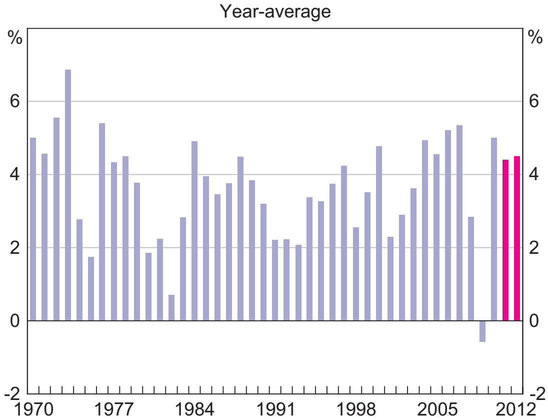
1. International Economic Developments

The world economy continues to recover, although the extent of the recovery varies significantly across regions. In 2010, global output is estimated to have increased by around 5 per cent in year-average terms, and the IMF forecasts a continuation of above-trend growth in both 2011 and 2012 (Graph 1.1; Table 1.1). World industrial production expanded robustly over October and November, and the global manufacturing and services PMIs both rose firmly over recent months to levels consistent with solid output growth.

While the world economy as a whole has grown strongly over the past year, most developed countries continue to operate with extensive spare capacity and high unemployment rates, with some unlikely to return to their pre-crisis levels of quarterly

Graph 1.1
World GDP Growth*
Year-average



* Weighted by GDP at PPP exchange rates
Source: IMF

Table 1.1: World GDP Growth
Year-average, per cent(a)

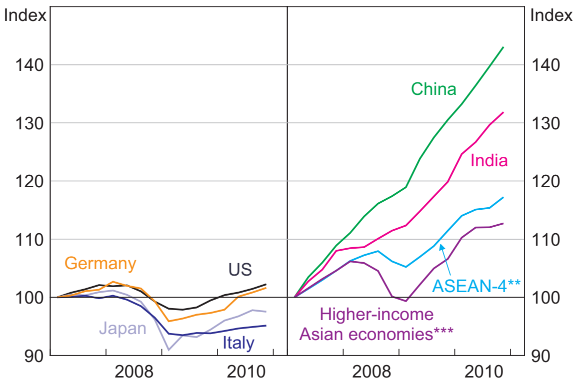
	2009	2010	2011	2012
		Estimate	IMF forecasts(b)	
United States	–2.6	2.8	3.0	2.7
Euro area	–4.1	1.8	1.5	1.7
Japan	–6.3	4.3	1.6	1.8
China	9.2	10.3	9.6	9.5
Other east Asia(c)	0.0	7.6	5.0	4.9
India	5.8	9.7	8.4	8.0
World	**–0.6**	**5.0**	**4.4**	**4.5**
Australia's trading partners(d)	–0.3	6.7	5.1	5.3

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Forecasts from the January *World Economic Outlook Update*
(c) Weighted using GDP at market exchange rates
(d) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Reuters

output until 2013 or even later (Graph 1.2). In many of these economies, ongoing balance-sheet repair by households and corporates, tightened credit standards and (in some economies) continuing financial sector fragility have meant that growth has not rebounded as quickly as has typically occurred in earlier recoveries. In addition, many of the advanced economies face the challenge of putting their public finances on a sounder footing.

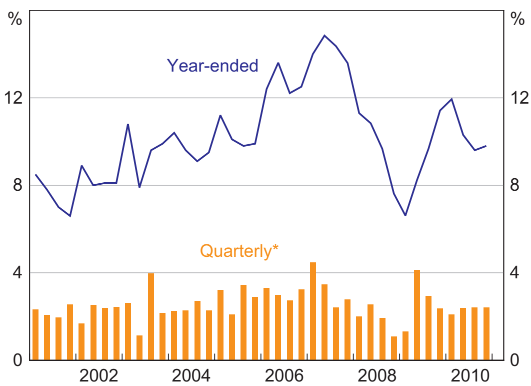
In contrast, the recovery from the global downturn has been strong in many emerging market economies. In Asia, output is now well above pre-crisis levels, and the attention of policy-makers has in many cases turned to controlling consumer and asset price inflation and credit growth, rather than stimulating activity. Strong growth in industrial production in these economies is putting upward pressure on global commodity prices.

Graph 1.2
World Output*
March quarter 2007 = 100



* Includes some RBA estimates for December quarter 2010
** Indonesia, Malaysia, the Philippines and Thailand; PPP-weighted
*** Hong Kong, Singapore, South Korea and Taiwan; PPP-weighted
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 1.3
China – GDP Growth



* RBA estimates
Sources: CEIC; RBA

The Chinese economy has grown particularly strongly, with GDP estimated to have expanded by around 2½ per cent in the December quarter to be around 10 per cent higher over the year (Graph 1.3). Retail sales increased at a robust pace in the quarter and passenger vehicle sales rose very strongly in advance of the increase in sales tax on some cars and the expiry of the car scrappage scheme at the end of 2010.

Urban fixed asset investment moderated in the December quarter, as a fall in real estate investment more than offset strong investment growth in the manufacturing sector and moderate growth in infrastructure investment. The decline in real estate investment reflects, to some extent, the effects of government measures to cool the property market earlier in 2010, which have also resulted in more modest increases in property prices than were recorded at the start of 2010. More recently, property taxes were introduced in Shanghai and Chongqing as part of a pilot program to curb speculation in the property market. At the same time, however, ongoing efforts to increase the supply of low-income housing form an important part of government policy towards the property market and will support construction investment over the coming year.

Consistent with strength in domestic and external demand, industrial production has continued to expand at a firm pace in recent months. Growth has been broad-based, although the production of machinery and transport equipment has been particularly strong, having been boosted by a surge in automobile manufacturing. The production of crude steel recovered strongly towards the end of 2010, after having fallen earlier in the year (Graph 1.4; see also the article 'China's Steel

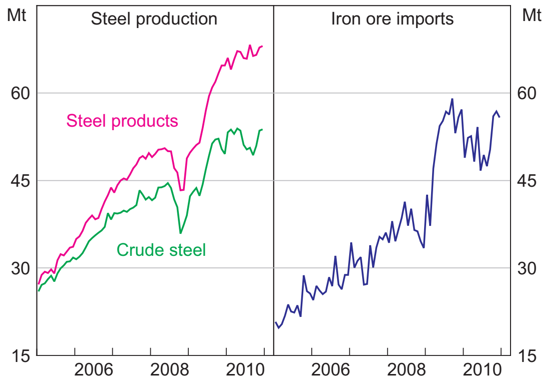
Industry' in the December 2010 *Bulletin*). Imports of iron ore, which had increased prior to the recovery in crude steel production, have remained high in recent months. More generally, China's merchandise imports continue to grow at a robust pace, consistent with strong domestic demand and signs of a recovery in intra-Asian trade (following some softness around mid 2010). Exports rebounded strongly in the December quarter, with increases in shipments to all of China's major trading partners.

Inflation rose noticeably in the last few months of 2010, reaching 4.6 per cent over the year to December (Graph 1.5). As has been the case in a number of previous episodes, the recent pick-up in inflation has been primarily due to rises in food prices, although there is evidence that broader inflation expectations are rising as well. Until recently, food price increases had been fairly broad-based, with the prices of pork and rice rising noticeably, along with the prices of fresh vegetables (although these fell significantly in December; Graph 1.6). While price increases for some food items appear to be mostly due to an especially bad run of weather in China's food-producing regions, strong growth in demand as per capita incomes rise has also had an effect over a longer horizon. Non-food inflation has also picked up recently, with non-food prices rising strongly over the three months to December.

In response to rising food price inflation, the Chinese Government announced an anti-inflation plan in late November that included measures to combat activities related to hoarding and speculation. The government also announced additional support for low-income households to help them cope with the higher cost of living. In addition to these administrative measures, the People's Bank of China (PBC) raised deposit and lending rates in late December, the second increase in the current tightening phase. The 1-year benchmark deposit and lending rates were increased by 25 basis points, while deposit rates for other maturities were increased by between 30 and 35 basis points. The PBC has also raised

Graph 1.4

China – Steel Production and Iron Ore Imports

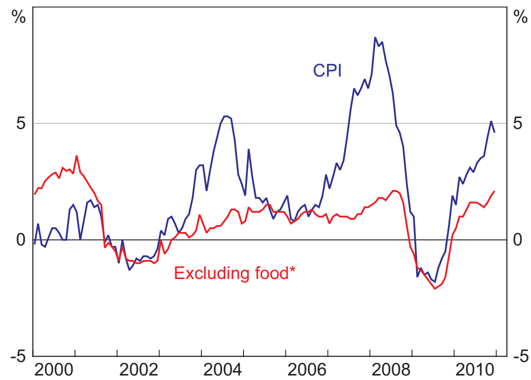


Sources: CEIC; RBA

Graph 1.5

China – Consumer Price Inflation

Year-ended



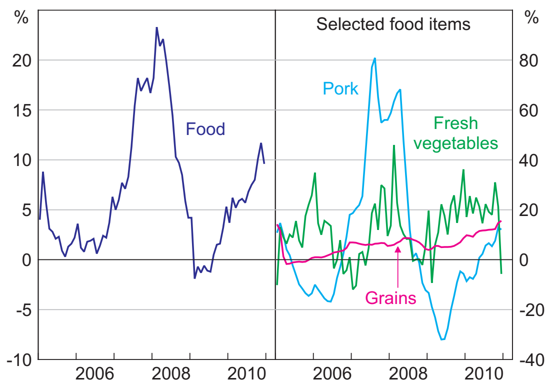
* RBA estimates

Sources: CEIC; RBA

Graph 1.6

China – Consumer Price Inflation

Year-ended

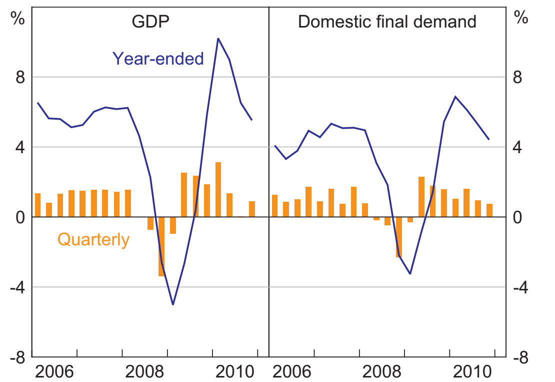


Source: CEIC

reserve requirements by a cumulative 200 basis points since the previous *Statement*, with the reserve requirement ratio for large banks now exceeding its previous peak in mid 2008. Notwithstanding these moves, the stance of policy remains accommodative; real lending rates are close to zero and real deposit rates are negative, while growth in the money supply (M2) remains strong at around 20 per cent over the year to December.

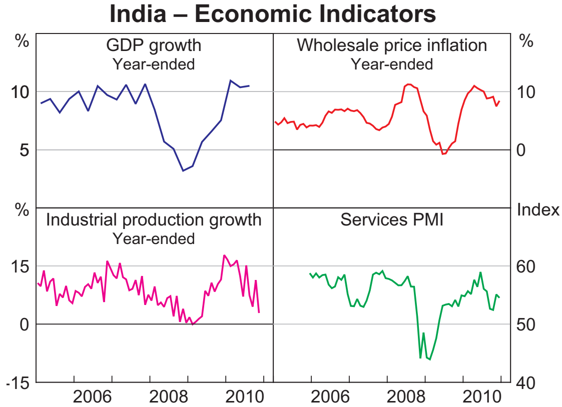
Elsewhere in east Asia (excluding Japan), aggregate domestic final demand continued to expand in the September quarter, and retail sales data for the higher-income Asian economies point to further growth in household consumption in the December quarter (Graph 1.7). Exports have also picked up strongly across the region, after a brief period of weakness around the middle of last year. As a result, firm output growth appears to have resumed in the December quarter following a temporary pause in the September quarter driven by the inventory cycle, some slowing in external demand growth, and disruptions to agricultural production in a number of countries. However, December quarter GDP growth was subdued in Korea, with activity increasing by only 0.5 per cent, held down by a decline in investment.

Graph 1.7
East Asia* – GDP and Demand Growth



* Excludes China and Japan; RBA estimates for December quarter 2010
Sources: CEIC; IMF; RBA

Graph 1.8
India – Economic Indicators



Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

With aggregate domestic final demand growth remaining firm for the seventh consecutive quarter, inflationary pressures have continued to build in the region. Aggregate year-ended consumer price inflation rose to 3½ per cent in December, although this primarily reflects a surge in food prices, with year-ended non-food inflation increasing only modestly. Central banks in most countries in the region have responded by tightening policy since the last *Statement*, although the stance of policy generally remains accommodative.

The Indian economy has also continued to expand at a robust pace (Graph 1.8). Growth has been underpinned by broad-based strength in domestic demand, with output in each of the agriculture, manufacturing and services sectors growing rapidly over the year to the September quarter. More timely data indicate some moderation in the pace of expansion in the December quarter, with growth in industrial production easing towards the end of 2010 and the services PMI suggesting a more modest pace of expansion in that sector. Conditions in the agricultural sector, however, remain supportive of growth due to the favourable summer monsoon.

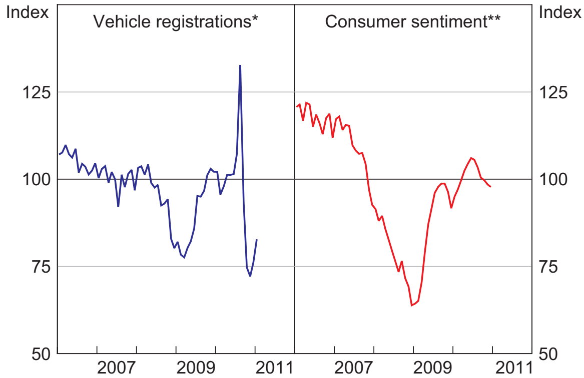
Inflation in India has also been high over the past year, with the wholesale price index rising by 8½ per cent over the year to December. Although the year-ended rate eased over the latter half of 2010, prices rose again strongly in the month of December (up by 2 per cent), reflecting increases in primary food prices. The spike in prices for fresh food such as onions, garlic and tomatoes, which has continued into January, has been attributed to recent unusually heavy rain in some major food producing regions. In response to the renewed inflationary pressures, the Reserve Bank of India increased its policy rates by 25 basis points at its January meeting.

In Japan, output appears to have increased only moderately over the second half of 2010. Growth was strong in the September quarter, led by private consumption (which increased by over 1 per cent), but this robust outcome was driven by a temporary policy-induced boost to demand, including a sharp pick-up in vehicle sales ahead of the expiration of government incentives in early September. New vehicle registrations have since plunged and consumer confidence has weakened over recent months, although it remains close to its long-run average (Graph 1.9). Export volumes and industrial production picked up solidly in the final months of 2010, although this followed a period of noticeable declines in both.

In the United States, output growth picked up to a solid 0.8 per cent in the December quarter, following sub-trend growth over the preceding six months (Graph 1.10). Consumption was stronger than earlier expected, rising by over 1 per cent in the December quarter, its fastest pace of expansion since early 2006. The household saving ratio fell modestly in the quarter and has now been around 5–6 per cent since late 2008 after rising by around 3 percentage points over the prior year. This saving ratio is proving sufficient to allow households to undertake some balance sheet repair by gradually paying down debt. Mortgage debt has been falling since mid 2008, to be nearly 5 per cent below its peak, while credit card debt (including the effect of write-offs) has declined every month for more than two years, to be nearly 20 per cent below its peak in August 2008.

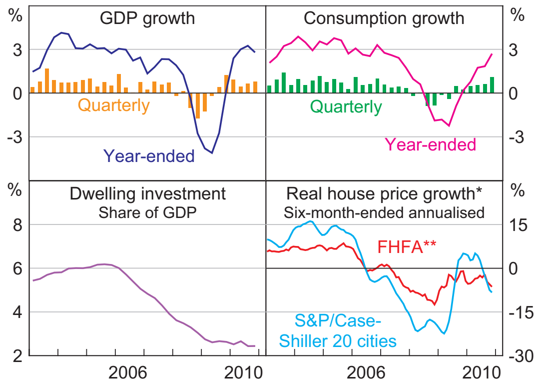
Conditions in the US housing market remain weak. Dwelling investment is around its lowest level as a share of GDP in the post-War period, despite increasing modestly in the December quarter. In addition, after broadly holding steady for more than a year, house prices have fallen again recently, following the cessation of government support measures for buyers around mid 2010. Sales of new homes continue to be depressed, and the stock of vacant dwellings remains elevated.

Graph 1.9
Japan – Consumption Indicators



* 2007 average = 100
** Average since January 1992 = 100
Sources: CEIC; Thomson Reuters

Graph 1.10
United States – Activity and Housing Indicators

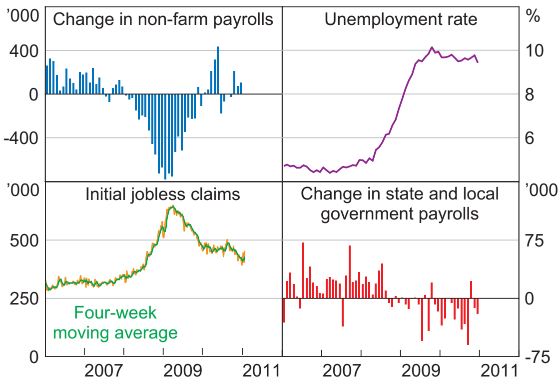


* Deflated by core CPI
** Federal Housing Finance Agency
Sources: Standard & Poor's; Thomson Reuters

Business sector conditions, in contrast, continue to be more positive. Both the manufacturing and non-manufacturing ISM surveys picked up further over recent months, to stand at levels consistent with firm growth in output. Industrial production expanded by 1 per cent over the three months to December, although the level of production remains well below its peak in the latter part of 2007, and equipment investment rose by 1.4 per cent in the quarter. While non-residential construction remained weak in the December quarter, leading indicators suggest that the outlook has improved in recent months.

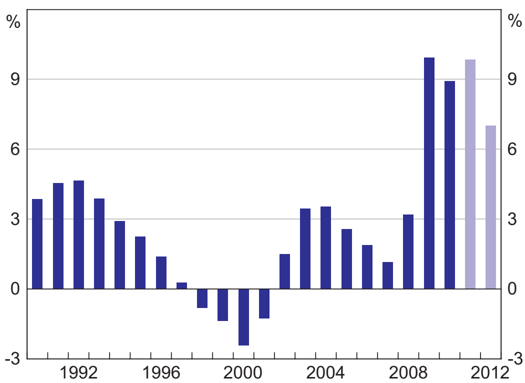
Labour market conditions have also picked up somewhat, although they remain subdued. The US economy added around 400 000 non-farm payrolls jobs in the December quarter, and weekly initial jobless claims have shifted lower over the past few months after remaining broadly unchanged at an elevated level through much of 2010 (Graph 1.11). Nevertheless, the unemployment rate remains well above 9 per cent – with nearly half of those unemployed having been jobless for more than six months – and there remain over 7 million fewer payrolls jobs than at the pre-crisis peak in late 2007. More rapid private sector jobs growth will be necessary to reduce these figures significantly,

Graph 1.11
United States – Labour Market Indicators



Sources: Bureau of Labor Statistics; Thomson Reuters

Graph 1.12
United States – Federal Budget Deficit*
Per cent of GDP



* Data are for fiscal years which end on 30 September
Source: Congressional Budget Office

particularly given the ongoing budgetary pressure on state and local governments, which saw them shed around 250 000 jobs over the course of 2010.

In addition to the gradual underlying recovery under way in the labour market, jobs growth should receive a further boost from recently enacted additional stimulus measures. Late last year, the US Administration and Congress agreed to extend a range of tax cuts, which had been scheduled to expire at the end of 2010, for a further two years and also enacted a number of further discretionary measures including a temporary payroll tax cut. These additional measures are estimated to amount to around US$350 billion over 2011 and 2012, or 2½ per cent of annual GDP. In 2011, the United States appears likely to record its third consecutive federal deficit of around 9 per cent of GDP or more, with the Congressional Budget Office also expecting the deficit to remain very large in 2012 (Graph 1.12).

In the euro area, a gradual recovery remains under way, with particular strength in the manufacturing sector recently. Industrial production increased solidly in October and November, and the European Commission's industrial sentiment indicator remained at an elevated level in January.

However, the level of aggregate output remains low and is not expected to regain its pre-crisis peak until late 2012. Moreover, solid aggregate growth over 2010 masks large divergences in performance across countries within the region. Recovery is proceeding most briskly in Germany, which is benefiting from the significant improvement in competitiveness achieved over the decade prior to the crisis (through wage restraint and productivity growth), as well as the absence of the sorts of household balance sheet problems besetting some other countries in Europe. German GDP expanded by 3 per cent over the six months to September, and the unemployment rate is already well below its pre-crisis level, after barely rising during the crisis. Output growth has generally been more subdued but still solid in some neighbouring euro area economies, such as France and the Netherlands, since mid 2009.

By comparison, recovery from the downturn thus far remains modest in Italy, and output barely expanded in Spain over the year to the September quarter. Activity also continues to contract sharply in Greece in the face of severe austerity measures and a prolonged decline in international competitiveness prior to the global downturn. All of these countries, as well as Portugal, Ireland and even Belgium, face market concerns about the creditworthiness of their governments. Such concerns initially arose in relation to Greece, prompting the emergency bailout package announced in May 2010. In late 2010, Ireland became the focus of sovereign debt concerns, following the news that the Irish government would need to provide further very large capital injections to the Irish banking system. This was the culmination of a series of major shocks to Ireland's economy and domestic banks, and triggered the implementation of a second emergency bailout package within the euro area.

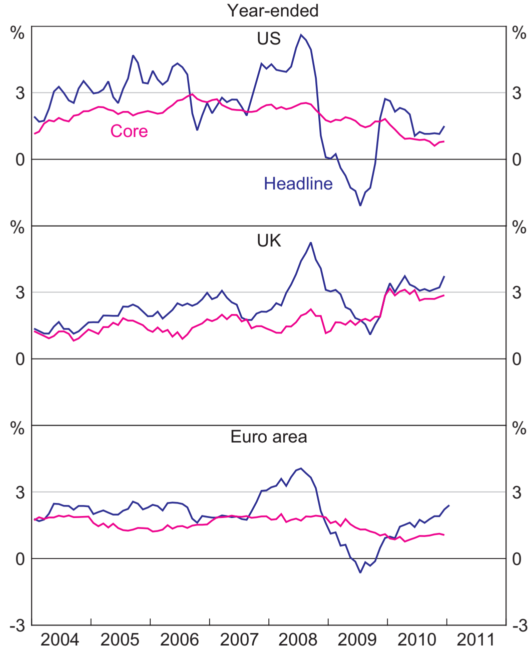
Core inflation generally remains subdued across the advanced economies, although deflation fears have eased in the United States and policy-makers in Europe have noted some signs of emerging price pressures (Graph 1.13). These have been most evident in the United Kingdom, where year-ended core inflation is around 3 per cent, having drifted up since mid 2009 despite GDP remaining well below its pre-crisis level. Headline inflation is higher and likely to remain elevated in the near term due to the 2½ percentage point increase in the VAT rate at the start of January. In the euro area, headline inflation has also been pushed up recently by energy price pressures and increases in a range of tax rates and administered prices.

Commodity Prices

Commodity prices have risen sharply over recent months, reflecting strong demand from Asia and a range of weather-related disruptions to supply.

Graph 1.13

Advanced Economies – Consumer Price Inflation



Sources: Eurostat; Thomson Reuters

In particular, bulk commodity prices have been supported by strong growth in emerging economies, with Asian industrial production expanding at a solid pace over 2010 to a level that is well above the peak reached prior to the global recession (Graph 1.14).

The RBA's Index of Commodity Prices has increased by 12 per cent in SDR terms since the previous *Statement* and is now around 12 per cent above its previous peak in September 2008 (Table 1.2). The strength in commodity prices has boosted the terms of trade to a historically high level and is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.

The average export prices of Australia's major bulk commodities (coal and iron ore) are estimated to have increased by around 7–14 per cent in recent months in SDR terms. Spot prices, which typically affect the contract prices that producers receive with a lag, have risen more significantly. In late

Table 1.2: Commodity Price Growth

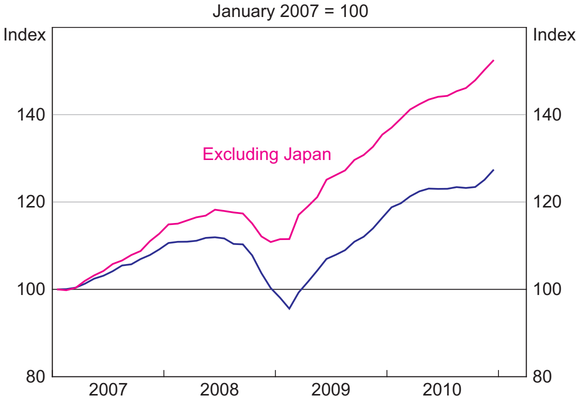
Per cent, SDR terms

	Since end October 2010	Since end January 2010
RBA index	12	54
– Excluding coal and iron ore	11	31
Bulk commodities	12	82
– Coking coal[a]	7	64
– Iron ore[a]	14	116
– Thermal coal[a]	13	35
Rural	21	51
– Wheat	21	81
– Cotton	42	165
– Sugar	5	26
Base metals	13	31
– Copper	22	47
Gold	–2	23
Oil[b]	14	30

(a) RBA estimates for recent months
(b) Average of WTI and Tapis crude oil prices
Sources: Bloomberg; RBA

Graph 1.14
East Asia – Industrial Production

January 2007 = 100



Sources: CEIC; RBA; Thomson Reuters; United Nations

January, the spot price for iron ore was around 30 per cent above the estimated March quarter contract price level, while the spot price for hard coking coal was around 50 per cent above its contract price (Graph 1.15). The strength in the prices of iron ore and coking coal has reflected growth in Chinese steel production as well as significant disruptions to supply. In particular, recent heavy flooding in Queensland's coal producing regions has constrained mine output and hampered transportation to the ports.

The spot price for thermal coal has risen strongly over recent months, supported by strong demand from Northern Hemisphere countries facing unusually cold weather and the disruptions to coal supply in Australia and other key export countries. The Australian thermal coal spot price was around 30 per cent above the current Japanese financial year contract price in early February, suggesting the next contract price will be significantly higher than its current level.

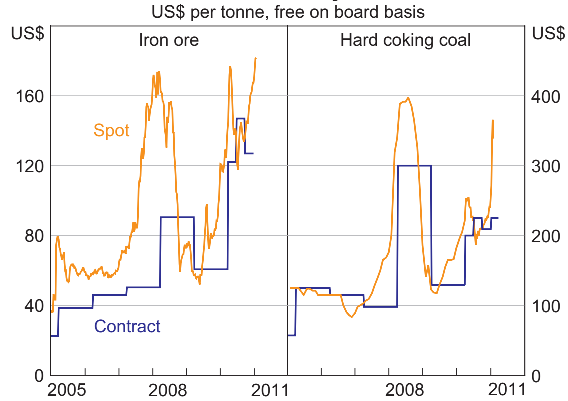
Global food prices have risen further in recent months; the IMF Food Price Index is estimated to have increased by around 34 per cent over the past year to be higher than its previous peak in mid 2008. The recent rise in food prices has been attributed mainly to a range of supply disruptions, with unfavourable weather conditions in a number of key agricultural producing countries weighing on production, particularly for crops such as wheat, corn, sugar and soybeans (Graph 1.16). These supply disruptions have coincided with a period of ongoing strong demand for food commodities. Rising living standards in emerging and developing economies are leading to an increase in demand for higher protein sources of food, which – through demands on land usage and demand for feed grains – is flowing through into broad-based pressure on the prices of food commodities. For example, much of the growth in global grain consumption in recent years has come from Brazil, Russia, India, Indonesia and China. China's domestic grain stocks are at low levels; as a result, grain import volumes increased by around 30 per cent over the year to the December quarter. Reflecting the run-up in global prices, the RBA index of rural prices has increased by 21 per cent since the November *Statement*, to be well above its previous peak in early 2008 (Graph 1.17). Recent price increases have also been partly due to heavy rain in Australia's eastern states, which has damaged wheat and sugar crops and disrupted the supply and distribution of beef.

Exchange-traded mineral commodity prices have also risen since the November *Statement*. The RBA index of base metals prices has risen by around 13 per cent over this period, in part reflecting the ongoing increase in demand for base metals as global industrial production has recovered. Copper prices have risen particularly sharply, as supply has been disrupted in key exporting countries, while demand remains solid. Crude oil prices have also risen over recent months, reflecting unusually cold weather in the Northern Hemisphere and supply disruptions. ☧

Graph 1.15

Bulk Commodity Prices

US$ per tonne, free on board basis

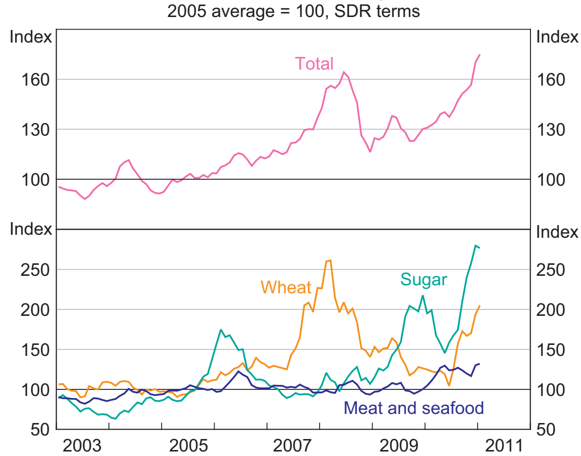


Sources: ABARES; Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

Graph 1.16

Global Food Commodity Prices*

2005 average = 100, SDR terms

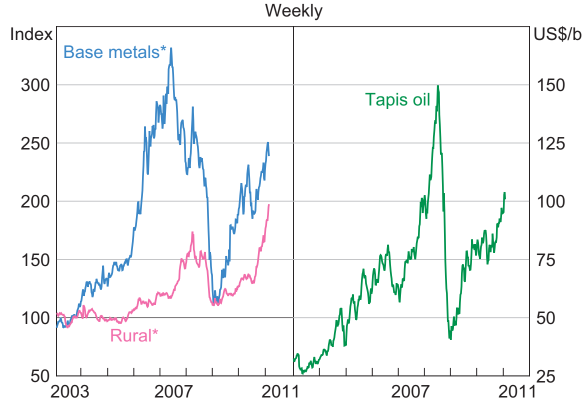


* RBA estimates for January 2011
Sources: IMF; RBA

Graph 1.17

Commodity Prices

Weekly



* 2003 average = 100; SDR terms
Sources: Bloomberg; RBA