1. The International Environment

The upward pressure on inflation evident over the second half of 2021 has persisted and the global economic outlook remains uncertain. Inflation in many advanced economies increased in March and is now expected to reach 6–9 per cent during 2022, 1–2 percentage points higher than forecast earlier in the year and well above central banks' inflation targets. The recent increase in inflation largely reflects the increase in energy, food and other commodity prices associated with the Russian invasion of Ukraine, but inflation pressures are broad based. At the same time, goods production in China is being disrupted by the widening spread of COVID-19 and associated restrictions. These supply shocks are affecting the global economy at a time of limited spare capacity – unemployment rates are at generational lows and job vacancy rates at historical highs in a number of economies.

The rise in inflation has exceeded the increase in wages growth, eroding households' purchasing power across a wide range of economies. Lower-income households are particularly affected by higher fuel and food prices. The impact of higher commodity prices will boost national incomes for some economies but be negative for overall global growth. European economies are especially affected, due to their reliance on Russian gas. More generally, higher commodity prices transfer income from commodity importers to commodity exporters, who will tend to save much of the additional income.

Central banks in many advanced economies have begun to withdraw the extraordinary monetary stimulus introduced during the pandemic by increasing policy rates and announcing plans to reduce their asset holdings. This reflects the increase in inflationary pressures, including from tight labour markets in many economies, and a desire to avoid the risk that high inflation causes a noticeable increase in longer-term inflation expectations. Many central banks have signalled that further policy rate increases are likely in the near term. Government bond yields have risen considerably, and financial conditions for households and businesses have become less accommodative in many economies. Central banks in emerging markets – including in Asia – have already increased policy rates or are expected to start raising rates in the next few months, in response to rising inflation.

In China, conditions have become significantly more challenging as a result of the recent outbreaks of COVID-19 and stringent restrictions on mobility in some cities. Restrictions have reduced consumer spending and the production of manufactured goods, adding to the challenge facing the government in meeting its recently announced growth target. Fiscal policy settings had already turned expansionary earlier this year, as the authorities' priorities shifted towards stabilising economic growth; however, they have announced additional targeted measures in recent weeks as risks to growth have increased. Chinese authorities have also eased monetary policy since the previous *Statement*, but by less than markets had expected.

Table 1.1: Commodity Price Growth[(a)]

SDR terms; percentage change

	Since previous *Statement*	Over the past year
Bulk commodities	11	72
– Iron ore	–1	–13
– Coking coal	6	368
– Thermal coal	45	364
LNG – Asia spot price	–6	165
Rural	12	42
Base metals	4	43
Gold	9	6
Brent crude oil[(b)]	16	105
RBA ICP	11	51
– Using spot prices for bulk commodities	7	61

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

(b) In US dollars.

Sources: Bloomberg; McCloskey by OPIS; RBA

Commodity prices have risen since early February

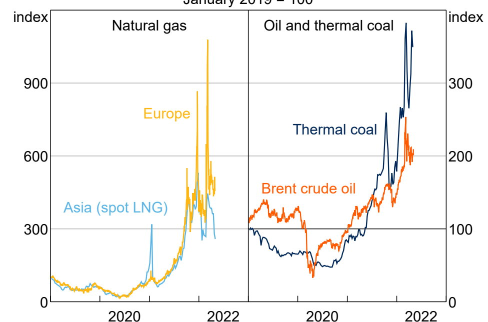
The prices of thermal coal and European gas have risen by 30–40 per cent since the start of February, while the price for oil is around 20 per cent higher (Graph 1.1; Table 1). These increases follow the invasion of Ukraine, as official sanctions and other private sector decisions have led to significant disruptions to global trade and financial flows with Russia – the world's largest exporter of natural gas and the second-largest exporter of crude oil. However, the price of Asian gas – which is most relevant to Australia – diverged from that in Europe during April to be lower than at the start of February (but still well above its 2021 average). The disruption to the global supply of energy has added pressure to what was an already tight market, in large part due to strong underlying demand conditions ahead of the conflict. While market participants generally expect commodity prices to ease from current high levels, analyst forecasts and market pricing imply that prices for energy commodities are still expected to be at least 70 per cent higher by the end of the year than at the start of 2021.

The United States, the United Kingdom, the European Union and Japan have all announced or are considering bans on crude oil or coal imports from Russia; collectively, this amounts to about 5 per cent of world crude oil and thermal coal trade. A number of global energy firms have also decided to cease buying Russian oil. In addition, many countries have prohibited new investment in Russian energy projects and

Graph 1.1

Energy Prices

January 2019 = 100



Sources: Bloomberg; McCloskey by OPIS; RBA; Refinitiv

several private firms have sold or written down their investments in Russia. To offset this reduction in crude oil supply, members of the International Energy Agency (and particularly the United States) have released oil from their strategic reserves. This is equivalent to slightly less than half the reduction in their imports from Russia over the next six months. At the same time, it is possible that some non-sanctioning countries purchase more oil from Russia and less from elsewhere.

Russian gas supplies to Europe have mostly continued. However, Russia suspended deliveries to Poland and Bulgaria in late April and the risks that trade between Europe and Russia might cease more broadly, or that critical infrastructure will be damaged by the war, have contributed to a high and volatile risk premium on gas prices. The European Commission has proposed to reduce dependency on Russian gas by two-thirds by the end of 2022. This is possible if Europe increases other LNG imports and reduces gas consumption. Some ways of reducing consumption are relatively costless (e.g. by modestly reducing demand for heating), but a large reduction would be costly for economic activity.

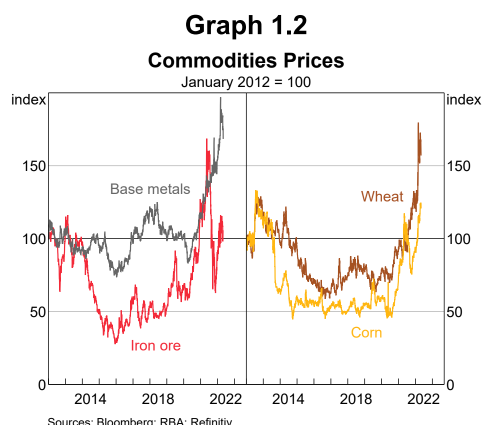
The war has also caused significant disruption to agricultural supply chains, particularly for wheat (Graph 1.2). Global wheat prices have increased by around 30 per cent since February, reflecting the fact that Ukraine and Russia collectively account for nearly 30 per cent of global exports. In addition, disruptions to the supply of nitrogen have caused fertiliser prices to rise sharply, which may reduce global crop yields in the year ahead if farmers respond by restricting their use of fertilisers.

Supply concerns and higher energy prices have also supported the prices of base metals and some other minerals. This includes aluminium, nickel, palladium and various noble gases – commodities that are either energy-intensive to produce, or notably supplied by Russia or Ukraine. Prices for iron ore have also increased by 20 per cent since the start of the year, as strength in Chinese infrastructure investment has outweighed concerns about the impact of the Omicron outbreak and the recent tightening of the annual limit on steel production (see below). Trade routes for Ukrainian iron ore (which accounts for around 3 per cent of global iron ore exports) have also been blocked.

COVID-19 restrictions in China are amplifying supply chain challenges

The outbreak of COVID-19 in China continues to place additional pressure on the supply chains for manufactured goods. While case numbers have been low in an international context, the authorities have continued their strategy of seeking to suppress the virus, including through very strict restrictions on movement in a number of cities. With the south-east of the country serving as the gateway for more than half of China's trade, outbreaks and restrictions there could materially disrupt the export of manufactured goods.

Exports from China declined in March, but remained above the levels of mid-2021 (Graph 1.3). The fall reflects reduced traffic through the port of Shenzhen in mid-March associated with restrictions to stop the virus spreading (with other ports only partly able to



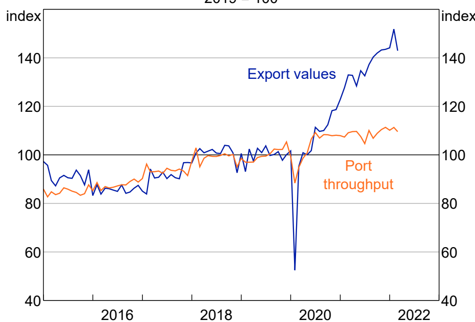
offset this). Restrictions in Shenzhen were eased in late March and throughput quickly recovered, but the lockdown in Shanghai since that time saw throughput at that port fall in April. Various adjustments, including some factories establishing worker 'bubbles' that allow production to continue, have mitigated the fall in exports to date; however, disruptions to goods distribution domestically mean these responses will be less effective the longer restrictions are in place (see below).

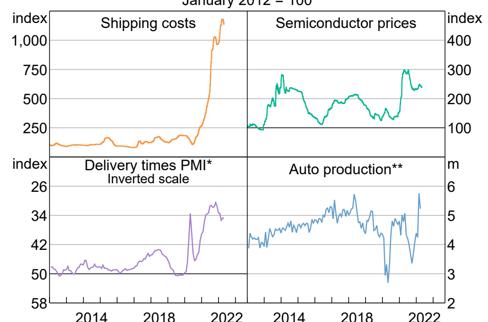
Various measures of supply chain pressures remain elevated, although they have generally eased from their recent peaks. Global shipping costs are the main exception and have risen further, with the increase in oil prices in recent months adding to the cost of transport (Graph 1.4). The price of semiconductors has also risen modestly due to concerns that supply could be disrupted by the reduced supply of neon – a key input for which Ukraine makes up around half of global supply. However, these factors are yet to be reflected in survey measures of supply constraints; while supplier delivery times are still significantly elevated, they have eased from their 2021 peaks in countries other than China. One reason for recent easing could be that labour supply has improved in advanced economies since early in the year, as the number of workers who are sick or isolating due to COVID-19 has declined.

These disruptions are adding further impetus to inflation

Year-ended inflation in major advanced economies picked up in March. For most, headline inflation is in the 5–8 per cent range. The increase in inflation in the early part of this year reflects the surge in wholesale oil prices flowing through to consumer petrol prices (Graph 1.5). Higher prices for energy and food are expected to continue to be passed through into higher consumer prices over the rest of the year. Professional forecasters expect headline inflation to peak at around 6–9 per cent in many advanced economies, 1–2 percentage points higher than had been expected late last year.

Core inflation is also well above its pre-pandemic average across a wide range of economies, with the notable exceptions of China, Japan and some parts of Asia where activity remains depressed (Graph 1.6). Recent monthly growth rates show little sign of an easing in core inflation. High rates of underlying inflation are consistent with broad-based inflationary pressures associated with the lack of spare capacity in many economies, including in labour markets. Inflation continues to be more





rapid for goods than services, and further disruptions to global supply chains could exacerbate this. Inflation in the price of consumer services – which comprises a much larger share of the basket and tends to be more persistent – has, however, increased to be above historical norms in many economies. Inflation could increase further in the year ahead if rising inflation expectations feature in wage- and price-setting behaviour. Measures of near-term consumer and business inflation expectations are substantially elevated relative to recent decades, and measures of longer-term expectations derived from financial markets have also lifted moderately (see below).

These supply disruptions occurred amid strong demand and tight capacity

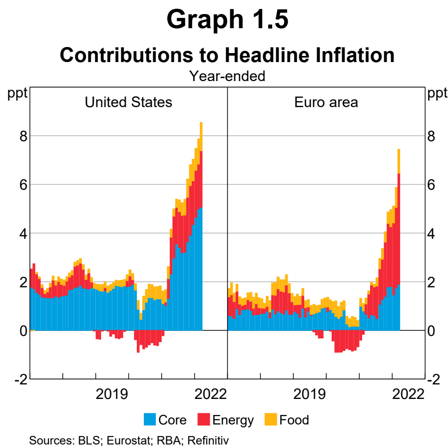
GDP increased strongly in most economies over the year to the March quarter (Graph 1.7). In advanced economies, this strength was underpinned by the relaxation of mobility restrictions, expansionary monetary policy and the ongoing boost from generous fiscal support during the pandemic. Goods consumption has remained robust even as services consumption has picked up, supported by strong household incomes and accumulated savings. Household saving rates generally remain above pre-pandemic levels (the United States is a notable exception), suggesting the recovery in consumption has further potential. In many emerging market economies, the recovery has been sizeable but less complete than in advanced economies, largely due to their more limited capacity to provide fiscal support and ongoing weakness in international tourism.

The strong recovery in many advanced economies has seen unemployment rates fall to

Graph 1.5

Contributions to Headline Inflation

Year-ended

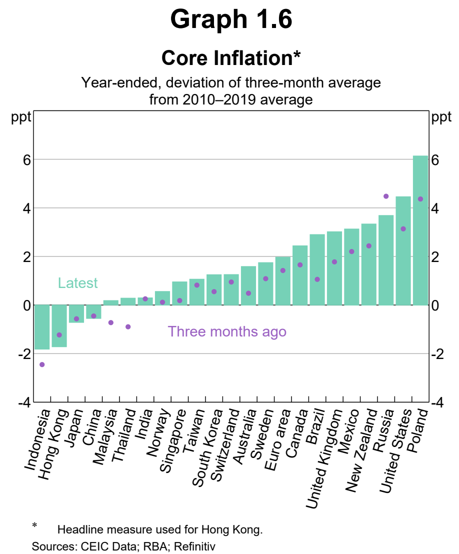


Sources: BLS; Eurostat; RBA; Refinitiv

Graph 1.6

Core Inflation*

Year-ended, deviation of three-month average from 2010–2019 average



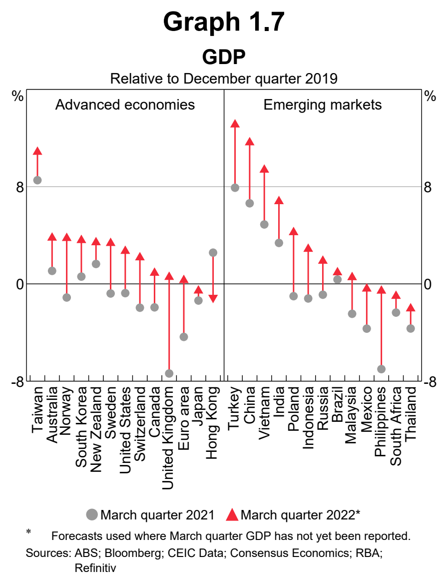
* Headline measure used for Hong Kong.

Sources: CEIC Data; RBA; Refinitiv

Graph 1.7

GDP

Relative to December quarter 2019

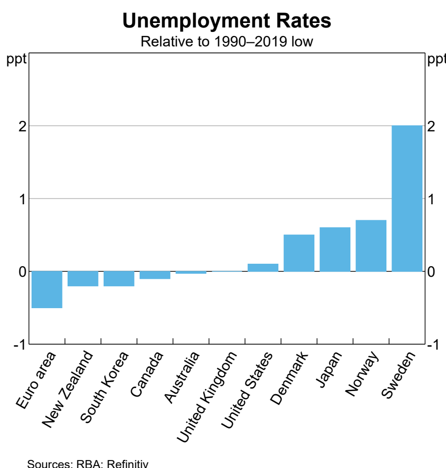


* Forecasts used where March quarter GDP has not yet been reported.

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

around generational lows (Graph 1.8). Broader measures of labour market conditions also show considerable strength. Employment has risen strongly and job vacancies are around record highs, particularly in the leisure and hospitality industry that is now recovering strongly. In many economies, measures of underutilisation have decreased by more than unemployment rates.

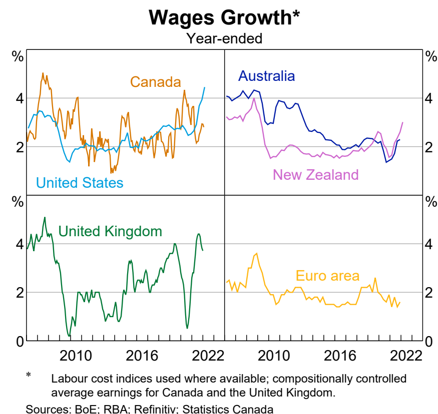
Despite very low unemployment, wages growth has been slow to pick up in most advanced economies (Graph 1.9). The notable exceptions are the United States and the United Kingdom, where wages are growing at their fastest pace in many years. In the United States, a reduced supply of labour (in part due to lingering health concerns) has contributed to this, especially in the leisure and hospitality industry. However, labour supply is starting to recover; the participation rate has lifted significantly since October and employment in leisure and hospitality has grown strongly (partly in response to higher wages). Labour supply also contracted in the United Kingdom during the pandemic but, unlike in the United States, is yet to recover.



High inflation is eroding household purchasing power …

Real wages have fallen significantly in advanced economies over the past year, as the increase in inflation has outpaced growth in nominal wages (Graph 1.10). This has reduced household purchasing power and contributed to sizeable declines in consumer confidence over recent months (Graph 1.11). These effects are likely to have been larger for lower-income households because they typically spend a greater share of income on energy and food. They also tend to have less savings (both from current income and past accumulation) with which to buffer consumption in the face of negative income shocks.

Governments in many countries have recently announced additional fiscal support to mitigate the effects of high inflation on household income. In Europe, national governments have announced energy rebates, income support or reductions in value-added taxes that equate to around 0.5 per cent of household income in the euro area and around 1 per cent in the United Kingdom. In some cases, these fiscal measures have been uniformly distributed to all households; in others, they are targeted towards households with lower incomes. Many Asian governments have also provided tax cuts or



increased fuel subsidies (in some cases by maintaining fuel price caps).

… weighing on the outlook for global growth

The reduction in real purchasing power is forecast to be most significant for European economies, given electricity prices are expected to rise most there. Consensus forecasts for GDP growth in the euro area in 2022 have been revised down by around 1½ percentage points since earlier in the year (Graph 1.12); forecast growth in most other trading partner economies has also been revised down, but generally by around ½ percentage point. In these economies, higher inflation and commodity prices are reducing real wages – and the national incomes of commodity-importing economies – while also lifting the expected path of policy rates in some cases. For many energy exporters, forecasts have been little changed given increases in their terms of trade and national incomes; Russia is a notable exception. Asian growth is expected to slow but only modestly, despite most economies in the region being energy importers. This is largely because the impact of higher commodity prices on consumer prices is expected to be diluted by existing price-setting mechanisms and contractual arrangements in the energy sector, as well as food consumption patterns that are less exposed to the commodities with the fastest rising prices.

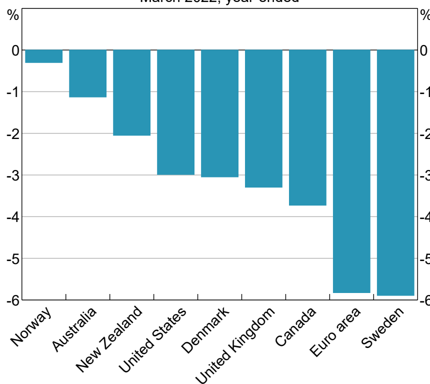
Forecasts for growth in China have been revised down largely because of the disruptions stemming from COVID-19 restrictions there. Year-average GDP growth is forecast to be about ½ percentage point short of the 'around 5.5 per cent' GDP growth target announced by policymakers in March.

Overall, growth in Australia's major trading partners in 2022 and 2023 is forecast to be around 4 per cent, which is below its pre-pandemic decade average. The forecast for

Graph 1.10

Real Wages Growth*

March 2022, year-ended



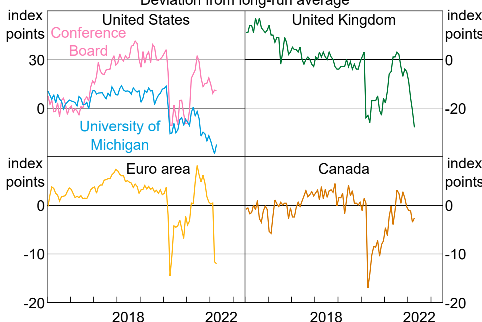
* Using earnings measures; forecast used for Australia; nominal wages growth for March 2022 assumed to equal December 2021 where March 2022 data are unavailable.

Sources: RBA; Refinitiv; Statistics Canada

Graph 1.11

Consumer Confidence Indicators

Deviation from long-run average

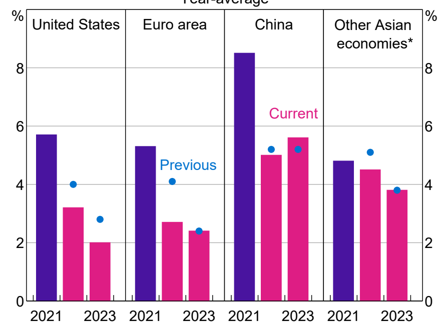


Sources: RBA; Refinitiv

Graph 1.12

GDP Growth Forecasts

Year-average



* Exports-weighted average of major Asian economies excluding China.

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

2022 has been revised down by ½ percentage point since the February *Statement*.

There are some scenarios where global growth could be stronger than currently forecast. For instance, European economies could substitute away from Russian energy faster and in a less disruptive way than currently anticipated. It is also possible that the transition to living with COVID-19 as an endemic disease is smoother than assumed, with strong household and business balance sheets underpinning more spending than currently envisaged. However, the balance of risks to the global economic outlook appear to be skewed to the downside, and reflect the following:

- *Financial conditions could tighten more quickly than implied by current market pricing.* The persistent rise in commodity prices and ongoing supply disruptions are complicating the policy trade-offs facing central banks. If central banks remove monetary stimulus relatively quickly in response to further rises in inflation, they could slow economic activity and increase unemployment by more than expected, particularly in highly indebted economies. Alternatively, if policy-makers choose to 'look through' the rise in commodity prices and other supply disruptions, there is a risk that higher inflation expectations feed into a further pick-up in wage and price inflation; this could be more costly for growth in the future if it necessitates a much larger eventual policy tightening. More generally, there is evidence that growth in some economies, including the United States, is increasingly constrained by capacity. Unless these economies can lift productivity or increase labour force participation, additional growth in demand could manifest in persistently higher inflation that would require much tighter monetary policy and could unsettle financial conditions.
- *The global economy could be more sensitive to falling real incomes (and consumption) than currently envisaged.* Consumer sentiment has recently declined sharply in a number of advanced economies as inflation and interest rates have increased and real wages have fallen. Uncertainties relate to how much households will reduce their savings to sustain spending in the face of lower purchasing power, and the willingness of governments to continue providing fiscal support in response to cost-of-living pressures when inflation is already high. Although labour markets are tight, it is also uncertain how much workers can offset recent falls in real wages by demanding larger nominal wage rises.
- *The Chinese economy could slow more sharply than forecast if outbreaks of COVID-19 are not contained quickly and long-running macro-financial vulnerabilities worsen.* Further mobility restrictions in response to COVID-19 outbreaks would compound supply disruptions and add to upward pressure on inflation globally. Slower growth would also amplify the risks already present in China's residential property sector, adding to the stress already faced by property developers. However, it is also possible that China manages to contain the impact of COVID-19 outbreaks on the economy, or that the authorities are able to largely offset the impact with more policy stimulus.

Central banks in many advanced economies have raised policy rates and indicated that further rate increases are likely

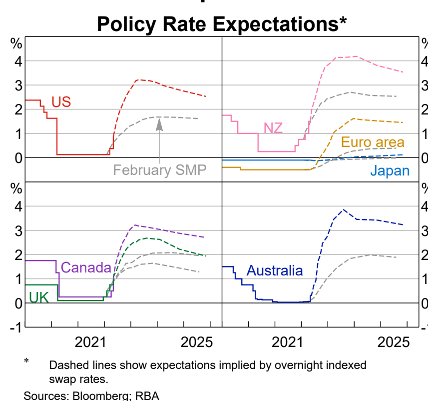
Many central banks in advanced economies have begun to withdraw some of their substantial monetary stimulus in response to improved economic conditions and higher-than-expected inflation. Several central banks have increased their policy rate in recent

months, some for the first time this cycle, and have indicated that further increases are likely in the near term (Graph 1.13). A number have noted that higher policy rates are needed to avoid the risk that longer-term inflation expectations increase to a degree that threatens the return of inflation to target. Some have signalled that policy rates may need to reach a restrictive level – that is, above estimates of the longer-run neutral rate – within the next year or so. In particular:

- At its meetings in March and May, the US Federal Reserve (Fed) increased the target range for its policy rate by a cumulative 75 basis points to 0.75 to 1 per cent. The Fed indicated that further increases are likely to be appropriate because of broad price and labour market pressures, with the potential for rate rises in 50 basis point increments at its next few meetings. Fed policymakers project that the policy rate will reach around 2.8 per cent by the end of 2024.
- In March, the Bank of England (BoE) increased its policy rate by another 25 basis points to 0.75 per cent. The BoE expects that the rise in commodity prices will increase inflation and, in turn, lower real household incomes and economic activity. Nonetheless, it judged that less accommodative monetary policy settings were appropriate because of a tight labour market, strong domestic cost and price pressures, and the risk that those pressures would persist.
- In March, Norges Bank increased its policy rate by 25 basis points to 0.75 per cent and revised up its projected path for the policy rate. It projects that the rate will reach around 2.5 per cent by the end of 2023.
- At its meetings in March and April, the Bank of Canada (BoC) increased its policy rate by a cumulative 75 basis points to 1 per cent. It noted that economic slack had been absorbed, and indicated that it will need to raise rates further to return inflation to its 2 per cent target and keep inflation expectations well anchored.
- At its meetings in February and April, the Reserve Bank of New Zealand (RBNZ) increased its policy rate by a cumulative 75 basis points to 1.5 per cent. In April, the RBNZ said it was increasing the policy rate to a more neutral stance sooner than it had projected in February in order to reduce the risk of rising inflation expectations. It projects that its policy rate will peak at around 3.25 per cent by the end of 2023.
- At its meeting in April, Sveriges Riksbank increased its policy rate by 25 basis points to 0.25 per cent. It also revised up its forecast path for the policy rate; at its previous meeting in February, the Riksbank had indicated that the first increase in the policy rate would occur in 2024. The Riksbank noted that it was increasing the policy rate to prevent high inflation from becoming entrenched in wage and price setting.

Many central banks have outlined plans to reduce their asset holdings

Central banks in advanced economies have ended the purchasing phases of their pandemic-related quantitative easing (QE) programs (Graph 1.14). Only the European



Central Bank (ECB) and the Bank of Japan (BoJ) continue to make net asset purchases – both under asset purchase programs introduced prior to the pandemic. Many central banks have ceased reinvesting proceeds from maturing bonds, which will lead to a gradual decline in their bond holdings. While these central banks note that this process will contribute to the removal of some monetary stimulus, they continue to emphasise that the policy rate will be the main tool for removing stimulus.

The BoC, the BoE, the Fed, the Riksbank and the RBNZ are reducing their holdings of government bonds by allowing bonds to mature or have announced that they will begin doing so in coming months. The RBNZ has also announced that it will sell NZ$5 billion per annum of its portfolio to New Zealand Debt Management, the issuer of New Zealand Government bonds. The BoE has said it will consider bond sales once its policy rate reaches 1 per cent. The Riksbank and the Fed will continue to reinvest a portion of the proceeds from maturing bonds such that their holdings decline in a gradual manner. In the case of the Fed, from June it will only reinvest proceeds from maturing Treasury securities that exceed a cap of US$30 billion per month; it will increase that cap to US$60 billion per month from September.

Meanwhile, the ECB has said it will reinvest maturing assets purchased under pandemic-related programs for some time. At its March meeting, the ECB announced a faster tapering of purchases under its asset purchase program – a distinct QE program that preceded the pandemic. It now expects to end net purchases early in the September quarter.

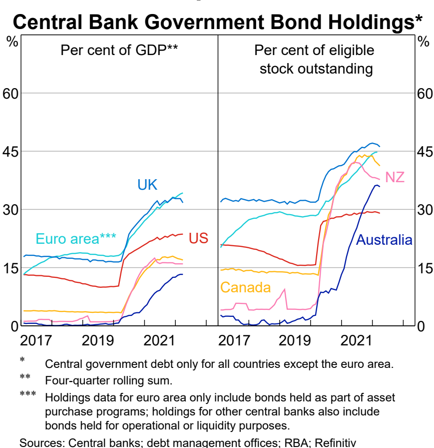
In contrast, the BoJ has reaffirmed that it will continue to implement its accommodative monetary policy stance until inflation has reached the 2 per cent target in a stable and sustainable manner, and has increased asset purchases across the yield curve. This includes further fixed-rate operations to maintain its yield curve control, whereby it seeks to maintain the yield on 10-year Japanese Government bonds within a range of zero per cent plus or minus 25 basis points.

Government bond yields have risen further …

Government bond yields have risen significantly over recent months, reflecting an increase in compensation for inflation and expectations that central banks will tighten policy faster and to a greater extent in response (Graph 1.15; Graph 1.16). The increase in bond yields has been more pronounced for shorter-term maturities in several advanced economies; in other words, yield curves have 'flattened'.

Market-implied inflation expectations have increased notably for the year ahead, a direct impact of the increase in energy and food prices. Long-term market-implied inflation expectations have risen moderately but remain around levels consistent with central bank inflation targets. Real yields remain well below their pre-pandemic levels in Germany but have increased significantly in the United States, Canada and Australia, consistent with market expectations that policy will be tightened more quickly in these economies than in the euro area (Graph 1.17).

Graph 1.14



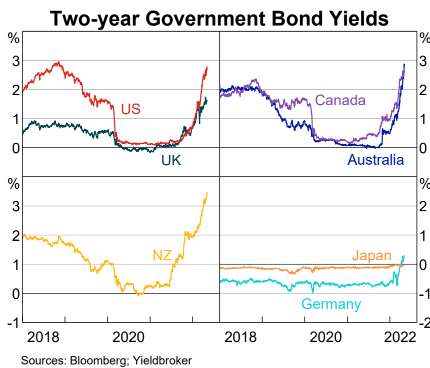
* Central government debt only for all countries except the euro area.
** Four-quarter rolling sum.
*** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.
Sources: Central banks; debt management offices; RBA; Refinitiv

… contributing to less-accommodative financial conditions for the private sector

Conditions in corporate bond markets have become less accommodative. Corporate bond yields have risen alongside an increase in government bond yields and there has been some widening of credit spreads in Europe due to concerns about the economic implications of tighter monetary policy and Russia's invasion of Ukraine (Graph 1.18). As yields have increased in recent months, issuance of sub-investment grade bonds has declined, while issuance of investment grade bonds has remained robust.

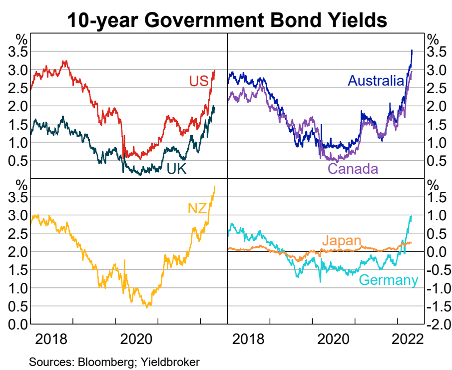
Equity prices in most major markets declined sharply following Russia's invasion of Ukraine and are below their levels at the start of the year (Graph 1.19). This reflects some ongoing concern about the economic impact of the war, as well as the effect of tighter monetary policy and the COVID-19 situation in China. The additional compensation that investors require to invest in equities versus government bonds (the equity risk premium) has risen somewhat, to be around its pandemic peaks for European equities. Equity issuance has been subdued since the start of the year in both the United States and Europe.

Graph 1.15



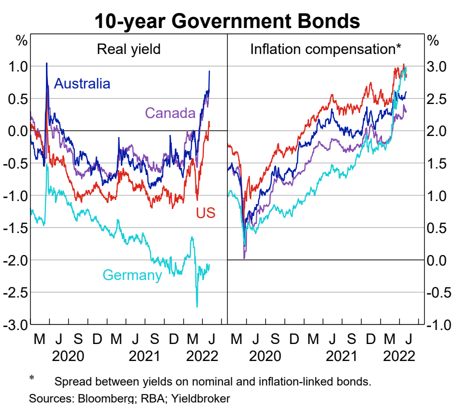
Sources: Bloomberg; Yieldbroker

Graph 1.16



Sources: Bloomberg; Yieldbroker

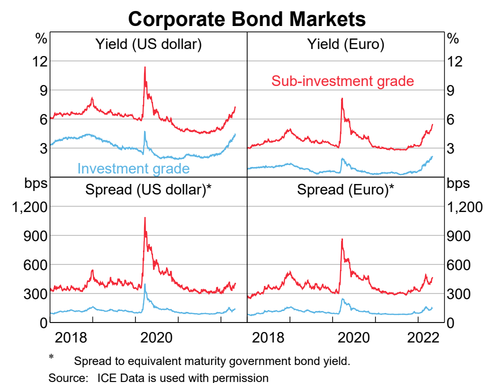
Graph 1.17



* Spread between yields on nominal and inflation-linked bonds.

Sources: Bloomberg; RBA; Yieldbroker

Graph 1.18



* Spread to equivalent maturity government bond yield.

Source: ICE Data is used with permission

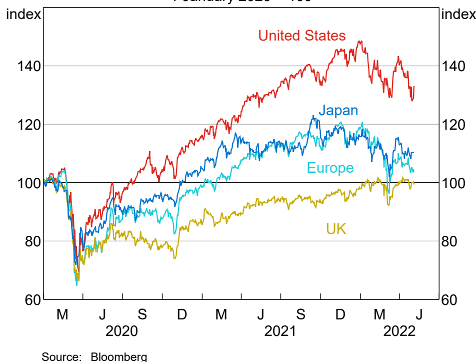
The US dollar has appreciated

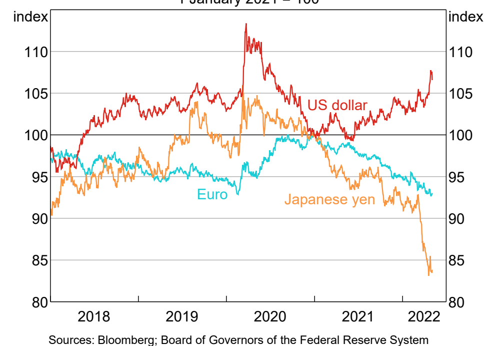
The US dollar has appreciated against most currencies since the start of the year alongside the increase in US Government bond yields relative to many other advanced economies (Graph 1.20). Conversely, the Japanese yen has depreciated noticeably over the same period, reaching its lowest level since 2015 on a trade weighted (TWI) basis, as yields of Japanese Government bonds have remained at low levels. The euro and British pound have depreciated since the invasion of Ukraine, largely as a result of increased uncertainty about the outlook for growth in Europe. The currencies of commodity-exporting economies, including the Australian dollar, have depreciated on a TWI basis over the past month but are higher than levels seen prior to the invasion of Ukraine, supported by the rise in commodity prices (see chapter on 'Domestic Financial Conditions' for recent developments in the Australian dollar).

Spillovers from the invasion of Ukraine have so far been limited for most emerging market economies

Russia's financial markets have experienced significant disruptions since February, following its invasion of Ukraine and international sanctions imposed on its economy. The rouble depreciated sharply in the first two weeks of the war, notwithstanding the Central Bank of Russia (CBR) more than doubling its policy rate to 20 per cent and the Russian authorities introducing extensive capital controls (Graph 1.21). These measures include banning foreign investors from selling Russian assets, and requiring exporters to buy roubles with their foreign-currency receipts. There is currently very little rouble trade in foreign exchange markets, making the exchange rate indicative at best. The CBR subsequently lowered its policy rate twice by a cumulative 600 basis points to 14 per cent, citing constraints to economic activity. Premiums on Russian credit default swaps and spreads on US-dollar-denominated government bonds widened substantially as market participants became increasingly concerned about Russia's ability and willingness to repay its sovereign debts. Spreads narrowed considerably in early May after Russia reportedly made two overdue bond payments in US dollars before the end of a grace period.

The effects of the war have not yet spilled over to most other emerging market economies other than via the adverse impact of higher commodity prices. Emerging European economies that are proximate to Ukraine and some economies in North Africa and the Middle East that import large amounts of food have been most affected by higher commodity prices.





Local currency government bond yields in emerging markets have risen in line with broader inflation pressures and increases in policy rates, particularly in Europe and Latin America (Graph 1.22). The currencies of emerging European economies also depreciated against the US dollar since the start of the war amid large outflows by foreign investors in their bond and equity markets.

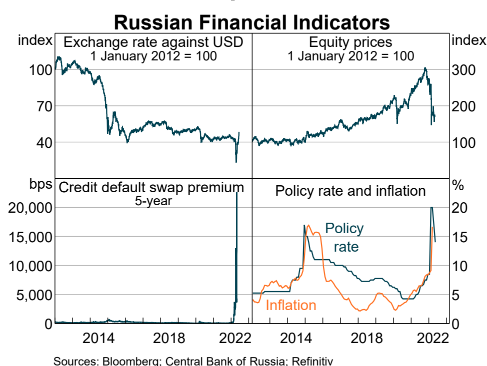
Emerging market central banks are increasingly concerned about inflation

Most central banks in middle-income Asian economies have left policy rates unchanged amid subdued inflation there, with many noting that higher global commodity prices will contribute to higher domestic inflation (Graph 1.23). The Reserve Bank of India raised its policy rate by 40 basis points at an unscheduled meeting in early May, citing elevated inflationary pressures. Market-implied paths of policy rates continue to suggest that most other Asian central banks are expected to gradually start raising rates this year. By contrast, central banks in much of Latin America have tightened policy further since the February *Statement* due to continued concerns about high inflation, and are expected to raise policy rates further.

Many emerging market central banks have continued to express concerns around the potential for disruptions from a faster-than-expected tightening in monetary policy in advanced economies. However, emerging markets had received only modest banking and portfolio inflows as a share of GDP in the years leading up to the pandemic compared with earlier episodes of capital inflows.

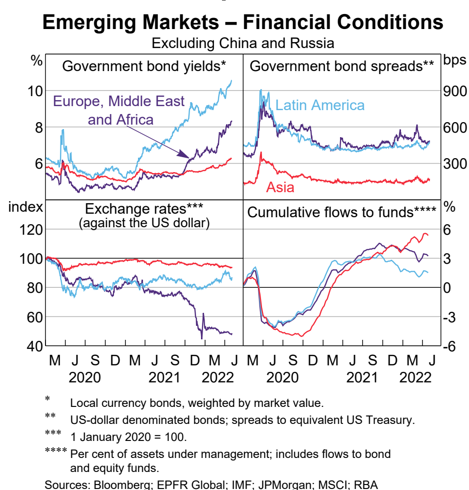
The International Monetary Fund (IMF) approved a new lending program for Argentina in late March. The US$44 billion program will help Argentina cover the sizeable repayments it is due to make to the IMF over the next few years from an earlier program, as well as provide a boost to its international reserves. As part of the

Graph 1.21



Sources: Bloomberg; Central Bank of Russia; Refinitiv

Graph 1.22



* Local currency bonds, weighted by market value.

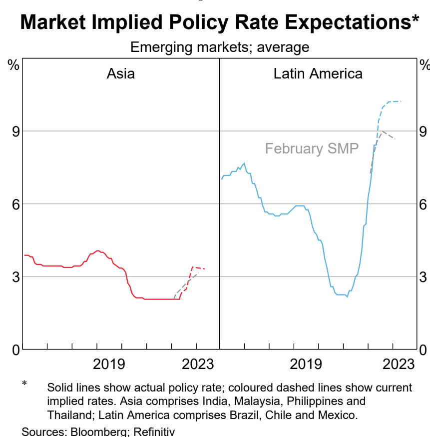
** US-dollar denominated bonds; spreads to equivalent US Treasury.

*** 1 January 2020 = 100.

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

Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 1.23



* Solid lines show actual policy rate; coloured dashed lines show current implied rates. Asia comprises India, Malaysia, Philippines and Thailand; Latin America comprises Brazil, Chile and Mexico.

Sources: Bloomberg; Refinitiv

new program, Argentine authorities have agreed to take steps to improve public finances and start to reduce the persistently high rates of inflation. More recently, the IMF has been in discussions with a number of countries affected by Russia's invasion of Ukraine to arrange support. Most notably, the Fund has already provided US$1.4 billion in emergency assistance to Ukraine.

China has increased policy stimulus, as strict mobility restrictions disrupt activity

Chinese authorities shifted towards prioritising economic growth and stability earlier this year. While tackling climate change and reducing risk in the financial system will remain important objectives, the focus of new policies will be on sustaining growth. Consistent with this, China announced a GDP growth target of 'around 5.5 per cent' in 2022, which was significantly stronger than most forecasts at the time.

In support of this target, policymakers unveiled plans for a fiscal expansion of around 2½ per cent of GDP in 2022, after a fiscal drag of around 3 per cent of GDP in 2021 (Graph 1.24). A sizeable portion of this expansion is expected to come from increased infrastructure spending. While authorities set the annual quota for issuance of special local government bonds (which are normally tied to infrastructure projects) at the same high level as last year, it asked local governments to fill these quotas by September. Moreover, a large share of special bonds raised last year were issued in the final months of 2021, with funds being carried over into 2022. Together, this would suggest significantly higher infrastructure investment (and, in turn, steel demand).

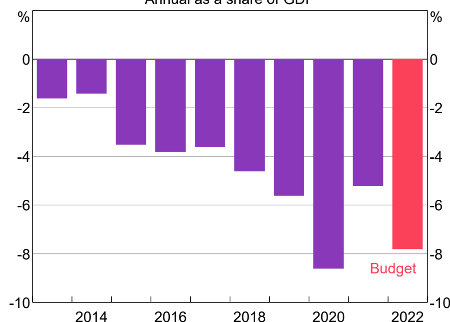
The shift in policy focus contributed to solid growth in late 2021 and early 2022. However, the Chinese economy slowed notably in March because of COVID-19 restrictions. During March and April, strict lockdowns were imposed in cities that account for around 6 per cent of national GDP, with an additional 25 per cent of the economy experiencing tighter restrictions than seen in 2021 (Graph 1.25). Accordingly, household consumption fell a little in the March quarter (Graph 1.26). Industrial production also retraced the growth it recorded in the first two months of the year, led by falling automotive production, and the manufacturing PMI signalled further contraction in April, recording its lowest level since February 2020. By contrast, business investment remained strong, led by infrastructure and manufacturing. The weakening in economic growth prompted the Chinese Government to announce a variety of measures to support incomes of affected businesses, beyond the fiscal expansion already announced as part of the budget.

Conditions in China's real estate markets remain subdued, and stress continues to build for many developers. However, a range of indicators – such as property sales, new housing prices and construction sector PMIs – had improved slightly prior to the spread of COVID-19. This was partly in response to authorities' attempts to stimulate demand for housing (Graph 1.27). These signs of housing market stabilisation, together with expectations of stronger infrastructure investment, have supported the outlook for Chinese steel. Reflecting this, the price of iron

Graph 1.24

China – Fiscal Balance*

Annual as a share of GDP



* Consolidated measure that includes central government, local government and government funds.

Sources: CEIC Data; RBA

ore has increased by 60 per cent since late 2021, despite the Omicron outbreak and an announcement that steel production quotas will be tighter this year. Notwithstanding these signs of stabilisation, any recovery in residential construction is likely to be modest, since authorities continue to emphasise that they will not turn to the real estate sector as a short-term means of stimulating the economy.

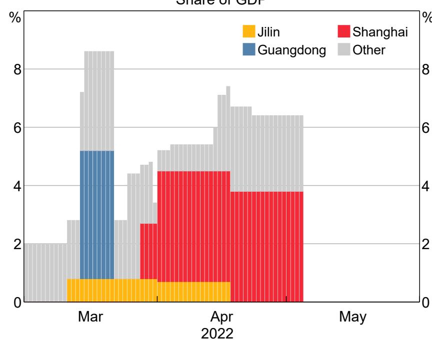
Private Chinese property developers remain under acute stress

Private Chinese real estate developers remain under acute financial stress, with some of the largest developers delaying the publication of their audit results (Graph 1.28). The Chinese authorities have not announced any significant new policies to alleviate developers' funding pressures, despite stating that they will put forward a 'strong and effective response plan to prevent and defuse risks' for developers. However, more local governments have announced measures to support the housing market, including removing bans on purchasing second homes and abolishing the minimum period before resales.

Graph 1.25

China – Regions in Full Lockdown

Share of GDP

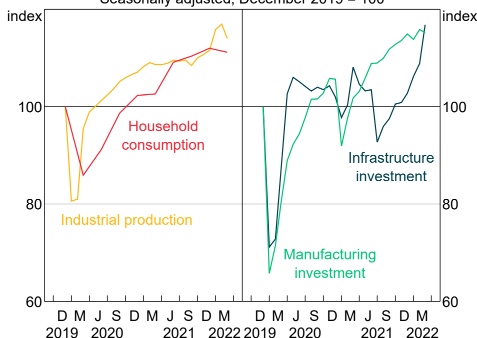


Sources: CEIC Data; Gavekal Dragonomics; Plenum China; RBA

Graph 1.26

China – Activity Indicators

Seasonally adjusted, December 2019 = 100

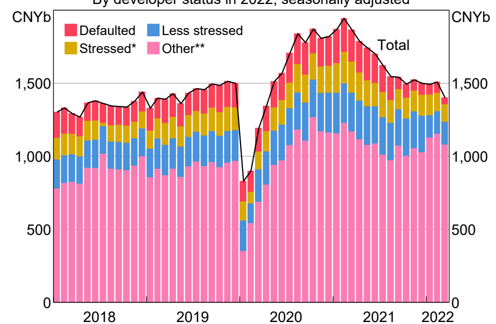


Sources: CEIC Data; RBA

Graph 1.27

China – Property Sales

By developer status in 2022, seasonally adjusted



* Developers with bonds trading at above 50 per cent yield to maturity in 2022.

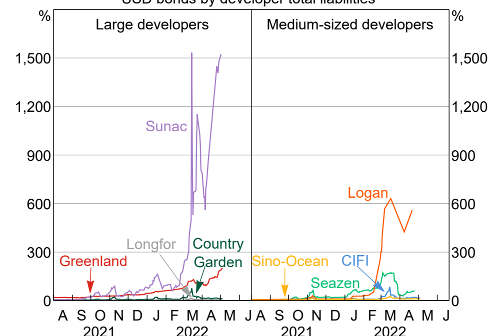
** Calculated as the difference between national sales and sales published by 31 large Chinese developers.

Sources: CEIC Data; RBA; WIND Information

Graph 1.28

Chinese Developer Bond Yields

USD bonds by developer total liabilities*



* Next maturing bond; large developers are those with liabilities of more than CNY500 billion in 2020; medium-sized developers are those with liabilities of CNY100 billion–CNY500 billion in 2020.

Sources: Bloomberg; RBA

Chinese financial markets have been volatile

Chinese equity prices have fallen considerably since the previous *Statement*, reflecting both international and domestic developments (Graph 1.29). International factors include rising commodity prices and faster-than-expected tightening in the monetary policy of advanced economies. Domestic factors include growing COVID-19 disruptions, weaker-than-expected household lending data and less policy easing than the market had been expecting. Onshore corporate bond spreads are around levels seen near the start of the year.

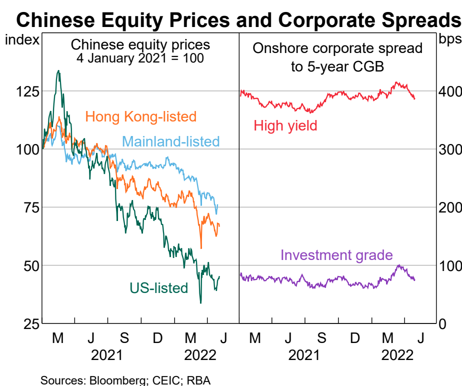
The People's Bank of China (PBC) eased monetary policy modestly in April by lowering its reserve requirement ratio by 25 basis points for most banks (Graph 1.30). It kept policy interest rates unchanged, however, despite market expectations of a cut. The authorities also announced targeted relending arrangements for specific sectors, particularly those affected by COVID-19 restrictions; these arrangements provide funding from the PBC on favourable terms to banks that lend into specified sectors. Chinese Government bond (CGB) yields have been little changed.

Growth in Chinese total social financing (TSF) has been steady over recent months. The easing in credit conditions pursued by authorities continues to be targeted mostly at businesses – especially small and micro-enterprises and those in the agriculture sector – and growth in business financing has risen moderately. Strong government bond issuance has contributed significantly to TSF growth, but this has been offset by a sharp deceleration in household credit growth (Graph 1.31).

The Chinese renminbi has depreciated against the US dollar since the previous *Statement* as the COVID-19 situation deteriorated in China (Graph 1.32). In late April, the PBC reduced its reserve requirement ratio for foreign-currency deposits, which should increase the amount of foreign currency available onshore and reduce

Graph 1.29

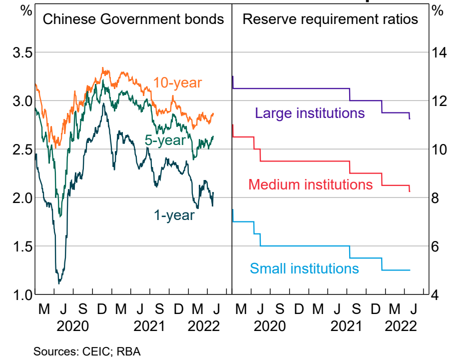
Chinese Equity Prices and Corporate Spreads



Sources: Bloomberg; CEIC; RBA

Graph 1.30

Chinese Bond Yields and Reserve Requirements

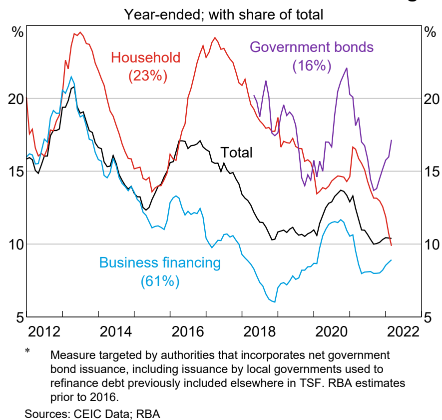


Sources: CEIC; RBA

Graph 1.31

China – Growth in Total Social Financing*

Year-ended; with share of total

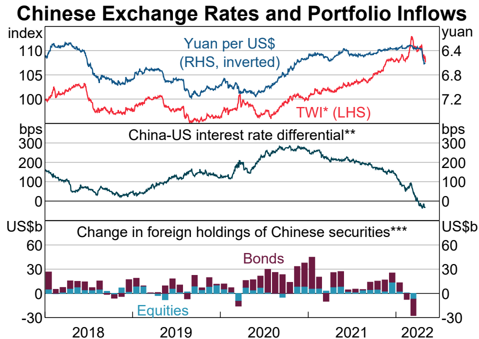


* Measure targeted by authorities that incorporates net government bond issuance, including issuance by local governments used to refinance debt previously included elsewhere in TSF. RBA estimates prior to 2016.

Sources: CEIC Data; RBA

depreciation pressure on the renminbi. The interest rate differential between Chinese and US government bonds has continued to decline to become negative. In line with this, there has been a net outflow of foreign investments in Chinese bonds and equities since the start of 2022.

Graph 1.32



* Trade-weighted index; indexed to 1 January 2018 = 100.

** 5-year government bond yields.

*** Equity flows are those via Northbound StockConnect, bond flows are changes in foreign holdings reported by China Depository Clearing and Shanghai Clearing House.

Sources: Bloomberg; CEIC; China Foreign Exchange Trade System