1. The International Environment

The global outlook remains reasonable but uncertain. In January, the United States and China signed a partial trade agreement thereby de-escalating their dispute over trade and technology. This has reduced, but not eliminated, a key downside risk to global growth and, together with some more positive signs in global economic data, supported forecasts for a pick-up in global growth in 2020 and 2021. More recently, however, the outbreak of a new strain of coronavirus is expected to weigh on near-term growth and has created a new uncertainty for the outlook.

Developments in global financial markets over recent months have reflected evolving perceptions of these key risks. Overall though, global financial market conditions remain supportive of economic growth. Following a period in 2019 of monetary easing, central banks in advanced economies have indicated that their current policy settings are likely to remain appropriate for some time, though they remain prepared to ease further if necessary. Long-term government bond yields had risen as concerns about key downside risks eased, but have since declined noticeably and are back at very low levels. Corporate financing conditions have generally remained favourable; credit spreads are at low levels and equity prices have generally risen further over the past couple of months, notwithstanding recent declines.

US–China trade and technology tensions have eased which is supportive of global growth …

Since October there have been some positive developments on the US–China trade and technology disputes. Threatened tariff increases in October and December 2019 were cancelled as the United States and China negotiated the limited phase one trade agreement signed in January. The agreement provides for a small reduction in overall tariffs, increased Chinese purchases of US products and some steps to address US concerns about market access and the protection of intellectual property. Despite the agreement, tariffs between the two countries remain around the highest they have been in about 30 years after they were increased to nearly 20 per cent in 2018 and 2019.

There have also been signs of stabilisation in global manufacturing and trade since late 2019 (Graph 1.1). However, most of these indicators remain at subdued levels, as do business investment intentions. Spillovers from the weakness in conditions for export-oriented sectors have been limited so far partly because of support from stimulatory policy. Consumption growth has generally remained resilient through the past year. Employment growth has slowed a little in the major advanced economies but labour markets remain tight. Despite that, inflation remains low and below most central banks' targets.

The easing in trade tensions between the United States and China, and signs of stabilisation in a number of economic indicators, led to small

improvements in the underlying growth outlook for a number of economies. Forecasts released by the International Monetary Fund in mid January showed global growth picking up in 2020 and 2021, led by emerging market and developing economies.

… but the coronavirus outbreak has lowered the near-term growth outlook and increased uncertainty

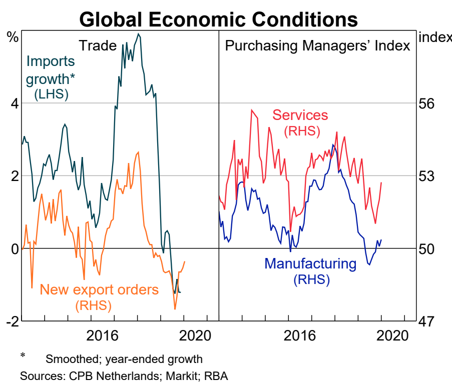
The recent outbreak of a new strain of coronavirus has lowered the near-term growth outlook for China and some other economies, particularly in Asia. In China, economic effects include lower domestic travel and other consumption, and disruption to the movement of goods. Also, business shutdowns will negatively affect industrial production and services. The effects of the outbreak are likely to flow through to other economies, particularly in east Asia, including via sharply lower Chinese outbound tourism, weaker Chinese demand for other exports and disruption to global supply chains. As China and east Asia are large trading partners for Australia, overall growth in Australia's major trading partners is expected to be a little lower in 2020 before picking up in 2021 (Graph 1.2).

There is considerable uncertainty regarding the duration and severity of the coronavirus outbreak. If it persists for an extended period, the effect on economic activity is likely to be larger than currently projected. The outlook for China, and how policy responses there could affect China's demand for Australia's exports and the exports of Australia's other key trading partners in Asia, remains an important consideration for the Australian economy.

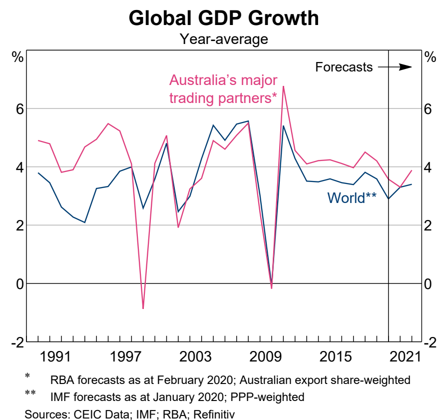
A number of other downside risks remain. Despite the recent positive developments in US–China negotiations, an escalation in the dispute remains a key downside risk to the outlook given the limited nature of the phase one deal and the potential for renewed tensions to weigh on trade and investment.

Considerable uncertainty also remains for other trade arrangements. The United States postponed a decision on possible actions affecting automotive imports from the European Union. The trade dispute between Japan and South Korea has raised uncertainty about supply in the South Korean semiconductor industry and reduced tourism flows between the two countries. The United Kingdom formally exited the European Union in January under a short transition arrangement, reducing the prospects of a disorderly near-term breakdown of the UK–EU trading relationship, although the ultimate form of the trading relationship remains

Graph 1.1



Graph 1.2



uncertain. The future functioning of the World Trade Organization is also unclear. By contrast, lingering uncertainty about the United States, Mexico and Canada trade agreement was alleviated when it was passed by the US Congress in January.

In China, growth appeared to stabilise in late 2019

In China, GDP growth slowed in 2019, to 6.1 per cent compared with 6.7 per cent in 2018. The slowdown was driven by domestic demand, and was mostly the result of longer-term structural factors and ongoing actions to reduce risks in the financial sector. Uncertainty associated with the US–China trade and technology dispute is also likely to have affected investment decisions, and growth in retail sales has been easing.

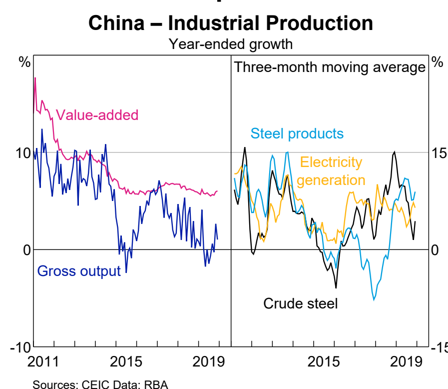
Over the course of the December quarter, however, a range of indicators of Chinese activity recovered somewhat (Graph 1.3 and Graph 1.4). This suggested that targeted fiscal and monetary easing were helping to stabilise economic conditions. Growth in fixed asset investment strengthened, driven by a pick-up in investment in the manufacturing sector. Industrial sector indicators also showed some signs of improvement in the December quarter. Growth in industrial production picked up, particularly for the output of construction materials such as steel and plate glass. Car production also increased modestly after declining over the past couple of years, and producer prices stopped declining as the deflationary effect of falling raw materials and manufactured goods prices began to abate.

The January trade agreement with the United States should have alleviated some of the uncertainty affecting investment, and local governments are also in a position to rekindle infrastructure investment growth now that preliminary bond issuance quotas have been released. However, the coronavirus outbreak creates a new uncertainty. At this stage, growth is expected to decrease significantly in the March quarter before rebounding later in the year, although the situation is very dynamic and the timing over Chinese New Year will make the economic impact especially difficult to read.

Conditions in Chinese property markets remained mixed in the December quarter (Graph 1.5). Property prices continued to rise, although the pace of price growth has been moderating for some time. Sales declined in the quarter, while spending on construction and fittings remained robust. Local governments continued to tailor housing policies to account for local conditions, with restrictions eased in some areas to offset weak conditions.

Graph 1.3

Graph 1.4

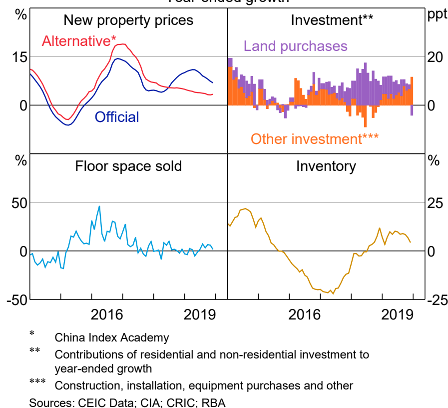


Core consumer price inflation continued its gentle downward trend and was 1.4 per cent in December (Graph 1.6). Headline inflation increased sharply as pork supply shortages caused by the outbreak of African swine fever drove large increases in pork prices and other meat products. Pork prices have declined a little from their peak in December, reflecting signs that pork production is beginning to recover, but prices are expected to remain elevated for some time.

Graph 1.5

China – Residential Property Indicators

Year-ended growth

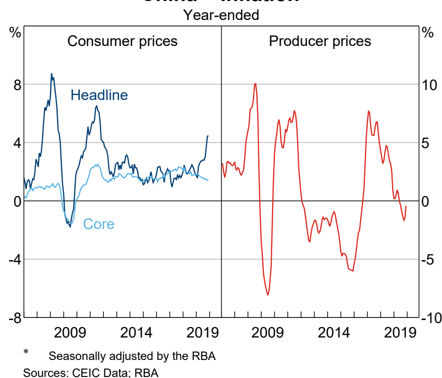


* China Index Academy
** Contributions of residential and non-residential investment to year-ended growth
*** Construction, installation, equipment purchases and other
Sources: CEIC Data; CIA; CRIC; RBA

Graph 1.6

China – Inflation*

Year-ended



* Seasonally adjusted by the RBA
Sources: CEIC Data; RBA

Chinese authorities have announced further targeted policy easing

Chinese policymakers have continued to balance their objectives of supporting economic growth and reducing risks in the financial system. Fiscal and monetary policy measures have been modest overall and generally focused on specific areas of weakness in the economy – namely, public infrastructure spending and access to finance for small and private sector firms. More recently, the authorities have announced some measures to support liquidity and bank lending in the near term to alleviate disruptions related to the coronavirus. It remains unclear at this stage whether additional support will be needed in response to the virus.

To support infrastructure spending, local governments were given a preliminary allocation of their 2020 special bond issuance quota so that they could plan for, fund, and begin work on eligible infrastructure projects before the final quota is set at the National People's Congress in March. The preliminary allocation of CNY 1 trillion was around 25 per cent higher than the equivalent allocation granted in 2019 and local governments have responded by issuing these bonds earlier than in previous years (Graph 1.7). The authorities also reduced the amount of equity capital required for some infrastructure projects including for ports, roads, rail, logistics and ecological protection.

The People's Bank of China (PBC) reduced the reserve requirement ratio by 50 basis points for all financial institutions in January (Graph 1.8). In part, this was aimed at ensuring sufficient liquidity ahead of Chinese New Year. In late 2019, the PBC also marginally reduced the interest rates on its short-term and medium-term lending operations. Subsequently, the one-year Loan Prime Rate (LPR), the new reference rate for non-mortgage lending by Chinese banks, declined by 5 basis points. In addition, authorities implemented further measures to

support financing conditions for micro and small enterprises (MSEs). In particular, the State Council called upon banks to lower financing costs for some MSEs by 50 basis points and instructed the five largest commercial state-owned banks to increase the value of loans extended to MSEs by 20 per cent over the next year. Growth in total social financing (excluding government bond issuance) has remained stable in year-ended terms but declined in the December quarter because off-balance sheet financing contracted more quickly than earlier in the year. More recently, authorities announced a range of measures to avoid a tightening in financial conditions as a result of the coronavirus outbreak. In particular, the PBC has pledged to maintain adequate liquidity in the system and has encouraged banks to reduce lending rates to assist firms affected by the outbreak.

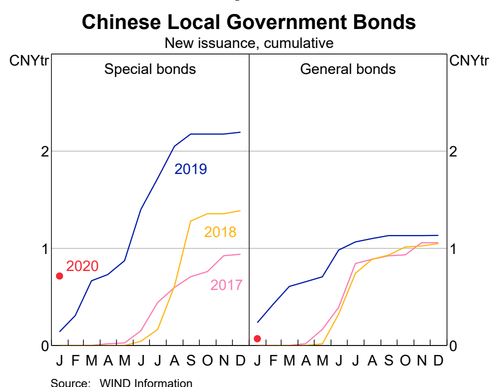
As part of ongoing efforts by the Chinese authorities to improve the transmission of monetary policy and the transition towards market-based pricing of financial products, the PBC announced the next stage of its lending rate reform in late 2019. The PBC instructed banks to begin shifting the outstanding stock of loans to reference the LPR from March 2020, and it expects this transition to be complete by the end of August. Banks were also instructed to cease issuing new loans that referenced the old benchmark rate from 1 January 2020, although most new loans issued had already been referencing the LPR. The LPR is linked to the rate offered by the PBC on its medium-term lending facility (MLF), so interest rate changes by the PBC will directly affect lending rates. However, to avoid overstimulating the housing market, authorities have stated that mortgage rates must remain unchanged at the time of conversion and that the repricing period must be at least one year. This means that mortgage rates will not change until at least 2021, even if the PBC reduces the MLF rate.

Growth in east Asia also appeared to stabilise in late 2019

Growth indicators in east Asia stabilised in late 2019 following a period when weak external demand, particularly from China, and the effects of the US–China trade dispute on global supply chains had weighed on growth. The levelling out in activity indicators in the region is consistent with more favourable trade developments evident since October 2019. After a period of decline, industrial production has been flat in recent months, while surveyed manufacturing sector conditions and new export orders have picked up somewhat (Graph 1.9). Merchandise export volumes have been largely flat over the past year, supported by relatively resilient semiconductor exports. However, weak

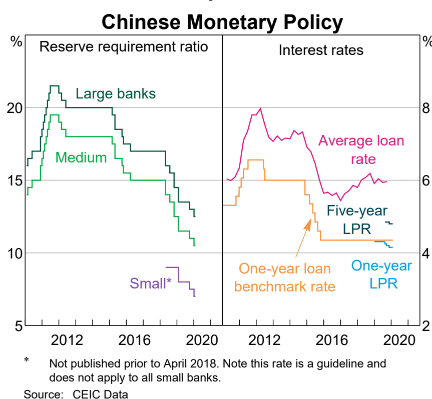
Graph 1.7

Chinese Local Government Bonds

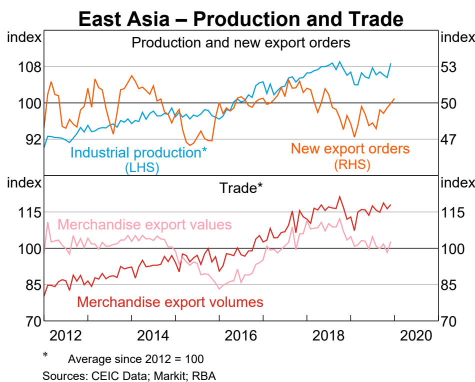


Graph 1.8

Chinese Monetary Policy



memory chip prices have weighed on export values, particularly in South Korea and Singapore, and on business profits and investment. More recently, memory chip prices appear to have bottomed out, which should support future activity and investment in this key sector for the region (Graph 1.10). The easing of US–China trade tensions, signs of a turnaround in the global electronics cycle and more stimulatory policies are supportive of slightly stronger growth in east Asia over the next couple of years. However, the coronavirus outbreak in China is expected to weigh on growth in the region in early 2020 because of the disruption to Chinese traveller flows and supply chains.

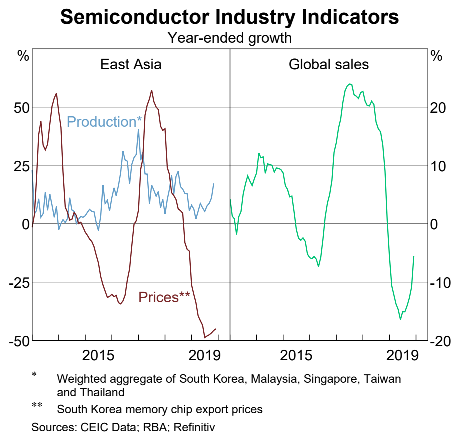


* Average since 2012 = 100

Sources: CEIC Data; Markit; RBA

GDP growth in most of the export-oriented economies in the region was subdued over 2019 because business investment and exports have weighed on growth (Graph 1.11). In South Korea, weak residential investment and softer household consumption have also contributed to the weakest GDP growth in a decade, although public consumption has supported growth and fiscal policy is expected to be very expansionary in 2020. In contrast, GDP growth in Vietnam has been strong, boosted by export growth to the United States as some production has been relocated from China in response to the US–China trade dispute. Activity has also picked up in some of the less export-oriented economies in the region, such as the Philippines. Growth in Indonesia has been steady, driven by relatively resilient consumption growth. Ongoing political unrest continues to weigh heavily on Hong Kong economic activity.

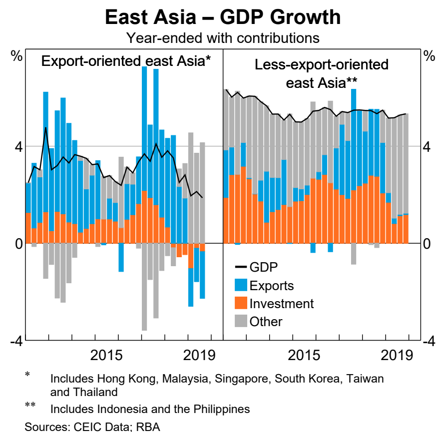
Inflation remains low in east Asia. Inflation in South Korea has been especially low and well below target, although headline inflation picked up sharply in January (Graph 1.12). Inflation in Indonesia has been relatively steady, while it has been quite volatile in Malaysia following changes in consumption taxes. In the Philippines, inflation rose again as domestic



* Weighted aggregate of South Korea, Malaysia, Singapore, Taiwan and Thailand

** South Korea memory chip export prices

Sources: CEIC Data; RBA; Refinitiv



* Includes Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand

** Includes Indonesia and the Philippines

Sources: CEIC Data; RBA

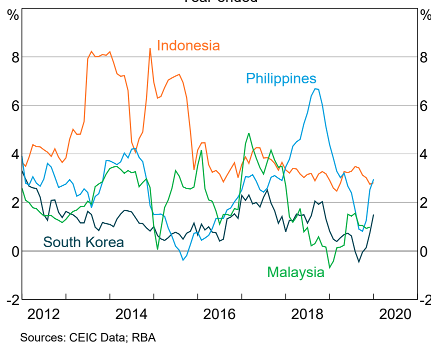
activity picked up and as food prices increased because of weather-related factors.

Monetary policy became more accommodative in the region over 2019 to support growth against the backdrop of low inflation and amid reduced concerns about capital outflows (Graph 1.13). For a few economies in the region there was a pause in the policy easing cycle in late 2019 driven by an expectation that earlier episodes of monetary and fiscal easing would support the economic outlook. More recently, however, some central banks have highlighted a willingness to ease policy further in response to the effects of the coronavirus.

Graph 1.12

East Asia – Headline Inflation

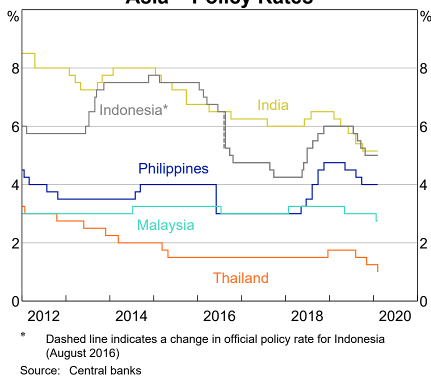
Year-ended



Sources: CEIC Data; RBA

Graph 1.13

Asia – Policy Rates



* Dashed line indicates a change in official policy rate for Indonesia (August 2016)

Source: Central banks

Economic activity in India slowed further

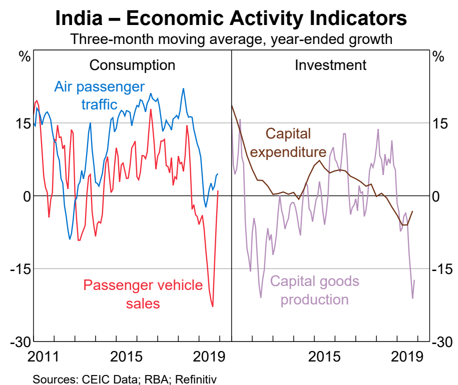
Economic growth in India has slowed sharply since early 2018, reflecting ongoing weakness in domestic demand (see 'Box A: The Recent Economic Slowdown in India'). In the September quarter, exports contracted while public consumption helped support growth. Credit provision to the services sector has contracted in recent months despite the government and the Reserve Bank of India (RBI) taking a number of measures to encourage both bank and non-bank lending. The slowdown in growth has been larger than expected. There are some tentative signs, however, that growth will stabilise soon: car sales have increased in recent months after declining since mid 2018; air passenger traffic growth has picked up in recent months; and, in the December quarter, capital expenditure increased for the first time since the June quarter of 2018 (Graph 1.14). Even so, any pick-up in growth is likely to be modest in the near term. Indicators of industrial sector activity are weak and credit conditions remain challenging.

Headline inflation increased to be above the top of the RBI's target range, reflecting damaged crops and higher vegetable prices following heavy rainfall late in the monsoon season (Graph 1.15). This was accompanied by a sharp

Graph 1.14

India – Economic Activity Indicators

Three-month moving average, year-ended growth



Sources: CEIC Data; RBA; Refinitiv

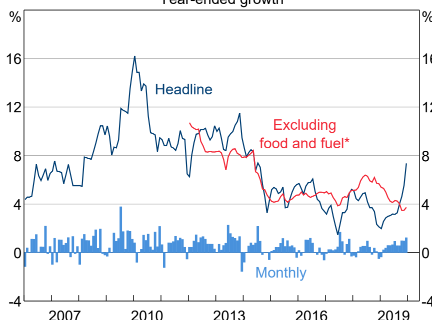
increase in household inflation expectations. In response, the government eased restrictions on onion imports and banned onion exports. Price pressures have moderated in most other expenditure categories and core inflation remains relatively subdued. The RBI kept its policy rate unchanged in December, citing the less favourable inflation environment and its expectation that the lagged effects of monetary and fiscal stimulus implemented in 2019 will support activity. It noted that there is space for further monetary easing if required.

Activity in major advanced economies slowed in 2019 but there have been signs of stabilisation

Growth in the major advanced economies was slower in 2019 than in 2018 (Graph 1.16). Manufacturing activity declined, especially in the euro area, external demand has been weak and services activity has eased. In this environment, and amid uncertainty about trade and technology policies, growth of investment has eased. However, consumption growth has remained resilient because it has been supported by tight labour markets. More recently there have been signs of stabilisation in the manufacturing sectors of these economies and in US investment intentions (Graph 1.17).

Graph 1.15

India – Consumer Price Index
Year-ended growth



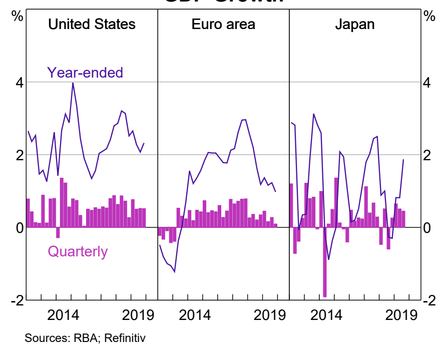
* Constructed by the RBA; food and fuel comprise 52.7 per cent of the CPI basket

Sources: CEIC Data; RBA

GDP growth in the United States eased to around trend over 2019. Business investment declined and investment intentions eased sharply (Graph 1.18). Consumption growth slowed a little in late 2019, although it remains firm and consumer confidence is high (Graph 1.19). Lower interest rates have supported a pick-up in residential investment. The US growth outlook is also a little stronger than three months ago because reduced uncertainty around trade is expected to support business investment, and the resilient labour market is expected to continue supporting consumption. GDP growth over the next two years is expected to continue at around its

Graph 1.16

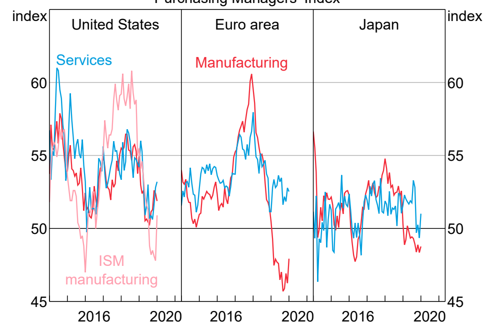
Major Advanced Economies – GDP Growth



Sources: RBA; Refinitiv

Graph 1.17

Major Advanced Economies – Business Conditions
Purchasing Managers' Index



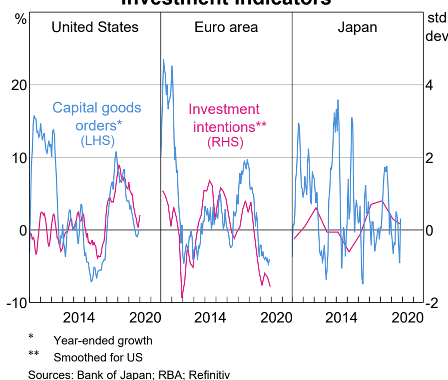
Sources: Markit; Refinitiv

current pace, which is consistent with potential growth.

In the euro area, GDP growth has been subdued over the past two years because of pervasive weakness in external demand. This has particularly affected economic conditions in Germany, where industrial production has declined significantly. Survey indicators of conditions in the manufacturing sector remain very weak. The investment outlook in the euro area is subdued. Investment intentions and industrial confidence are well below average levels. Consumption has remained firm so far, despite some spillovers from the industrial sector to the services sector and the labour market. Euro area growth is expected to remain weak over the next two years because external demand is expected to recover only gradually and uncertainty persists about key trading relations, including with the United Kingdom.

Graph 1.18

Major Advanced Economies – Investment Indicators



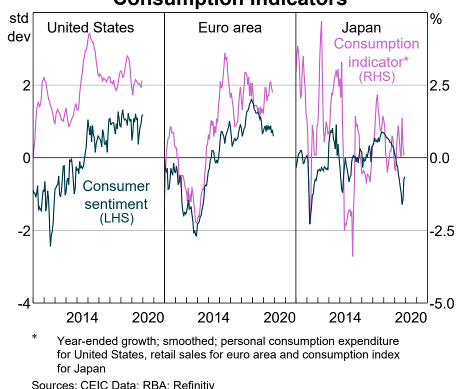
* Year-ended growth

** Smoothed for US

Sources: Bank of Japan; RBA; Refinitiv

Graph 1.19

Major Advanced Economies – Consumption Indicators



* Year-ended growth; smoothed; personal consumption expenditure for United States, retail sales for euro area and consumption index for Japan

Sources: CEIC Data; RBA; Refinitiv

Japanese economic activity slowed following the consumption tax increase in October 2019. As was expected, consumption and residential investment indicators fell sharply after the tax increase following strong growth in the middle of the year as activity was brought forward. Surveyed conditions in the services sector, which had been quite resilient, declined in the December quarter but largely recovered in January. Business investment growth, while still strong, has slowed and investment intentions have eased. Industrial production has declined in recent months and conditions in the manufacturing sector remain around their recent lows, partly because of the disruption from the consumption tax increase and partly because of weak external demand. The coronavirus outbreak in China is also likely to lower traveller flows from China significantly in early 2020. However, fiscal stimulus, focused on infrastructure and equivalent to around 1 per cent of GDP, has been announced to support growth in 2020 and early 2021. Accordingly, the outlook for Japan is little changed in net terms; growth is expected to dip below trend in late 2019 and early 2020, before gradually recovering to around trend growth in 2021 as external demand improves.

Labour market conditions have eased but remain tight

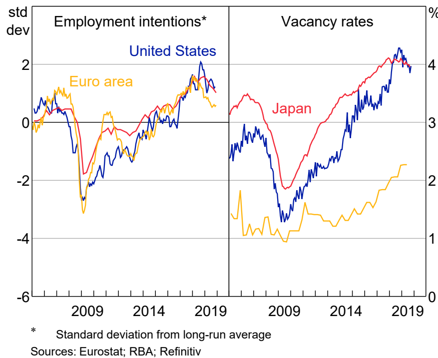
Employment growth in the major advanced economies has slowed since early 2019, particularly in the manufacturing sector. Near-term forward-looking indicators of labour demand, such as vacancy rates and employment intentions, have eased a little but are still at high levels (Graph 1.20). Nonetheless, employ-

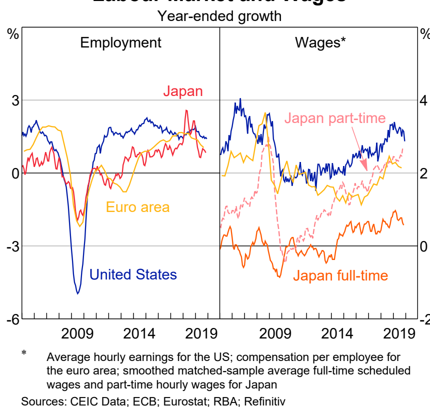
ment growth remains above working-age population growth and therefore unemployment rates, which are already at multi-decade lows, continue to fall. Wages growth in the major advanced economies remains around decade highs but has eased a bit in the United States (Graph 1.21). These labour market outcomes continue to support consumption growth.

Inflation remains low in the major advanced economies

Inflation remains below central banks' targets in the major advanced economies (Graph 1.22). Core inflation in the United States has eased since August. Inflation in the euro area has increased since October, largely due to stronger services and food inflation. Inflation has been little changed in Japan despite the increase in the consumption tax because its effects were largely offset by the introduction of free preschool education.

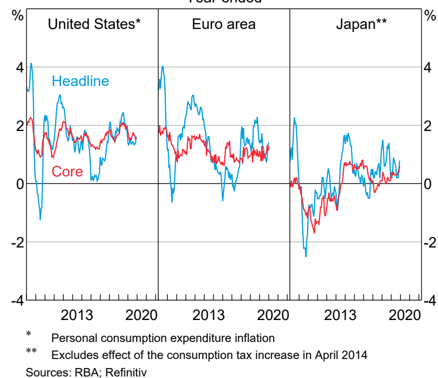
After trending higher towards the end of 2019, market-based measures of short-term inflation expectations decreased in late January following the outbreak of the coronavirus and (related) noticeable declines in oil prices. Longer-term market-based inflation expectations remain low.





After easing last year, central banks in major advanced economies are expected to leave policy settings unchanged for some time

Central banks in advanced economies left policy rates unchanged at recent meetings, but signalled that they are prepared to ease further if necessary. A number of central banks noted that the key risks that prompted pressures to ease policies in 2019 – including escalation in trade tensions and slower global growth – had receded somewhat. The US Federal Reserve (Fed), European Central Bank (ECB), and Bank of Japan (BoJ) indicated that their current policy stances are likely to remain appropriate in the



near term, while noting that future policy settings will depend on the resolution of ongoing uncertainties. Market pricing now implies that central banks in advanced economies are expected to either ease a little further or leave policy rates at around current low levels for some time (Graph 1.23).

The Fed lowered the target range for its policy rate by 75 basis points to 1.5–1.75 per cent in the second half of 2019, in response to subdued inflation and downside risks to the outlook for global growth. The Fed has since signalled that it would take a material reassessment of the outlook to trigger further changes to policy settings. Market pricing suggests that the Fed is expected to lower its policy rate one or two more times over the second half of the year.

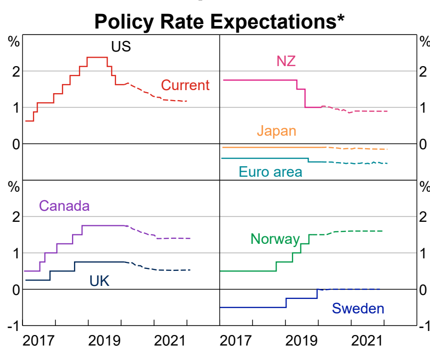
In September, the ECB announced a package of stimulus measures, which will continue to be implemented over coming years, in response to weakening domestic economic activity and downside risks to the outlook (Graph 1.24). Governing Council members have stated that there had been some tentative signs of stabilisation in economic activity following the slowdown seen in 2019, and that there had been a moderate increase in underlying inflation. The ECB's new President, Christine Lagarde, reiterated that monetary conditions will remain highly accommodative until there is evidence of a sustained increase in inflation towards 2 per cent. Market pricing suggests that the ECB's interest rate policy settings will remain unchanged in the coming year.

The BoJ has indicated that it is prepared to ease policy if it considers that there has been a loss of momentum in inflation reaching the 2 per cent target. The BoJ recently made further adjustments to some aspects of how it implements policy in an effort to improve the sustainability of its current policy stance by mitigating the side effects of its asset purchases on the financial sector. In October, the BoJ also reduced its purchases of long-term government bonds in an effort to steepen the yield curve. Following the Japanese Government's announcement of a fiscal stimulus package and easing in some global risks, market pricing now implies that policy settings will remain unchanged this year.

The Bank of Canada (BoC) left its policy rate unchanged in January, after having being on hold over 2019 amid a tight labour market and inflation near target. However, the BoC stated that growth has eased a little recently and now judges there to be a little more spare capacity than previously thought. The BoC indicated that the policy rate may be lowered if the recent slowdown persists and weighs on inflation. Market pricing implies that the policy rate will

Graph 1.23

Policy Rate Expectations*

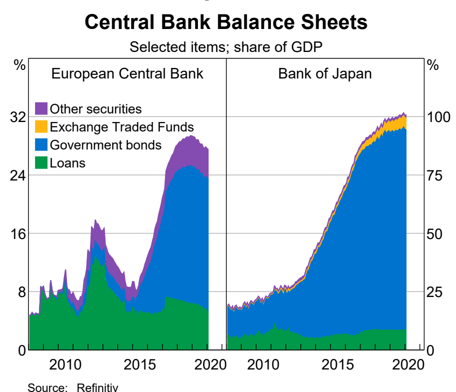


* Expectations for Norway and Sweden are based on central bank forecasts

Sources: Bloomberg; Norges Bank; Sveriges Riksbank

Graph 1.24

Central Bank Balance Sheets



Source: Refinitiv

be lowered by 25 basis points to 1.5 per cent towards the end of the year.

The Bank of England (BoE) has stated that incoming information about the global and domestic economy will guide future interest rate decisions. The BoE noted that slower global growth and elevated Brexit-related uncertainties had weighed on growth in 2019, and spare capacity had been larger than expected. However, more recent indicators of domestic activity have strengthened. Market pricing implies that the policy rate is expected to be lowered by 25 basis points by the end of the year. In December, the incumbent Conservative Party secured an outright majority in Parliament, paving the way for passage of the Withdrawal Agreement Bill. This allowed the UK to formally leave the European Union under an interim agreement at the end of January. The full terms of the agreement need to be negotiated over the course of this year.

In Sweden and Norway, both central banks expect policy rates to be little changed this year, following a recent cycle of monetary tightening. The Swedish Riksbank raised its policy rate by 25 basis points to 0 per cent in December, which followed a 25 basis point increase in late 2018 and a period of around five years where policy rates had been in negative territory. In doing so, it highlighted its concerns about the side effects of a prolonged period of negative nominal interest rates. Norges Bank left its policy rate unchanged at 1.5 per cent, after having raised the policy rate three times in 2019 in response to a solid domestic growth outlook and concerns related to financial stability.

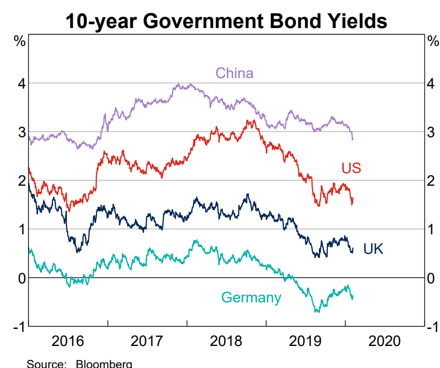
Government bond yields are around record lows

Yields on long-term government bonds remain low. Yields have declined recently following a gradual upward trend late last year, which had been in line with moderating downside risks to growth and higher market-implied inflation compensation (Graph 1.25). These movements were unwound in late January as concerns around the potential effects of the coronavirus weighed on growth outlooks. Looking through recent volatility, yields remain at low levels, reflecting ongoing subdued inflation, uncertainty in the outlook for global growth and expectations that monetary policies will remain accommodative. In China, yields have declined following further targeted easing by the PBC and as the outbreak of the coronavirus intensified.

Funding costs for corporations have edged lower

Corporate bond yields have declined a little further in recent months (Graph 1.26). The low cost of corporate debt combined with robust bond issuance reflects strong demand from investors that are seeking assets with higher yields than those available on government bonds.

A general narrowing in spreads has occurred despite a slight upward revision to market analysts' expectations for a rise in corporate defaults from their current low levels. This revision appears to have reflected concerns about high levels of leverage in an environment of moderate economic growth. Consistent with this, the share of firms that have received credit rating downgrades has increased. Market



analysts expect defaults to be concentrated at the lower end of the credit rating spectrum, particularly in the energy sector where spreads have remained elevated compared with the broader US high yield market.

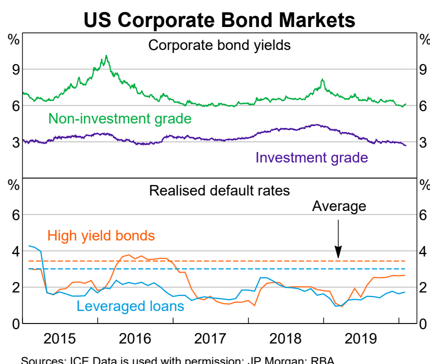
In China, the cost of funding for corporations has been relatively stable over recent months. This is despite a pick-up in corporate bond defaults, albeit from a low base. In the coming months, firms adversely affected by the coronavirus outbreak may face difficulties in meeting bond repayments. To address this risk authorities have encouraged investors to extend repayment deadlines for affected firms, in addition to the range of measures announced to support broader financial conditions.

Global equity prices have risen further over recent months, notwithstanding recent declines related to concerns around the coronavirus. Equity prices have risen by around 8 per cent since the recent trough in September and are around 20 per cent higher than late 2018 (Graph 1.27). In the United States, equity prices are near record highs. Valuation metrics show that much of the increase in equity prices reflects investors' increased willingness to pay for future earnings, rather than expectations that earnings will grow at a faster pace than previously thought. This largely reflects valuation effects from the substantial decline in risk-free rates seen since late 2018 (which increases the discounted value of future earnings).

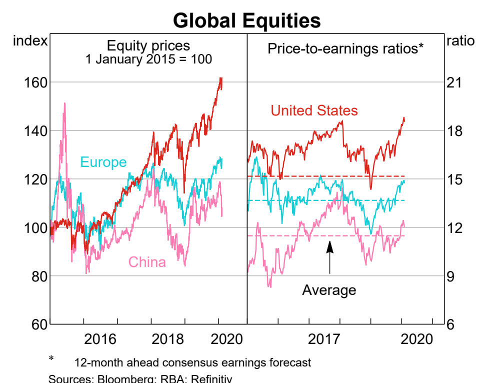
In short-term US dollar money markets, spreads (over and above expected policy rates) declined towards the end of 2019. US repo markets functioned smoothly despite a build-up of funding pressures in the second half of the year, partly reflecting the Fed's injection of short-term liquidity through repos as well as its purchases of Treasury bills (which are underpinning a build-up of bank reserves held at the Fed). These measures may have contributed to a reduction in the cost of funding in US dollars, including in exchange for other currencies (Graph 1.28). The Fed has signalled that it expects to pare back its repo operations over the coming months as reserve balances in the banking system become more plentiful.

Movements in exchange rates reflected an easing in trade tensions and an escalation in concerns about coronavirus

The US dollar and Japanese yen depreciated over December and early January, before partly reversing these moves later in January as concerns related to the spread of coronavirus increased (Graph 1.29). The euro has been little changed and has remained in a relatively narrow range over the past year or so. In contrast, the



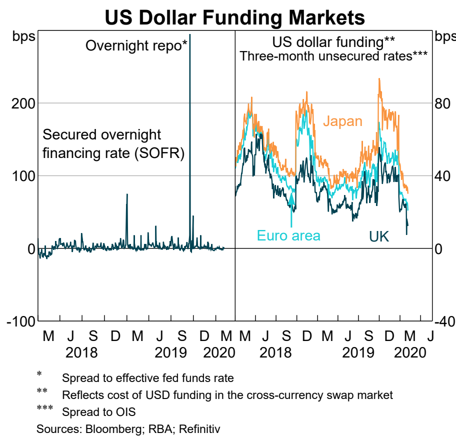
Sources: ICE Data is used with permission; JP Morgan; RBA

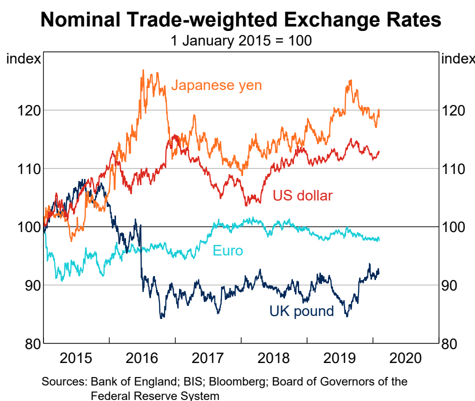


* 12-month ahead consensus earnings forecast
Sources: Bloomberg; RBA; Refinitiv

UK pound has appreciated since around the middle of 2019 as the near-term risk of a disorderly Brexit diminished. Measures of volatility for the major currencies have continued to decline and are at historically low levels.

The Chinese renminbi appreciated further against the US dollar around the turn of the year, although it has depreciated more recently as concerns about coronavirus intensified (Graph 1.30). Much of the earlier appreciation occurred alongside progress on phase one of the US–China trade agreement. Among other things, the agreement includes pledges by both parties to refrain from devaluing their currencies for competitive purposes, and to disclose relevant information related to exchange rates and external balances in a timely manner. The US Government also determined that China would no longer be designated a 'currency manipulator'. China's foreign reserves have remained stable at around US$3 trillion and capital outflows have remained within the range experienced over the past couple of years.





Financial conditions in many emerging markets have eased

Emerging market equity prices continued to rise through to early January, but have fallen more recently as concerns about coronavirus intensified. Local currency government bond yields have declined and exchange rates have been little changed (Graph 1.31). There have been inflows into emerging market equity funds in recent months following an extended period of outflows. This easing in financial conditions reflects a range of factors including the continued accommodative global financial environment and policy easing by many emerging market central banks during 2019 and early 2020.

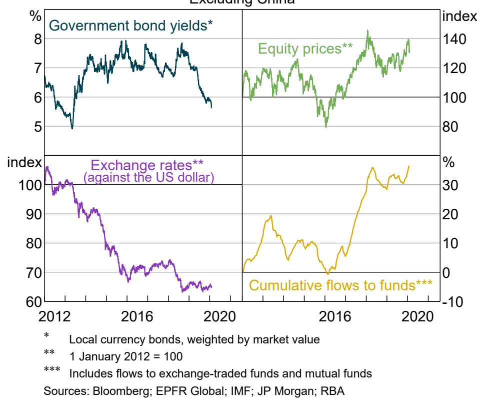
While financial conditions in emerging markets have generally eased, the outbreak of coronavirus has introduced a new source of uncertainty and risks remain for some

economies with specific political and/or macrofinancial vulnerabilities. Social unrest and political uncertainty have increased in Latin America in recent months. In Argentina, the new administration has suggested that another round of debt restructuring is close to hand. The central banks of Chile and Brazil have intervened in the foreign exchange market to support their currencies against recent depreciations (Graph 1.32). In Turkey, the exchange rate has continued to depreciate despite general sentiment toward emerging markets turning more positive in recent months.

Graph 1.31

Emerging Financial Markets

Excluding China



* Local currency bonds, weighted by market value

** 1 January 2012 = 100

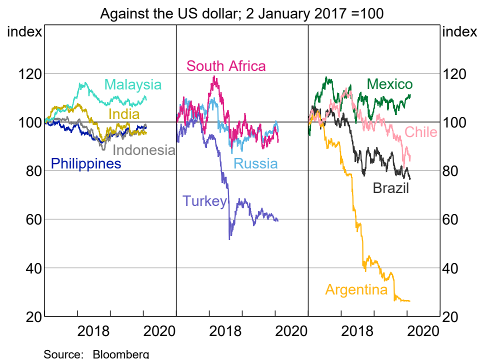
*** Includes flows to exchange-traded funds and mutual funds

Sources: Bloomberg; EPFR Global; IMF; JP Morgan; RBA

Graph 1.32

Emerging Market Exchange Rates

Against the US dollar; 2 January 2017 =100



Source: Bloomberg

The outbreak of coronavirus has affected commodity prices

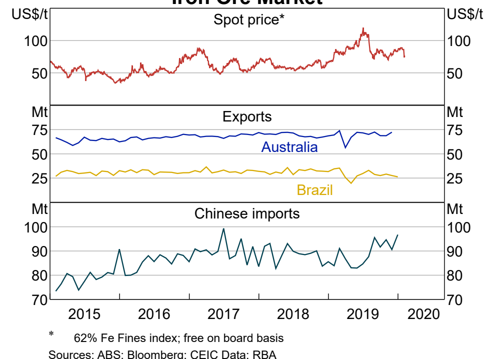
The iron ore price has declined recently in response to concerns about the near-term outlook for demand, particularly from China, following the coronavirus outbreak (Graph 1.33, Table 1.1). The outbreak has disrupted some industrial production and construction activity, which could reduce steel demand, at least in the near term. Policy measures announced in China in recent months to support the economy are expected to provide some support to steel demand, although uncertainty about the outlook for China and any potential policy responses is likely to result in some volatility in the iron ore price in coming months.

Thermal and coking coal prices have increased since the previous *Statement*, but are around 30 per cent lower than a year ago (Graph 1.34). Rising thermal coal supply from Indonesia, Russia and Australia has outpaced demand over the past year; thermal coal demand has also eased as competition from gas-fired and renewable electricity generation has increased. Meanwhile, weaker steel production in some other steel producing economies, including India, has weighed on coking coal demand.

The prices of commodities that tend to be most responsive to changes in the outlook for global demand – particularly oil and base metals –

Graph 1.33

Iron Ore Market



* 62% Fe Fines index; free on board basis

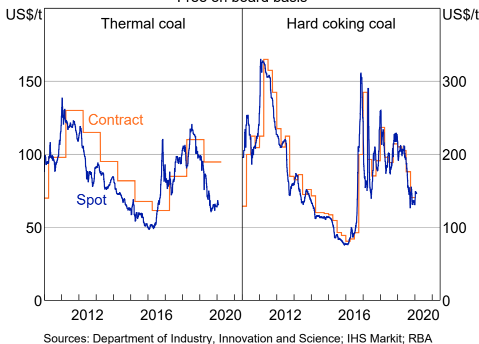
Sources: ABS; Bloomberg; CEIC Data; RBA

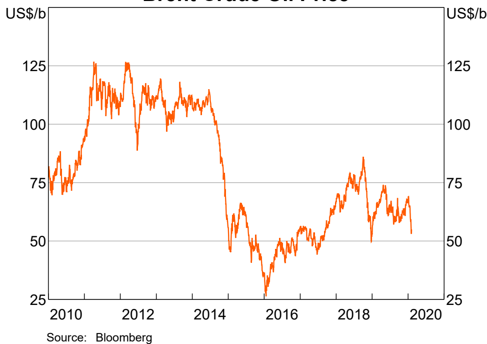
have declined recently in response to concerns about the potential impact of the coronavirus outbreak on global activity (Graph 1.35 and Graph 1.36). This more than offset increases in oil prices earlier in the year, after the US–China trade agreement was announced and OPEC members agreed to deepen production cuts in the first quarter of 2020.

Prices for Australian rural exports have increased in recent months. Wheat prices have been supported by supply concerns stemming from unfavourable weather conditions in key global producing regions, including in Australia. Beef prices increased sharply in late 2019 because of strong demand from Asia; however, prices have declined more recently because of an increase in supply owing to drought-related destocking.

Lamb prices have declined from their recent peak because of a seasonal increase in supply and drought-related destocking.

Based on partial export price data (including the prices of non-commodity exports), the terms of trade are expected to have declined in the December quarter reflecting lower iron ore and coal prices for much of the period. The terms of trade are expected to moderate further over the next couple of years as demand for bulk commodities eases and more supply comes online.





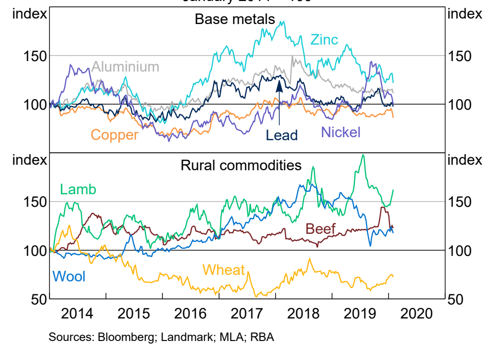


Table 1.1: Commodity Price Growth[a]

	Since previous *Statement*	Over the past year
Bulk commodities	4	–17
– Iron ore	2	–8
– Coking coal	11	–28
– Thermal coal	2	–32
Rural	3	–4
Base metals	–9	–13
Gold	6	18
Brent crude oil[b]	–12	–11
RBA ICP	–1	–9
– Using spot prices for bulk commodities	1	–14

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

(b) In US dollars

Sources: Bloomberg; IHS Markit; RBA