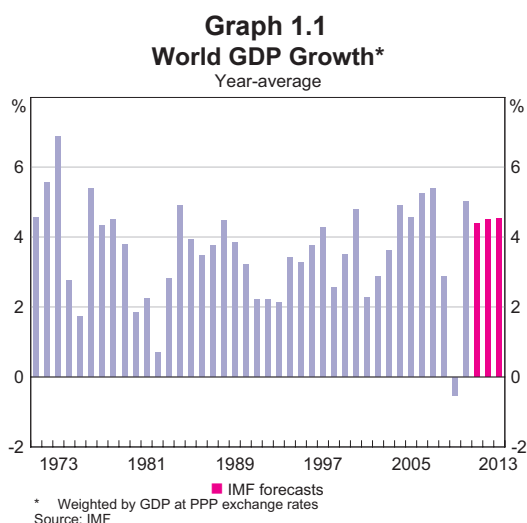


1. International Economic Developments

The global economy is continuing to grow at an above-average pace, although conditions vary significantly across different regions of the world. Growth in most of Asia remains strong, although below the rapid pace experienced earlier in the recovery. The main exception is Japan, where earthquake-related damage (including to power infrastructure) is having a significant effect on economic activity. In the North Atlantic economies, the recovery is continuing, with unemployment rates in a number of countries declining. Notwithstanding this, most of these economies continue to operate with large amounts of excess capacity and many still face the difficult challenge of putting their public finances on a sounder footing.

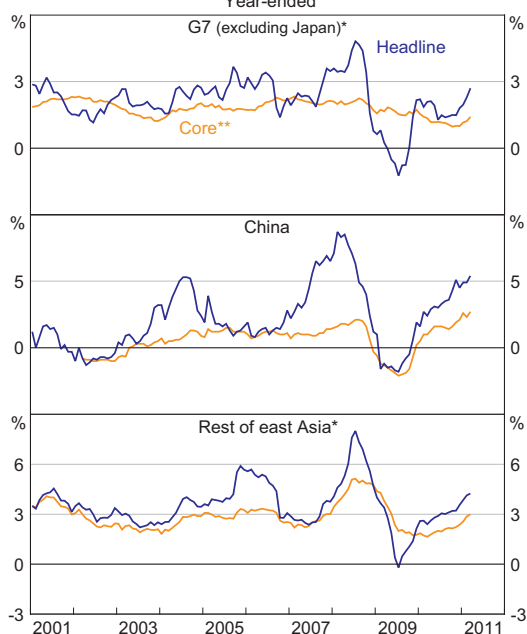
Overall, in 2010 the world economy grew by around 5 per cent, compared with average growth of 4 per cent over the decade to 2008. The International Monetary Fund (IMF) is forecasting growth to continue at an above-trend pace in the next few years, although below the rate recorded in 2010 (Graph 1.1). This forecast – which is consistent with the Bank’s central scenario for the world economy – is broadly unchanged from that of three months ago, with downward revisions to the forecasts for Japan and the United States offset by upward revisions for the euro area and Latin America.

Over recent months, headline inflation rates have increased significantly in a number of countries, largely due to higher commodity prices (see ‘Box A: Commodity Prices and Global Inflation’). Above-average growth in the world economy, combined with political unrest in North Africa and the Middle East has seen oil prices rise by 30 per cent



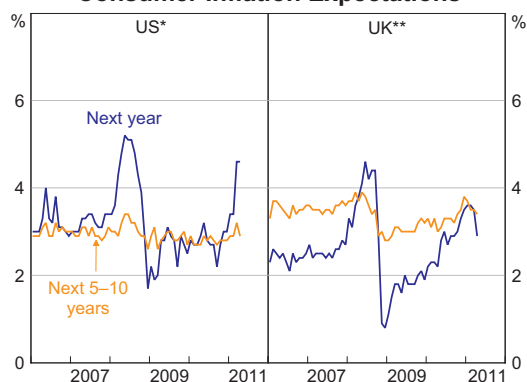
over the past year (in SDR terms), while prices of bulk mineral commodities have increased on average by around 36 per cent. Food prices have also been increasing rapidly, with weather-related disruptions affecting supply in an environment in which demand has been growing strongly. In Asia, where economies are operating at or close to full capacity, ‘core’ inflation rates have also risen and there are signs that higher commodity prices are flowing through to higher prices for some consumer goods (Graph 1.2). In most advanced economies there is little upward pressure on inflation from domestic factors, although global factors operating through commodity markets are leading to an increase in inflation rates. While the strength in commodity prices primarily reflects strong global demand, for some economies, it can be viewed as an adverse supply shock, and is having a negative impact on real household incomes.

Graph 1.2
Consumer Price Inflation
Year-ended



* Weighted by GDP at PPP exchange rates
 ** Excludes food and energy except for Germany, France, Italy and the UK which also exclude alcohol and tobacco, Canada which excludes eight of the most volatile components as well as the effect of changes in indirect taxes and China which includes energy
 Sources: Bank Indonesia; CEIC; IMF; RBA; Thomson Reuters

Graph 1.3
Consumer Inflation Expectations



* University of Michigan Consumer Sentiment Survey; median response
 ** YouGov/Citigroup Inflation Tracker Survey; median response
 Source: Thomson Reuters

In some countries, rising commodity prices and the resulting increase in headline inflation rates have led to a noticeable increase in inflation expectations for the year ahead, to above-average levels. Longer-term inflation expectations have risen, but by a considerably smaller amount and remain well within the range seen over the past decade or so (Graph 1.3).

Asia

Growth in the Chinese economy remains strong, with GDP increasing by 2.1 per cent in the March quarter to be 9.7 per cent higher over the year (Graph 1.4). Industrial production has continued to expand at a robust pace, with output of steel products increasing by more than 10 per cent over the past year (Graph 1.5). Power generation and cement production were also particularly strong in the March quarter.

The strength in the production of key building materials is consistent with robust growth in fixed asset investment over recent months. While growth in infrastructure investment has slowed from its extremely rapid stimulus-related pace in 2009, real estate investment has picked up recently and there has been continued solid growth in manufacturing investment. The rebound in real estate investment followed temporary weakness in the latter half of 2010, which was partly the result of measures to cool the property market. These policies appear to have had some effect on measured residential property price inflation, which has moderated significantly from the double-digit rate recorded in the first half of 2010.

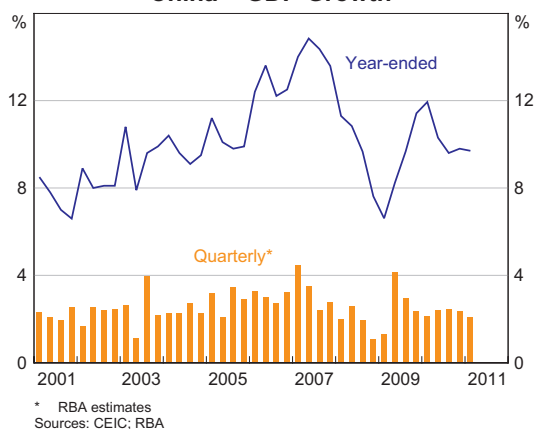
External demand has also grown solidly. Exports to all of China's major export destinations have increased over recent months, with particularly strong growth in exports to the United States and east Asia (excluding Japan). The value of imports from both major advanced economies and commodity exporters has also increased strongly, with higher commodity prices boosting import values. Consumption has continued to grow at a robust pace. Real retail sales have increased by around 15 per cent over the year, a pace similar to that recorded during 2010.

Year-ended consumer price inflation rose to 5½ per cent in March, up from 2½ per cent a year earlier. Food prices increased by nearly 12 per cent over the year and inflationary pressures are also being seen in non-food prices; in March, year-ended inflation in non-food prices reached its highest level in at least 10 years (Graph 1.6). Higher commodity prices are having a considerable effect on some consumer prices. Higher prices for grains are being seen in the prices of items such as alcoholic beverages, and higher cotton prices are being reflected in rises in clothing prices, which had fallen over the previous decade. Housing prices have also contributed significantly to inflation, with rental costs rising by 8 per cent over the year to March, their fastest pace in at least seven years.

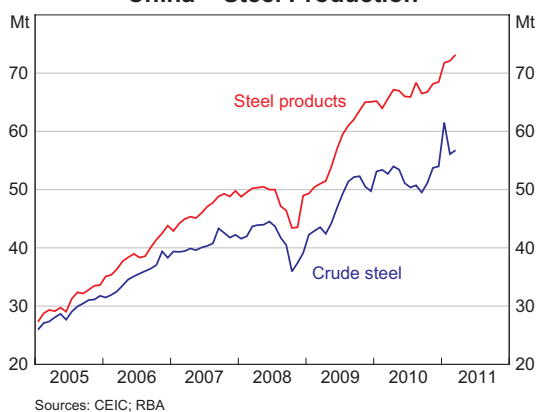
Policymakers have responded to this rise in inflation with a number of measures, including higher interest rates and further steps to restrain credit growth. Since the February *Statement*, the People’s Bank of China has raised its benchmark 1-year deposit and lending rates by 50 basis points, taking the cumulative increase to 100 basis points since October. The reserve ratios applying to banks have also been increased by 1.5 percentage points over the past three months, largely in an effort to offset the effects on liquidity from the continuing build-up in China’s foreign exchange reserves. Credit controls have also been tightened, with credit growing at an annualised rate of 12 per cent over the first three months of 2011, significantly slower than its pace of expansion over 2010. Fiscal policy is, however, expected to remain stimulatory in 2011, with government expenditure expected to continue growing strongly.

In Japan, the earthquake and accompanying tsunami devastated the Tohoku region. Beyond the human cost, the earthquake has significantly damaged the capital stock and impaired electricity generation assets, including some that supply the greater Tokyo region. Around one-quarter of the total electricity generation capacity in the Tokyo region was damaged, with 6 per cent lost permanently and about a further 6 per cent offline for an undetermined amount of

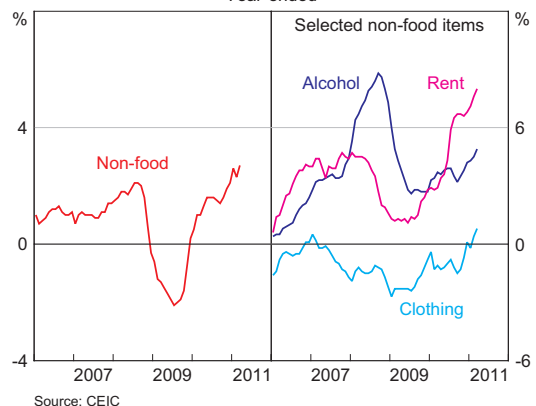
Graph 1.4
China – GDP Growth



Graph 1.5
China – Steel Production



Graph 1.6
China – Consumer Price Inflation
Year-ended



time. The loss of capacity is particularly significant since the electricity networks in the regions affected by the earthquake operate at a different frequency to the ones further south and there is only a very limited capacity to convert between frequencies. Damage to nuclear plants has also resulted in radiation leaks that have contaminated sea water and some agricultural produce.

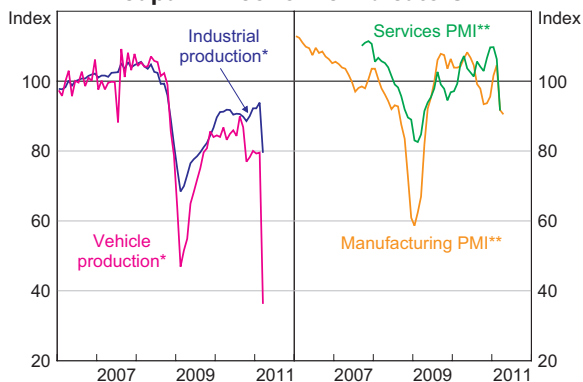
Although economic indicators had been improving in January and February, data received for the month of March indicate that the earthquake caused a sharp contraction in activity in that month. Industrial production fell by 15 per cent in March as many production facilities immediately shut down, even outside the Tohoku region (Graph 1.7). In the weeks following the earthquake, many production facilities remained closed or operated at reduced capacity due to supply-chain disruptions and, in the Tokyo region, electricity supply issues. Motor vehicle production fell by over 50 per cent in March given the widespread shutdown of automakers in the month due to factory damage and electricity shortages. Housing starts and construction orders also fell in March, as did business activity in the services sector as measured by the services PMI survey. On the consumption side, consumer confidence and retail sales fell noticeably in March (Graph 1.8). Department store sales fell across

almost all regions, with the largest falls occurring in the Tohoku and, to a lesser extent, Kanto (Tokyo) regions, while vehicle registrations fell by over 20 per cent in both March and April.

With blackouts officially suspended from early April, industrial production is expected to increase gradually as production facilities restart and production picks up in areas not directly affected by the earthquake or electricity supply issues; the low level of capacity utilisation in Japan prior to the earthquake and the fact that manufacturers tend to have factories in a number of regions is allowing the relocation of some production. Partly reflecting this, conditions in the manufacturing sector deteriorated only modestly in April, as measured by the manufacturing PMI survey. Following some shortages of electricity in the summer months, rebuilding efforts, an increase in production from repaired plants, and better supply and demand balance in the Tokyo region electricity market are likely to boost growth. However, there is considerable uncertainty about the resolution of the situation at the Fukushima Daiichi Nuclear Power Station and its effect on sentiment and activity in Japan.

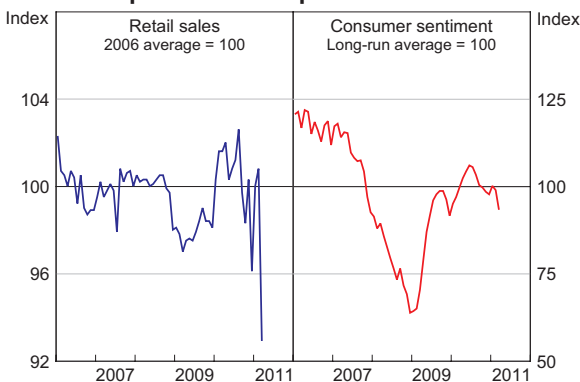
Currently, Japan accounts for around 6 per cent of world merchandise trade, ranking fourth after the United States, China and Germany, and is

Graph 1.7
Japan – Economic Indicators



* 2006 average = 100
** Long-run average = 100
Sources: CEIC; Markit Economics; Thomson Reuters

Graph 1.8
Japan – Consumption Indicators



Sources: CEIC; Thomson Reuters

an important producer of intermediate goods, particularly for the global automotive and IT sectors. With the widespread closure of manufacturing plants after the earthquake, Japanese export volumes fell by 8 per cent in March and import volumes fell by 1.5 per cent. As a result, there have been some disruptions to production in other economies, largely in the automotive sector. However, the ability of Japanese firms to switch production to other areas of the country (or the ability of competing firms in other economies to expand production) and the faster recovery of component production for export will limit the adverse effects on economic growth outside of Japan. In the medium term, the rebuilding effort in Japan is likely to provide a modest boost to growth in other economies in the Asian region.

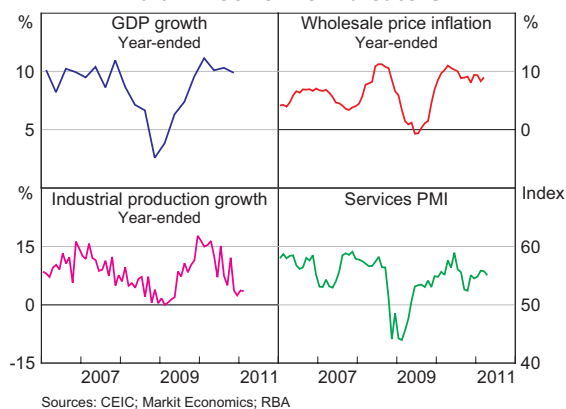
Conditions in the Indian economy remain robust, although some indicators suggest an easing recently. Trends in industrial production indicate that growth in the industrial sector of the economy has slowed since the middle of 2010. The value of exports, however, increased noticeably in the March quarter, while conditions in the services sector remained robust and vehicle sales continued to expand in the quarter. This followed strong GDP growth in the December quarter (Graph 1.9). Net exports and household consumption both contributed strongly to growth in the quarter, offsetting weakness in investment and government consumption. Output in the business services, agriculture, utilities and construction sectors all recorded solid growth over the year to the December quarter.

Inflation in India remains elevated, with the wholesale price index rising by 9 per cent over the year to March. While primary food price inflation has eased in recent months, inflation in primary non-food prices has continued to trend higher and non-food manufacturing inflation has picked up. The increase in prices partly reflects pass-through of higher commodity prices, particularly for oil and coal, into input costs, although demand pressures are also contributing to inflation. In response to these developments, the Reserve Bank of India has

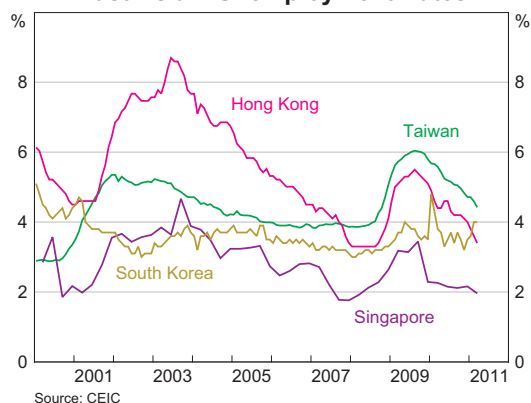
increased its policy rates by a cumulative 75 basis points since the February *Statement*.

After recovering rapidly from the global downturn, there are signs that the economies in the rest of east Asia are operating close to, or at, full capacity. In Malaysia, the Philippines and South Korea, indicators of capacity utilisation are now a little above pre-crisis levels and the unemployment rate in many economies has fallen significantly, although it has picked up recently in South Korea (Graph 1.10). Reflecting these trends, core inflation is increasing in a number of economies in the region, albeit from below-average levels. In response, most economies have begun tightening both monetary and fiscal policy.

Graph 1.9
India – Economic Indicators



Graph 1.10
East Asia – Unemployment Rates



Timely indicators suggest growth in the region was robust in the March quarter. Domestic demand looks to have expanded further; retail sales volumes in January and February were 1 per cent above the December quarter average and, although indicators of investment suggest modest growth in that component, credit growth is accelerating in many countries and surveys indicate that business confidence is high. Industrial production has also increased strongly across the region, partly reflecting a continued expansion in trade. Exports to all major economies picked up in the March quarter, after significant growth in intra-regional trade in the December quarter (including with China).

North Atlantic

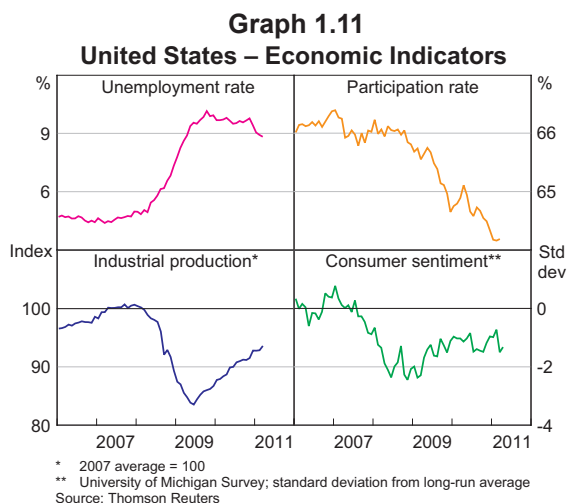
The recovery in the US economy has continued over recent months and output growth is expected to be around trend in 2011. Output grew by 0.4 per cent in the March quarter, a little slower than in the previous quarter as severe weather conditions hampered construction activity and the government reduced defence spending. Both business equipment investment and household consumption expanded further. Consumption growth in the December and March quarters was driven by large increases in purchases of motor vehicles, which had been quite weak since mid 2008. Consistent with this, consumer credit has increased in each month since October after falling significantly during the previous two years.

Although consumer sentiment remains well below average, households are benefiting from a gradual improvement in the labour market. Payrolls employment and the unemployment rate have improved somewhat in recent months, although employment has still only regained around 20 per cent of its peak-to-trough fall (Graph 1.11). Forward-looking indicators of labour demand, such as temporary help services employment, have also increased over the past three months. With business balance sheets generally in good shape and a relatively solid outlook for demand,

employment is expected to continue to pick up, although the pace of decline in the measured rate of unemployment is likely to be slowed by reductions in underemployment and an increase in labour force participation from its recent lows.

The business sector continues to expand, particularly the manufacturing sector. Manufacturing production rose by 2.3 per cent in the March quarter and the ISM manufacturing index is around its highest level since mid 2004. With solid profits growth and relatively low levels of gearing, many firms are in a position to increase investment. Indicators of machinery & equipment investment have improved and firms are beginning to borrow again, helped by some relaxation of lending standards for larger firms. On the fiscal side, the tenor of recent budget negotiations suggests that Congress is becoming more concerned about the level of government debt. Given rising health care and social security spending, further debt increases are inevitable without significant fiscal consolidation efforts.

Construction activity and the housing market more generally remain weak in both the United States and Europe. Residential investment has fallen significantly as a share of GDP in both regions, especially in the United States (Graph 1.12). The fall in non-residential construction has also been sizeable, though less severe than for residential construction.



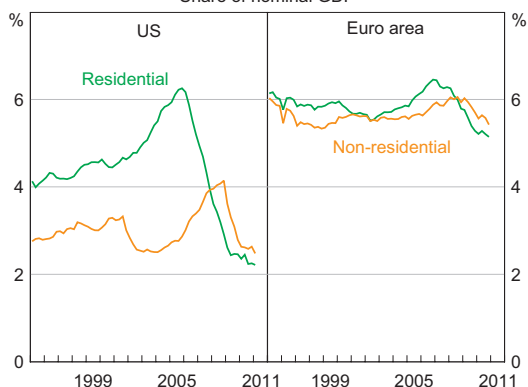
In both cases, construction booms, particularly in the residential sector, have led to an oversupply of properties and vacancies remain high, most notably in the United States. After stabilising throughout the year to mid 2010, house prices in the United States have fallen further and are now more than 30 per cent below their peak in early 2006. House prices in some European countries also continue to fall.

The economic recovery is also continuing in the euro area, although there remains a wide disparity in conditions across the region. The recovery has been led by the export sector, particularly in Germany, France and Spain (Graph 1.13). Growth is broadening in Germany and France, but economic conditions remain very weak in a number of countries where public and private debt problems are prominent. Over the period ahead, planned fiscal consolidation efforts will weigh on growth in most of these countries.

In the March quarter, output in the euro area looks to have increased moderately. Exports growth remained strong, with export values increasing by an average of 2.5 per cent in January and February to be almost 25 per cent higher over the year. Germany, in particular, has benefited from demand growth in China and emerging Europe, with the largest increases in exports over the past year in machinery and transport equipment goods to these economies. Increasingly, however, there are signs that the recovery is broadening into other sectors of the economy. Leading indicators of machinery & equipment investment picked up further in the March quarter and surveys of business conditions continue to improve. Consumer sentiment remains at above-average levels.

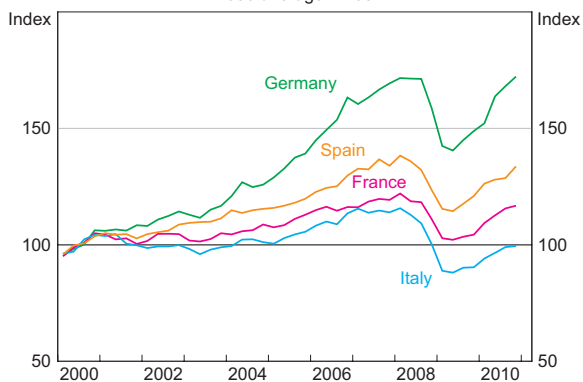
Reflecting the general pick-up in business conditions, the labour market has improved slightly over recent months. Year-ended growth in employment across the euro area as a whole is now positive for the first time since mid 2008, driven largely by gains in Germany and France. This has led to slight falls in the aggregate unemployment rate in recent

Graph 1.12
Construction Investment
Share of nominal GDP



Source: Thomson Reuters

Graph 1.13
Euro Area – Export Volumes
2000 average = 100



Source: Thomson Reuters

months, although unemployment rates remain particularly high in Spain and Ireland. The European Central Bank (ECB) has expressed concern about increasing energy and commodity prices fuelling higher inflation expectations and wage demands. Reflecting this, in April the ECB increased its policy rate by 25 basis points to 1.25 per cent.

Commodity Prices

As noted above, global commodity prices have risen strongly since mid 2010; over this period, the IMF All Primary Commodities Index has risen by around 30 per cent (Graph 1.14, Table 1.1). With the global economy expanding at an above-trend pace and real incomes rising in Asia, there has been strong demand for commodities, with capacity constraints tightening in a range of markets. In some cases, these constraints have been amplified by disruptions to production because of extreme weather events.

In the oil market, crude oil prices moved steadily higher over the second half of 2010 as global demand for oil rose strongly. More recently, political unrest in some oil-producing countries in the Middle East and North Africa has led to concerns about oil supply, adding to the upward pressure on oil prices. The most widely

Graph 1.14
Global Commodity Prices
SDR terms, 2002 average = 100

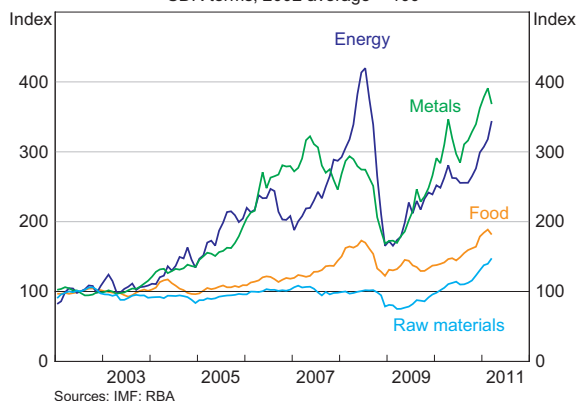


Table 1.1: Commodity Price Growth
Per cent, SDR terms

	Change since previous Statement	Change over the past year
Oil ^(a)	19	30
– US\$ terms	22	39
Base metals		
– Aluminum	8	22
– Copper	–9	24
– Lead	–7	16
– Nickel	–5	3
– Zinc	–12	–2
Gold	10	20
Rural		
– Beef	–6	10
– Cotton	–16	79
– Sugar	–34	31
– Wheat	–9	61
– Wool	9	62
Bulk commodities ^(b)		
– Iron ore	14	33
– Coking coal	39	47
– Thermal coal	14	26

(a) Average of WTI and Tapis crude oil prices

(b) Average Australian monthly export prices, RBA estimates for recent months

Sources: Bloomberg; RBA

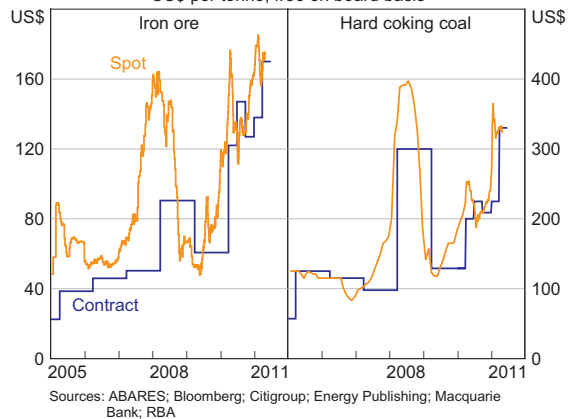
cited benchmark, West Texas Intermediate (WTI) crude, has risen around 23 per cent over the past year (in SDR terms). The increases have been more pronounced for the other crude oil benchmarks such as Tapis crude, which is more relevant to Australia. Exchange-traded mineral commodity prices have also risen sharply since mid 2010, with particularly large increases in the prices of lead and copper. The price of gold reached a record high in the past month.

There have also been significant increases in the prices of iron ore and coal – Australia’s two largest exports – as global steel production has continued to rise. Looking through some volatility in prices in recent months, spot prices for iron ore and coking coal have risen 58 per cent and 73 per cent since mid 2010 (Graph 1.15). In line with these higher spot prices, Australian exporters are receiving higher contract prices for the June quarter. Iron ore contract prices are estimated to have been set 23 per cent higher than their March quarter levels. Coking coal contract prices for the June quarter appear to have been settled around 45 per cent higher than they were in the March quarter, largely reflecting the impact on global coal trade from the heavy flooding and the subsequent loss of production in the coal mining regions of Queensland. Contract prices for thermal coal for the Japanese financial year 2011/12 have reportedly been settled around 33 per cent above the 2010/11 contract price. The strong growth in export prices for bulk commodities has been a major factor in the rise in the terms of trade in recent years, with the terms of trade expected to reach a record high in the June quarter.

Global food prices, as measured by the IMF Food Price Index, are around 28 per cent higher over the past year and slightly higher than the levels reached in mid 2008. Price increases have been relatively broad-based, with particularly large increases in wheat, corn, sugar and soybeans prices. Strong income and population growth in developing countries – where the income elasticity of food demand is typically higher than in developed countries – has supported demand for grains and increasingly also for protein sources such as meat. The spike in some food prices also reflects weather-related disturbances. Wheat

production has been affected by drought in the Black Sea region and dry winter conditions in China, while sugar production has been constrained by supply disruptions in key sugar-producing countries including Brazil and Australia. While weather-related disruptions may be temporary, there have been longer-run supply factors constraining food production. Growth in crop productivity declined over the 1990s and 2000s following the gains made from productivity-enhancing technological advances in earlier decades (Graph 1.16). Declining relative food prices over that time may have reduced the incentive to invest in agriculture, although recent increases in food prices are likely to encourage an expansion in food production.

Graph 1.15
Bulk Commodity Prices
US\$ per tonne, free on board basis



Graph 1.16
Global Grain Production
Five-year average annual growth

