1. The International Environment

The global economy continued to recover over the first half of this year from the largest and sharpest decline in decades. In a number of large economies, the very substantial fiscal and monetary policy response, together with vaccinations and the associated relaxation of containment measures, enabled a rapid recovery with less economic scarring than previously feared. The outlook over the next few years is for the global recovery to continue, underpinned by significant and ongoing policy support and vaccination programs. However, global economic conditions are likely to remain uneven for some time. New outbreaks of the COVID-19 virus, including of more transmissible variants, are currently hampering the recovery in many economies, especially where vaccination rates remain low. For many developing and emerging market economies, the outlook will remain dependent on obtaining access to vaccines. A noticeable increase in inflation globally has been driven by a range of factors related to the pandemic. These factors are expected to be mainly transitory, but inflation pressures could persist if demand strengthens relative to supply and inflation expectations move higher on a sustained basis.

Yields on longer-term government bonds have declined over recent months, partly reflecting concerns about the new outbreaks of the virus. This has unwound much of the increase seen earlier in the year associated with optimism about the prospects for economic recovery underpinned by vaccinations and better-than-expected economic data. Advanced economy central banks have maintained very accommodative monetary policy settings. Most advanced economy central banks have announced some slowing in the pace of their asset purchases in recent months or are expected to do so in the near future. Market pricing implies that some central banks are expected to begin lifting policy rates sooner than others, in economies where spare capacity is assessed to be lower and underlying inflation pressures greater. Even so, financial conditions in advanced economies remain very accommodative. That is also the case in emerging market economies, but some central banks have tightened monetary policy in recent months in response to rising inflation.

The global recovery is expected to continue

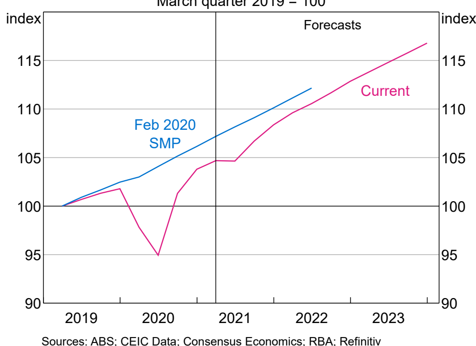
The outlook is for further recovery in the global economy over the next few years, at a pace that is broadly unchanged since the May *Statement*. However, the near-term outlook has become more uncertain given the global spread of the Delta variant. There is also a widening gap in the outlook across economies, largely reflecting differences in vaccination progress and health outcomes . The outlook remains solid for Australia's major trading partners; year-average growth is expected to be around 7 per cent in 2021 and 5 per cent in 2022 (Graph 1.1). This would see the level of output in these economies in late 2022 only a little below what was expected prior to the pandemic.

The outlook for advanced economies in North America and Europe has strengthened this year. Economic activity has picked up sharply in the

United States and is expected to exceed its pre-pandemic path by late 2021; this is largely due to highly stimulatory fiscal and monetary policies and an easing of restrictions earlier in the year after vaccinations reached relatively high rates. Similarly, the recovery is well underway in much of the euro area. However, output in the euro area is expected to remain a little below the pre-pandemic path throughout 2022; this is because of the smaller fiscal policy stimulus there and the greater importance in some member economies of the tourism industry, which has been significantly impacted by travel restrictions imposed during the pandemic.

In China, where authorities have been successful in containing outbreaks over the past year, GDP is expected to continue growing around its pre-pandemic path. Some advanced economies in Asia have experienced outbreaks recently amid a slow start to their vaccination programs. GDP in these economies is expected to reach or surpass pre-pandemic paths over the next few years. Strong demand for manufactured exports, particularly for semiconductors and related products, should support the recoveries there.

Slow vaccinations, limited vaccine supplies and large recent outbreaks have weighed on the recovery prospects in many emerging market economies, including in Asia. In India, economic activity has picked up as state governments have lifted lockdowns, but the lingering impact of the pandemic on private sector finances and the labour market is expected to weigh on output over the next two years. Similarly, severe pandemic-related disruptions and limited policy responses are likely to have resulted in significant economic scarring in many emerging economies; business closures and skill losses will contribute to this. As a result, the level of GDP is expected to remain well below pre-pandemic paths for an extended time in many emerging market economies.



Significant uncertainties continue to surround the global economic outlook:

- In the near term, further outbreaks of the highly transmissible Delta variant could slow the recovery, particularly in countries with low vaccination rates. The potential emergence of vaccine-resistant virus strains poses a risk to all countries. Conversely, reduced circulation of the virus and a faster rollout of vaccines, particularly in emerging market economies, could speed up and strengthen their recoveries relative to current projections.
- Recent inflation pressures could turn out to be more persistent if labour markets tighten faster than expected. The pandemic could also depress labour mobility within and across economies for a number of years, resulting in a prolonged period of skills mismatches. Financial conditions in advanced economies could tighten substantially if the recent upswing in inflation was expected to persist and materially exceed central banks' targets. In turn, this could spill over into tighter financial conditions for many emerging market economies while they are still dealing with virus outbreaks and/or at a relatively early stage of recovery. Conversely, inflation could return to be below central banks' targets prior to the pandemic if

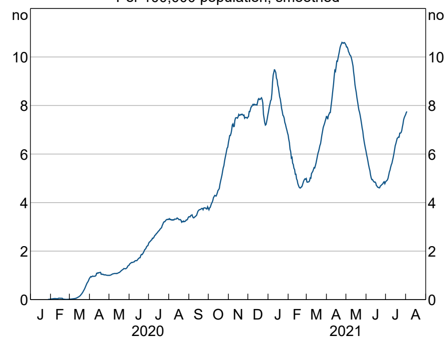
demand does not fully recover and spare capacity in labour markets persists.

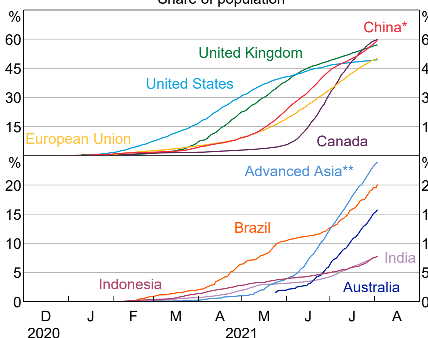
Vaccinations have ramped up but many countries are being hindered by limited vaccine supplies and fresh COVID-19 outbreaks

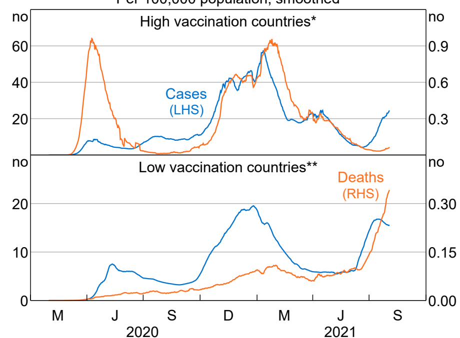
COVID-19 vaccinations have accelerated over recent months in a range of countries (Graph 1.2). Some were able to vaccinate significant shares of their populations in the first half of the year, such as the United States and the United Kingdom, where COVID-19 case numbers had been high in 2020 and early 2021. China has also significantly sped up its vaccination rollout in recent months. However, in most emerging market economies, vaccination coverage remains low largely as a result of limited vaccine supplies.

Global infections have risen again since early July due to the spread of the highly contagious Delta variant (Graph 1.3). This follows a decline in global case numbers from their recent peak in May, after a major outbreak in India was brought under control and vaccination programs contributed to declining case numbers in the United States and Europe. The recent resurgence in infections has been very strong across much of Asia, including among many of Australia's trading partners such as Japan, South Korea, Indonesia and Thailand.

Infections have also increased sharply in some highly vaccinated countries. However, as the rise in hospitalisations and deaths in these countries has been much smaller, the containment measures used so far have been less severe than earlier in the pandemic; there are also early signs that infections have already peaked in some of these countries (Graph 1.4). Because of this, and because households and firms have adapted their behaviour over time, the effects on economic activity have been less severe than earlier in the pandemic.







Activity is picking up quickly where restrictions have been relaxed

A key feature of the global recovery to date is that it has remained highly uneven (Graph 1.5). Activity has picked up quickly in economies where restrictions have eased following strong vaccination campaigns or where infection rates have remained low. Some economies have received a boost from being highly integrated in global goods trade. Elsewhere, including in many emerging market economies, the recovery has been hampered by resurgences in infections, renewed containment measures and more constrained policy responses.

Economic activity picked up strongly in the June quarter in North America and Europe led by a resumption in consumer spending on services (Graph 1.6). This was enabled by the quick unwinding of containment measures following high rates of vaccination achieved during the first half of the year; however, in some jurisdictions, containment measures have been tightened a little again to slow the spread of the Delta variant. Consumer and business sentiment in these economies has recovered to around or above long-run averages. The recovery in the United States has been further boosted by sizeable fiscal stimulus earlier this year, which has continued to support the global demand for goods. Favourable financing conditions have supported a strong recovery in residential and business investment in North America and to a lesser extent in Europe over the past year. Widespread vaccinations have also allowed for some international travel to resume, particularly in European economies intent on restarting their tourism sectors.

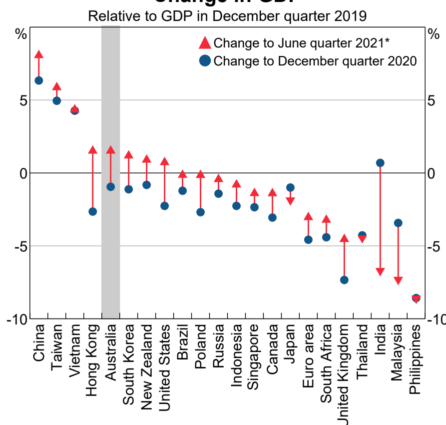
In China, where the economic recovery is most progressed, activity has continued to expand at a solid pace (Graph 1.7). This has been driven primarily by manufacturing investment and exports. Household consumption growth has also been strong overall, despite spending on services remaining sensitive to ongoing outbreaks of COVID-19. However, fiscal spending and infrastructure investment have slowed since the start of the year, possibly reflecting a shift in the authorities' focus towards addressing longer-term fiscal sustainability and financial stability issues. New restrictions on property developer debt levels have also contributed to a slowing in real estate construction.

Elsewhere in Asia, a tightening of containment measures weighed on consumption in the first half of the year, particularly for contact-intensive services. For the more export-oriented advanced

Graph 1.5

Change in GDP

Relative to GDP in December quarter 2019



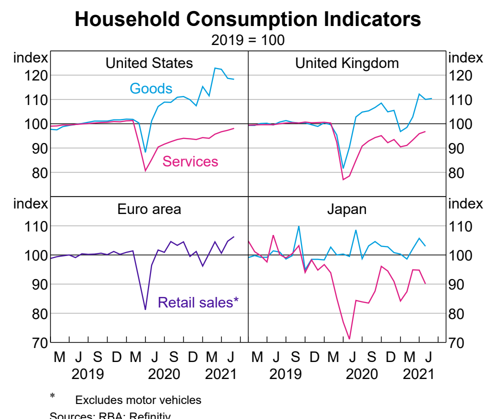
* Forecasts used where June quarter GDP has not yet been reported

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

Graph 1.6

Household Consumption Indicators

2019 = 100



* Excludes motor vehicles

Sources: RBA; Refinitiv

economies in this region, this has been offset by buoyant external demand, which has supported exports and prompted an uplift in business investment, including in semiconductor capacity.

In India, economic activity declined sharply in the June quarter, though by less than was seen a year earlier. This was because the containment measures introduced during the recent outbreak were more localised and population mobility was less affected than in 2020. Likewise, severe outbreaks in the emerging economies in Southeast Asia have led to weaker domestic demand in the June quarter; significant containment measures are likely to remain in place throughout the September quarter. The recoveries in a number of large emerging market economies outside Asia, including in Brazil and Russia, have also slowed since the start of the year because of surging infections and tightened containment measures. Recent civil unrest in South Africa has set back the economic recovery there. The potential for financial conditions to tighten before recoveries are well entrenched has also weighed on the growth outlook for some emerging market economies. Such a tightening could occur if above-target inflation is expected to persist, or if expectations about monetary policy tightening in advanced economies were brought forward.

Housing prices have picked up globally supported by low interest rates

Conditions in housing markets have strengthened considerably in advanced economies and much faster than following typical recessions (Graph 1.8). Housing prices and demand are being supported by very low interest rates, increased household savings during the pandemic and household balance sheets that have remained in better shape than is typical for an economic contraction. Regulators in some jurisdictions have expressed concerns about the financial stability risks associated with buoyant housing market conditions, including rapid mortgage growth, and some jurisdictions have tightened macroprudential policies to address these risks.

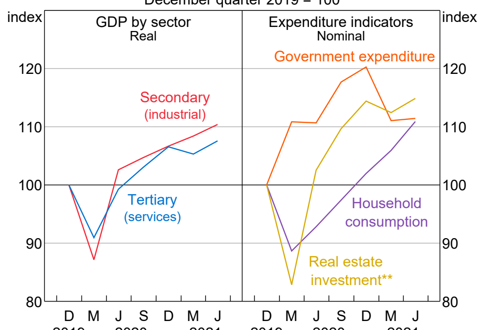
Labour markets have continued to improve but spare capacity remains

Despite the strong recovery in economic activity, employment, participation rates and hours worked are still well below pre-pandemic levels in many economies (Graph 1.9). This suggests that there is spare capacity remaining in these labour markets – a point recognised by a number of central banks – although labour

Graph 1.7

China – Activity Indicators*

December quarter 2019 = 100



* Seasonally adjusted by the RBA

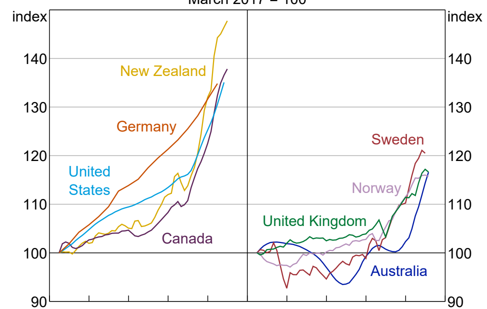
** Excludes land

Sources: CEIC Data; RBA

Graph 1.8

Housing Price Indices

March 2017 = 100



Sources: National sources; RBA; Refinitiv

market conditions have tightened relatively quickly for some industries. Demand for labour has picked up strongly in advanced economies where containment measures have been eased; timely labour market indicators, including job ads, vacancies and surveyed measures of employment conditions, are at elevated levels. Labour market support measures are generally pivoting from supporting incomes and employment relationships to incentivising job creation and the return to work.

Labour supply has generally been slow to recover. This has been most evident in the United States, where GDP recovered to pre-pandemic levels in the June quarter while labour force participation remained well below its previous levels. The slow recovery in labour supply in most advanced economies reflects a range of factors, including school closures increasing child caring responsibilities, lingering health concerns and, in some economies, ongoing wage subsidies. Mismatches between labour demand and supply have contributed to high job vacancies in some industries and pockets of wage pressures; however, overall wages growth has remained moderate.

A relatively robust labour market recovery is expected in most advanced economies because of the strong rebound in activity and limited economic scarring. Unemployment rates are expected to fall over the next couple of years to levels similar to before the pandemic and, in many cases, to levels broadly consistent with some estimates of full employment (Graph 1.10). This should contribute to a pick-up in wages growth.

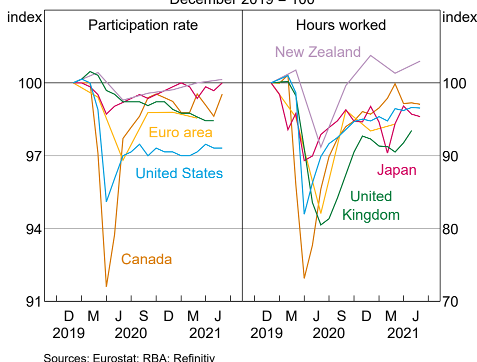
Strong demand for goods and ongoing supply disruptions are putting pressure on global supply chains …

Recent COVID-19 outbreaks, particularly in Asia, are disrupting global supply chains that were already stretched by the strong global demand for goods. Global merchandise trade has remained robust alongside ongoing strong demand for goods from advanced economies; exports from Asia continue to increase strongly as a result (Graph 1.11). Supplier delivery times have also increased further, which is causing some downstream production disruptions, notably in automotive manufacturing. This has led to temporary falls in industrial production in some economies with large automotive sectors, including Japan, South Korea and Germany. Supply capacity is expected to increase gradually in key sectors in response to strong demand. For example, significant investment is planned over the next couple of years in the global semiconductor and shipping industries

Graph 1.9

Labour Market

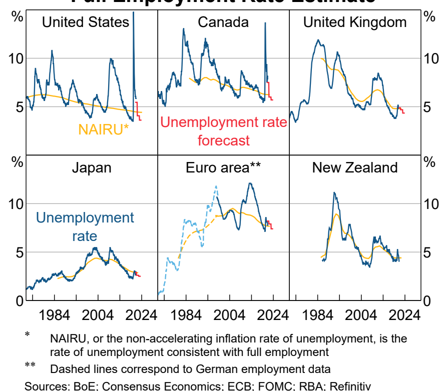
December 2019 = 100



Sources: Eurostat; RBA; Refinitiv

Graph 1.10

Unemployment and Full Employment Rate Estimate



* NAIRU, or the non-accelerating inflation rate of unemployment, is the rate of unemployment consistent with full employment

** Dashed lines correspond to German employment data

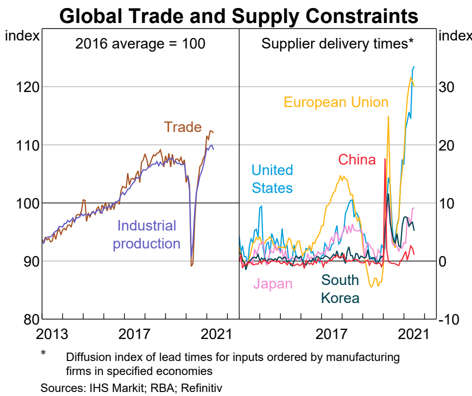
Sources: BoE; Consensus Economics; ECB; FOMC; RBA; Refinitiv

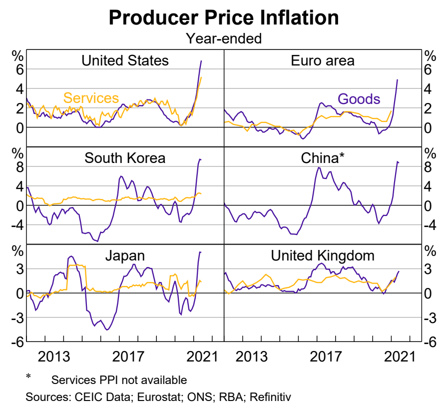
where shortages have been pronounced. Strong global goods demand has also supported strong growth in Chinese steel production and, in turn, Chinese imports of iron ore; around 60 per cent of iron ore imports are sourced from Australia (Graph 1.12).

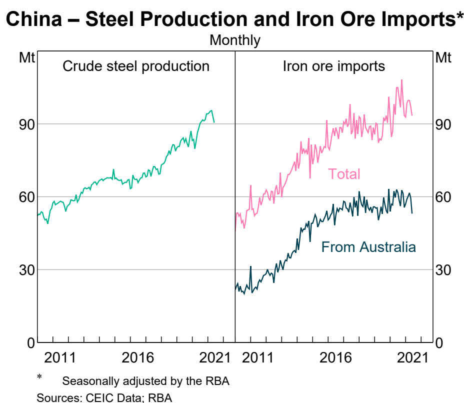
… which has boosted prices of resource commodities and other inputs

The combination of strong goods demand and supply pressures has seen the prices for certain key inputs – including commodities, semiconductors and container shipping – rise sharply since the beginning of the year. Producer price inflation in many economies has risen to the highest rates in more than a decade, partly due to the increase in input prices (Graph 1.13). Survey measures suggest that producers have been passing on some of the increase in their input costs to consumers. However, downstream inflationary pressures are expected to subside over time as global supply bottlenecks are resolved and as global consumption rebalances away from goods to services following the relaxation of containment measures.

Among key Australian commodity exports, prices for coal and LNG have increased further since the previous *Statement* (Graph 1.14; Table 1.1). This has driven Australia's terms of trade to historically high levels.







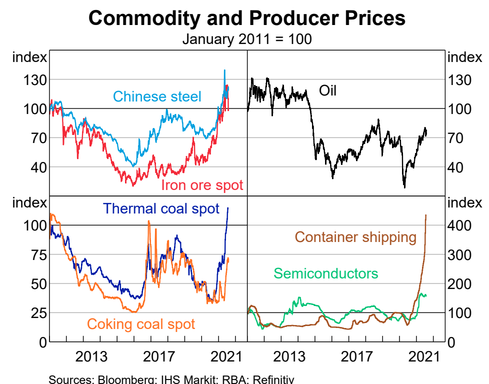


Table 1.1: Commodity Price Changes[a]

Per cent

	Since previous *Statement*	Since start of year
Bulk commodities	3	31
– Iron ore	–14	13
– Coking coal	91	107
– Thermal coal	63	87
Rural	2	14
Base metals	–1	24
Gold	–1	–4
Brent crude oil[b]	3	37
RBA ICP	12	27
– Using spot prices for bulk commodities	3	23

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

(b) In US dollars

Sources: Bloomberg; IHS; RBA

Iron ore prices reached a record high level in May, underpinned by robust demand from China and the rest of the world as global steel production has recovered (Graph 1.14). On the supply side, persistent weather-related disruptions and maintenance at some Australian mines and ports contributed to elevated prices. However, prices have since fallen following signs that Chinese authorities will reduce steel output over environmental concerns and as temporary supply issues ease. Chinese authorities have also sought to discourage speculative trading activity in the iron ore and steel markets in an effort to moderate prices. More broadly, analysts have noted that the recovery in supply from Brazil and easing demand from China could weigh on prices over the remainder of the year.

Strong global steel production and elevated steel prices have also supported the price of coking coal, which has almost doubled the previous *Statement*. Indian demand for coking coal has rebounded as domestic restrictions have been eased and steel mills have started to restock. The price of some base metals, notably zinc and copper, remain elevated, supported by the continued recovery in global industrial production. However, they have eased in recent months, partly in response to China releasing government reserves of industrial metals in an effort to ease price pressures.

The ongoing global economic recovery and strong energy demand from Asia ahead of a warm northern hemisphere summer have also supported energy-related commodity prices. The Newcastle thermal coal spot price has increased further since the previous *Statement* to be at its highest level in 12 years; the spot price for LNG in Asia has also picked up. The price of Brent crude oil has increased further since the previous *Statement* and is now around its highest level since early 2019 (Graph 1.14). Oil prices are also being supported by an increase in travel as economies reopen, alongside tighter global supply.

Recent inflationary pressures are likely to be transitory, but some upside risk remains

Headline consumer price inflation has picked up noticeably in some advanced economies this year. The increase reflects a combination of factors, including base effects from some price

declines early in the pandemic, the pick-up in input prices and a rapid recovery in demand for some consumer items as economies have reopened. In many economies, the increase in inflation has largely come from a small set of pandemic-affected items and is less apparent in trimmed mean measures of underlying inflation (Graph 1.15).

Most central banks expect pandemic-related shocks to supply and demand to wash through in coming quarters. Once this has occurred, inflationary pressures will depend on the extent of spare capacity and the speed at which it is absorbed, which also remains more uncertain than usual. It is possible, however, that the concurrent nature of the global upswing could see bottlenecks persist into next year, in part because of ongoing strength in private demand due to household and business balance sheets being in reasonable health. While medium-term inflation expectations in advanced economies are higher than a year ago, they have generally risen to rates consistent with, or only a little below, central banks' inflation targets (Graph 1.16).

Longer-term yields have declined

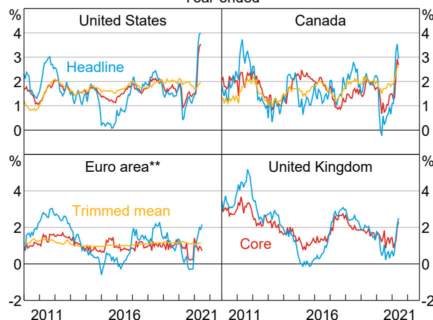
Longer-term government bond yields have declined over recent months in most advanced economies, unwinding much of the increase that occurred over the first 3 months of the year (Graph 1.17). That earlier rise in yields reflected the improving economic outlook, aided by fiscal support measures. Real yields rose, as did market measures of inflation expectations, which moved closer to central banks' inflation targets (Graph 1.18). Central banks had continued to emphasise that monetary policy would remain very stimulatory until inflation outcomes were higher on a sustainable basis.

Longer-term yields have since declined. Real yields are back around the historic lows they reached at the start of the year. Measures of longer-term inflation expectations have declined a little despite the increase in inflation outcomes in some economies (Graph 1.19). The decline in real yields in part reflects concerns among market participants about longer-run growth prospects in advanced economies. Over the past month, the decline in yields has been amplified by some market participants closing out positions that were designed to benefit from higher yields.

Graph 1.15

Consumer Price Inflation*

Year-ended



* Personal consumption expenditure deflator used for the United States; CPI used elsewhere

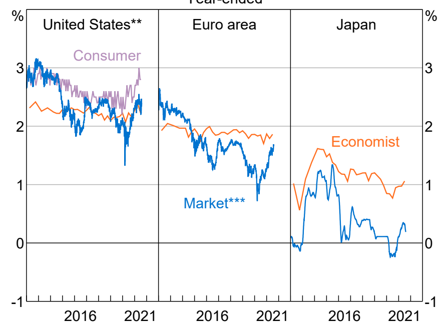
** The euro area trimmed mean shows the Persistent and Common Component of Inflation

Source: Refinitiv

Graph 1.16

Medium-term Inflation Expectations*

Year-ended



* Expectations for headline CPI

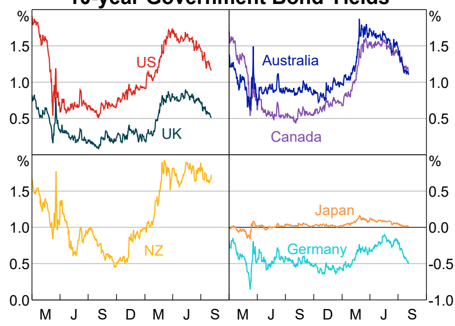
** Fed's preferred inflation measure is PCE inflation, which has averaged about 30 basis points less than CPI inflation since 2000

*** Implied from 5-year, 5-year forward inflation swaps; smoothed for Japan

Sources: Bloomberg; Consensus Economics; RBA; Refinitiv

Graph 1.17

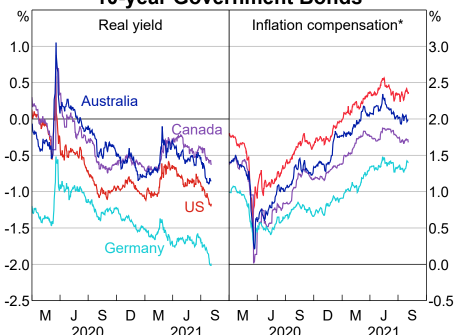
10-year Government Bond Yields



Sources: Bloomberg; Yieldbroker

Graph 1.18

10-year Government Bonds



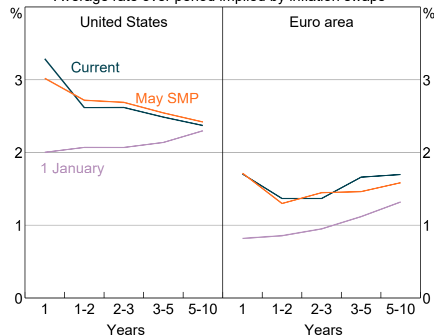
* Spread between yields on nominal and inflation-linked bonds

Source: Bloomberg

Graph 1.19

Inflation Expectations

Average rate over period implied by inflation swaps*



* Swaps return a payoff based on observed values of consumer price indexes (CPI). The prices of these swaps also embed time-varying risk premia to compensate investors for uncertainty about the outlook for inflation, which can complicate the interpretation of these prices as expected inflation

Source: Bloomberg

Movements in shorter-term government bond yields over recent months have been in line with changes in the outlook for monetary policy in advanced economies (see below). Shorter-term bond yields have increased sharply in New Zealand, and to a lesser extent in Canada and the United States (Graph 1.20). In contrast, shorter-term bond yields in Germany and Australia have declined a little alongside developments in longer-term yields.

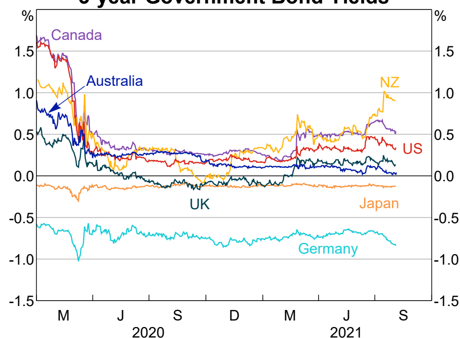
Central banks have maintained very accommodative monetary policies

Central banks in advanced economies continue to provide substantial monetary policy support through very low policy rates, sizeable asset purchases and lending programs; their balance sheets have increased substantially and in some cases will continue to grow under announced policies (Graph 1.21). Central banks have continued to signal that recent increases in inflation outcomes to above-target levels are likely to be transitory and that monetary stimulus will be maintained until there is sustained progress towards employment and inflation goals.

Most central banks in advanced economies continue to provide support through asset purchases (see 'Box A: Central Bank Purchases of Government Bonds'). In response to progress in

Graph 1.20

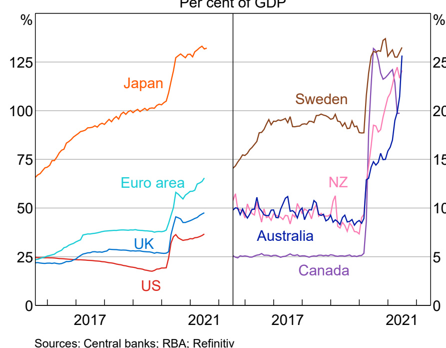
3-year Government Bond Yields



Sources: Bloomberg; RBA; RBNZ; Yieldbroker

the economic recovery, several central banks have reduced the pace of purchases in recent months:

- Following a gradual slowing of purchases since the start of the year, the Reserve Bank of New Zealand (RBNZ) halted asset purchases in July, having purchased a little over half of the NZ$100 billion upper limit of their purchase program.
- As was widely expected, the Bank of Canada (BoC) further reduced the pace of its asset purchases from C$3 billion to C$2 billion per week in July. This followed a similar-sized reduction in April. The BoC indicated that the latest adjustment reflected continued progress towards recovery and increased confidence in the economic outlook.
- The Bank of England (BoE) reduced the pace of its government bond purchases from around £4.4 billion to £3.4 billion per week in May, but emphasised that this did not reflect a change in policy stance since the target stock of purchases remained at £875 billion.
- The US Federal Reserve (Fed) has continued to purchase Treasury securities at a pace of US$80 billion per month. However, Chair Powell flagged that the Federal Open Market Committee (FOMC) is likely to discuss an appropriate tapering timeline at upcoming meetings, consistent with Fed officials' expectations that the economy will continue to make progress towards the Fed's inflation and employment goals. Market expectations are that the Fed will begin reducing its pace of purchases in late 2021 or early 2022 and that net purchases will cease by the end of 2022.



Progress in the global economic recovery over the course of this year has also led to a shift higher in the market-implied path of expected policy rates in a number of advanced economies, although these paths have generally declined over the past month due to concerns about new outbreaks of the COVID-19 virus (Graph 1.22). However, expectations for the policy rate have risen further over the past month in New Zealand, with current market pricing suggesting that the RBNZ is expected to raise its policy rate before the end of this year. This is in response to stronger-than-expected economic data and indications from the RBNZ that domestic capacity constraints are expected to begin putting upward pressure on wages and inflation.

In June, Norges Bank indicated that it expects to raise its policy rate in September this year, in line with its earlier communication that this was expected to occur in the second half of the year. Market pricing suggests that the BoC is expected to raise its policy rate in mid 2022. In mid July, the BoC reaffirmed that it expects the first increase in its policy rate to occur in the second half of 2022, provided that the economic outlook evolves as expected at the time. The BoE is expected to raise its policy rates around mid-to-late 2022.

In the United States, market pricing suggests that the Fed is expected to start raising policy rates around early 2023. At the June FOMC meeting, the majority of participants indicated that they expected the policy rate to increase by 50 basis points during 2023; this is in contrast to March when the majority expected that the policy rate would remain unchanged until at

least 2024. This adjustment was accompanied by upward revisions to FOMC participants' projections for economic growth and inflation in the near term.

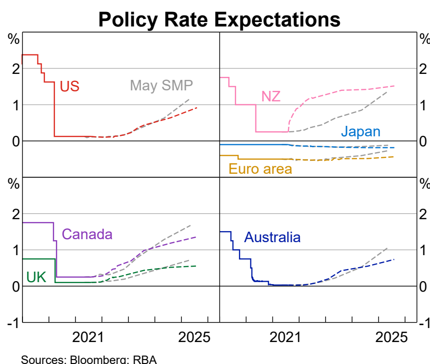
In the euro area and Japan, market pricing continues to indicate that investors do not expect changes to policy rates for at least several years. The European Central Bank (ECB) announced its new monetary policy strategy in July following a comprehensive review. The ECB now has a symmetric inflation target of 2 per cent inflation over the medium term that aims to provide a clear anchor for inflation expectations; the previous target was for inflation to be 'below, but close to, 2 per cent'. In updated forward guidance, the ECB said that it does not expect to increase the policy rate until inflation is forecast to reach 2 per cent on a sustainable basis 'well ahead' of its 3-year forecast horizon. This suggests a somewhat higher threshold for a policy rate rise than previously.

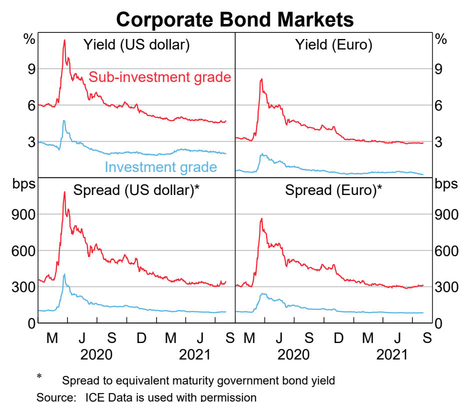
The ECB's strategy also committed the central bank to a climate-related action plan, which includes incorporating climate factors into monetary policy assessments. The Bank of Japan (BoJ) has also announced its new strategy on climate change – it will establish a climate-based lending facility this year, which will provide banks with funding for green and sustainability-linked bonds and loans, and transition finance. The BoJ will also purchase foreign-currency-denominated green bonds to form part of its foreign exchange reserves.

Private sector funding conditions in advanced economies remain very accommodative

Conditions in corporate bond markets remain highly accommodative. Over recent months, corporate bond yields have declined further alongside the decline in government bond yields at similar maturities (Graph 1.23). Credit spreads remain close to their lowest levels since the start of the pandemic. In particular, credit spreads on US investment grade corporate bonds have fallen to around their lowest levels since 2007. Issuance has declined since the start of the year, though corporations continue to take advantage of low borrowing costs and have issued debt at a steady pace in recent months.

Equity prices have increased further in most major markets and are either at all-time or post-pandemic highs (Graph 1.24). Measures of equity price volatility have increased over the past month as concerns have risen about the new outbreaks of COVID-19. Equity issuance in the United States and Europe in the year to date remains higher than pre-pandemic levels. However, activity in the United States has slowed considerably in recent months as





issuance by so-called 'blank-cheque' vehicles (Special Purpose Acquisition Companies), which raise funds to identify and invest in private companies to take public, has declined sharply due to waning investor appetite.

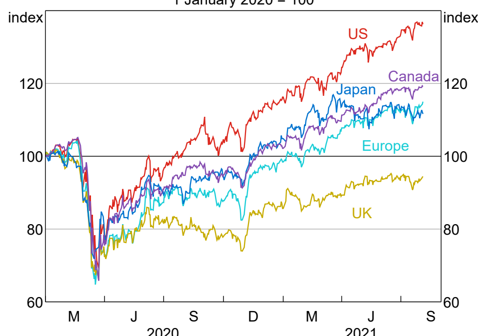
There has been a broad-based appreciation of the US dollar

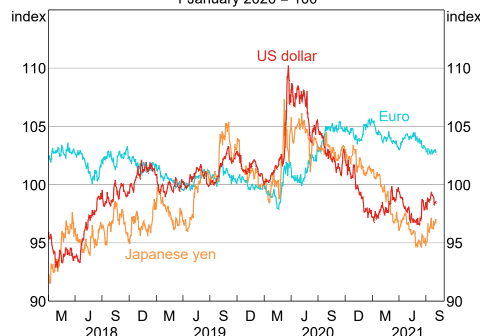
The US dollar has appreciated since June on a trade-weighted (TWI) basis alongside the rise in shorter-term government bond yields in the United States (Graph 1.25). Some other advanced economy currencies, including the Australian dollar, have depreciated since June on a TWI basis alongside the broad strength of the US dollar (see 'Domestic Financial Conditions' chapter for recent developments in the Australian dollar). While the US dollar is around its levels at the beginning of the year, the Japanese yen and euro are lower since that time, consistent with the relatively modest increase in government bond yields in those economies over the period.

Emerging market financial conditions have remained stable, but are tighter than at the start of the year

Financial conditions in many emerging market economies have remained stable over the past few months, following a tightening of conditions in early 2021 (Graph 1.26). Yields on local-currency government bonds have generally remained higher than earlier in the year, while yields in Latin America have increased noticeably alongside recent policy rate increases in Brazil, Mexico and Chile. Spreads between US dollar-denominated bonds in emerging markets and equivalent US Treasury bonds have increased a little and remain slightly above their pre-pandemic levels. Portfolio flows into bond and equity funds have picked up again after slowing earlier in the year. Despite increases in actual or expected policy rates, the currencies of most emerging market economies have depreciated slightly against the US dollar. In Asia, some currencies have depreciated sharply over recent months, including the Philippine peso and Thai baht, in part because the pace of their economic recoveries has been hampered by the ongoing increases in COVID-19 cases.

Some emerging market economies remain vulnerable to a tightening of global financial conditions at a time when their economic recoveries are still tentative, including because of the ongoing health crisis. This is of particular concern for economies with large fiscal deficits, high levels of debt and/or a large share of external financing, such as Turkey, Brazil and South Africa. In South Africa, social unrest over





recent weeks has caused some volatility in domestic financial markets and has slowed the country's vaccine rollout program.

Some emerging market central banks face rising inflation despite a weak economic recovery

In emerging market economies, some inflation-targeting central banks are now facing the difficult task of balancing rising inflation and weak economic recoveries. Inflation has risen most notably for those economies with exchange rates that remain well below their pre-pandemic levels and where inflation expectations are not well anchored. The market-implied paths of expected policy rates have shifted higher, with many central banks in these economies expected to begin lifting policy rates this year. However, a premature withdrawal of monetary policy support could exacerbate existing financial vulnerabilities and slow recoveries.

These pressures have been most pronounced in Latin America where a number of central banks have already increased policy rates in the past few months and are expected to lift them substantially further by the end of the year (Graph 1.27). The central banks of Brazil and Russia have raised their policy rates several times this year in response to rising inflation that has remained persistently above target; both central banks have signalled further increases this year. In Mexico, the central bank unexpectedly raised its policy rate for the first time since 2018, also in response to concerns about inflation. The central bank of Turkey continued to hold its policy rate unchanged, after having raised it in early 2021 to be above the rate of inflation. Policy rates have been left unchanged by a number of other emerging market central banks that view recent increases in inflation to be temporary or for which inflation remains subdued.

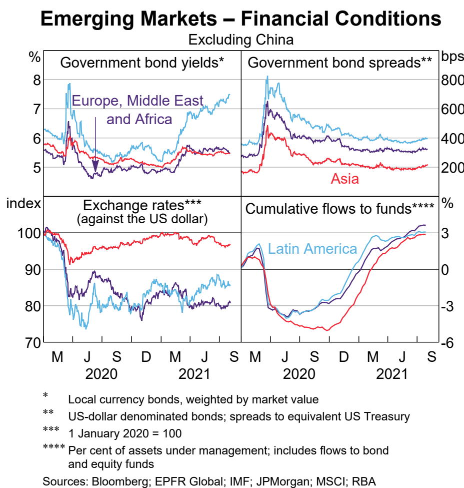
Chinese financial conditions remain accommodative but growth in total financing has slowed

Chinese financial conditions remain accommodative as policy continues to support economic activity. In early July, the People's Bank of China (PBC) announced an unexpected cut to the reserve requirement ratio (RRR) of 50 basis points for most banks, the first such cut since the early phase of the pandemic (Graph 1.28). The authorities cited two reasons for the cut: lowering costs for smaller businesses; and

Graph 1.26

Emerging Markets – Financial Conditions

Excluding China

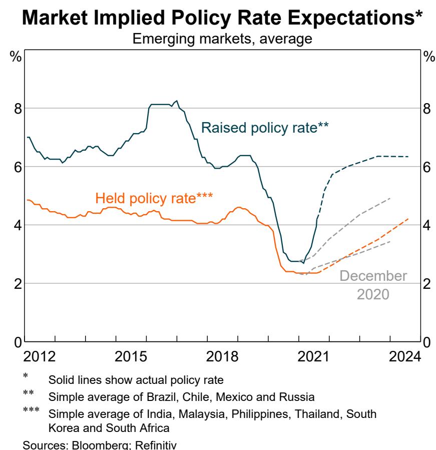


* Local currency bonds, weighted by market value
** US-dollar denominated bonds; spreads to equivalent US Treasury
*** 1 January 2020 = 100
**** Per cent of assets under management; includes flows to bond and equity funds
Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 1.27

Market Implied Policy Rate Expectations*

Emerging markets, average



* Solid lines show actual policy rate
** Simple average of Brazil, Chile, Mexico and Russia
*** Simple average of India, Malaysia, Philippines, Thailand, South Korea and South Africa
Sources: Bloomberg; Refinitiv

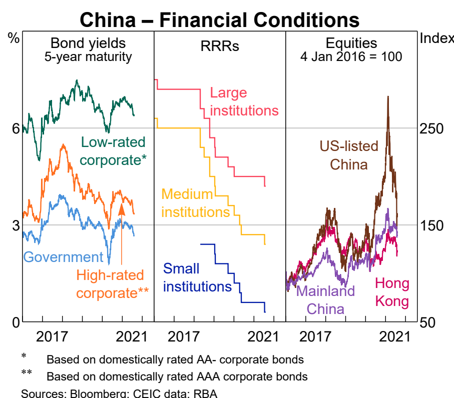
supporting liquidity. By lowering bank-funding costs, the cut was aimed at reducing financing costs for micro, small and medium enterprises, some of which have recently faced a sharp rise in input costs. Policymakers have placed considerable focus on improving these firms' access to bank credit in recent months. A part of the additional liquidity from the RRR cut will offset maturing medium-term lending facility funds.

Yields on government and corporate bonds have declined in recent months to around pre-pandemic levels, and moved lower on news of the RRR cut. Money market rates have also remained slightly lower than pre-pandemic levels. Chinese equity prices fell sharply in late July as investors reassessed the prospects for a range of private-sector companies in light of recent regulatory actions. The decline was triggered by authorities announcing extensive reforms of the for-profit education sector, and followed earlier regulatory actions against Chinese technology companies and listings outside mainland China.

The recent measures to ease overall financial conditions have occurred against the backdrop of ongoing actions to address medium-term financial stability risks. Recently, new measures have continued to target the property sector and less transparent financing channels, such as the trust industry. These measures have contributed to a slowing in the growth of debt over recent months and total social financing has been stable as a share of GDP, in line with the target set by Chinese authorities earlier in the year (Graph 1.29).

The Chinese renminbi has been little changed against the US dollar in recent months, and remains close to its recent highs (Graph 1.30). Ongoing pressure on the renminbi to appreciate eased as market participants brought forward their expectations for policy normalisation in the United States, and with a decision in June by the PBC to increase the reserve requirement for foreign currency deposits. However, trade surpluses and portfolio inflows to Chinese equity and bond markets this year have continued to support the renminbi, and interest rates on Chinese government bonds remain higher than those in advanced economies. ✠

Graph 1.28



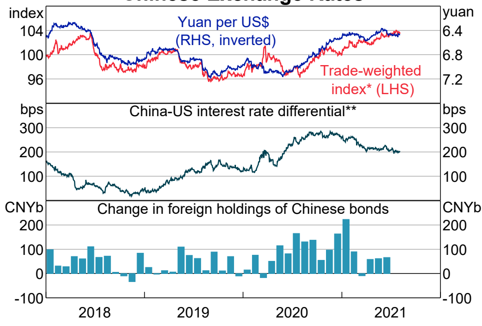
* Based on domestically rated AA- corporate bonds
** Based on domestically rated AAA corporate bonds
Sources: Bloomberg; CEIC data; RBA

Graph 1.29

* Measure targeted by authorities which incorporates net government bond issuance; incl issuance by local governments used to refinance debt previously included elsewhere in TSF; RBA estimates prior to 2016
Sources: CEIC; RBA

Graph 1.30

Chinese Exchange Rates



* Indexed to 1 January 2018 = 100

** 5-year government bond yields

Sources: Bloomberg; CEIC; China Foreign Exchange Trade System