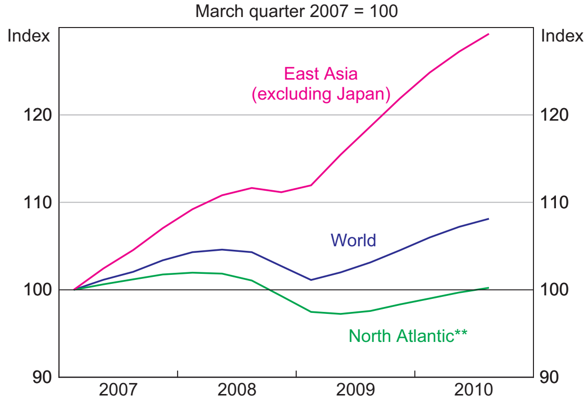
International Economic Developments

Data on the global economy over the past few months have been consistent with output growth slowing to around trend rates from the rapid pace experienced in late 2009 and early 2010. In Asia (with the exception of Japan) a strong recovery has taken place, whereas the recovery has been much more subdued in the North Atlantic economies (Graph 1). The above-trend growth in Asia in late 2009 and early 2010 has significantly reduced output gaps in the region and steps are being taken to gradually reduce the degree of policy stimulus, with output growth easing to a more sustainable pace. Asset prices in the region are generally higher than they were in mid 2007, and balance sheets are in better shape than in most of the advanced economies.

In contrast, in many of the North Atlantic economies and in Japan output remains considerably below its previous trend and the momentum of the recovery has slowed as domestic private demand struggles to gain traction. The process of repairing balance sheets continues to restrain household spending in many countries, as discussed further in 'Box A: Household Saving Rates in Advanced Economies'. Growth prospects are also likely to be affected by planned fiscal consolidation in some countries. In response to the slow recovery and high unemployment rates, the United States and Japan are undertaking additional monetary easing.

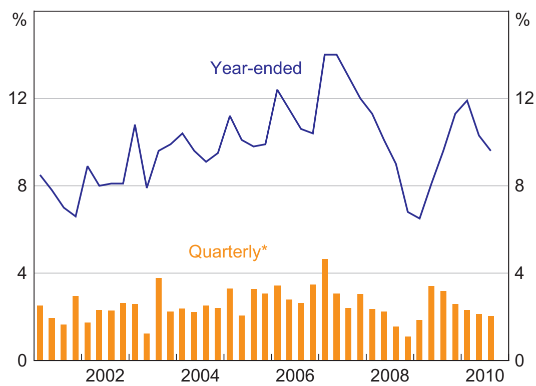
The Chinese economy continues to expand strongly, although the pace of growth has eased to a more sustainable pace. GDP is estimated to have increased by around 2 per cent in the September quarter and by 9½ per cent over the year (Graph 2). Domestic demand has driven much of the recent growth, while exports have contracted for several months, consistent with trade developments in the rest of east Asia. The fiscal stimulus is being gradually withdrawn and there have been moves to tighten monetary conditions,

Graph 1
World Output*
March quarter 2007 = 100



* Aggregated using PPP exchange rates; RBA estimates for September quarter 2010
** Canada, euro area, the UK and US
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2
China – GDP Growth

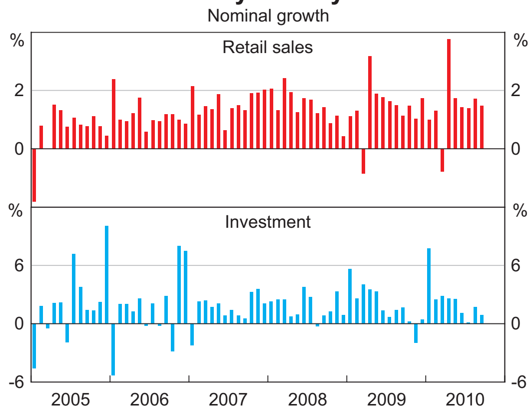


* RBA estimates
Sources: CEIC; RBA

with the People's Bank of China recently raising benchmark deposit and lending rates after having increased reserve requirement ratios earlier in the year.

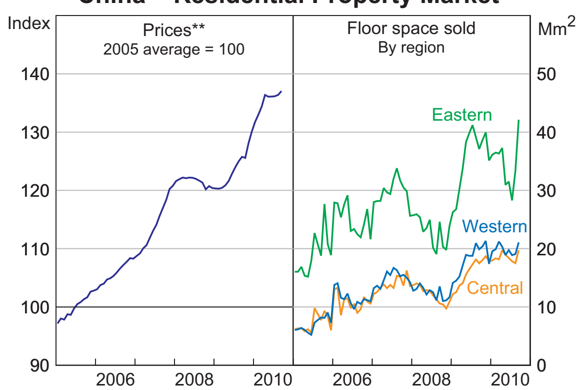
Activity indicators show that domestic demand in China has remained firm over recent months. Retail sales grew at a robust pace during the September quarter and rose by around 15 per cent over the year in real terms (Graph 3), while the level of passenger vehicle sales has grown strongly, supported by policy measures including lower sales taxes and the extension of the car scrappage scheme. Growth in urban fixed-asset investment has eased since June, mainly reflecting weaker growth in infrastructure investment as the government gradually withdraws its fiscal stimulus. Real estate investment has picked up in recent months and manufacturing investment has remained strong. While growth in infrastructure spending is expected to be moderate over the coming year as the effects of the fiscal stimulus fade, the level of spending is expected to remain high, especially as the government focuses on further economic development of central and western provinces.

Graph 3
China – Monthly Activity Indicators*



* RBA estimates
Sources: CEIC; RBA

Graph 4
China – Residential Property Market*



* RBA estimates
** Average of new and existing residential property prices
Sources: CEIC; RBA

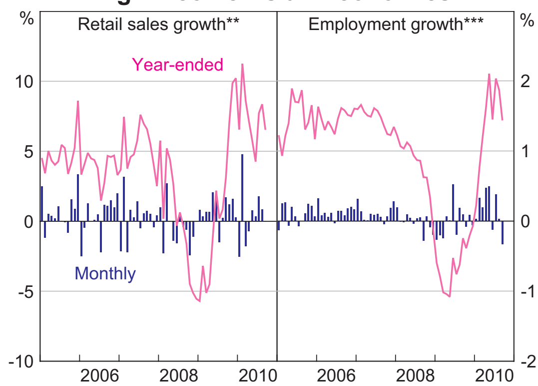
Industrial production grew solidly through the September quarter after recording weaker growth through the June quarter. Growth in production was driven by machinery and transport equipment manufacturing, which had been weak for several months, as well as by activity in the mining and chemical industries. The production of crude steel continued to fall through the September quarter partly as a result of policies aimed at curbing the activities of high-polluting and energy-intensive producers. Export volumes are estimated to have contracted by around 3 per cent in the September quarter, with weakness evident across all of China's major trading partners, although this partly reflects a fall in exports of steel after strong growth in the months leading up to the removal of export rebates on some steel products in July. Notwithstanding the weak economic conditions in the major advanced economies, the manufacturing PMIs for China are consistent with an ongoing expansion of that sector.

Conditions in the property market have strengthened recently after cooling following the introduction of policy measures in April. According to the National Bureau of Statistics, property prices were broadly flat between May and August but increased modestly in September (Graph 4). Turnover of residential property, which had fallen after the April measures, recovered strongly in September, mainly reflecting an increase in the eastern provinces. The limited effect of earlier measures on housing prices has prompted the central government to recently announce a range of policy measures to reduce borrowing for the purchase of housing. A more detailed discussion of recent property market developments in the region is provided in 'Box B: East Asian Property Markets'.

Inflation has increased in recent months, mainly due to higher food prices, which have been affected by flooding in the major food-producing regions of southern China. Non-food inflation has remained at around 1½ per cent in year-ended terms for the past five months. With higher headline inflation over the year and renewed inflationary pressures in the property market, the People's Bank of China raised deposit and lending rates in mid October. The 1-year benchmark deposit and lending rates were raised by 25 basis points, with larger increases in longer-term deposit rates.

In the June quarter, output grew by 1.7 per cent in east Asia (excluding China and Japan), down from an average rate of 2.4 per cent over the previous four quarters. Growth was broad based, with all expenditure components except stocks contributing in the quarter. With the pace of inventory rebuilding having slowed in most countries in the Asian region and demand from key trading partners easing, recent data suggest that growth in east Asia is now being driven more by domestic demand. Export volumes fell by 1¾ per cent over the three months to August, driven by falls in intra-regional exports. Soft export performance is also being reflected in weaker industrial production in the region. In contrast, retail sales grew by an average of 2¾ per cent in the high-income Asian economies in the September quarter and the outlook for consumption is being buoyed by solid labour markets and rising net wealth (Graph 5). Recent data also point to continued strength in investment.

Graph 5
High Income Asian Economies*

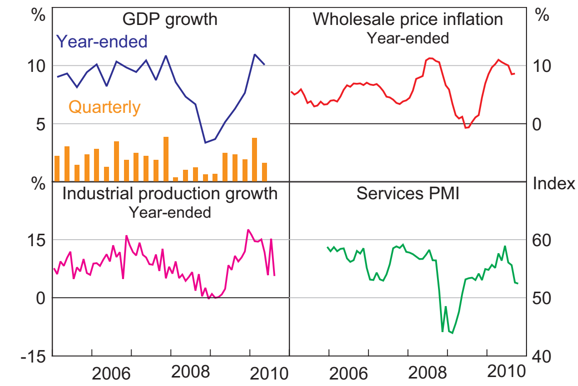


* Hong Kong, South Korea, Singapore and Taiwan
** GDP-weighted at market exchange rates; RBA estimate for September 2010
*** Excludes Singapore
Sources: CEIC; IMF; RBA

Despite strong output growth in the region over the past year, core inflation remains contained at around 2 per cent. Monetary conditions remain accommodative, although central banks have begun to tighten monetary policy gradually including, for some countries, through modest exchange rate appreciations. Low (and in some cases negative) real interest rates in east Asia have led to rapid house price growth in some economies (see 'Box B: East Asian Property Markets'), prompting – as has occurred in China – policies in Hong Kong, Taiwan and Singapore to temper house price inflation.

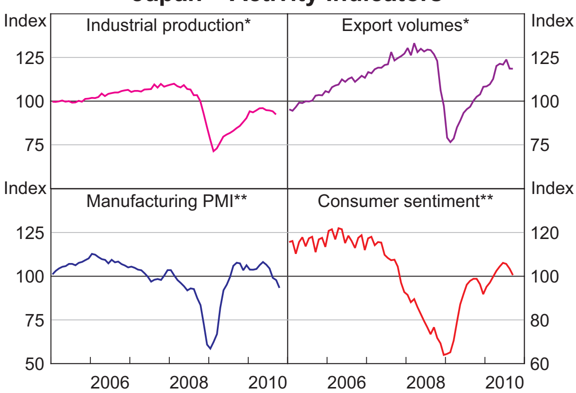
The Indian economy has continued to expand at a firm pace. GDP recorded robust growth in the June quarter to be 10 per cent higher over the year (Graph 6). There was strong growth in household and government spending, although exports fell in the quarter. Manufacturing activity slowed in the quarter, while output in the agricultural and services sectors continued to expand solidly. More timely monthly data point to a strengthening in industrial production and merchandise exports, while the services PMI is consistent with continued solid growth in that sector. Improved rainfall in the recent summer monsoon season is also likely to boost production in the agricultural sector, which accounts for about one-sixth of the Indian economy, and to help contain rises in food prices.

Graph 6
India – Economic Indicators



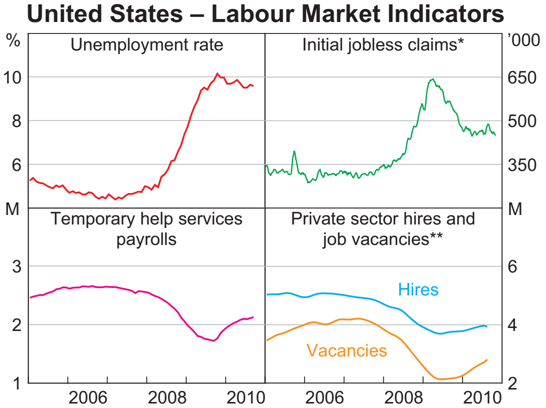
Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

Graph 7
Japan – Activity Indicators



* 2005 average = 100
** Long-run average = 100
Sources: CEIC; JPMorgan Chase & Co. and Markit; Thomson Reuters

Graph 8
United States – Labour Market Indicators



* Four-week moving average
** 13-period Henderson trend; vacancies open to external applicants
Sources: Bureau of Labor Statistics; RBA; Thomson Reuters

Over recent months, inflation in India has eased from the double-digit rates recorded earlier in the year. Non-food manufactured goods inflation, which had been a key driver of inflation developments, has moderated, bringing year-ended growth in the wholesale price index to 8½ per cent. The Reserve Bank of India increased interest rates further in November citing concerns about the level of inflation and the recent sharp rise in asset prices; cumulatively, the repo and reverse repo rates have increased by 150 and 200 basis points since the beginning of 2010.

In contrast with most other Asian economies, economic conditions in Japan remain subdued. Consumption grew only slightly in the first half of 2010 and weak labour market conditions appear set to constrain household spending going forward (although household demand was boosted in the September quarter by fiscal stimulus measures). Export growth has slowed from its very rapid pace earlier in the year as trading partner growth has eased, while industrial production has tracked broadly sideways this year (Graph 7). The softer pace of growth in exports and continued strength in the yen in nominal terms (particularly relative to the US dollar; see 'International and Foreign Exchange Markets' chapter) also appear to have weighed on business confidence in recent months.

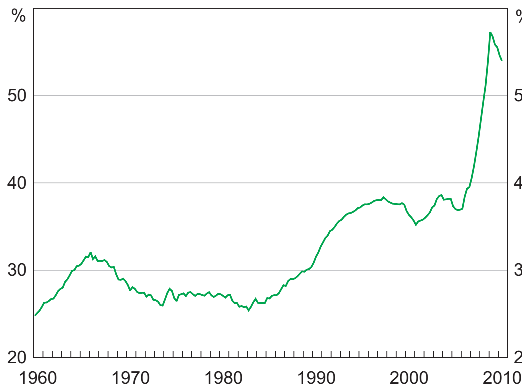
The United States economy continues to expand, although the pace of growth has slowed over the past six months. GDP rose by 0.5 per cent in the September quarter, with robust growth in business investment and a solid contribution from stocks. Although consumption grew by 0.6 per cent in the quarter, it is yet to recover its earlier fall. Consumption of durables remains weak, with purchases of motor vehicles still over 20 per cent below the average rate seen over the 2000–2007 period. Household expenditure continues to be constrained by the weak recovery in the labour market. The unemployment rate was essentially flat for the four months to September and jobless claims remain elevated, despite other indicators of labour demand such as temporary hires and private job vacancies continuing to improve (Graph 8).

Conditions in the housing market remain weak. Dwelling investment is at a post-War low as a share of GDP and, with the overhang of vacant homes still at historical highs, appears likely to remain subdued. House prices have also been broadly flat over the past 18 months, after earlier large falls contributed to a significant deterioration in household balance sheets; the gearing ratio on household property rose from around 37 per cent in 2006 to around 55 per cent as house prices fell (Graph 9). As a result, balance sheet repair is expected to continue to weigh on household demand for a protracted period. In contrast, business balance sheets are in better shape. Corporate profitability has rebounded over the past year and a half, liquid assets have increased sharply and business gearing is falling (Graph 10). While access to finance remains difficult for some firms, business investment appears to have scope to pick up further, from near the lowest levels as a share of nominal GDP in many decades, if sentiment recovers and the outlook for household spending improves. The depreciation of the US dollar has also improved the outlook for exports.

Conditions remain subdued in the euro area, notwithstanding GDP growing by a surprisingly robust 1 per cent in the June quarter. There continues to be a wide disparity in economic conditions in the region; the strong June quarter GDP outcome was largely driven by growth of 2.2 per cent in Germany, while GDP in Greece and Ireland contracted in the quarter. Investment was the key driver of growth in Germany in the quarter, rising by 4.7 per cent, although it remains at low levels as a share of GDP (Graph 11). More recently, Germany has continued to outperform the other euro area economies in a range of indicators, with relatively strong labour market outcomes and high levels of consumer and business confidence (Graph 12).

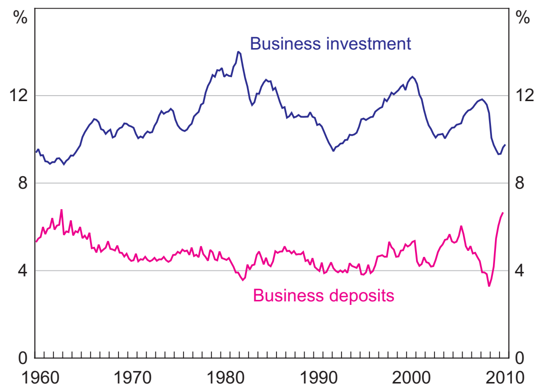
While a number of euro area economies have performed poorly over the past few years, conditions in Greece and Ireland have been particularly weak. GDP has contracted by 13½ per cent in Ireland since its peak in December 2007 and consumer prices have fallen by 4 per cent over the past 2 years.

Graph 9
United States – Household Property Gearing Ratio
Housing debt as per cent of housing assets



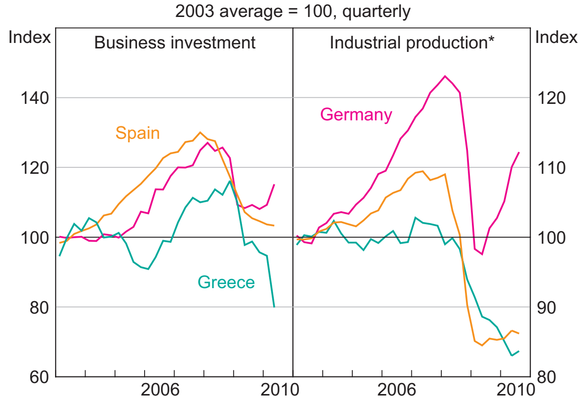
Source: Thomson Reuters

Graph 10
United States – Business Investment and Deposits
Per cent of nominal GDP



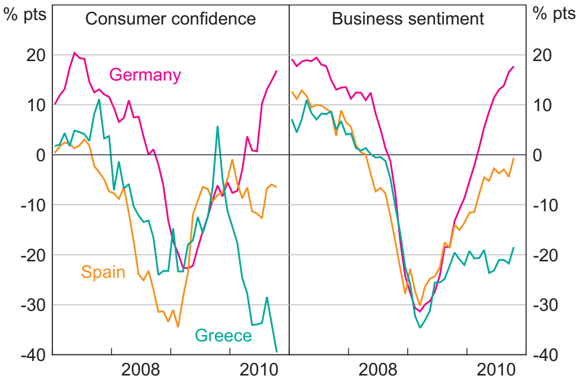
Sources: RBA; Thomson Reuters

Graph 11
Euro Area – Investment and Production
2003 average = 100, quarterly



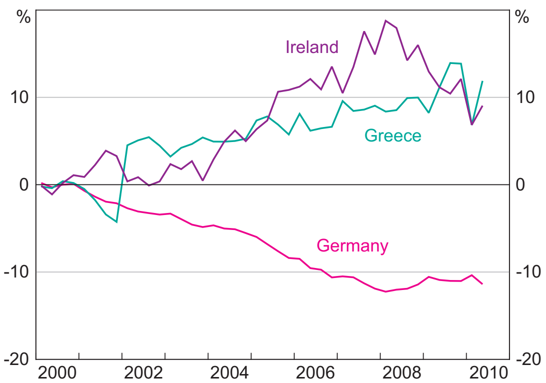
* RBA estimates for September quarter 2010 based on July and August data
Sources: Eurostat; RBA; Thomson Reuters

Graph 12
Euro Area – Sentiment Measures
Deviation from average since January 1990



Source: Thomson Reuters

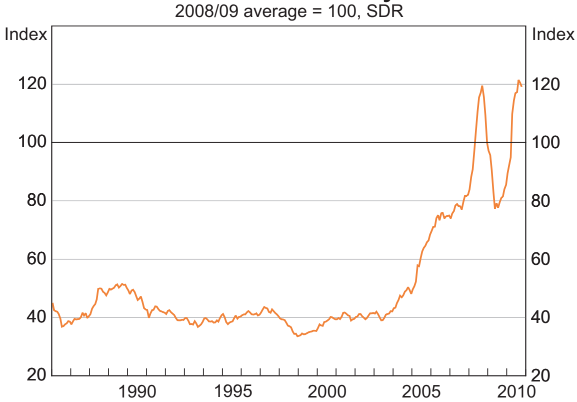
Graph 13
Euro Area – Nominal Unit Labour Costs*



* Percentage change in individual country index relative to euro area average index since 2000

Source: Eurostat

Graph 14
RBA Index of Commodity Prices
2008/09 average = 100, SDR



Source: RBA

In Greece, GDP has fallen by about 6 per cent since September 2008 and private demand has contracted by 9 per cent. Concerns over fiscal and banking problems persist in these and some other euro area countries, and governments are now undertaking significant fiscal consolidation. While fiscal measures will weigh on growth across Europe, the sovereign debt and banking issues in some countries have forced reforms that are likely to improve competitiveness in the long term, following a significant deterioration in relative competitiveness over the past decade (Graph 13).

Commodity Prices

Commodity prices have risen sharply over the past year, supported by strong demand from Asia. The RBA's Index of Commodity Prices has increased a little since the August *Statement*, and is now around 55 per cent above its trough in mid 2009 and around its previous peak in September 2008 (Graph 14). The increases in commodity prices have boosted Australia's terms of trade to a historically high level, which in turn is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.

The increase in commodity prices over the past year has been broad based, with the prices of all commodities included in the RBA's Index of Commodity Prices having increased (Table 1). There has been a particularly large increase in the price of iron ore – the main raw material in steel-making – with export prices for iron ore rising by 110 per cent (in US dollar terms) since mid 2009. These price rises have been associated with the increase in global steel production since early 2009 – which is back to around the level prior to the financial crisis, underpinned by production in China – as well as the reasonably positive outlook for demand for steel. Strong Asian demand for steel has seen markets for iron ore and coking coal tighten over the past year, with production in Australia and other major exporters running at near full capacity.

Table 1: Commodity Price Growth
Per cent, SDR terms

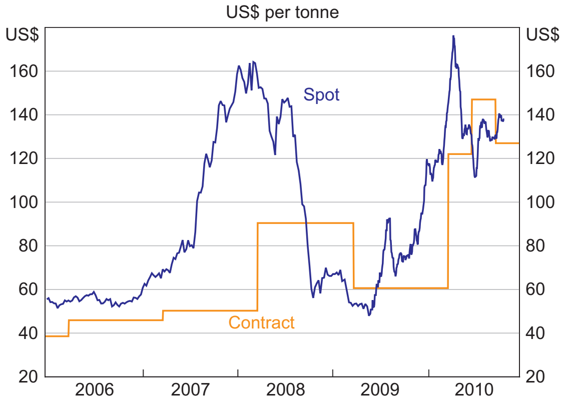
	Since end July 2010	Since end October 2009
RBA index	1	45
– Excluding bulk commodities	7	26
Bulk commodities	–4	68
– Coking coal[(a)]	–3	53
– Iron ore[(a)]	–6	97
– Thermal coal[(a)]	1	31
Rural	18	36
– Sugar	40	63
– Wheat	15	42
– Other	15	29
Base metals	10	25
Gold	10	30
Oil[(b)]	6	12

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

Spot prices for bulk commodities, which have typically affected the contract prices that producers receive with a lag, have increased by around 5–10 per cent in recent months, reflecting improved market sentiment about steel production and restocking of inventories, and are significantly higher than the trough in mid 2009. The increases in coal prices have also been associated with the impact of poor weather on production in Australia, Indonesia and Columbia as well as infrastructure constraints in China. Prices of iron ore and coal appear to have been little affected by policies in China aimed at curbing the activities of high polluting and energy intensive steel producers.

Spot prices for iron ore in early November were around 10 per cent above the estimated December quarter contract price level, while spot prices for thermal and hard coking coal were around their respective contract prices (Graph 15). The December quarter contract prices appear to be lower than those for the September quarter, with Australian producers reportedly having settled on a price decrease of around 15 per cent for iron ore

Graph 15
Iron Ore Prices*

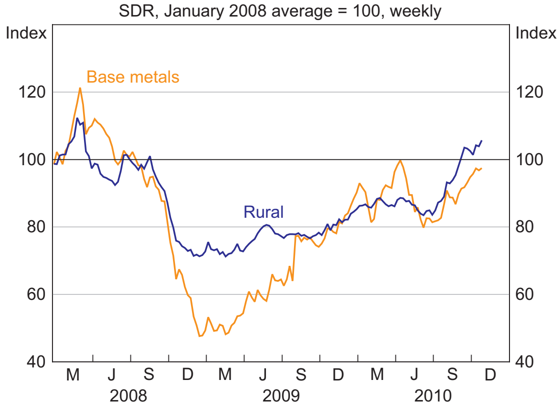


* Free on board price to China; RBA estimates for spot price used prior to December 2008 based on weekly data on China landed import price
Sources: ABARE; Bloomberg; RBA

fines in the December quarter, and between 5 per cent and 20 per cent for various grades of coking coal (relative to the previous quarterly contracts).

The prices of exchange-traded commodities have also risen strongly over the past year (Graph 16). The RBA index of base metals prices has risen by around 25 per cent over this period, and is up 10 per cent since the August *Statement*, reflecting the steady increase in demand for base metals as global industrial production has recovered. Crude oil prices have also risen over the quarter and are 6 per cent higher in SDR terms since the August *Statement*. Oil prices have been supported by limited increases in production and strong demand from Asia – with the volume of China's crude oil imports having increased by around 35 per cent over the year to September – though subdued demand from advanced economies has offset this to some extent, with oil stocks in the US remaining high. The price of gold has risen by around 30 per cent over the past year, partly reflecting investor unease with other assets.

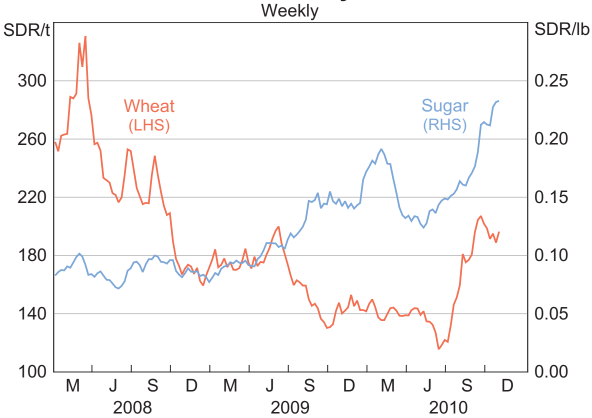
Graph 16
Commodity Prices
SDR, January 2008 average = 100, weekly



Sources: Bloomberg; RBA

Rural commodity prices have also risen strongly over the past year, particularly in recent months, with large increases in the prices of sugar, wheat, barley and cotton (Graph 17). Strength in these prices has been largely driven by supply disruptions in key exporting countries, with concerns that supply may not keep pace with the recovery in demand. The price of cotton has increased by around 75 per cent since the August *Statement,* reflecting flooding in Pakistan, as well as increasing demand. Sugar prices have risen by around 40 per cent in recent months, reflecting weather-related effects on production in Australia and Brazil.

Graph 17
Rural Commodity Prices
Weekly



Sources: ABARE; Bloomberg

More generally, global food prices have been increasing over the past year; the IMF Commodity Food Price Index has increased by over 20 per cent over this period, with the increase being relatively broad based. As well as supply disruptions, there are signs that demand, particularly from Asia, has supported this rise. In China, grain import volumes increased by over 50 per cent over the year to September and sugar imports have also risen. Food and live animal imports to other east Asian economies have been growing at an annual pace of around 20 per cent. Increasing development and rising living standards in Asia, particularly in China and India, are also leading to a rise in the demand for higher-quality food and the consumption of protein.