

1. International Economic Developments

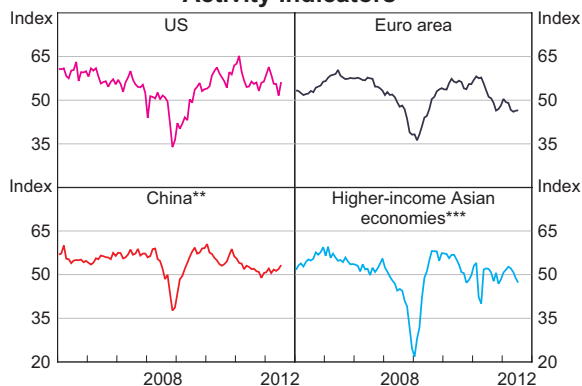
Growth in global economic activity slowed in recent months after having picked up in early 2012, as concerns about banking stability and fiscal sustainability in the euro area escalated. Indicators of economic activity deteriorated noticeably across the euro area itself in the June quarter. Growth in the United States and in Asia has also slowed in response to domestic and global factors, although in China it appears that growth has stabilised in recent months (Graph 1.1). The global outlook remains clouded by the underlying problems in Europe. Accordingly, volatility in financial markets and in economic conditions is expected to persist for some time yet, and large downside risks to the global economy remain.

Consistent with this renewed weakness in the June quarter, forecasters have generally revised down their outlook for global growth. The International Monetary Fund is now forecasting growth of 3.5 per cent in 2012

and 3.9 per cent in 2013, 0.1–0.2 percentage points lower than in April. Nonetheless, faster-growing Asian economies are helping to drive global growth. As a consequence, growth in Australia's major trading partners, which are predominantly in Asia, is forecast to be almost a percentage point above global growth in 2012 and 2013.

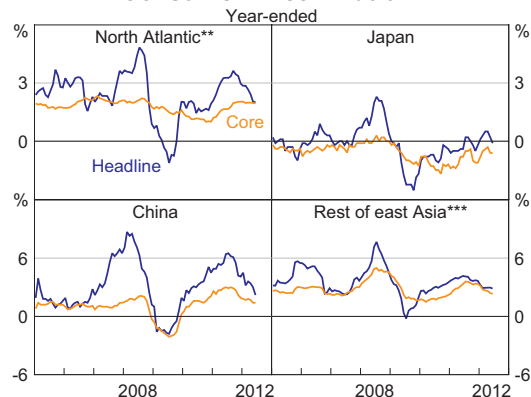
Weaker global growth has contributed to falls in many commodity prices, which have flowed through to lower CPI inflation. Weaker growth has also slowed core inflation outside the major advanced economies (Graph 1.2). The easing has been most pronounced in China, where slowing food price inflation was an important contributor. This lessening in inflation pressure has led to an easing of monetary policy in a number of economies. However, the downward trend in food prices may not continue given the recent increases in grains prices.

Graph 1.1
Activity Indicators*



* Manufacturing PMI output indices except for the euro area, Hong Kong and the US which are Composite PMI output indices
 ** Average of HSBC and NBS measures; seasonally adjusted by RBA
 *** Hong Kong, Japan, Singapore, South Korea and Taiwan; weighted by GDP at market exchange rates
 Sources: CEIC; IMF; Markit Economics; RBA

Graph 1.2
Consumer Price Inflation*

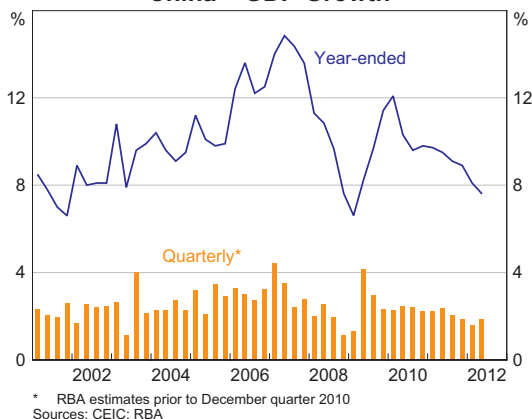


* Data are up to June 2012
 ** Canada, the euro area, UK and US; weighted by GDP at PPP exchange rates
 *** Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand; weighted by GDP at PPP exchange rates
 Sources: CEIC; IMF; RBA; Thomson Reuters

Asia

The Chinese economy has expanded at a more sustainable pace over recent quarters after slowing from the brisk growth experienced up to mid 2011. Earlier restrictive monetary policies, a normalisation of fiscal policies following the stimulus introduced during 2008 and 2009, and policies aimed at curbing speculative activity in the property market have all helped to generate a gradual slowing in the Chinese economy. In the June quarter, GDP grew by 1.8 per cent, to be 7.6 per cent higher over the year (Graph 1.3). Overall export growth has slowed somewhat, with exports to Europe notably weaker, although exports to the United States and emerging markets outside of Asia have continued to grow strongly.

Graph 1.3
China – GDP Growth



Despite the recent slowing, domestic demand continues to grow at a reasonably fast pace. There has been fairly steady growth in household consumption, supported by strong income growth and a range of incentives that encourage the purchase of more energy-efficient vehicles and household appliances. There are signs that growth in aggregate investment has steadied in recent months, with the year-ended pace of growth remaining above 20 per cent. This follows a generalised slowing over the past year, although the trends have varied across the different types of investment (Graph 1.4). The moderation in manufacturing investment had

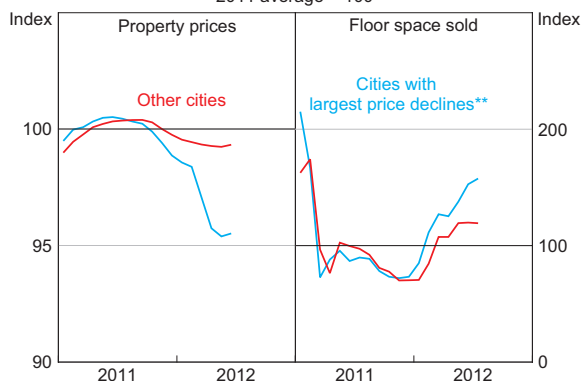
Graph 1.4



been concentrated in the more trade-exposed industries – including clothing & textiles and electrical, computers & telecommunications – while industries with a domestic focus have continued to increase investment at a rapid pace. As foreshadowed in the government’s budget in March, growth in infrastructure investment has picked up in recent months, with particular strength in utilities and water & environmental management.

Annual growth in real estate investment has slowed from over 30 per cent in mid 2011 to a little above 20 per cent in recent months. A noticeable deceleration in residential building activity has been only partly offset by the construction of office buildings and public housing. The slowing in residential building largely reflects the tighter financing conditions facing Chinese developers since the imposition of credit and property market controls. Earlier falls in prices and sales volumes restricted developers’ cash flows, while access to credit became more difficult for those not engaged in the construction of affordable housing. However, in recent months, conditions in the housing market have improved; prices rose slightly in June for the first time in a year, and sales volumes were 9 per cent above their recent trough. The strongest increases in sales volumes appear to have occurred in cities that experienced larger price falls over the past year (Graph 1.5). Furthermore, first home buyers have

Graph 1.5
China – Residential Property Market*
 2011 average = 100



* RBA estimates; property price data are up to June 2012; floor space sold data are up to July 2012

** Cities which recorded a price decline of at least 2 per cent over the year to June 2012

Sources: CEIC; RBA

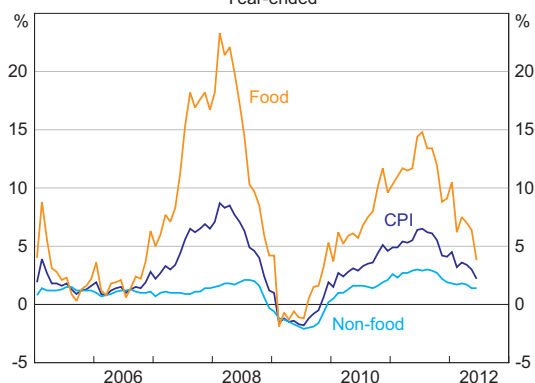
been attracted to the market with various incentives, including tax concessions and, more recently, lower mortgage rates. According to the Urban Depositor Survey conducted by the People's Bank of China (PBC), the increase in sales volumes partly reflects a shift in expectations about housing prices; compared with earlier in the year, more people expect housing prices to increase, while the share of respondents planning to buy an apartment in the next three months has risen from its recent lows.

Conditions in the industrial sector have remained broadly stable since the beginning of the year, notwithstanding recent falls in electricity generation. There has been a moderate slowing in the production of electrical machinery and equipment, consistent with softer external demand. Output of crude steel is little changed since January, with recent weakness in flat steel products broadly offsetting a pick-up in long steel products, which is partly owing to the recovery in infrastructure investment. However, falls in steel prices over recent months suggest that overall demand for steel has moderated.

Inflationary pressures have continued to ease in China. The slowing in domestic demand and lower global commodity prices have contributed to inflation falling from its peak of 6½ per cent in mid 2011 to just above 2 per cent in June (Graph 1.6).

Improved agricultural conditions, particularly in the south-east, have contributed to recent falls in vegetable prices, while pork prices have continued to trend lower. Lower commodity prices have contributed to easing inflation, including from cuts to retail diesel and petrol prices in China. Weaker housing market conditions have dampened inflation of housing costs. Although upstream price pressures generally remain very weak, the extent to which lower costs will be passed on to consumers is expected to be limited. This reflects earlier decisions not to pass on higher commodity prices in full to consumer prices.

Graph 1.6
China – Consumer Price Inflation*
 Year-ended



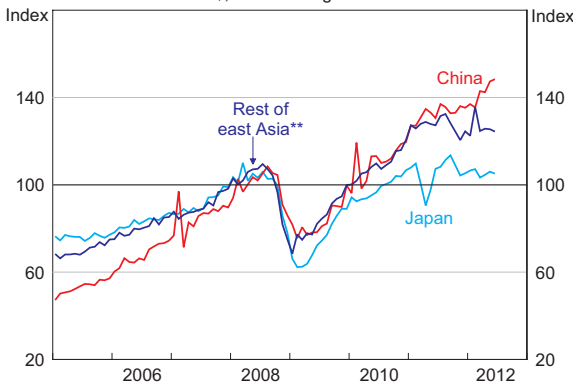
* Data are up to June 2012
 Source: CEIC

Monetary conditions have become more accommodative since the beginning of the year. Credit growth had been particularly weak in January and February, but since then policy adjustments aimed at increasing the supply of credit, including reductions in reserve requirements, have contributed to a rise in credit growth. With inflationary pressures having abated, the PBC cut benchmark interest rates in June and July, and reduced the floor on lending rates, which should support credit growth.

In the rest of east Asia, overall conditions are noticeably weaker. Industrial production has been broadly flat over the past year, and export growth has been quite weak, particularly in comparison with the rise of exports from China (Graph 1.7). The weakness

relative to China does not reflect differences in exposure to the slower growing advanced economies; in fact, exports to the United States and Europe account for a larger share of exports from China than they do for other economies in east Asia (see 'Box A: Trade Exposures to the Euro Area' for a discussion of trade linkages). Rather, this divergence may reflect a continuation of the longer-run trend for supply chains that used to be spread across much of the region to be increasingly concentrated in China and in the other lower-income economies in the region.

Graph 1.7
East Asia – Merchandise Export Values*
 US\$, 2008 average = 100



* Data are up to June 2012
 ** Excluding Hong Kong and the Philippines
 Sources: CEIC; IMF; RBA; Thomson Reuters

The pace of domestic demand growth in the higher-income economies of Asia outside of Japan has softened over the past year. Retail sales growth has slowed, consumer confidence fell in June and employment growth has eased (Graph 1.8). Indicators of investment remain weak and growth of house prices and credit have generally slowed throughout the region.

In contrast, domestic demand growth has held up in Japan. Indicators of consumption have continued to rise, with motor vehicle sales staying at a high level helped by government subsidies for fuel-efficient cars (Graph 1.9). Construction growth is also increasing, largely reflecting reconstruction spending. Housing starts in the earthquake-affected areas have picked up noticeably and public

machinery orders have trended higher in recent months. In contrast, core domestic machinery orders were noticeably lower in May and June, although it is difficult to identify to what extent this was influenced by concerns about electricity supply in the summer months. Data received to date suggest that electricity supply constraints do not appear to have weighed too heavily on activity, partly owing to the restart of two nuclear reactors in July, the reopening of unused thermal power stations and voluntary reductions of electricity usage by both households and businesses.

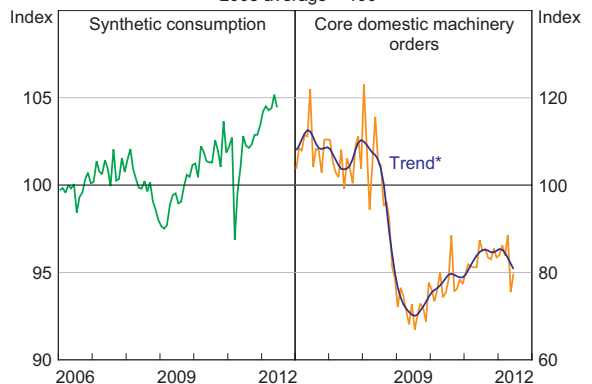
In India, GDP growth slowed to 5½ per cent over the year to the March quarter, to be well below

Graph 1.8
East Asia* – Domestic Indicators



* Excluding China and Japan
 ** Also excluding Indonesia, Malaysia, the Philippines and Thailand
 Sources: CEIC; IMF; RBA

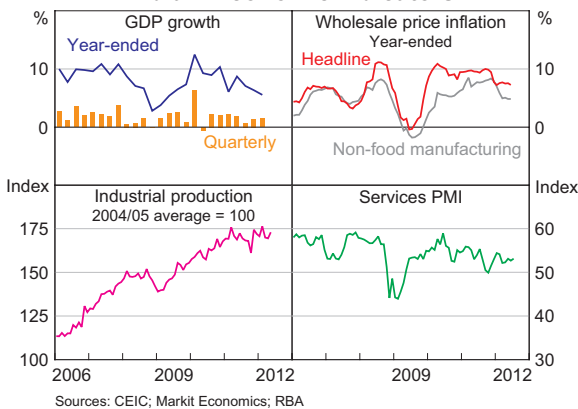
Graph 1.9
Japan – Consumption and Investment
 2008 average = 100



* 13-period Henderson trend
 Sources: RBA; Thomson Reuters

the average of the past decade, with investment continuing to shrink and household consumption growth easing (Graph 1.10). This slowdown has in part been induced by relatively tight monetary policy aimed at reducing inflation. Industrial production has been broadly flat since mid 2011, and a survey by the Reserve Bank of India (RBI) suggests that industrial conditions deteriorated significantly in the June quarter 2012. In contrast, exports have grown strongly, supported by the recent depreciation of the rupee.

Graph 1.10
India – Economic Indicators



Notwithstanding the slowing in domestic demand, inflation has remained elevated. The depreciation of the rupee has added to cost pressures and low rainfall during the current monsoon is likely to put some upward pressure on food prices. However, lower global commodity prices, particularly for oil, are likely to work in the other direction. In recent statements, the RBI has revised down its estimate of trend growth in the Indian economy citing price distortions and supply-side constraints. It has also signalled its reluctance to reduce interest rates much further given the limited extent to which inflation has responded to softer domestic demand.

Europe

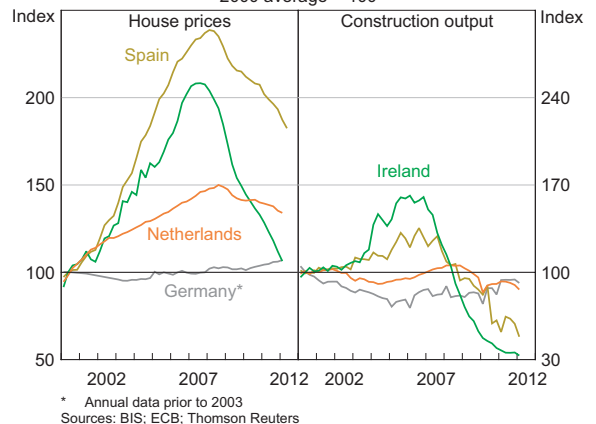
Economic conditions in the euro area worsened in the June quarter, with timely indicators of economic activity falling to levels consistent with a contraction

in GDP. The ongoing weakness in the balance sheets of banks and governments in some countries has continued to weigh on activity. Investment spending has been very weak since the onset of the global downturn in 2008, and there are no indications of a recovery in the near term.

Part of this weakness in investment reflects the ongoing adjustments in the housing market, following significant run-ups in house prices and construction in several euro area economies in the mid 2000s. Since house prices peaked in Ireland and Spain in late 2007 and early 2008, construction in these economies has more than halved, and house prices continue to decline (Graph 1.11). In contrast, house prices and construction in Germany – which did not experience a housing boom – have been rising gradually.

Consumption growth in the euro area also weakened further in recent months, as consumer confidence remained low, fiscal consolidation continued and household wealth declined (Graph 1.12). Labour markets also generally remain extremely weak. Unemployment rates have continued to increase in many economies, including in Greece and Spain where rates were already very high (Graph 1.13). In contrast, the unemployment rate in Germany is still falling, consistent with the better economic outcomes there. Outside of Germany, real wage growth is very weak. These adjustments have helped

Graph 1.11
Euro Area – Housing and Construction
2000 average = 100



Graph 1.12

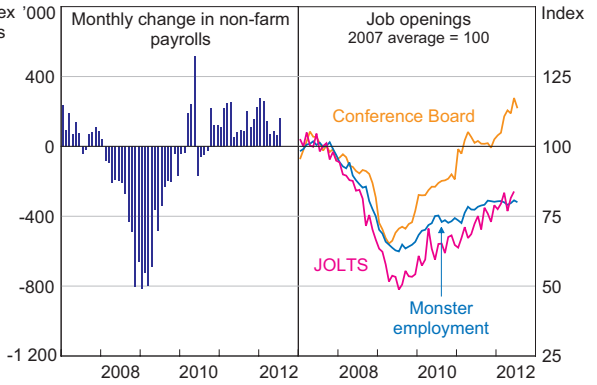
Euro Area – Household Indicators



Source: Thomson Reuters

Graph 1.14

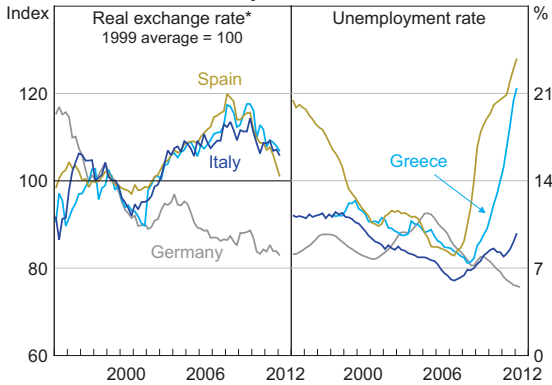
United States – Labour Market



Sources: Bureau of Labor Statistics; Conference Board; Thomson Reuters

Graph 1.13

Euro Area – Competitiveness and Labour



* Trade-weighted; deflated by unit labour costs
Sources: ECB; RBA; Thomson Reuters

to improve competitiveness over the past three years in many of the economies facing the greatest difficulties, with the euro depreciating and unit labour costs declining.

United States

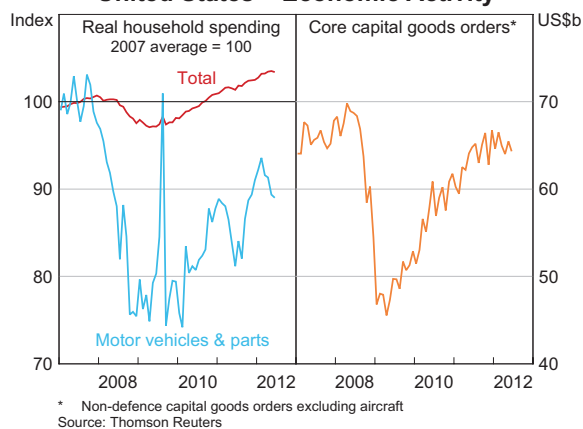
Growth in the United States slowed in the June quarter to an annualised pace of 1½ per cent, and most measures of business conditions and consumer confidence have remained at low levels in July. Employment growth has slowed noticeably, with average monthly payrolls growth of 96 000 since March, after growth of 226 000 per month in the first three months of the year (Graph 1.14). The unemployment rate has increased a little, although

the employment-to-population ratio has remained broadly flat. Other timely indicators of the labour market, such as survey measures of employment intentions, advertised job openings and initial jobless claims, have been mixed.

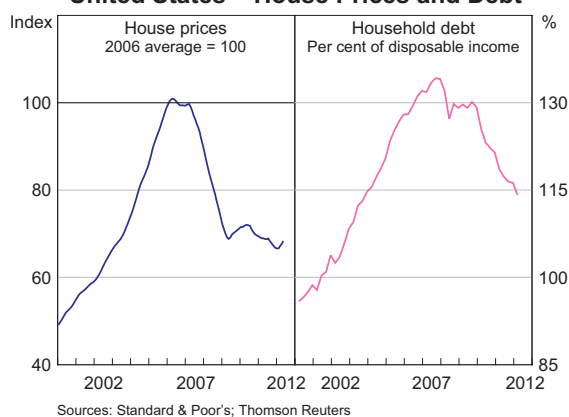
Alongside some softening in the labour market, consumption growth has slowed, largely reflecting weaker sales of motor vehicles (Graph 1.15). Consumption grew by 0.4 per cent in the June quarter, following growth of 0.6 per cent in the previous quarter. Growth in business investment also remained subdued, with core capital goods orders broadly flat since June last year, although the outlook for non-residential construction looks to have improved a little, with the Architecture Billings Index pointing to some construction growth in the remainder of 2012. Demand for commercial and industrial loans has also picked up.

The recent tentative signs of improvement in the housing market are encouraging for growth prospects in the United States. House prices have risen slightly after falling by more than 30 per cent from their peak in 2006. The debt-to-income ratio for the household sector has declined significantly in recent years, although this in part reflects the large number of mortgage foreclosures (Graph 1.16). New mortgage applications for house purchases remain at a low level despite mortgage interest rates being at their lowest level for at least 40 years, and many

Graph 1.15
United States – Economic Activity



Graph 1.16
United States – House Prices and Debt



households have negative equity in their homes (that is, their mortgages are larger than the current value of their homes). A sustained pick-up in house prices would go some way to reducing the influence of these constraining forces on household spending.

Commodity Prices

Commodity price movements have been mixed over the past three months (Table 1.1). Iron ore and coal prices have declined, consistent with a softening in global demand and rising supply. However, food prices have increased due to drought conditions in some key grain producing regions.

Energy prices have fallen since the *May Statement*. The price for Brent oil – which is increasingly being used as a global benchmark for oil, including in Australia – has decreased by 5 per cent in US dollar terms since the *May Statement* (Graph 1.17). The fall in the oil price partly reflects weaker expectations for world economic growth, somewhat offset by supply constraints, including sanctions on Iranian oil commencing in July and disruptions related to an industrial dispute in Norway. Spot prices for thermal coal have also fallen considerably in recent months, with the Newcastle spot price now back at early 2010 levels, 20 per cent below the contract price for the Japanese fiscal year 2012. The fall in thermal coal spot prices is partly attributable to the low level of the

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

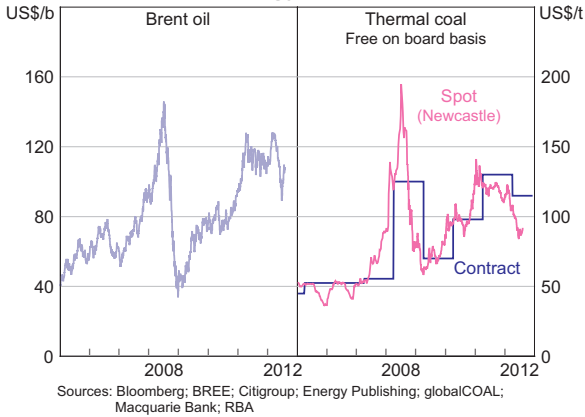
	Change since previous Statement	Change over the past year
Bulk commodities		
– Iron ore	–19	–33
– Coking coal	–8	–33
– Thermal coal	–5	–19
Rural	8	–1
– Beef	–1	9
– Cotton	–11	–20
– Wheat	45	21
– Wool	–10	–20
Base metals	–7	–12
– Aluminium	–6	–16
– Copper	–8	–9
– Lead	–8	–9
– Nickel	–7	–22
– Zinc	–5	–5
Gold	0	–1
Brent oil ^(b)	–5	9
RBA ICP	1	–9

(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

**Graph 1.17
Energy Prices**

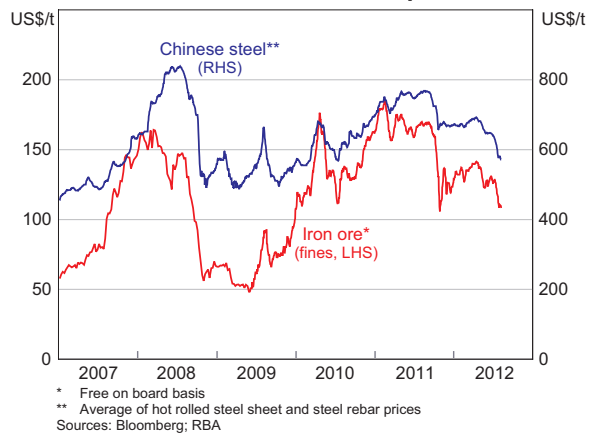


price of natural gas in the United States, the supply of which has increased significantly over recent years. As natural gas is a substitute for thermal coal in electricity generation, coal demand in the United States has declined, which has encouraged thermal coal producers in both North and South America to export to Asia, putting downward pressure on spot prices.

Global crude steel production, the major source of demand for iron ore, was broadly unchanged over the June quarter, though more timely data show Chinese steel prices and the spot price for iron ore have fallen by around 20 per cent since the *May Statement* (Graph 1.18). Over recent years, there has been a trend to shorter-term pricing arrangements in the iron ore market, so that short-term movements in iron ore prices flow through to average Australian export prices more quickly (see 'Box B: Iron Ore Pricing' for further details).

Consistent with the fall in steel prices in China, the spot price for hard coking coal has also fallen over the past month. Prior to this, prices for hard coking coal had been supported by supply disruptions in Australia, the world's largest exporter of coking coal, with industrial action at BHP Billiton Mitsubishi Alliance (BMA) mines in Queensland slowing production. In early July, BMA lifted *force majeure* on its Australian coking coal contracts as BMA and the

**Graph 1.18
Chinese Steel and Iron Ore Spot Prices**



unions have agreed on a framework to guide their ongoing negotiations. The expected recovery in coal production at the BMA mines is likely to have contributed to the recent fall in the spot price for hard coking coal.

Base metal prices, which tend to follow cycles in global industrial production, have also declined. The RBA base metals index is 7 per cent lower in SDR terms than at the time of the *May Statement*. Aluminium prices continued to fall and are at low levels relative to history, which may prompt further cuts in global production. Copper prices have also fallen, despite a decrease in copper inventories held in London Metal Exchange warehouses (See 'Box C: Recent Developments in the Global Copper Market' for more details).

In contrast, prices for some rural commodities have risen significantly. In particular, the prices of certain food commodities have increased, largely reflecting supply disruptions from the droughts in the US and Black Sea cropping regions. Prices of corn and soybeans reached record highs during July. These regions also account for around 40–50 per cent of the world's wheat exports. Wheat prices have increased by around 45 per cent in SDR terms since the *May Statement*, but to date remain well below their peak in 2008. The RBA rural index has increased by 8 per cent in SDR terms since the *May Statement*.