Overview

Global economic developments have, on balance, been more positive in recent months after economic conditions weakened earlier in 2012. There have been further signs that the Chinese economy has stabilised, underpinned by public spending and accommodative financial policies. This has provided some additional support for commodity prices and activity in east Asia, outside of Japan. In Japan, the new government has announced plans to boost domestic economic activity and combat deflation. In the United States, the full extent of the large fiscal consolidation that had been legislated to commence at the beginning of 2013 has been avoided, although decisions on spending measures and the debt ceiling were only postponed for a short while. These developments, together with earlier policy measures in the euro area, provided a boost to financial markets and have lessened some of the downside risks to global growth. At the same time, growth in most advanced economies remains subdued, unemployment rates are elevated, and these economies are likely to continue to face headwinds for some time to come; Europe, in particular, is likely to remain a potential source of instability for a while yet.

World GDP is expected to grow at around 3½ per cent in 2013, before picking up to around 4 per cent in 2014. Growth in the US economy is likely to return to a long-run average pace and activity in the euro area is expected to stabilise over the next few quarters before picking up modestly. While, overall, the large advanced economies are forecast to experience only moderate growth in the near term, relatively strong growth in the fast-growing (and increasingly large) Asian economies is expected to make a substantial contribution to global demand.

Iron ore prices have increased significantly over recent months after falling sharply over July and August last year. The price rise has coincided with increased industrial production in China and elsewhere in the region, although expectations are that iron ore prices will not be sustained at current high levels. Coal prices have also increased, but to a much lesser extent and they remain well below their levels of a year ago. Improved global economic conditions have led to a rise in the spot prices for many metals and crude oil over recent months, while rural prices are generally little changed. The terms of trade finished 2012 around 17 per cent below their 2011 peak. The recent rebound in bulk commodity prices is likely to see a small increase in the terms of trade in the early part of this year. Thereafter, bulk commodity prices and Australia's terms of trade are expected to decline gradually as global supply responds to the significant investment in mining infrastructure in Australia and elsewhere in the world.

As noted, conditions in global financial markets have improved further since the previous *Statement*, partly reflecting better economic data as well as the partial resolution of the fiscal situation in the United States, the absence of negative news from Europe and developments in Japan. Accommodative monetary policies, especially in the large advanced economies, have also contributed to increases in many asset prices. Since mid 2012, there has been a marked decline in volatility in financial markets as the perceived risk of extremely adverse outcomes has declined and expectations increased that policy will respond further if required. These favourable market conditions have seen a sizeable portfolio reallocation since the turn of the year, as a number of investors who had adopted a conservative strategy through the second half of 2012 shifted funds into assets with a higher expected return, including shares. Also, with favourable credit market conditions, non-financial corporations have issued a large amount of bonds, in some cases replacing more expensive bank-intermediated credit.

Over the year to the September quarter, Australia's GDP grew at around trend pace. While growth slowed a bit through the year to September, and was 0.5 per cent in that quarter, the available indicators of activity suggest that growth may have picked up in the December quarter.

In the September quarter, the national accounts indicate that public demand fell, which is consistent with the fiscal consolidation currently underway. Household consumption growth slowed in the quarter from the fast pace seen in the first half of 2012, consistent with slower growth in income. Over more recent months, the value of retail sales has declined and retail prices have been flat. On the other hand, sales of motor vehicles to households have grown strongly and measures of consumer sentiment have moved higher to be at or above long-run average levels.

Resource exports have increased strongly in the December quarter, including coal exports following the end of the industrial dispute at the BHP Billiton Mitsubishi Alliance (BMA) mines. The recent heavy rainfall in Queensland is having a noticeable impact on the transport of coal to ports, but at this early stage it appears that the effect on exports will be much less than was the case in 2011.

Growth in mining investment has been strong over the past year. However, with the falls in bulk commodity prices in mid 2012 leading to a reassessment of conditions and the viability of some projects, investment plans were scaled back. This was particularly the case in the coal sector, where price declines have been larger and more persistent. The expectation remains that growth in mining investment will slow and the level of investment will peak sometime over the next few quarters. But with a large amount of investment currently underway, or having been committed to, expenditure on mining investment is still expected to remain at a high level for some time.

Near-term prospects for business investment outside the mining sector continue to be subdued. However, there are signs that the housing market is responding to the series of interest rate cuts over the past 15 months. Since the middle of 2012, residential building approvals have increased, rental yields have moved higher and prices in the established housing market have picked up.

The labour market has remained soft, with the unemployment rate edging higher over recent months and labour force participation edging down. Despite no growth in total hours worked over 2012, the number of employed persons grew moderately. Over the second half of 2012, employment in mining and business services declined, but employment in household services continued to grow strongly and the decline in construction employment abated at least for a time. Forward-looking indicators have continued to soften but are consistent with some employment growth in the months ahead.

Wage growth moderated slightly in the September quarter, in line with the softening in labour market conditions as the year progressed. Over the year, wage growth in the private sector eased in industries more directly tied to consumer demand. Despite the small decline in mining employment of late, wages in that industry continued to record strong growth.

Inflation of consumer prices in the December quarter slowed following the temporary boost to inflation in the September quarter from the introduction of both the carbon price and means testing of private health insurance rebates. Also, inflation of a broad range of food items was modest in the December quarter, with a pronounced fall in the prices of fruit and vegetables.

Prices of tradable items declined in the December quarter, despite the effects of the earlier appreciation of the exchange rate having been largely passed through to measures of import prices. This suggests that the continued decline in the price of tradable items partly reflects the effect of ongoing competitive pressures. Inflation in the prices of non-tradable items (excluding utilities and medical services) increased a little in the December quarter, largely reflecting price rises for a range of market services.

The various measures suggest that underlying inflation was about ½ per cent in the December quarter. Based on the latest data, year-ended underlying inflation has remained around 2¼ per cent since the middle of 2012.

The outlook for the Australian economy is slightly weaker than it appeared at the time of the November *Statement*. GDP growth is now expected to be a little below trend over 2013 before picking up a little in 2014. The revisions to the central forecasts for growth in the near term largely reflect information accumulating late last year suggesting that the outlook for mining and non-mining investment was a little weaker than had previously been thought. The forecasts for growth over the next year or so reflect several factors: the expectation that the mining investment boom will reach its peak; the effect of both fiscal consolidation and the persistently high level of the Australian dollar; and little sign of a near-term pick-up in non-mining business investment. Overall, improving conditions in the housing market are expected to continue to provide support to dwelling investment, while non-mining business investment is forecast to pick up gradually over time.

With growth of economic activity expected to be a little below trend in the near term, employment growth is forecast to remain modest over the course of this year, before rising gradually over 2014. The unemployment rate is expected to edge higher over the next year or so.

The near-term forecasts for inflation are a little lower than published in the November *Statement,* reflecting the lower inflation rate recorded in the December quarter data and the slightly softer outlook for activity and labour demand. Over the next few quarters, the pace of underlying inflation is expected to remain at an annual rate of around 2½ per cent and continue to be consistent with the inflation target for the rest of the forecast period. This is predicated on a further gradual slowing in the growth rate of wages combined with a faster rate of productivity growth than the slow pace that was seen over the 2000s.

Overall, the risks to the international outlook appear to be more balanced than they were late last year. The most obvious downside risks stem from the problems in the euro area, where prospects for a pick-up in growth remain fragile. Risks appear to be more balanced now for both China and the United States than was the case three months ago. Indeed, growth in the United States could well surprise on the upside if there is further timely progress on fiscal consolidation that avoids a sharp near-term fiscal contraction.

For the domestic economy, the forecasts continue to embody a gradual recovery in dwelling investment and non-mining business investment. While many of the drivers of investment support such an outlook, when, and by how much, non-mining business investment might pick up remains particularly uncertain, including because of the high level of the exchange rate. The profile for mining investment will depend on the sensitivity of mining investment plans to commodity prices.

Risks to the outlook for inflation reflect uncertainty about aggregate demand, the labour market, productivity and the exchange rate. While labour market conditions are expected to remain soft over the forecast period, a more pronounced or protracted slowdown in activity could see a larger-than-expected rise in unemployment, which would constrain wage costs and consumer incomes, and limit further the ability of firms to raise prices. The effects of the high exchange rate on inflation may also be longer lasting than expected. On the other hand, inflation could be higher than forecast if wage growth does not edge down as expected or if productivity growth is weaker than anticipated.

Following the 75 basis point reduction in the cash rate in mid 2012, the Board reduced the cash rate by a further 25 basis points in October in response to weaker global conditions, lower commodity prices and the resulting softer outlook for investment and domestic demand. By the time of the December meeting, there were further indications that the peak in mining investment was approaching, and with public spending expected to weigh on growth, the Board judged that there was more scope for other sources of demand to strengthen. With the near-term outlook for business investment outside the resources sector also remaining subdued, the Board decided to reduce the cash rate by an additional 25 basis points. This reduction brought borrowing interest rates to well below their longer-run averages, and only a bit above the low levels achieved in 2009. The cumulative reduction in interest rates is affecting interest-sensitive parts of the economy, though the full effects will, of course, take more time to become apparent.

By early February, global economic and financial market conditions had improved. Also, expansionary monetary policies had led to a significant rise in asset prices and commodity prices had held up or even moved higher since the last months of 2012. Domestically, growth in economic activity is still expected to be a bit below trend this year, before picking up to around trend through 2014. Inflation, in underlying terms, is expected to remain close to the middle of the inflation target over the next couple of years. Given the significant monetary stimulus already in place, and signs of lower interest rates having some of the expected effects, the Board judged that the stance of monetary policy remained appropriate for the time being. The current inflation outlook would afford scope to ease policy further, should that be necessary to support demand. The Board will adjust the cash rate as appropriate to foster sustainable growth and low inflation.