1. The International Environment

A durable global economic recovery has become more likely since the February *Statement on Monetary Policy*. Progress with vaccinations, additional fiscal policy support in many economies and ongoing accommodative monetary policy have improved prospects for a strong recovery this year. Even so, the outlook will remain highly uncertain and uneven for some time. GDP is expected to remain well below its pre-pandemic trajectory in many economies and labour market slack will take time to be absorbed. This is likely to keep underlying inflationary pressures contained, although the rebound in commodity and higher input prices more generally will contribute to higher inflation in the near term.

The market-implied path of expected central bank policy rates has shifted a little higher in a number of economies in response to the improved economic outlook. Central banks have responded to these developments by restating their commitment to maintain very accommodative monetary policy settings until there has been a sustainable increase in inflation that is consistent with targets, and by emphasising that this is likely to be some way off. Financial conditions in advanced economies remain very accommodative overall, despite an increase in government bond yields. Corporate bond yields remain around historically low levels, issuance conditions are favourable, and equity prices have increased further.

The global outlook has firmed up

The global economic recovery is well underway. The outlook for the US economy has picked up considerably following substantial additional fiscal stimulus, a drop in infection rates and good progress in the vaccination rollout. Ongoing strong demand for goods continues to support the recovery in China and export-oriented economies in east Asia. The prospects for recovery have mostly firmed elsewhere but ongoing activity restrictions will continue to weigh on activity in the near term in some economies and the increase in sovereign yields in advanced economies is likely to hamper the recovery of some emerging market economies.

The speed and strength of recovery have diverged across economies of late because vaccine rollouts are proceeding at different rates and control over the virus more generally has varied widely. Significant shares of the population have been vaccinated in only a few economies (Graph 1.1). While vaccine supplies are expected to increase soon in most advanced economies, they will remain limited in many emerging market economies, hampering their recoveries. In particular, India is experiencing a significant surge in cases and the near-term outlook is highly uncertain.

The GDP of Australia's major trading partners is expected to grow by around 7 per cent in 2021 and by 4½ per cent in 2022 in year-average terms (Graph 1.2). Households and firms have continued to adapt to containment measures. Stronger-than-expected outcomes in some economies in the March quarter have broadly offset the effects of tightened or extended containment measures in a number of other economies. Further out, the economic recovery in Australia's major trading partners is expected to be sustained by control of the virus through vaccinations, as well as ongoing monetary and fiscal policy support and the rebound in global trade.

Even with a strong recovery, GDP in many economies is expected to remain well below its pre-pandemic trajectory over coming years. Significant spare capacity is therefore expected to persist in these economies. Consistent with this, price pressures should remain contained for some time, with underlying measures of inflation still expected to be below central bank targets for a number of years.

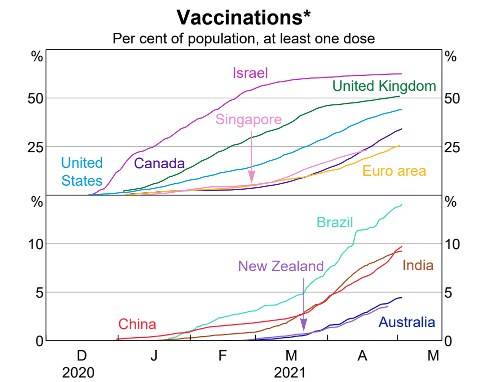
The United States is expected to recover faster and further than other large advanced economies because of its extensive fiscal support and rapid vaccination rollout. Longer-term US Government bond yields have increased as a result of the improved economic outlook. The latest US fiscal package is expected to boost GDP in the rest of the world by around ½ percentage point, with the strongest effects in economies with the largest direct trade links such as Canada and Mexico.

The outlook for the other major advanced economies has improved, although the recovery is likely to be slower than in the United States, partly because fiscal policy is less stimulatory. Good progress on vaccinations has lifted the near-term economic outlook in the United Kingdom, and a similar boost to activity is anticipated for the euro area when more of the population are vaccinated. The outlook for Japan has been bolstered by strong external demand but the recent increase in infections may temporarily slow the recovery.

The outlook in east Asia continues to be supported by two main factors: strong global demand for goods buoying export-oriented economies, and success in lowering infections in some economies in the region. Chinese GDP is expected to remain close to its pre-pandemic trajectory, with growth expected to rebalance away from the industrial sector towards services and household consumption. However, some emerging market economies in the region, including the Philippines and Thailand, are currently facing significant surges in infections and have limited vaccine supplies, which will delay their recoveries. Vaccination rollouts have been slow in many east Asian countries.

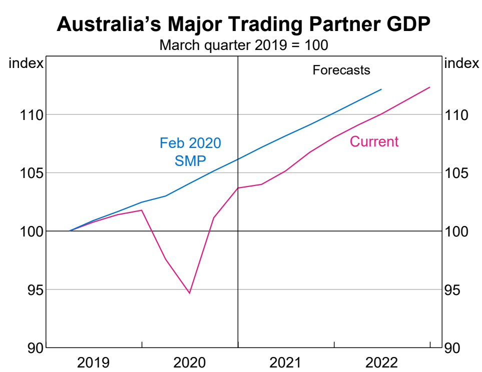
The recovery in many other emerging market economies is expected to take longer and be more variable because of limited vaccine supplies, surging infections, limited policy flexibility and tighter global financial conditions (see 'Box A: Emerging Market Vulnerabilities and Financial Conditions in Advanced Economies').

Graph 1.1



* Total doses divided by 2 for Australia and China
Sources: Our World in Data; RBA

Graph 1.2



Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

Risks to the global outlook overall have become more balanced, but significant uncertainties remain:

- The speed of vaccine rollouts will affect the speed of the recovery. Slower vaccination rates will require containment measures to fight increases in infections. Conversely, a faster rollout of effective vaccination programs will allow activity to resume more rapidly. The potential emergence and spread of vaccine-resistant COVID-19 virus variants is a key downside risk.
- The stimulatory effects of fiscal policy on activity, particularly in the United States, could be larger than expected. A stronger pick-up in US activity could increase inflationary pressures by more than expected, pushing up US bond yields and leading to a tightening in US and global financial conditions. Global supply chain pressures may also persist if the sharp rebound in demand is sustained longer than expected, which could result in higher inflation persisting for longer than expected.
- The extent of recoveries in consumption will depend on households' response to changes in income and their willingness to spend out of recent increases in wealth and the additional savings accumulated in the past year. Experience from countries where activity restrictions have eased suggests that spending bounces back quickly once consumption possibilities are restored. Reduced uncertainty, stronger wages growth and higher asset prices could also boost consumption by more than expected in the period ahead. But in countries where incomes have fallen or restrictions have persisted for an extended period, precautionary saving could remain high and slow the overall recovery.

Recent economic outcomes have varied across countries

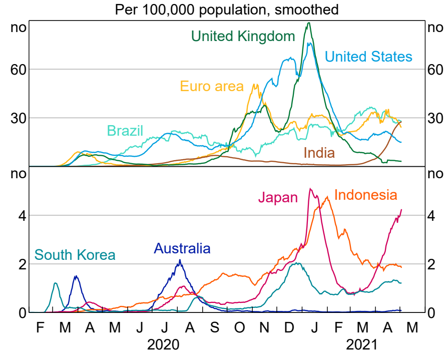
Uneven vaccination progress and differences in containment measures have contributed to divergences in activity recently. High vaccination rates have allowed a few economies, including Israel, the United Kingdom and the United States, to start easing restrictions without infections and hospitalisations increasing significantly (Graph 1.3). However, infections have increased sharply in many other countries, which has led to tighter containment measures. Infections have increased rapidly in India, accounting for more than two-fifths of the global increase in reported cases in recent weeks. Authorities in the worst-affected states have introduced restrictions on services activity to reduce the virus's spread, but healthcare systems are under strain.

March quarter activity in the United States has been boosted by the substantial direct payments to households since December. Goods consumption has remained strong and services consumption has started to recover as containment measures have been wound back. Unlike in most other economies, business investment in the United States has rebounded to above pre-pandemic levels as businesses plan for growth in domestic demand.

Graph 1.3

COVID-19 – New Cases

Per 100,000 population, smoothed



Sources: Johns Hopkins CSSE; RBA

Strong external demand for goods continued to underpin the recovery in the March quarter in China and export-oriented Asian economies. Domestic demand also picked up in the quarter in South Korea as containment measures were eased, but activity remains subdued in parts of the region where infections have been more widespread.

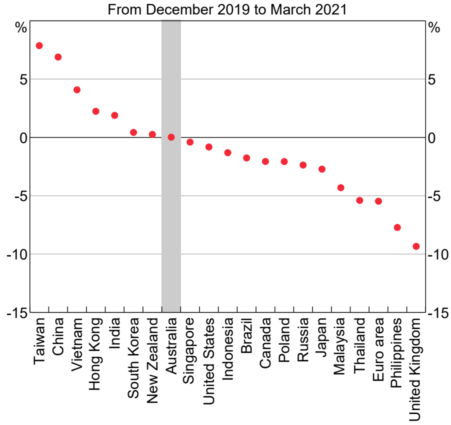
Elsewhere, the economic recovery stalled in the March quarter (Graph 1.4). Ongoing containment measures have weighed on economic activity in large parts of Europe and Japan. GDP contracted in the March quarter in the euro area, and is expected to have declined in Japan and the United Kingdom. Activity weakened in some large emerging market economies, including Brazil and South Africa, due to a rebound in infections, renewed containment measures and tighter financial conditions in these economies.

Households across many advanced economies substantially increased their savings over the past year, as the consumption of services declined and fiscal policy supported household incomes (Graph 1.5). Households have continued to save more of their income than they did prior to the pandemic, but in most economies saving ratios have declined from their peak in the June quarter last year as households have purchased more goods and restrictions on services have started to be lifted. US household savings increased strongly in the March quarter following further fiscal support for household incomes.

Graph 1.4

GDP Growth*

From December 2019 to March 2021



* Forecasts used where March quarter GDP has not yet been reported

Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

Fiscal policy is highly expansionary in the United States and remains supportive in many other economies

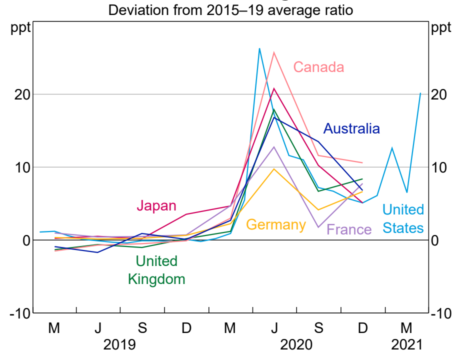
In March, the United States legislated the latest tranche of its very significant fiscal response to the pandemic, focused on further supporting household incomes. This brought the total US fiscal response to about 25 per cent of GDP, which has been by far the largest direct fiscal response to the pandemic (Graph 1.6). Fiscal policy continues to support private incomes and the health responses in a range of other countries. Canada, Germany, the United Kingdom, China and some east Asian economies have extended existing acute-phase fiscal measures and rolled out new initiatives. Some emerging economies have also provided further fiscal support but on a smaller scale.

Fiscal measures this year have generally been smaller than last year since private incomes have needed less support as economic activity has adapted somewhat to containment measures.

Graph 1.5

Household Saving Ratio

Deviation from 2015–19 average ratio



Sources: Cabinet Office Japan; RBA; Refinitiv

As a result, fiscal deficits are expected to be smaller in many economies, with the exception of some large economies like the United States and Germany. Fiscal support in many economies is also expected to begin to shift from supporting incomes during the acute phase of the downturn, towards public investment in infrastructure in the post-pandemic recovery.

Further broad-based fiscal packages involving multi-year spending and tax measures are being pursued in the United States. These include initiatives for infrastructure investment (equivalent to 9 per cent of GDP) and social initiatives (equivalent to 10 per cent of GDP) that will largely be funded over time by increased taxes on corporations and higher-income individuals (Graph 1.7). These packages should further boost US activity and inflationary pressures, although the effects may be drawn out. Over time, the infrastructure spending will expand the capacity of the US economy and some of the social initiatives may increase labour supply, which would dampen inflationary pressures in the future.

A few other economies have also unveiled further measures to support their post-pandemic recovery. Canada plans to boost childcare and 'green' projects. Most EU member states announced detailed plans for the EU Recovery and Resilience facility, to be used for infrastructure, 'green' investment and digitisation over the next 5 years.

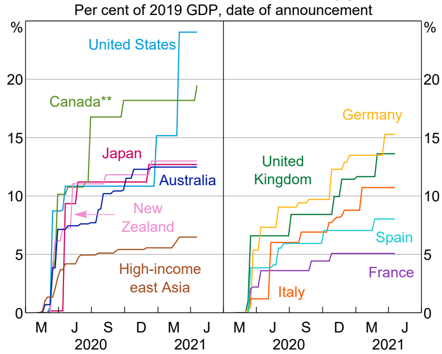
The global recovery has been concentrated in goods demand, which has boosted trade in Asia …

Global goods trade has recovered very quickly, driven by strong durable consumer goods imports in advanced economies as households have substituted away from services consumption during the pandemic. This has supported activity in economies with significant manufacturing and goods exporting sectors, including in Asia and parts of Europe (Graph 1.8). Exports from Asia have surged by 23 per cent since the pandemic started, while global exports are just a little above pre-pandemic levels. The sharp rebound in trade and its unevenness has strained global supply chains (see 'Box B: Supply Chains during the COVID-19 Pandemic'). Supply disruptions have contributed to some upward price pressures in select areas; these are expected to be temporary and ease once bottlenecks are alleviated. Supply shortages of key components have also disrupted some

Graph 1.6

Acute Phase Direct Fiscal Support*

Per cent of 2019 GDP, date of announcement



* Includes state government stimulus for Australia, Canada and Germany; excludes loan guarantees, unallocated funds, public investment and consumption incentives

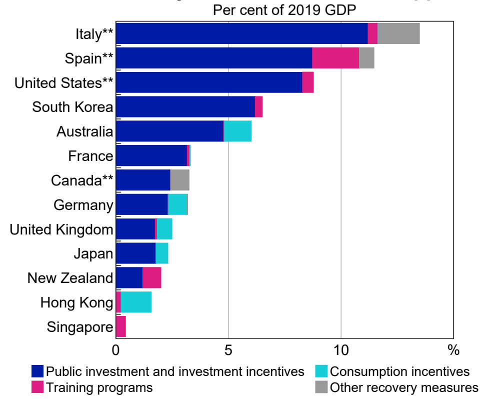
** April 2021 increase is not yet approved

Sources: IMF; national sources; RBA; Refinitiv

Graph 1.7

Recovery Phase Direct Fiscal Support*

Per cent of 2019 GDP



* Fiscal measures aimed for the recovery phase, i.e. after the pandemic has passed; includes state governments for Australia, Canada and Germany; includes EU Recovery and Resilience Facility funds for EU countries where spending plans are available; expected to be spent over multiple years

** Proposed support not yet approved

Sources: IMF; national sources; RBA; Refinitiv

Table 1.1: Commodity Price Changes[a]

Per cent

	Since previous *Statement*	Since start of year
Bulk commodities	8	16
– Iron ore	16	18
– Coking coal	–27	9
– Thermal coal	5	10
Rural	5	11
Base metals	19	21
Gold	0	–5
Brent crude oil[b]	17	34
RBA Index of Commodity Prices (ICP)	8	10
– Using spot prices for bulk commodities	8	13

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices

(b) In US dollars

Sources: Bloomberg; IHS; RBA

upstream production. For example, semiconductor shortages have hampered production in a wide variety of sectors, leading to production delays and temporary closures of motor vehicle assembly lines.

… and the recovery continues to support commodity prices

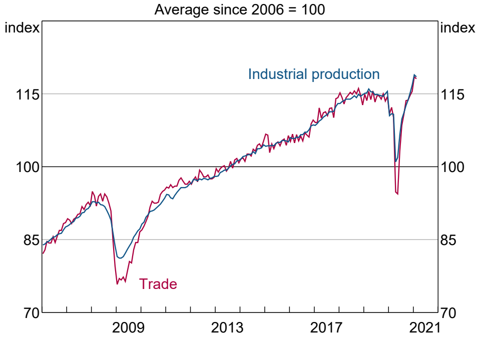
The global economic recovery and ongoing strength in Chinese steel production have continued to support the prices of a number of Australia's key commodity exports. Iron ore, thermal coal and oil prices have all increased further since the previous *Statement*, while a number of other commodity prices are also higher (Table 1.1).

The benchmark iron ore price has increased by 16 per cent since the previous *Statement* to be at its highest level in a decade (Graph 1.9). Demand for iron ore has been supported by the continued strength in Chinese steel production, and steel mills continue to build iron ore inventories while profit margins are elevated. Chinese authorities have signalled a desire to keep steel output in 2021 capped at or below 2020 levels, which may put downward pressure on iron ore prices in the second half of this year. Steel mills in some steel-producing cities in China have been instructed to lower production for the remainder of the year to reduce emissions. On the supply side, recent cyclone activity has reduced iron ore production in Western Australia, while market expectations for Brazilian exports for the remainder of this year have been revised down following recent lower-than-expected production.

Graph 1.8

Global Goods Trade and Production

Average since 2006 = 100



Sources: RBA; Refinitiv

The Newcastle thermal coal spot price has increased to be 10 per cent higher since the start of the year. The price has been supported by a recovery in global demand and supply disruptions from weather-related damage to coal transport infrastructure in New South Wales. Meanwhile, coking coal prices have decreased since the previous *Statement* and remain at a significant discount relative to domestic Chinese prices, in part because of the ongoing uncertainty surrounding Chinese demand for Australian coal.

The price of Brent crude oil has increased further since the previous *Statement* (Graph 1.10). OPEC+ members recently agreed to gradually increase output over the coming months amid a more positive outlook for global demand. The increase in oil prices over recent quarters will also support the price of Liquefied Natural Gas (LNG) received by Australian exporters, which is contractually linked to the price of oil with a lag. The prices of some base metals, notably aluminium and copper, have increased strongly in recent months, supported by the continued recovery in global industrial production.

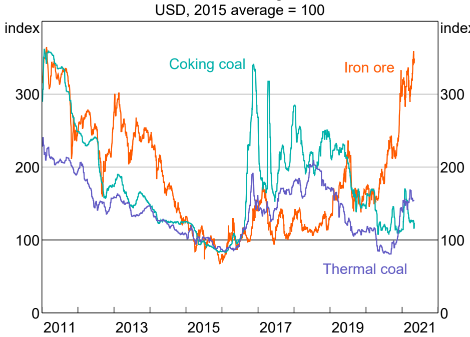
Chinese economic activity moderated in the March quarter, but remains around its pre-pandemic trajectory

China has experienced one of the strongest economic recoveries globally. However, renewed outbreaks of COVID-19 temporarily weighed on growth in parts of the economy in the March quarter. Household consumption growth moderated, at least partly as a result of travel restrictions over Chinese New Year in the north and east (Graph 1.11). Household expenditure on services, such as entertainment, tourism and transport, fell in the March quarter even as demand for goods continued to rise. The weakness appears to have been concentrated in January, and retail sales increased in February and March as the restrictions were eased, particularly for eating out.

Industrial production continued to grow strongly over the first quarter as many workers remained in cities over the Chinese New Year holiday period. Similar to other economies in the region, industrial production has been supported by strong global demand for goods. Investment in infrastructure and real estate also continued to grow. These factors have supported an increase in steel production and demand for iron ore imports, including from Australian producers who are the largest

Graph 1.9

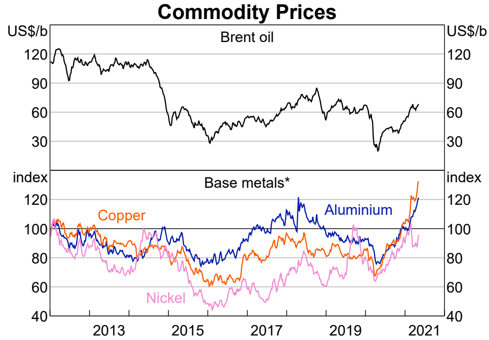
Bulk Commodity Prices



Sources: Bloomberg; IHS Markit; RBA

Graph 1.10

Commodity Prices



* SDR; January 2012 = 100

Sources: Bloomberg; RBA

suppliers to China (Graph 1.12). While GDP growth is expected to be strong over the remainder of this year, steel production growth is likely to slow as emissions policies and other factors encourage a shift away from heavy industry towards services.

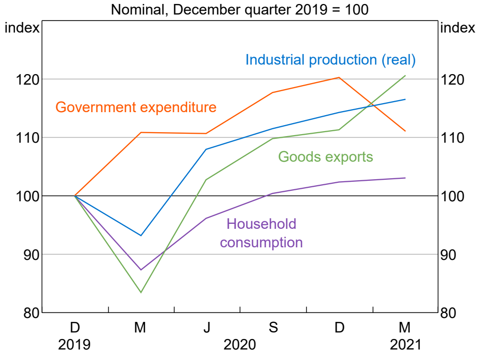
Fiscal and monetary policies remain accommodative in China but authorities are alert to financial risks

Policymakers in China have indicated that the moderately accommodative macroeconomic policy settings currently in place remain appropriate. This was reflected in the annual budget released in March, which projected only a small fiscal consolidation in 2021. The authorities have also said that any withdrawal of monetary stimulus will be gradual. In particular, support for smaller firms will continue for some time. At the same time, the authorities have emphasised that reducing risks in the financial system remains a priority. Policymakers have set a target of keeping overall debt levels in the economy stable relative to GDP in 2021, following notably higher growth in debt last year.

Graph 1.11

China – Activity Indicators*

Nominal, December quarter 2019 = 100



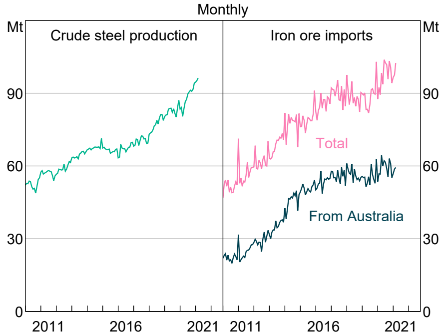
* Seasonally adjusted by the RBA

Sources: CEIC Data; RBA

Graph 1.12

China – Steel Production and Iron Ore Imports*

Monthly



* Seasonally adjusted by the RBA

Sources: CEIC Data; RBA

Chinese financial conditions remain broadly accommodative, which is consistent with policy-makers' stated desire for policy stability in 2021. In contrast to developments in other emerging markets, financial conditions in China have been little affected by the rise in sovereign bond yields in advanced economies. Chinese government and corporate bond yields have been broadly stable around pre-pandemic levels in recent months (Graph 1.13). Bank lending conditions also remain favourable: interest rates on business loans remain low, and lending to businesses and households grew strongly in the first quarter of this year despite the implementation of new regulations to limit the flow of credit to the property sector. This has contributed to growth in total social financing slightly outpacing growth in nominal GDP in the first quarter of the year (Graph 1.14). On the other hand, Chinese equity prices have declined sharply since mid February following comments from regulators warning investors of asset bubbles. Conditions have also tightened modestly for Chinese corporations that issue US dollar bonds offshore in the past month, as concerns have risen that a large finance firm (which is majority owned by the Chinese state) might default on its debt in that market.

The Chinese renminbi has been little changed against the US dollar over recent months and remains close to its recent highs (Graph 1.15). This has occurred despite the interest rate differential between government bonds in

China and those in the United States having declined and foreign inflows to Chinese bond markets easing. Authorities have recently noted potential risks associated with rising yields in advanced economies and the possibility of large capital outflows. However, they also highlighted that risks to domestic markets are low and they will continue to proceed with a gradual opening up of capital flows.

India is experiencing a new wave of infections and activity will decline over the near term

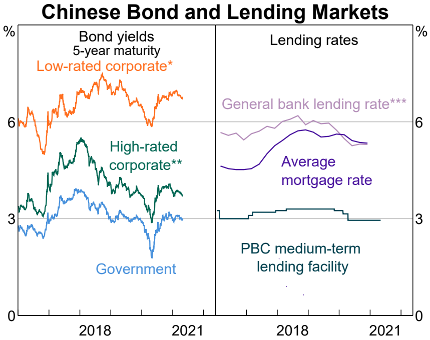
India is experiencing a rapid increase in COVID-19 cases. In the worst-affected states, authorities have imposed curfews and partial lockdowns. The measures introduced to date are less restrictive than the measures imposed in early 2020, which is evident in a smaller decline in mobility measures (Graph 1.16). At this stage, the restrictions are targeted at curbing service-sector activity in hospitality, tourism and transportation, with manufacturing and construction activity less affected. Activity is expected to decline in the June quarter. In response to the worsening health situation, the Reserve Bank of India has announced a number of policy measures to help support financial conditions, including a commitment to purchase a set quantity of government bonds and incentives for financial institutions to provide credit to small businesses. Over the medium term, the government's commitment to raise infrastructure investment and continued urbanisation should support Indian economic growth and demand for commodities.

Significant labour market slack remains and will take some time to be absorbed

Significant spare capacity remains in labour markets in advanced economies despite the rebound in employment over recent quarters. Employment-to-population and participation rates remain well below pre-pandemic levels and unemployment rates are elevated in most

Graph 1.13

Chinese Bond and Lending Markets

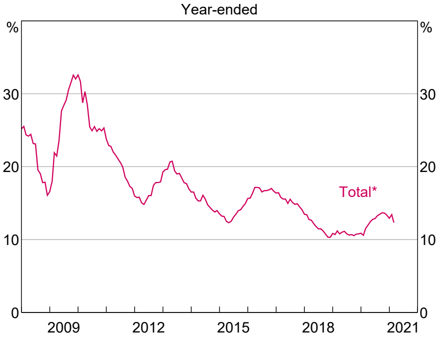


* Based on domestically rated AA- corporate bonds
** Based on domestically rated AAA corporate bonds
*** Business rate proxy
Sources: Bloomberg; CEIC data; RBA

Graph 1.14

China – Total Social Financing Growth

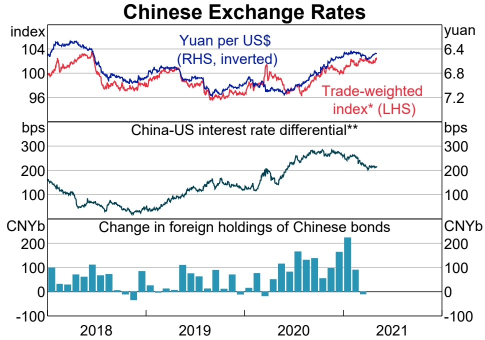
Year-ended



* Measure targeted by authorities; government bond issuance includes refinancing of debts previously included elsewhere in TSF; RBA estimated prior to 2016.
Sources: CEIC Data; RBA

Graph 1.15

Chinese Exchange Rates

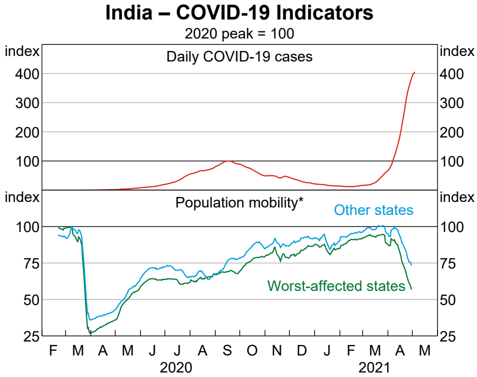


* Indexed to 1 January 2018 = 100
** 5-year government bond yields
Sources: Bloomberg; CEIC; China Foreign Exchange Trade System

advanced economies (Graph 1.17). It will take some time for spare capacity to be absorbed even as containment measures are eased. Wage subsidies continue to preserve employer-employee relationships and support incomes in many economies, and wages growth in some large advanced economies slowed only a little over the past year.

Labour demand has picked up in some advanced economies and survey indicators such as job ads and employment expectations point to a further and broader pick-up in coming months (Graph 1.18). By sector, the improvement across many economies has been most pronounced in healthcare and manufacturing, consistent with the strength in global goods demand. Hiring intentions have lifted even in economies that are still under strict containment measures as firms anticipate an increase in demand later in the year.

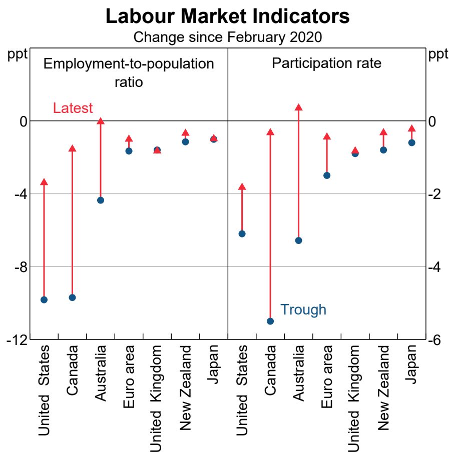
Graph 1.16



* Average of Google retail, grocery, workplace and transit station mobility data; worst-affected states are the 10 states with the highest active COVID-19 cases per capita; as of 4 May 2021

Sources: CEIC Data; RBA

Graph 1.17



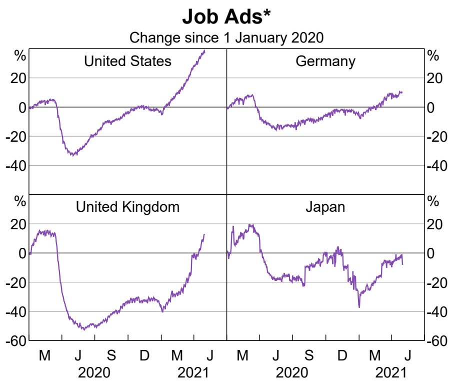
Sources: ABS; CEIC Data; RBA; Refinitiv

Underlying inflation is expected to remain below most central bank targets for the next few years

Underlying consumer price inflation in advanced economies remains low. Some measures of inflation will increase in the coming months because of higher commodity prices and cost pressures associated with bottlenecks in global manufacturing and shipping; surveyed measures of inflationary pressures in manufacturing are elevated globally (Graph 1.19). Year-ended inflation rates will be also boosted in the near term by the unwinding of some COVID-19 -related price reductions.

Later in the year, inflation is expected to ease again in most economies as the increase in oil prices washes out and some of the temporary bottlenecks in global supply chains are resolved. In most economies, spare capacity in labour markets is likely to contain inflationary pressures for some time. Spare capacity in the United

Graph 1.18



* Job ads posted on Indeed

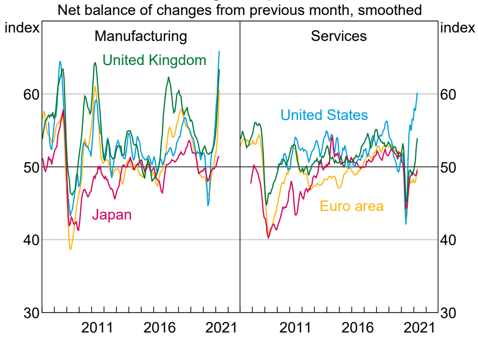
Sources: Indeed; RBA

States is expected to be absorbed more quickly than elsewhere; business surveys suggest that inflationary pressures are already picking up in the US services sector. The US Federal Reserve (Fed) expects its target measure of US inflation to increase and moderately exceed 2 percent in 2021 and then run close to 2 per cent in 2022, which will move inflation towards the Fed's goal of inflation averaging 2 per cent over time. Measures of US inflation expectations have increased recently to be consistent with the Fed's goal, while in some other advanced economies financial markets' and economists' expectations remain below central bank targets (Graph 1.20).

Graph 1.19

PMI Survey Output Prices

Net balance of changes from previous month, smoothed

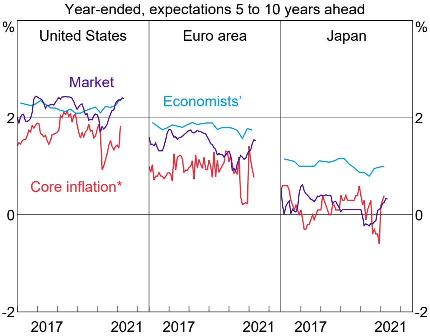


Sources: RBA; Refinitiv

Graph 1.20

Core Inflation and Expectations

Year-ended, expectations 5 to 10 years ahead



* Personal consumption expenditure inflation for the United States

Sources: Bloomberg; Consensus Economics; RBA; Refinitiv

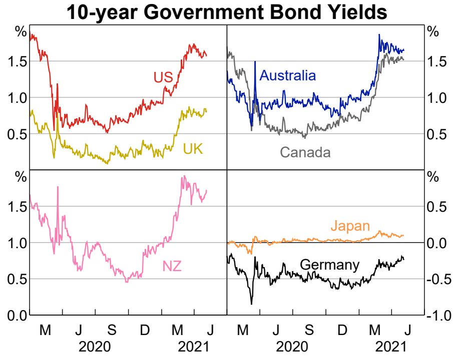
Government bond yields have increased due to the improved economic outlook and higher inflation expectations

Longer-term government bond yields have risen noticeably since early February in most advanced economies, following the passage of fiscal stimulus measures in the United States and further improvements in the economic outlook more generally (Graph 1.21). In contrast, government bond yields with maturities of up to 2–3 years have remained low, consistent with market expectations that policy rates will remain low for a prolonged period. Yields on longer-term bonds in most advanced economies experienced heightened volatility in late February amid a decline in market liquidity and significant bond issuance, but bond markets have generally been more stable since March. Yields on New Zealand Government bonds also experienced large moves in March alongside sharp revisions to policy rate expectations following government announcements of measures to curb growth in housing prices (discussed below).

Compensation for expected future inflation has increased across all bond maturities since yields began rising in early November, from near record lows to levels more consistent with central bank inflation targets. Real yields have decreased at the 5-year maturity and have

Graph 1.21

10-year Government Bond Yields



Sources: Bloomberg; Yieldbroker

increased or remained steady at the 10-year maturity in most advanced economies over the same time frame (Graph 1.22).[1] This is consistent with central banks' forward guidance that policy rates will not be raised until there is a substantial and sustained increase in inflation. In the euro area and Japan, real yields have decreased at longer maturities since November, because inflation is expected to remain below central bank targets for longer than in other advanced economies.

Central banks in advanced economies have restated their commitment to a prolonged period of substantial support

At recent meetings, most central banks have reaffirmed their commitments to an extended period of support through very low policy rates, asset purchases and lending programs. Given announced measures, central bank balance sheets will continue to grow for some time (Graph 1.23). Most central bank officials observed that the rise in longer-term government bond yields is consistent with the improved outlook for economic activity and inflation, but that policy needs to remain very supportive for an extended period to achieve a sustainable increase in inflation.

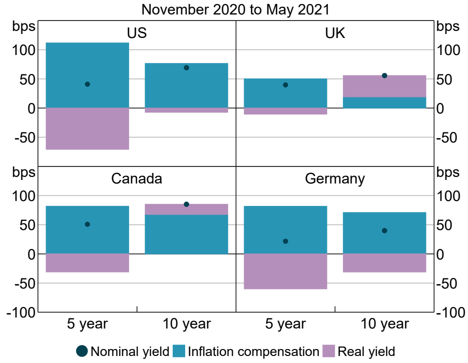
A couple of central banks have adjusted their guidance on the expected timing of a policy rate increase in response to an improved economic outlook, though in most cases the first policy rate increase is still not expected for some time. Norges Bank stated that it now expects to raise its policy rate in the second half of this year, earlier than previously expected. The Bank of Canada (BoC) has stated that it remains committed to holding the policy rate at its current level until inflation returns to 2 per cent on a sustained basis. The BoC now expects this condition to be met in the second half of 2022, brought forward from 2023. In the United States, most Federal Open Market Committee (FOMC) participants continued to expect the policy rate to remain unchanged until at least end 2023, though a few participants brought forward their expectations of the first policy rate increase to 2022 in response to improved economic forecasts. The FOMC said that the current economic outlook did not warrant policy tightening and that the Fed will be monitoring actual, not forecast, progress towards its employment and inflation goals to judge the appropriate time to raise the policy rate.

The market-implied path of expected policy rates has shifted higher in a number of advanced economies, and the expected timing of the first policy rate increase has been brought forward (Graph 1.24). Current market pricing suggests that the BoC is expected to raise its policy rate in the second half of 2022 and the

Graph 1.22

Change in Government Bond Yields

November 2020 to May 2021

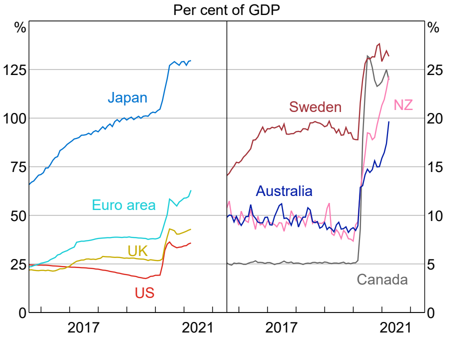


Source: Bloomberg

Graph 1.23

Central Bank Total Assets

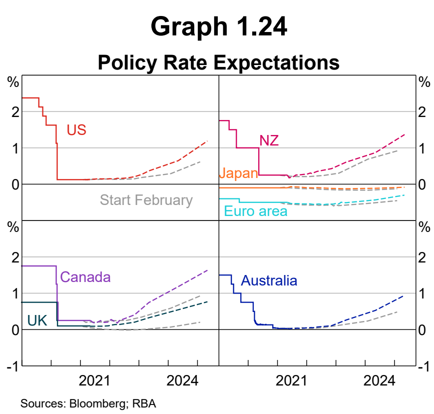
Per cent of GDP



Sources: Central banks; RBA; Refinitiv

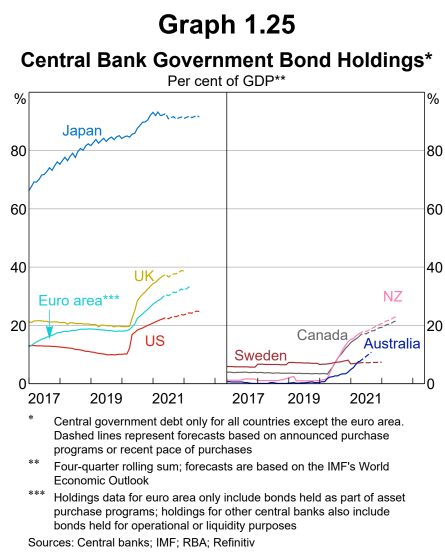
Reserve Bank of New Zealand (RBNZ) is expected to raise its policy rate in late 2022 or early 2023, while the US Fed and the Bank of England are expected to raise policy rates in the first half of 2023. In Australia, market pricing suggests that the cash rate is expected to remain around its current low rate for the coming 2 years and increase to around 50 basis points over 2023. In the euro area and Japan, market pricing continues to indicate investors expect no change to policy rates for at least several years.

Central banks in advanced economies continue to provide substantial additional stimulus through asset purchases, though in recent months some central banks have altered the pace of purchases. The European Central Bank (ECB) announced an increase in the pace of asset purchases under its Pandemic Emergency Purchase Programme (PEPP) in March, and said it will maintain a higher purchase pace in the second quarter of the year. The ECB noted that this was in response to the risk that rising government bond yields could lead to a premature tightening of financing conditions at a time when underlying inflation pressures remain subdued. In contrast, as was widely expected, the BoC reduced its target for government bond purchases from C$4 billion to C$3 billion per week to reflect progress made in the economic recovery, including an improved outlook for economic growth and inflation. The BoC noted that further adjustments will be gradual and guided by its ongoing assessment of the strength and durability of the recovery. Other central banks in advanced economies have continued to purchase assets at a steady pace in recent months (Graph 1.25).



The New Zealand Government directed the RBNZ to consider the impact on housing prices when making monetary and financial stability policy decisions. Under these changes, the Monetary Policy Committee's targets will not change, but the RBNZ will outline the effect of its monetary policy decisions on the government's objectives relating to sustainable house prices. The RBNZ's financial stability policies will take into account the government's objectives. The New Zealand Government subsequently announced a range of measures to dampen investor housing demand and boost housing supply.[2] In response, market participants scaled back expectations that the RBNZ would increase its policy rate more quickly than other advanced economies.

The Bank of Japan implemented a number of recommendations following a review of the effectiveness and sustainability of its monetary



policy measures. These included adjustments to its yield curve control framework to improve market functioning and a new interest rate tiering scheme to mitigate the impact of negative interest rates on bank profitability. Some other central banks, including the ECB and the BoC, will undertake or announce the results of reviews of monetary policy frameworks and tools later this year.

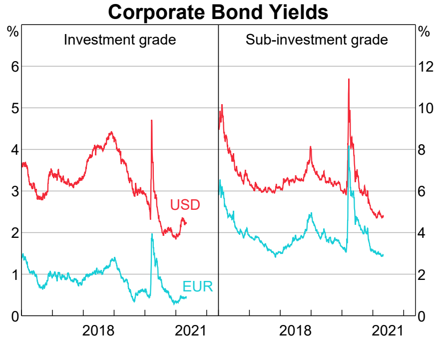
Corporate funding conditions in advanced economies remain accommodative

Corporate bond yields remain around historically low levels, even though they have increased for some borrowers in recent months as a result of the rise in sovereign bond yields. Yields on investment grade corporate bonds denominated in US dollars increased by around 35 basis points from their recent lows, while yields on euro-denominated investment grade bonds are around 15 basis points higher (Graph 1.26). Sub-investment grade yields remain close to record lows, as higher risk-free interest rates have been offset by a substantial narrowing in credit spreads. Spreads have narrowed most for firms in sectors that were disproportionately affected by the pandemic and which tend to have lower credit ratings, such as energy, travel and leisure, and industrials. Corporate bond issuance has remained robust over the year to date, particularly for sub-investment grade bonds.

Equity prices have increased further in recent months (Graph 1.27). Expectations that stronger economic growth will lift future earnings have generally outweighed the effect of higher yields on sovereign debt, which reduce the discounted value of those future earnings. Shares of companies that are more sensitive to the economic outlook – such as companies that produce capital equipment – have outperformed the broader market. Bank share prices have also outperformed as the steeper yield curve and improved economic outlook are expected to support bank profitability. Equity issuance remains elevated in the United States, driven by so-called 'blank-cheque' vehicles (Special Purpose Acquisition Companies (SPACs)), which raise funds to identify and invest in private companies to take public. However, SPAC issuance slowed substantially in April. This is possibly linked to an increased risk of regulatory intervention as well as a decrease in funding available from institutional investors that is typically used alongside SPAC funding to help finance acquisitions.

Graph 1.26

Corporate Bond Yields

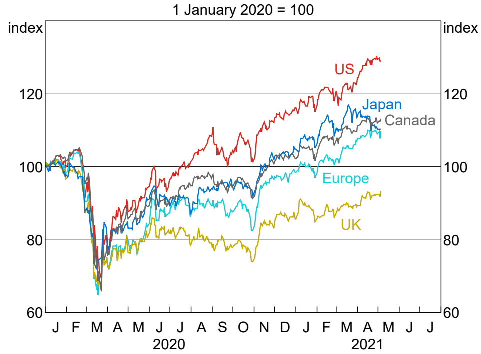


Source: ICE data is used with permission

Graph 1.27

Equity Prices

1 January 2020 = 100



Source: Bloomberg

The US dollar is around its levels earlier in the year

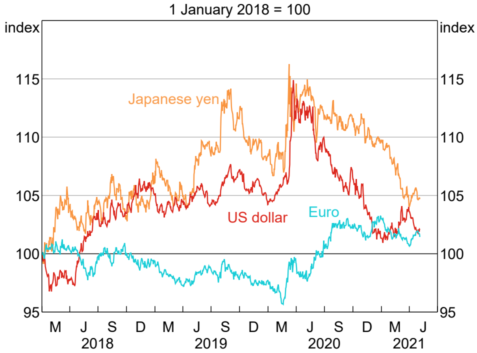
The US dollar appreciated on a trade-weighted (TWI) basis alongside rising US Government bond yields through to March, but has depreciated since then. It is now back around its levels at the start of the year (Graph 1.28). Most other advanced economy currencies have appreciated a bit over the past month or so. However, the Japanese yen, euro and Swiss franc remain lower than their levels earlier in the year. This is consistent with divergences in the near-term outlook for growth stemming from the slower rollout of vaccines and ongoing containment measures in Europe and Japan.

The currencies of commodity-exporting economies, including the Australian dollar, are around or above levels from earlier in the year supported by the high levels of many commodity prices (see 'Domestic Financial Conditions' chapter for recent developments in the Australian dollar). However, the New Zealand dollar depreciated through March as yields on New Zealand Government bonds declined and market participants scaled back their expectations about the RBNZ increasing its policy rate following the New Zealand Government's announcement of measures aimed at curbing housing price growth.

Graph 1.28

Trade-weighted Exchange Rates

1 January 2018 = 100



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System

Emerging market financial conditions have tightened, although to varying degrees

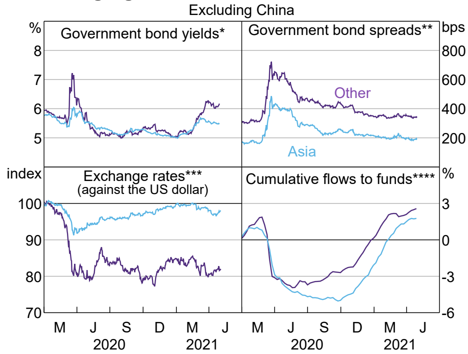
Financial conditions in emerging market economies (EMEs) have tightened in recent months, alongside the rise in advanced economy bond yields. Episodes of rising US yields often lead to a tightening of financial conditions in EMEs, which can be problematic if the outlook for these economies remains weaker than for advanced economies. Local currency government bond yields have increased noticeably in many EMEs, though to a lesser extent in Asia, while spreads between EME's US dollar-denominated bonds and equivalent US Treasury bonds have been little changed (Graph 1.29).

In Asia, the currencies of most emerging economies have depreciated slightly against the US dollar and inflows into bond and equity funds have slowed. In a number of EMEs outside Asia, there have been some large swings in exchange rates over recent months and a pause in portfolio flows to investment funds. In particular, Turkey's financial markets experienced significant volatility following the removal of the central bank governor there.

Graph 1.29

Emerging Markets – Financial Conditions

Excluding China



* Local currency bonds, weighted by market value

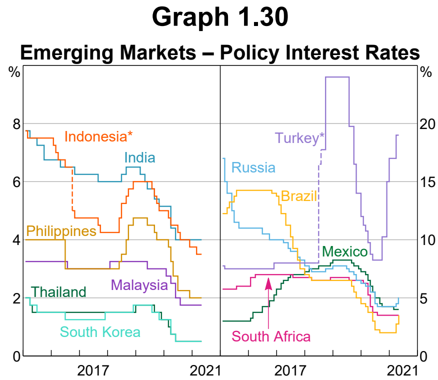
** US-dollar denominated bonds; spreads to equivalent US Treasury

*** 1 Jan 2020 = 100

**** Per cent of assets under management; includes flows to bond and equity funds

Sources: Bloomberg; EPFR Global; IMF; J.P. Morgan; RBA

A few EME central banks outside Asia have raised policy rates at recent meetings, while accommodative policy settings have been maintained elsewhere (Graph 1.30). The central banks of Brazil and Russia raised their policy rates at consecutive meetings in recent months due to rising inflation. In Turkey, the central bank raised its policy rate due to concerns about inflation, which was followed by the removal of the governor; rates were held steady at the subsequent meeting. Bank Indonesia left its policy rate unchanged, but signalled concerns about lowering its policy rate further following the recent depreciation of its exchange rate.



* Dashed lines indicate a change in the monetary policy framework and/or to the rate used as the official policy rate

Source: Central banks

Endnotes

[1] Nominal bond yields can be thought of as having two components: real yields, which are the yields on inflation-linked bonds, and an inflation compensation component which is the difference between real and nominal bond yields. The inflation compensation component represents both expected inflation and a risk premium.

[2] See RBA (2021), Financial Stability Review, April. Available at <https://www.rba.gov.au/publications/fsr/2021/apr>