (secondary) sector has also remained firm this year (Graph 1.4).

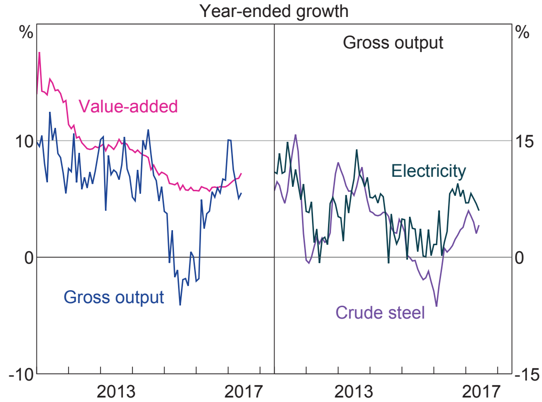
Growth in residential construction has remained strong in recent months, despite policy measures to restrain housing price inflation. Demand for consumer goods has grown strongly and the pick-up in exports has continued. Collectively, these developments have supported growth in output across a range of manufacturing industries (Graph 1.5). Ongoing growth in electricity generation has underpinned Chinese demand for thermal coal, which has been met

Graph 1.4
China – GDP Growth by Sector*
Year-ended



* Numbers in parentheses show 2016 shares of GDP
Sources: CEIC Data; RBA

Graph 1.5
China – Industrial Production
Year-ended growth



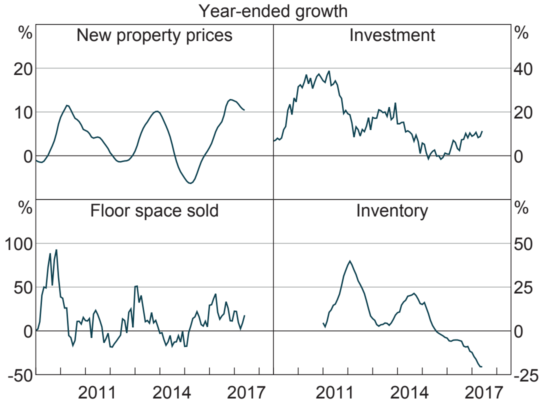
Sources: CEIC Data; RBA

largely by domestic production, following the removal of various output restrictions late last year. Crude steel demand has picked up along with strength in infrastructure and residential investment. This has supported imports of iron ore, including from Australia.

Falls in commodity prices placed downward pressure on Chinese producer price inflation over the year to June, despite a pick-up in the prices of manufactured items. Underlying consumer price inflation measures increased a little further, but remain low.

Housing price inflation remains elevated, but it has declined following the introduction of a range of policies over the past year, including restrictions on housing purchases and loan-to-value ratios (Graph 1.6). Prices have continued to increase rapidly in cities that have not tightened their local housing market policies. Floor space sold has continued to rise, albeit at a slower rate, and inventories of unsold housing have continued to fall. In recent months, some local authorities have introduced a range of new administrative controls on developer activity to slow housing price growth further.

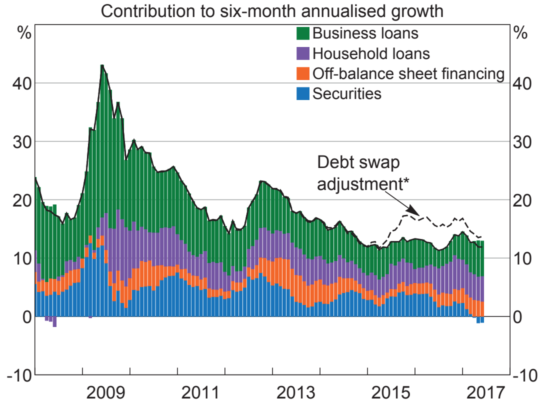
Graph 1.6
China – Residential Property Indicators
Year-ended growth



Sources: CEIC Data; RBA

Financial conditions remain accommodative, but they have tightened this year. Since the start of the year, a range of new financial market regulations have been initiated or proposed to constrain riskier forms of non-bank financing (see 'Box B: Recent Developments in Chinese Financial Regulations'). The five-yearly National Financial Work Conference, held in July, reinforced the authorities' commitment to address financial risks. The tighter regulatory stance has contributed to a fall in the issuance of securities and, in aggregate, growth in total social financing has eased over the past six months (Graph 1.7). The contribution of business loans has risen a little, possibly due to a substitution by borrowers in response to the regulations.

Graph 1.7
China – Total Social Financing
Contribution to six-month annualised growth



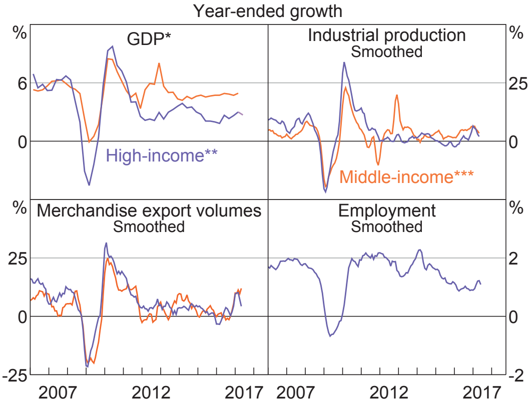
* Upper bound estimate of six-month annualised growth adjusting for impact of local government bond issuance to pay off debt previously included in TSF

Sources: CEIC Data; RBA

In the rest of east Asia, growth has been around estimates of potential in the first half of 2017, supported by the upturn in global trade (Graph 1.8). Merchandise exports and industrial production have picked up since early 2016 across the region, although growth in both has eased more recently. Core inflation has increased but remains low. Across the region, monetary and fiscal policies have been little changed in recent months and remain accommodative.

In the high-income east Asian economies, which are more exposed to trade, the pick-up in trade has started to flow into domestic activity. However, China's restrictions on Korean trade in response to geopolitical tensions have weighed on Korean service exports. Business investment growth has increased since late 2016. Although consumption growth has remained mostly subdued, timely indicators point to an increase in the period ahead; consumer confidence has increased sharply in Korea since the recent presidential election and retail sales growth has strengthened in Hong Kong. Employment

Graph 1.8
East Asia – Economic Indicators
Year-ended growth



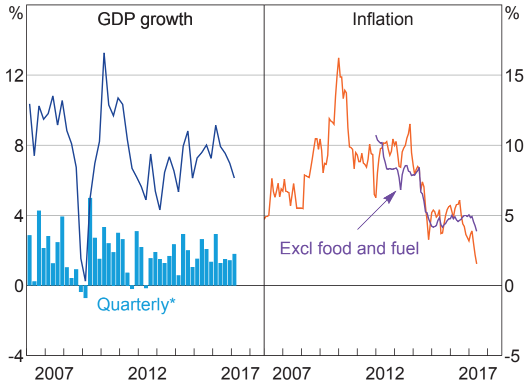
* Estimate for June quarter 2017
** Hong Kong, Singapore, South Korea and Taiwan
*** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC Data; IMF; RBA; UN

growth in most of the high-income economies has increased from multi-year lows.

In the middle-income east Asian economies, growth has been driven by strong domestic demand, particularly through investment and public consumption. Consumer confidence remained high in the June quarter, suggesting that consumption should remain strong. The improvement in global economic conditions has been associated with strong growth in merchandise exports and higher growth in visitor arrivals.

In India, economic growth has moderated over the past year to around 6 per cent (Graph 1.9). Investment growth has been weak, exacerbated by excess capacity, high corporate leverage and subdued business confidence. CPI inflation is currently well below the Reserve Bank of India's (RBI's) medium-term inflation target of 4 per cent, predominantly reflecting falling food prices, although core inflation has also eased. At its August meeting, the RBI lowered its policy rate for the first time since October 2016, having judged that some of the upside risks to inflation had abated. The RBI expects the introduction of the Goods and Services Tax in July, which

Graph 1.9
India – GDP Growth and Inflation
Year-ended

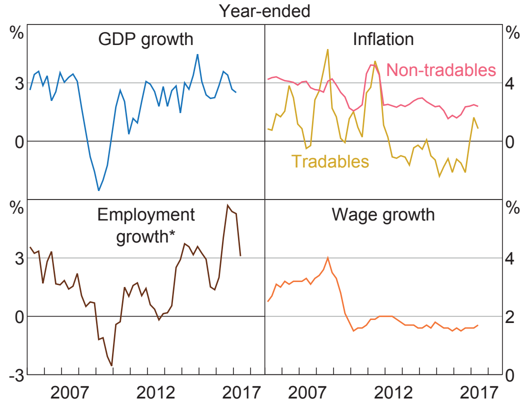


* Seasonally adjusted by RBA
Sources: CEIC Data; RBA

replaced numerous existing central and state taxes, to have little effect on inflation.

GDP growth in New Zealand is around its long-run average (Graph 1.10). Growth has been driven by domestic demand, which has been supported by record high net immigration over the past two years and accommodative monetary policy. While housing market conditions remain strong, additional regulatory measures introduced in 2016 have resulted in tighter credit conditions and contributed to an easing in residential investment growth and

Graph 1.10
New Zealand – Economic Indicators
Year-ended



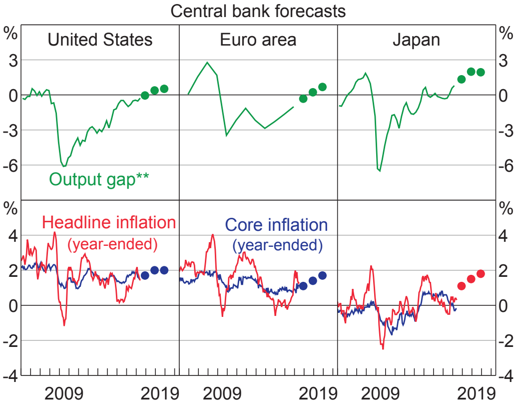
* Break adjusted by RBA
Sources: RBA; Statistics NZ; Thomson Reuters

housing price inflation. Labour market conditions have been strong, but growth in labour supply due to immigration has constrained wage growth. Headline inflation declined a little in the June quarter to the lower half of the Reserve Bank of New Zealand's target band, partly because of lower oil prices; non-tradables inflation was unchanged and remains below average.

Major Advanced Economies

GDP growth in the major advanced economies is above estimates of potential, as has been the case for a number of years now, which has led to a gradual absorption of spare capacity (Graph 1.11). Core inflation remains low across the major advanced economies and, in some instances, idiosyncratic factors have subtracted from core inflation in recent months. Headline inflation has fallen recently as the contribution from earlier increases in oil and other commodity prices has started to dissipate. Nonetheless, inflation in the major advanced economies is expected to increase as the absorption of spare capacity in these economies puts upward pressure on wages and prices.

Graph 1.11
Major Advanced Economies – Output Gaps and Inflation*
Central bank forecasts



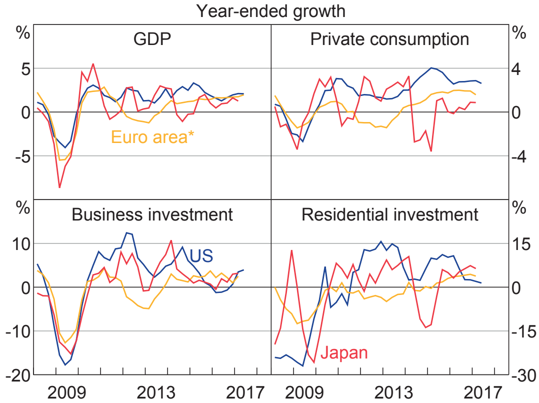
* FOMC and ECB inflation forecasts exclude food and energy; BoJ inflation forecast excludes fresh food; Japanese inflation data adjusted for the 2014 consumption tax increase

** Actual GDP relative to estimated potential GDP from CBO, EC and BoJ

Sources: BoJ; ECB; FOMC; RBA; Thomson Reuters

Year-ended GDP growth increased in the United States and euro area in the first half of 2017, and also looks to have increased in Japan. While private consumption remains the main driver of growth in the major advanced economies, business investment growth has increased since late 2016 (Graph 1.12). Residential investment growth looks to have eased in the June quarter in the United States and Japan, but to have continued at an above-average rate in the euro area.

Graph 1.12
Major Advanced Economies – GDP and Components
Year-ended growth



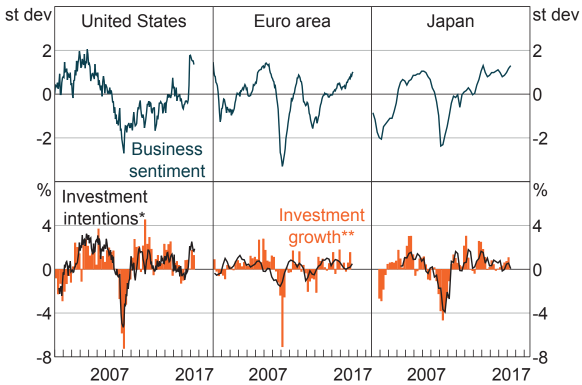
* For euro area, business investment is public and private non-residential investment; data exclude Ireland due to measurement issues

Sources: RBA; Thomson Reuters

Consumption growth picked up in the United States after the subdued March quarter outcome. Over the first half of 2017, consumption growth appears to have been around the average rate of recent years in the euro area, and above the average in Japan. The outlook for consumption growth in all three economies is being supported by strong employment growth, above-average consumer confidence and rising asset prices.

Growth in business investment has picked up since late 2016, following several years of weak growth, and has been a significant driver of GDP growth in the past couple of quarters. In the United States, where there is limited spare capacity, the revival of energy sector investment has contributed to the broader increase in business investment in 2017. Spare capacity is also low in the Japanese economy, and business investment growth has increased over the past year alongside a sizable increase in Japanese exports. Business investment growth in the euro area has also started to pick up, but remains well below its pre-crisis level. The outlook for business investment growth in the major advanced economies is being supported by increases in business confidence to multi-year highs and has been accompanied by a sustained period of growth in business credit (Graph 1.13). Investment intentions have increased and remain elevated in the United States, and there has also been a smaller pick-up in the euro area. Indicators of Japanese investment have been mixed, but point to a pick-up by early next year.

Graph 1.13
Major Advanced Economies – Investment Intentions and Business Sentiment



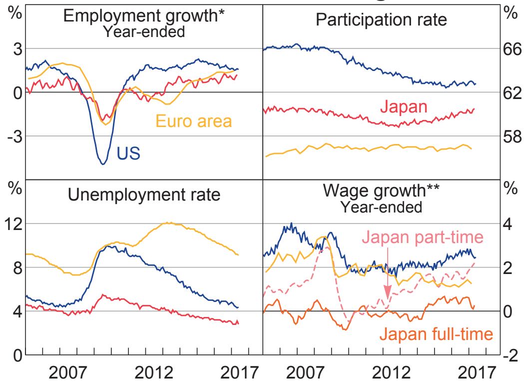
* Investment intentions mapped to national accounts investment growth

** Quarterly growth; euro area excludes Ireland due to measurement issues; smoothed for Japan

Sources: RBA; Thomson Reuters

Labour markets have improved considerably in the major advanced economies over recent years. Employment growth has been robust. Labour force participation has increased in Japan, while it has been flat in the United States (after a period of decline) and in the euro area (Graph 1.14). Participation rates of the elderly and females have been rising in Japan and

Graph 1.14
Major Advanced Economies – Labour Market and Wages



* Three-month moving average for Japan

** Employment cost index for the US; compensation per employee for the euro area; smoothed average full-time scheduled wages and part-time hourly wages for Japan

Sources: CEIC Data; Eurostat; RBA; Thomson Reuters

the euro area. In the United States and Japan, unemployment rates have declined to levels below estimates of full employment. The euro area unemployment rate has declined to its lowest rate in eight years, although it remains above estimates of full employment. The improvement in the euro area labour market has been broad based, but significant variation remains across the region; Germany and the Netherlands are around full employment, while unemployment rates are still high in countries that saw a larger increase after the financial crisis, such as Spain and Italy.

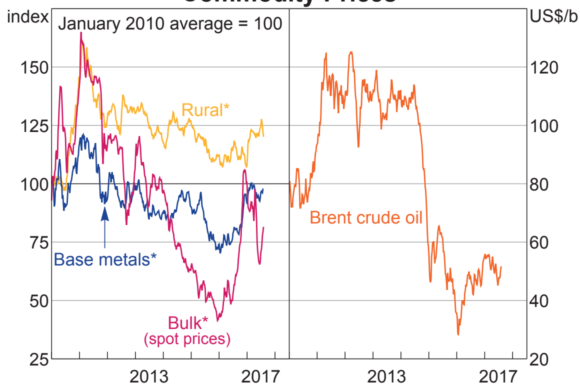
Wage growth remains relatively low in the United States, but it has picked up a little over the past few years and households expect a further small increase over the coming year. Japanese wage growth in the more flexible part-time sector has been increasing steadily since 2011 and is approaching its highest rate over the past 20 years. Despite some recent volatility, Japanese full-time wage growth has also picked up and has been positive over the past three years. Wage growth in the euro area remains low overall, although it is higher in some economies with stronger labour market conditions, such as Germany. Growth in unit labour costs, which takes into account productivity growth, has been above average over the past couple of years in a number of economies, including the United States, Japan and Germany.

In the United Kingdom, GDP growth had been more resilient than expected following the Brexit vote, supported by stronger-than-expected investment. Growth has eased more recently, however, and uncertainty around Brexit is likely to weigh on future investment. Inflation has increased sharply due to the depreciation of the British pound, and lower real wage growth is dragging on consumption. Consumer confidence has fallen this year to be a little below average.

Commodity Prices

Global commodity price movements have been varied since the previous *Statement*, reflecting a number of commodity-specific factors. The spot price of coking coal has declined, while iron ore, thermal coal and oil prices have increased (Table 1.1; Graph 1.15). Over the past year, the prices of wheat, wool and beef have risen, reflecting a range of idiosyncratic supply and demand side factors. The increase in base metal prices has coincided with the improvement in global economic conditions, although developments in supply and policy decisions in a number of other countries have also contributed. Overall, Australia's terms of trade are expected to decline over the forecast period, consistent with further increases in low-cost supply of bulk commodities (see the 'Economic Outlook' chapter).

Graph 1.15
Commodity Prices



* RBA Index of Commodity Prices (ICP) sub-indices; SDR
Sources: Bloomberg; RBA

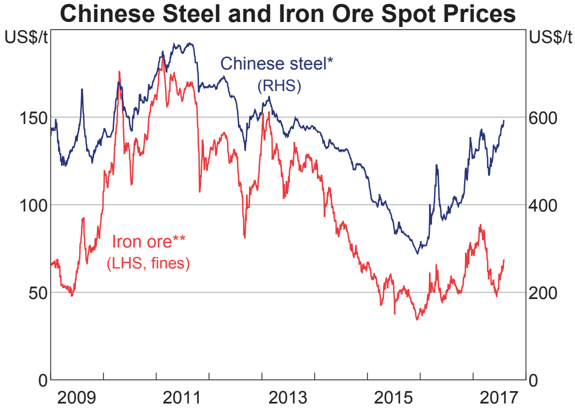
Table 1.1: Commodity Price Growth[(a)]
SDR, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	–2	32
– Iron ore	9	15
– Coking coal	–21	72
– Thermal coal	12	32
Rural	0	4
Base metals	3	21
Gold	0	–8
Brent crude oil[(b)]	9	28
RBA ICP	–8	13
– Using spot prices for bulk commodities	–1	21

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

The spot price of iron ore has increased since the previous *Statement*, alongside positive Chinese activity data and positive commentary from Chinese officials (Graph 1.16). More recently, prices have reportedly been supported by elevated Chinese steel margins, as well as more environmental inspections at Chinese iron ore mines that have disrupted production. However, the iron ore spot price remains around 25 per cent below its peak in late February; prices declined sharply in May because more of China's demand for iron ore was met by Chinese production. The iron ore spot price is still widely expected to decline over the next year or so as low-cost global supply continues to come on line and demand from China is expected to ease.

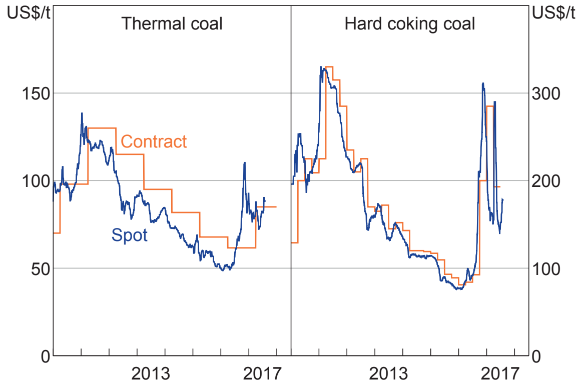
Graph 1.16
Chinese Steel and Iron Ore Spot Prices



* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; RBA

The spot price of premium hard coking coal has fallen since the previous *Statement* (Graph 1.17). This was because of a rebound in Australian exports after infrastructure was restored following damage related to Cyclone Debbie in late March. In recent weeks the spot price has rebounded, in line with the positive Chinese economic data and expectations of production cuts in China's largest coking coal region to address excess capacity. After significant delays,

Graph 1.17
Coal Prices
Free on board basis



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

the June quarter contract price was set at around US$193 per tonne, almost US$100 below the March quarter contract price.

Meanwhile, the spot price of thermal coal has increased since the previous *Statement*, following worker strikes at mines in New South Wales and supply disruptions in Indonesia. A benchmark price for the 2017 Japanese fiscal year contract was settled in May at US$85 per tonne, an increase of almost 40 per cent compared with the 2016 contract; less than a quarter of Australia's thermal coal exports are estimated to be sold on contract.

Oil prices have increased since the previous *Statement* (Graph 1.15). In late May, the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries agreed to extend the current production cap to March 2018. Declines in oil inventories in the United States and plans from some OPEC nations to limit exports have also supported prices recently. However, oil prices remain around 5 per cent lower than at the start of the year because of earlier increases in crude oil production in the United States and in some OPEC countries that are exempt from the production cap.