Overview

Moderate growth in the global economy has continued, though indicators have been somewhat mixed in recent months. Growth in the Chinese economy was a bit slower in the March quarter, but over the past year or so has been in line with the Chinese authorities' stated target. Infrastructure investment and demand for residential property continue to be important drivers of growth. In Japan, there is increased optimism regarding the outlook for the economy following fiscal and monetary policy initiatives, with measures of sentiment and forward-looking indicators of activity improving in early 2013. Elsewhere in east Asia, growth has generally eased a little in recent months following a noticeable pick-up in the December quarter. The US economy continues to grow at a moderate rate, notwithstanding the ongoing effects of fiscal consolidation. Information available to date suggests that the gradual improvement in US economic activity has not stalled following the cuts to public expenditure that came into force in early March. The euro area remains in recession and the unemployment rate across the region is high. The weak state of some key private sector balance sheets and government finances will weigh on activity in the euro area for some time and leave economies vulnerable to further adverse shocks. In recent months, there has been a decline in inflation in most regions of the world. Monetary policy settings globally are very accommodative.

The outlook for global economic activity is little changed. World GDP is expected to grow at a bit over 3¼ per cent in 2013, slightly below its long-run average, before picking up to 4 per cent in 2014. Growth in China is expected to remain around the rates seen in the second half of last year and provide a measure of support to activity in east Asia. The outlook in Japan has improved, while other advanced economies are expected to experience only a gradual improvement in economic conditions. Growth of Australia's major trading partners is expected to continue to exceed that of the world, reflecting the faster growth of Australia's trading partners in Asia.

Most commodity prices have declined over the past few months but remain at historically high levels. A decline in the spot price of iron ore had been expected after substantial gains in the latter part of last year. Nevertheless, the steady growth of investment in China should continue to underpin demand for steel and hence for iron ore. Prices for coking and thermal coal have declined, and many other commodity prices are also lower. The increase in the spot price of iron ore late last year contributed to an increase in Australia's terms of trade in the first part of this year but, with large increases in the global supply of bulk commodities still in train, the terms of trade are expected to resume their decline from their current very high level.

Financial markets have continued to be affected by significant policy initiatives of various central banks. In particular, the new policy measures announced by the Bank of Japan have contributed to a further depreciation of the yen and affected other asset markets. Equity prices in Japan have increased by more than 30 per cent this year, following gains at the end of last year of a similar magnitude. Prices in other equity markets have also increased. Globally, yields are at historically low levels for both sovereigns and corporations.

The Australian economy grew at an around trend pace over 2012. Growth was a bit below trend in the second half of the year, with growth of consumption slowing and public demand recording a sizeable contraction. For the March quarter, growth in consumer spending looks to have recovered, with a strong pick-up in retail sales early in the year and measures of consumer sentiment above their long-run average. Sales of motor vehicles to households have declined over recent months, but remain at a high level following substantial increases last year.

There are signs of an increasing appetite for borrowing in the household sector, with approvals for housing and personal loans increasing over recent months. This coincides with improved conditions in the housing market. Dwelling prices are around 4 per cent above their low point of mid 2012 and auction clearance rates have also increased to be at, or above, long-run average levels. Higher house prices, low borrowing rates and a tight rental market should support a recovery in dwelling investment. Notwithstanding a decline in building approvals for higher-density housing in the March quarter, forward-looking indicators suggest that demand for new housing is gradually strengthening. This is also apparent in the Bank's business liaison, with firms noting that enquiries from prospective purchasers and visits to display homes have increased.

Meanwhile, near-term indicators of growth in business investment remain soft; capital imports declined in recent months, office vacancy rates have increased and indicators of capacity utilisation are a little below long-run average levels. Measures of current business conditions remain below average and the growth of business debt has been more modest in the early part of 2013. Also, the Bank's liaison continues to suggest that firms remain cautious about undertaking significant expansion. Nevertheless, the most recent ABS capital expenditure survey implies a moderate increase in investment in 2013/14.

Export volumes are estimated to have grown at a more moderate rate in the March quarter after strong growth of resource exports in the December quarter. Flooding in Queensland in early 2013 disrupted coal exports, but by much less than was the case in 2011. Rural exports have remained high following earlier strength on the back of what had been reasonable rainfall across much of the country for the past three years. Given the current dry conditions in some parts of the country, prospects for the 2013 winter crop depend heavily on rainfall in the near term. Services exports have increased a little of late, helped by growth in tourism arrivals from Asia, particularly China.

Labour market conditions remain somewhat subdued. With growth in employment below that of the working-age population, the unemployment rate has drifted higher over recent quarters. Leading indicators of employment growth have been mixed recently. The quarterly ABS measure of vacancies continued to decline up to February, while more timely indicators of job advertisements suggest stabilisation, albeit at low levels. The Bank's liaison suggests that firms remain cautious about hiring staff. Patterns of employment growth across industries and states have been consistent with the changing nature of growth in the Australian economy. In particular, employment has begun to shift away from mining and business services, towards construction and goods distribution.

Growth in wages in the December quarter continued at around the same rate seen in the September quarter, which was lower than that of recent years, in line with softer conditions in the labour market over the past year.

Consumer price inflation slowed in the March quarter. The low quarterly outcome (0.1 per cent on a seasonally adjusted basis) was partly attributable to falls in the volatile prices of fruit, vegetables and automotive fuel. It also reflected a decline in prices for a broad range of tradable items, particularly for consumer durables. These declines have occurred despite the relative stability of the exchange rate over the past couple of years and highlight the pressures on domestic costs and margins relevant to tradable goods and services. In contrast, non-tradables inflation has increased a little over the past year, although part of this reflects the introduction of the carbon price (and changes to the private health insurance rebate).

The various measures suggest that underlying inflation was a little under ½ per cent in the March quarter, which was a touch softer than had been expected, and a little under 2½ per cent on a year-ended basis.

The outlook for economic growth overall is little changed from that published in the February *Statement*. GDP growth is expected to be a little below trend over 2013, before picking up through 2014 to be around trend pace. The approaching peak in resource investment, the high level of the Australian dollar and ongoing fiscal consolidation are all likely to weigh on growth over the next year or so, while at the same time the low level of interest rates is helping to support demand. The outlook for non-mining business investment remains relatively weak over the next few months, with indicators of investment intentions for the near term remaining below average. Further out, firms' stated capital expenditure plans for 2013/14 imply a gradual increase in non-mining business investment. Resource sector investment looks to be near its peak, although with many projects currently underway it is expected to remain at a high level for the next year or so.

With growth of economic activity forecast to be a little below trend, employment growth is expected to be moderate in the near term. Accordingly, the unemployment rate is expected to continue to edge higher for the next year or so, before a return to trend output growth gradually supports some improvement in labour market conditions.

In the near term, the forecasts for year-ended inflation are a little lower than those published in the February *Statement*, at close to 2 per cent through this year. To a large extent this reflects the fact that inflation in the March quarter was a bit lower than had been expected. Non-tradables inflation is expected to ease somewhat, given the improvement in productivity growth and recent moderate wage outcomes. But as deflation in tradables items is expected to pass, overall inflation is forecast to return to the middle of the inflation target by mid next year.

The risks to the global growth outlook appear to be broadly balanced for most economies, but still tilted to the downside in Europe, where banking and fiscal problems remain significant. As was the case in the February *Statement*, risks to the US economy appear balanced; while fiscal consolidation is weighing on growth, the repair of private sector balance sheets is progressing and monetary policy remains expansionary. The risks to the outlook for China also seem to be balanced, with growth of economic activity currently around the growth rate of the productive capacity of the economy. In Japan, there remains considerable uncertainty about the effectiveness of the policies to stimulate demand and raise inflation, and outcomes could be weaker or stronger than assumed in the forecasts.

For the domestic economy, the forecasts continue to embody a gradual shift in growth from investment in the resource sector towards exports, non-mining investment and household demand. This rebalancing appears to be beginning, but inevitably there remains considerable uncertainty about exactly how it will unfold.

Risks to the outlook for inflation appear broadly balanced. Inflation could be lower than expected if the labour market weakens by more than anticipated and wages are more responsive to this than they have been to date. Similarly, the sustained high level of the exchange rate could lead to further downward pressure on tradables prices. However, non-tradables inflation has not slowed and it could persist at higher levels than implied by the forecasts. Furthermore, the fall in the participation rate over the past couple of years may reflect more persistent determinants of labour supply, in which case there may be less spare labour than otherwise.

Over 2012, the Board reduced the cash rate by 125 basis points, bringing it to 3 per cent and borrowing rates close to their previous lows. Since then, signs have emerged that the economy has been responding to the low level of interest rates. Savers have been changing their portfolios towards assets with higher expected returns, asset values have risen and some interest-sensitive areas of spending have increased. On the other hand, the exchange rate has been little changed at a historically high level over the past 18 months, which is unusual given the decline in export prices and interest rates during that time. Moreover, the demand for credit has thus far remained relatively subdued.

Over the earlier part of this year, the Board held the cash rate steady while carefully assessing economic developments and noting that the inflation outlook would afford scope to ease further, should that be necessary to support demand. At its May meeting, with inflation a little lower than had been expected, and growth of economic activity likely to remain below trend into next year, the Board judged that a further reduction in the cash rate would help to support sustainable growth in the economy, and would be consistent with achieving the inflation target. The Board will adjust the cash rate as appropriate to foster sustainable growth and low inflation.