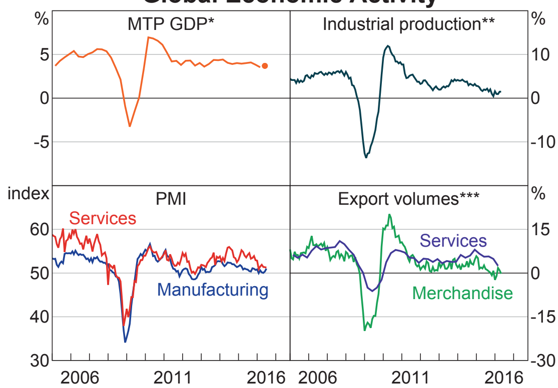
1. International Economic Developments

GDP growth in Australia's major trading partners was a little below its decade average over the first half of 2016 (Graph 1.1). Growth in China continued to ease, while GDP growth rates in the major advanced economies have been around or above their decade averages over the past year. Expansionary monetary policy is continuing to support growth in most economies and fiscal policies have become less contractionary. The outcome of the United Kingdom's referendum to leave the European Union led to heightened uncertainty and is expected to lead to lower growth in the United Kingdom. The impact on the rest of the world is likely to be limited, absent any financial market dislocation or wider political instability in the European Union.[1]

Growth in global industrial production, manufacturing activity and trade has been below average for much of the period since the global financial crisis. Among other things, this has reflected the effects of heightened uncertainty and the slow recovery in economic activity on investment, particularly in the advanced economies.[2] Since mid 2014, weaker demand from commodity-exporting emerging market economies (where imports have declined over the past two years) and China has also restrained trade growth (Graph 1.2). The decline in export growth over the past couple of years has been pronounced for the

Graph 1.1
Global Economic Activity



* Major trading partner (MTP) GDP weighted using Australia's export shares; dot indicates RBA estimate; year-ended growth

** Industrial production is weighted by world industrial production shares at market exchange rates; year-ended growth

*** Service exports are for select MTPs and Australia; year-ended growth

Sources: ABS; Bloomberg; CEIC Data; CPB; IMF; Markit Economics; OECD; RBA; Thomson Reuters

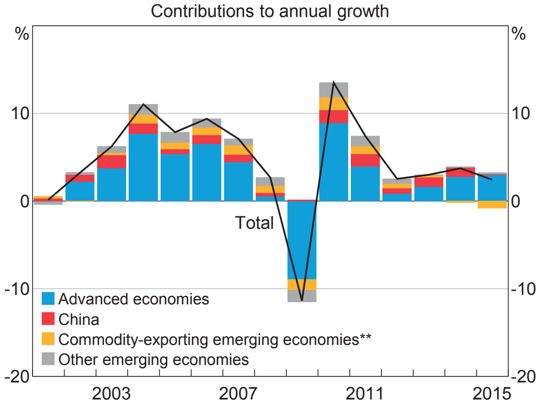
high-income east Asian economies, which have a high trade exposure to China and to other emerging market economies. While commodity prices remain low relative to recent years, they have increased over 2016 and are still well above the levels of a decade ago. Low oil prices should continue to support growth in Australia's major trading partners, which are generally net oil importers.

Labour market conditions in most advanced economies continue to improve and a number of these economies are close to full employment. Despite this, global inflation remains low and below most central banks' targets and longer-run averages (Graph 1.3). Year-ended headline inflation in advanced economies has picked up a little since late 2015, as the effect of earlier declines in oil prices

1 See, for example, Council of Financial Regulators (2016), 'Report on the Implications of Brexit', July, available at <http://www.cfr.gov.au/publications/cfr-publications/2016/report-on-the-implications-of-brexit/>.

2 See, for example, Jääskelä J and T Mathews (2015), 'Explaining the Slowdown in Global Trade', RBA *Bulletin*, September, pp 39–46.

Graph 1.2
Global Import Volumes*
Contributions to annual growth

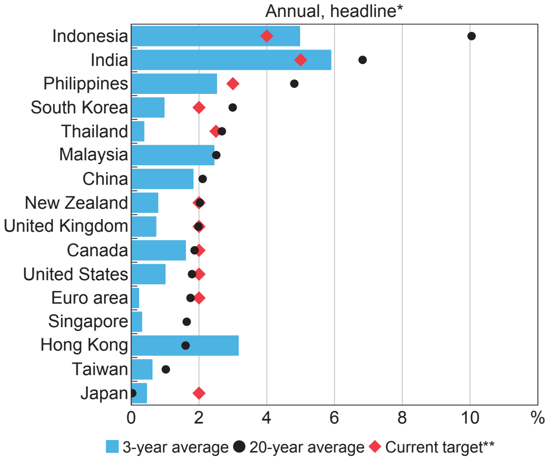


* Covers 87 per cent of global economies by PPP-weighted GDP, includes goods and services imports

** Economies for which gross commodity exports represent more than 35 per cent of total exports and net commodity exports represent more than 5 per cent of total trade, on average, between 1962 and 2014

Sources: OECD; RBA; Thomson Reuters

Graph 1.3
Major Trading Partners – Inflation
Annual, headline*



* The US measure is the personal consumption expenditure deflator. For Japan, the estimated effect of the 2014 consumption tax increase is excluded

** The mid-point is used for those economies with a target band

Sources: CEIC Data; central banks; IMF; RBA; Thomson Reuters

has moved out of the year-ended calculations. Core inflation has also increased in advanced economies over the past year, most notably in the United States, but has declined a little in emerging economies.

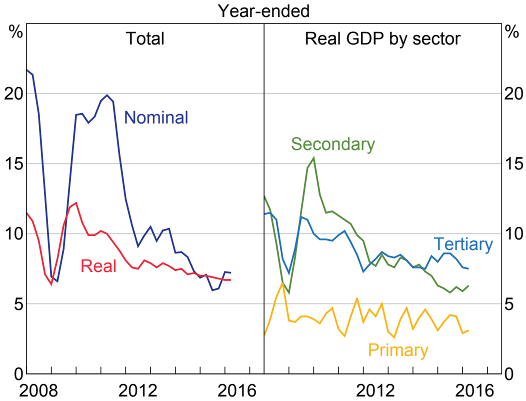
Asia-Pacific

In China, economic growth eased a little further in the first half of 2016 (Graph 1.4). Growth in the industrial (secondary) sector has declined considerably in recent years and subdued conditions in that sector have been associated with declining growth in private investment. Activity in the mining and manufacturing industries remains weak, although stronger conditions in the residential property sector in the first half of the year have supported the output of construction-related products, including steel.

Growth in Chinese private fixed asset investment has fallen sharply, although this has been partly offset by rapid growth in public investment spending over the past year, including on infrastructure (Graph 1.5). The Chinese Government has instructed relevant government agencies and local authorities to reduce impediments to private investment and facilitate increased bank lending to private sector firms.

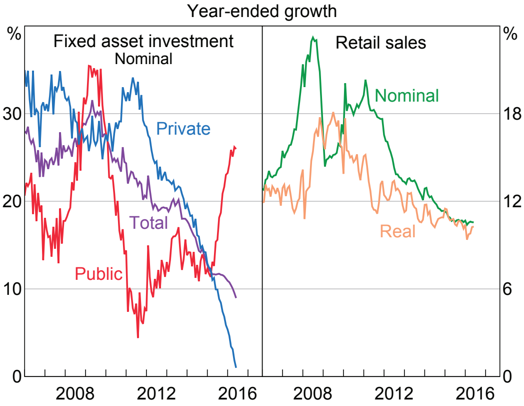
Overall growth in the Chinese economy has been supported by relatively strong growth in the services (tertiary) sector, notwithstanding slower growth in financial services of late. Indicators of consumption growth (including growth in retail sales) have been little changed in recent months.

Graph 1.4
China – GDP Growth
Year-ended



Sources: CEIC Data; RBA

Graph 1.5
China – Expenditure Indicators
Year-ended growth



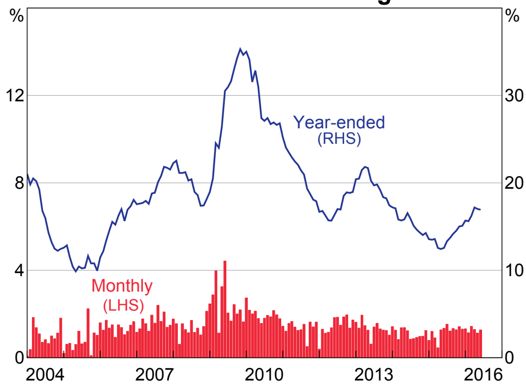
Sources: CEIC Data; RBA

Conditions in Chinese housing markets had strengthened since late 2015, in part reflecting earlier policy measures to support the market. More recently, however, conditions have moderated a little, including in some of the large and mid-sized cities where measures were recently introduced to restrain demand in response to very strong property price growth. In most cities, housing price growth has eased or remained little changed in recent months, while the volume of floor space sold and real estate investment have declined a little (see 'Box A: The Pick-up in the Chinese Housing Market').

Financial conditions in China remain relatively accommodative. Growth in total social financing has stabilised in recent months (after adjusting for the impact of the local government debt restructuring program) (Graph 1.6). The pace of corporate bond issuance has moderated, however, and growth in off-balance sheet lending has been low by historical standards.

Excess supply in the global industrial sector has contributed to weak global investment growth. Consistent with this, Chinese trade volumes have fallen over recent years (Graph 1.7). However, imports of iron ore, including from Australia, have risen in recent months, as Chinese iron ore production has declined further.

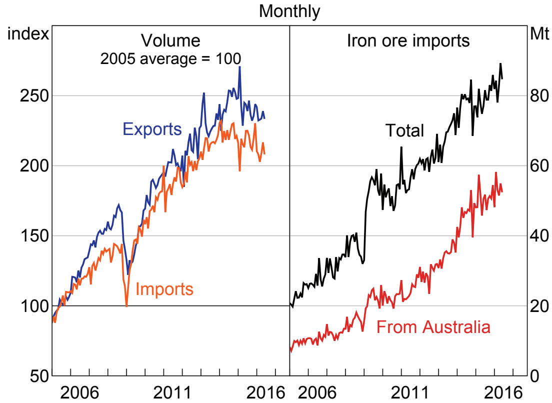
Graph 1.6
China – Total Social Financing Growth*



* Seasonally adjusted by RBA; upper bound estimate adjusting for impact of local government bond issuance to pay off debt previously included in TSF

Sources: CEIC Data; People's Bank of China; RBA

Graph 1.7
China – Merchandise Trade*
Monthly

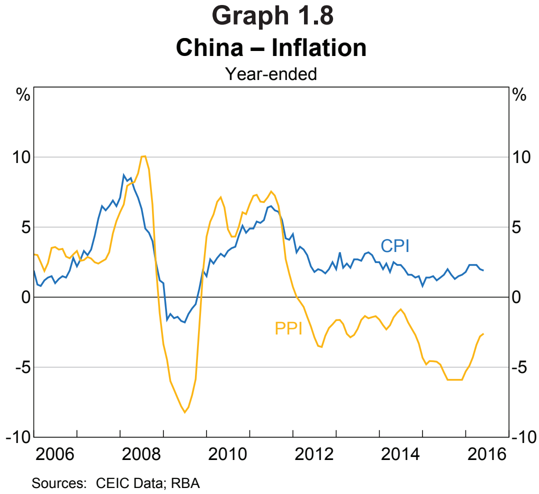


* Seasonally adjusted by RBA

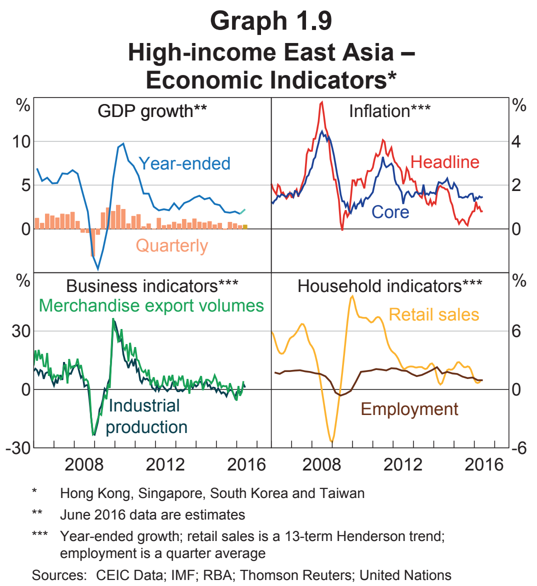
Sources: CEIC Data; RBA

Inflationary pressures remain subdued in China. CPI inflation has been little changed in recent months as earlier increases in food prices have been unwound. Deflation in producer prices has continued to ease, consistent with increases in commodity prices (Graph 1.8).

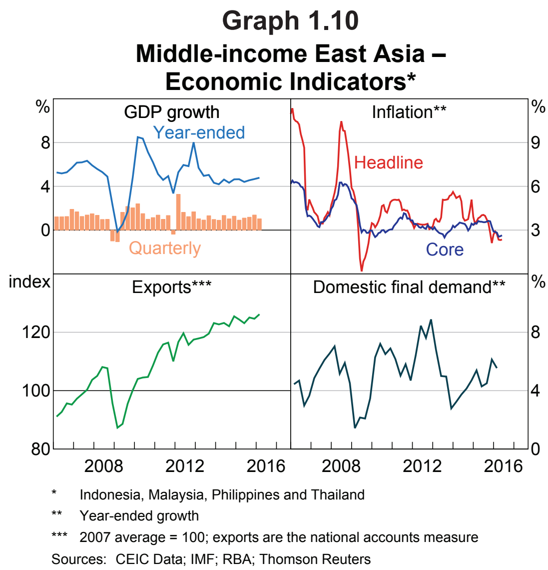
In east Asia (excluding China and Japan), economic growth has slowed since late 2014, driven almost entirely by developments in the high-income economies. As these economies are quite reliant on trade, softer demand from China and other emerging economies has led to stagnant



merchandise export volumes and industrial production (Graph 1.9).[3] Business investment has also been subdued over the past year. The exchange rate depreciations in the region over the past 1½ years should support net export volumes and economic activity more generally in the period ahead. Consumption growth in the high-income east Asian economies was resilient in 2015, but looks to have moderated in 2016. This has coincided with a decline in employment growth and a slight increase in unemployment rates. Core inflation has eased since late 2014 and headline inflation remains low. A number of central banks in the region have eased monetary policy in the past year and several governments have increased spending and implemented temporary tax reductions. This includes the Korean Government, which is planning the third package of stimulus measures since 2015 (equivalent to around 1 per cent of GDP) aimed at supporting domestic consumption.



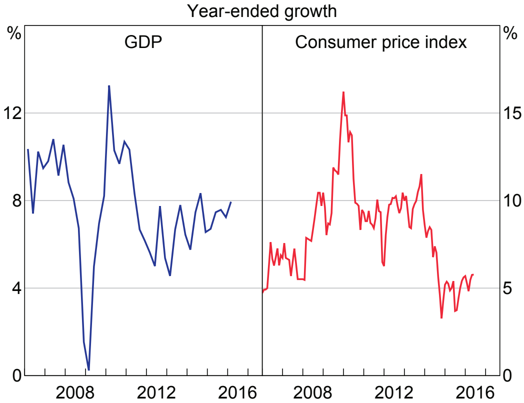
In contrast, GDP growth in the middle-income east Asian economies has been more resilient and remains around its decade-average (Graph 1.10). While these economies are also facing subdued external demand, they are less exposed to international trade than their high-income counterparts in the region. Domestic final demand in the middle-income economies has continued to be driven by moderate consumption growth and a marked increase in investment growth over the second half of 2015. Both headline and core inflation remain relatively low and have eased in recent months.



3 The ratio of exports to GDP in the high-income east Asian economies is around 80 per cent, compared with around 40 per cent in the middle-income east Asian economies.

In India, economic growth has continued to edge higher, as relatively strong consumption growth has more than offset weaker growth in investment (Graph 1.11). CPI inflation is currently a little above the Reserve Bank of India's interim goal of 5 per cent by March 2017. Rising food price inflation has contributed to the recent pick-up, although above-average monsoon rainfall has been forecast for 2016, which would support agricultural production and mitigate upward pressure on food prices.

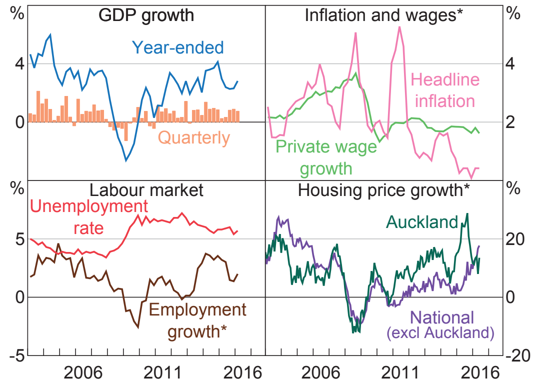
Graph 1.11
India – GDP Growth and Inflation
Year-ended growth



Source: CEIC Data

The New Zealand economy has grown at around its long-term average pace since mid 2015, supported by accommodative monetary policy and the earlier exchange rate depreciation (Graph 1.12). The unemployment rate is around its lowest level since 2009, as employment growth has been sufficient to absorb the record-high level of net immigration. Tax and regulatory changes aimed at curtailing investor activity in the housing market, particularly in Auckland, have seen housing price growth in Auckland moderate since October last year, although housing price growth has continued to increase in the rest of the country. The Reserve Bank of New Zealand has proposed new nationwide restrictions that will further limit high loan-to-valuation ratio lending and these are likely to come into effect in September this year. Headline consumer price inflation remains around historically

Graph 1.12
New Zealand – Economic Indicators



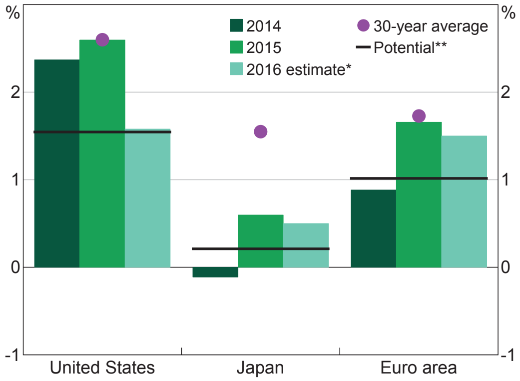
* Year-ended
Sources: RBA; REINZ; Thomson Reuters

low levels, reflecting downward pressure from energy prices and subdued underlying inflationary pressures. Nominal wage growth has been low, although modest productivity growth implies that unit labour costs are growing at around their average rate of 2 per cent in year-ended terms.

Major Advanced Economies

GDP growth in the major advanced economies is around or a little above estimates of potential growth, which are generally lower than long-term average growth rates due to declining working-age population growth, weaker productivity growth and, in some cases, lingering effects from the global financial crisis (Graph 1.13). Growth in the United States picked up a little in the June quarter, but has declined in year-ended terms, while Japanese GDP was little changed over the past year. The euro area economy grew at an above-trend rate in the first half of 2016, although heightened uncertainty following the outcome of the United Kingdom's referendum could dampen output growth a little in the period ahead. At this stage, the referendum outcome seems to have had relatively little economic impact outside the United Kingdom. Consumer confidence and survey measures of business conditions remain at or above average levels in the three largest advanced economies (Graph 1.14).

Graph 1.13
Major Advanced Economies – GDP
Annual growth

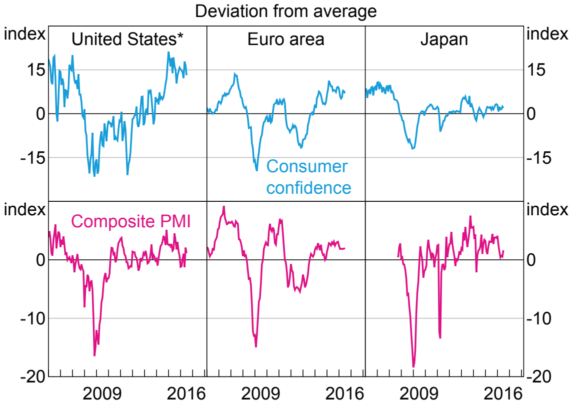


* US based on IMF forecast as at July 2016, adjusted for the June quarter GDP outcome; Japan and euro area based on Consensus Economics forecasts as at July 2016

** US and euro area estimates are for 2016; Japan estimate is for the six months ending March 2016

Sources: Bank of Japan; Congressional Budget Office; Consensus Economics; European Commission; IMF; RBA; Thomson Reuters

Graph 1.14
Major Advanced Economies – Survey Indicators
Deviation from average

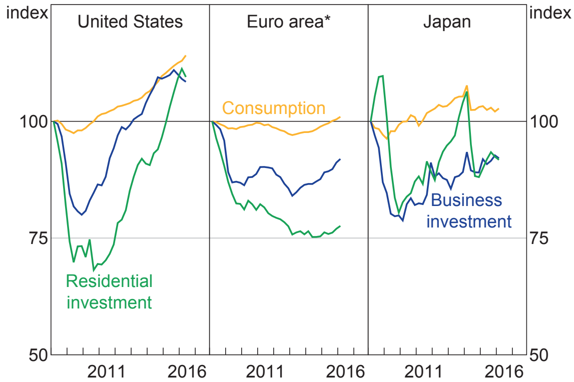


* ISM surveys used to construct a composite survey index

Sources: RBA; Thomson Reuters

Over the past two years, private consumption has been the key driver of growth in the United States and the euro area (Graph 1.15). In contrast, consumption in Japan has remained subdued since the increase in the consumption tax in early 2014. This led the Japanese Government to postpone the next scheduled increase in the consumption tax from April 2017 to October 2019 and to pursue further fiscal stimulus measures. Consumption growth in the major advanced economies continues to be supported by: low borrowing rates

Graph 1.15
Major Advanced Economies – GDP Expenditure Components
March 2008 = 100



* Business investment in the euro area includes both public and private investment

Source: Thomson Reuters

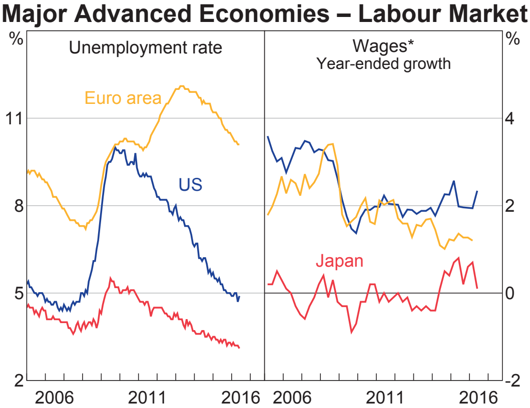
owing to accommodative monetary policies; the boost to real incomes from low fuel prices; and increases in household wealth, including from rising housing prices. Working in the other direction, nominal wage growth remains low.

In the United States, the strength in business investment has waned since late 2014. Investment has declined in the oil & gas and manufacturing sectors, reflecting the fall in oil prices, weaker external demand and the appreciation of the US dollar. In contrast, residential dwelling investment has grown strongly over the past year and a half, supported by an increase in demand for higher-density dwellings and low residential mortgage rates, although there are some signs that it has eased of late. In the euro area and Japan, residential and business investment remain well below their pre-crisis levels. Nonetheless, euro area investment has grown at an above-average rate since early 2015. Business investment in Japan appears to have declined in the first half of 2016, which may, in part, reflect the effects of the appreciation of the yen since late 2015 and weaker external demand; however, survey measures of business investment intentions have held up and corporations still expect to increase investment over the year to March 2017.

Labour markets have improved considerably in recent years across the major advanced economies. Employment growth has been robust in all three economies, resulting in declining rates of unemployment and underemployment (Graph 1.16). Unemployment rates in the United States and Japan are now at or below their long-run averages and estimates of equilibrium levels, indicating that there is little spare capacity in the labour market. Consistent with this tightening, some labour compensation measures suggest a slight pick-up in wage pressures in these economies. Even though nominal wage growth remains low, productivity growth has been weak, such that unit labour costs in the US and Japanese economies have been growing at above-average rates (Graph 1.17). The unemployment rate in the euro area remains well above its long-run average level. Consistent with this, growth in compensation per employee in the euro area remains close to its historic low and unit labour cost growth has declined.

Inflation in the major advanced economies remains below the respective central banks' targets. While core inflation is above its 2015 lows, it has declined in the euro area and Japan over the past six months or so (Graph 1.18). Most measures of inflation expectations in the major advanced economies have declined in recent years to historically low levels. Much of the decline in longer-term market-based inflation expectations in the United States and the euro area has coincided with the decline in oil prices that has also contributed to low headline inflation. Japanese long-term inflation expectations have fallen sharply since late 2015 and have returned to where they were before the Bank of Japan renewed its quantitative easing program in early 2013.

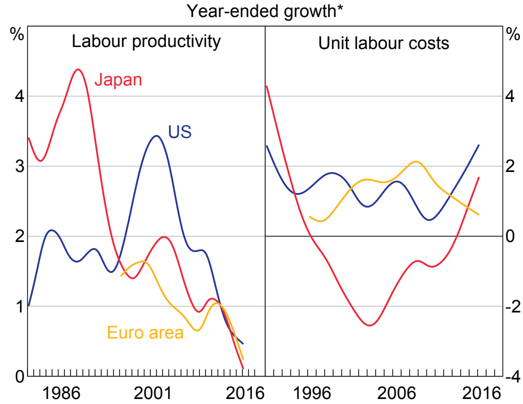
Graph 1.16
Major Advanced Economies – Labour Market



* Employment cost index for the US; compensation per employee for the euro area; average scheduled cash earnings for Japan

Sources: Eurostat; RBA; Thomson Reuters

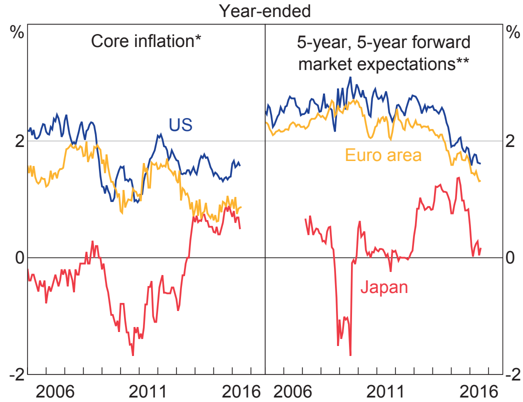
Graph 1.17
Major Advanced Economies – Productivity and Unit Labour Costs
Year-ended growth*



* HP filtered, with smoothing parameter set to 1600

Sources: Eurostat; RBA; Thomson Reuters

Graph 1.18
Major Advanced Economies – Inflation
Year-ended



* Personal consumption expenditures (PCE) inflation for the US; Japan data exclude the effects of the consumption tax increase in April 2014

** US expectations adjusted to be comparable to PCE inflation

Sources: Bloomberg; RBA; Thomson Reuters

United Kingdom

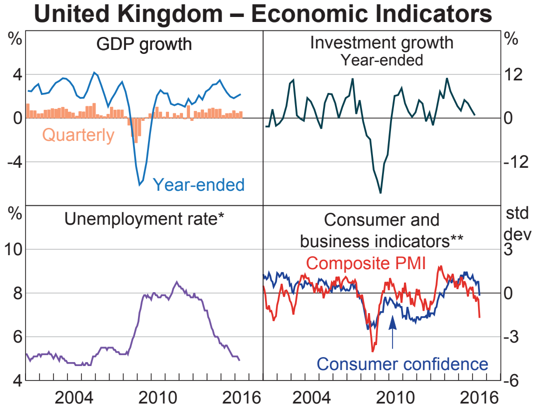
The United Kingdom voted to leave the European Union in a referendum held on 23 June. The formal notification of the decision will trigger a two-year period during which the terms of the United Kingdom's withdrawal from the European Union need to be negotiated.

Prior to the referendum, the UK economy had been growing at a moderate rate (Graph 1.19). Inflation had been below the Bank of England's target for some time, despite very stimulatory monetary policy and a tightening labour market. UK business investment had undergone a recovery, leading to the level of investment surpassing pre-global financial crisis levels in 2014. However, the increase in uncertainty in the lead up to the referendum may have dampened business investment more recently. Surveys of UK consumer confidence and business activity declined sharply after the referendum.

Leaving the European Union is likely to make it more costly and difficult for the United Kingdom to export goods and services to the region. This is important because the United Kingdom's international investment and trade flows, particularly with the European Union, are large. The United Kingdom's combined foreign assets and liabilities are equivalent to around 10 times its GDP;

Graph 1.19

United Kingdom – Economic Indicators



* Three-month moving average

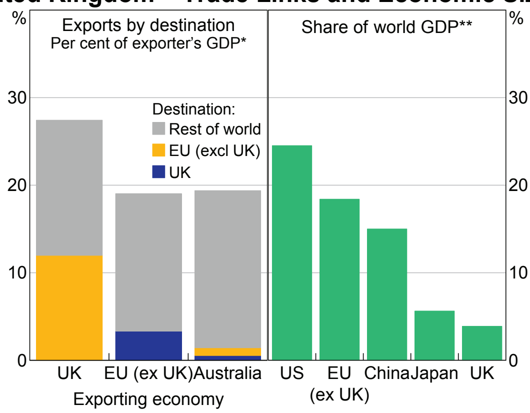
** Standard deviation from long-run average

Sources: Markit; RBA; Thomson Reuters

UK exports equate to around 27 per cent of GDP, nearly half of which are to the rest of the European Union (Graph 1.20). IMF and OECD estimates suggest that UK GDP could be between 1 and 5 per cent lower by the end of 2018, in the absence of any policy response.[4]

Graph 1.20

United Kingdom – Trade Links and Economic Size



* 2015 exports; excludes intra-European Union exports

** 2015 GDP at market exchange rates

Sources: IMF; Thomson Reuters

Commodity Prices

Commodity prices overall are above the lows reached around the turn of the year, but are about 50 per cent below their 2011 peak (Table 1.1; Graph 1.21). Those declines reflect both substantial increases in supply as resource projects have started production as well as weaker global demand, especially from Asia.

The spot price of iron ore has risen sharply in recent weeks, following declines over the previous couple of months (Graph 1.22). The spot price is now around 65 per cent below its 2011 peak, although it remains well above its mid-2000s level. The prices of iron ore and steel had been supported by the

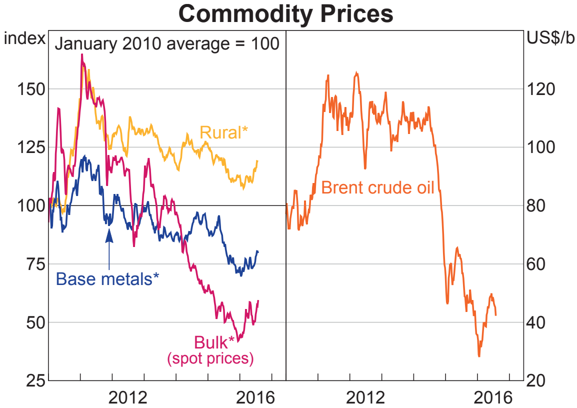
4 See IMF (2016), *'United Kingdom Selected Issues: Macroeconomic Implications of the United Kingdom Leaving the European Union'*, Staff Report on the 2016 Article IV Consultation, April, available at <http://www.imf.org/external/pubs/ft/scr/2016/cr16169.pdf> and OECD (2016), *'Box 1.1. Financial Market Shocks from Brexit'*, OECD Economic Outlook, 2016(1), available at <http://www.oecd.org/eco/outlook/OECD-Economic-Outlook-June-2016-general-assessment-of-the-macroeconomic-situation.pdf>.

Table 1.1: Commodity Price Growth(a)
SDR, three-month-average prices, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	2	–2
– Iron ore	–4	–5
– Coking coal	9	7
– Thermal coal	9	–5
Rural	4	–3
Base metals	2	–11
Gold	4	11
Brent crude oil(b)	20	–22
RBA ICP	4	–7
– using spot prices for bulk commodities	2	–5

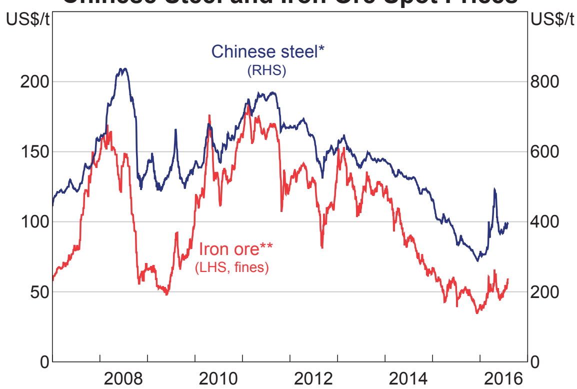
(a) Prices from the RBA ICP; bulk commodities prices are spot prices
(b) In US dollars
Sources: Bloomberg; IHS; RBA

Graph 1.21
Commodity Prices



* RBA Index of Commodity Prices sub-indices, SDR
Sources: Bloomberg; RBA

Graph 1.22
Chinese Steel and Iron Ore Spot Prices

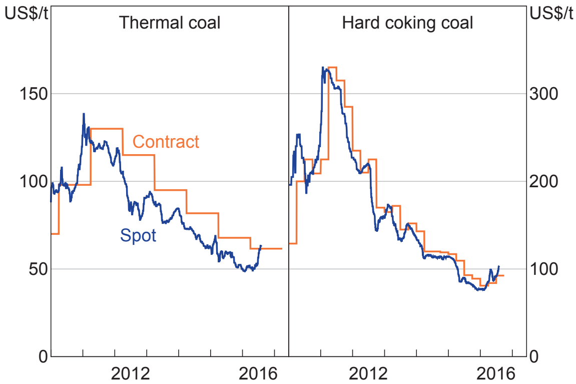


* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; RBA

Chinese Government's announcement of its 2016 growth targets in early March, which improved the near-term outlook for steel demand. Speculative activity in derivative markets and restocking of iron ore inventories were also likely to have played a role in pushing prices higher for a time, but the prices of steel and iron ore declined following actions by the Chinese authorities to curb speculative activity. Chinese steel production is expected to moderate over the year ahead. At the same time, global supply of iron ore is expected to rise as increased supply from Australia and Brazil more than offsets the recent cuts to Chinese iron ore production. The combination of these factors is expected to exert downward pressure on prices.

After declining for much of the past five years, prices of thermal and coking coal have increased in recent months, and are now over 30 per cent above their lows earlier in the year (Graph 1.23). While thermal coal prices remain under pressure from weaker global demand, both thermal and coking coal prices have been supported by ongoing reductions in global supply, including from Chinese

Graph 1.23
Coal Prices
Free on board basis



Sources: Department of Industry, Innovation and Science; IHS; RBA

and Indonesian producers. Notwithstanding recent increases, at current prices a substantial share of global coal production, including in Australia, is estimated to be unprofitable.

Concerns about global demand, particularly subdued growth of global industrial production, have led to declines in the prices of base metals over the past year, although declines in the production of some of these commodities have supported prices in recent months.

The Brent crude oil price has been higher in the past three months, following supply disruptions in several countries, including Canada and Nigeria (Graph 1.21). Prices have declined more recently, reflecting an increase in global supply and no indication that global production will be lowered. Regional liquefied natural gas (LNG) prices have been weak of late. This reflects the earlier decline in oil prices around the turn of the year, as changes in oil prices tend to affect LNG prices with a lag of a few quarters. The overall increase in the price of oil since then will flow through to the export price of contracted LNG volumes in coming quarters, but increased supply from Australian exporters is likely to place downward pressure on the regional LNG spot price over the next couple of years. ✠