# Overview

The global economy is continuing its expansion, although the pace of growth has slowed recently. This moderation in growth partly reflects disruptions to global supply chains following the Japanese earthquake, but there has also been a broader slowdown in a number of economies. Growth remains robust though in most of Asia, including China, with domestic demand growing strongly and unemployment rates trending lower.

While the central scenario of most forecasters remains for growth to be at, or above, average over the next year or so, the downside risks to this outlook have increased. Over recent months, the economic data in the United States have been disappointing. In addition, while recent measures have reduced the near-term pressures on the public finances in the United States and in a number of European countries, significant concerns about debt sustainability remain. In contrast, in many emerging market economies, including those in Asia, the main concern is the increase in inflation and signs of overheating, including in some asset markets. In most of these economies, there has been further tightening of monetary policy since the previous *Statement*.

The recent softening in global growth and the increased focus on downside risks has seen most commodity prices decline a little since earlier in the year. Overall, though, commodity prices remain at very high levels, with demand still strong relative to global supply. The increase in commodity prices over the past year is flowing through into higher global prices for a range of goods, and this has pushed up inflation in almost all countries, including those with high unemployment rates and considerable excess capacity.

Concerns about public finances in both Europe and the United States have had a significant impact on financial markets over recent months. Despite another EU/IMF assistance package for Greece, concerns about medium-term debt sustainability remain, and yields on Italian and Spanish debt have increased to their highest level since the euro was established. Equity markets have fallen, as have bond yields in the major countries. In currency markets, there has been a significant depreciation of the US dollar, especially during the debate regarding the raising of the debt ceiling. The Australian dollar in trade-weighted terms – and adjusting for differences in average rates of inflation across countries – is currently around its highest level since the mid 1970s. The strong global demand for low-risk assets has contributed to a reduction in yields on Commonwealth Government Securities.

Conditions in global credit markets have remained generally favourable, notwithstanding the concerns about public finances in Europe and the United States. Credit spreads have, however, widened a little, although they remain low, and bond issuance globally has slowed somewhat. In Australia, credit markets continue to be relatively unaffected by the global uncertainty. Issuance by Australian banks, both secured and unsecured, has remained solid and pricing has not changed materially. The banks have also experienced strong deposit growth over the past couple of years.

The Australian economy is continuing to benefit from the strong growth in Asia, with the terms of trade currently estimated to be at their highest level on record. Conditions are, however, quite uneven across industries, with the economy adjusting to what has been a very large change in relative prices. This change is to Australia's long-term advantage, although it is accelerating the pace of structural change at a time when the economy has relatively limited spare capacity.

The high level of commodity prices is contributing to particular strength in the resources sector. Mining investment, as a share of GDP, is already at historically high levels and is expected to increase further as large expansions take place in the LNG, iron ore and coal sectors. This growth in resources-sector investment is having positive spillovers to a number of other sectors, including a range of business services. High commodity prices have also provided a significant boost to real national income over recent years.

In contrast, a number of sectors are experiencing quite difficult conditions, with investment intentions outside the resources sector having been downgraded this year. There has been a fall in overall business confidence, although survey-based measures of business conditions remain around their long-term average. Business credit has been weak, with much of the resources-sector investment being financed through internal funds or global capital markets. Financing conditions for commercial property remain tight, although less so than in 2008 and 2009.

The high exchange rate is having a significant influence on a number of sectors, including manufacturing, tourism and tertiary education. Many firms facing international competition are re-evaluating their medium-term prospects and business strategies, given an assessment that the high exchange rate is likely to persist and is not just a temporary development. At the same time, the high exchange rate has lowered the Australian dollar cost of imported capital goods, which is supporting investment in plant and machinery in a number of industries.

Another important factor shaping the economy at present is the household sector's attitude to spending and borrowing. The household saving ratio has risen considerably over recent years as households return to more traditional saving patterns after more than a decade of very strong growth in consumption relative to income. Households remain cautious and retail spending is subdued, although growth in spending on services has been reasonably solid. Household confidence has fallen recently and there has been little growth in household net worth over the past year.

The change in household behaviour is also evident in borrowing decisions, with recent growth in housing and credit card debt the slowest for many years. Turnover in the housing market has declined, as have nationwide measures of housing prices, with notable weakness in the Perth and Brisbane markets after earlier large increases. In both Western Australia and Queensland, there has been an increase in loan arrears partly due to a deterioration in lending standards during the period of rapid price increases, similar to the experience in Sydney in the first half of the 2000s. Overall, though, loan arrears remain low.

The GDP outcomes over recent quarters have been significantly affected by the extreme weather conditions in late 2010 and early 2011, and these effects will continue for some time yet. In the March quarter, GDP declined by 1.2 per cent, with falls in iron ore and coal exports subtracting around 1¾ percentage points from growth. In contrast, domestic demand grew strongly in the quarter, underpinned by a lift in investment. Iron ore exports recovered in the June quarter and, while there has been a pick-up in coal production in Queensland, the recovery is taking longer than expected due to the difficulties in removing large volumes of water from flooded coal pits. The increase in resources exports will boost GDP outcomes over coming quarters, although the rebound is likely to be more protracted than previously expected.

The unemployment rate has held steady at around 5 per cent since late 2010. Employment growth has slowed from the rapid pace of last year, partly reflecting lower population growth as a result of less inward migration. Employment has grown strongly in the mining sector and a number of business and household service industries, while it has been weak in the manufacturing and construction industries. The forward-looking indicators continue to point to modest employment growth over the months ahead, although businesses appear more uncertain about the outlook than they have been for some time.

Reflecting the relatively tight labour market, growth in labour costs remains firm at around rates seen before the 2008–2009 downturn. There has, however, recently been some slowing in wages growth in the public sector. At this point, reports of skills shortages remain relatively isolated and confined to the resources and related sectors.

CPI inflation over the year to the June quarter was high at 3.6 per cent. This outcome was affected by the earlier extreme weather events, with fruit and vegetable prices rising by 35 per cent over the year; the increase in the price of bananas has been especially large and is estimated to have added up to ½ percentage point to CPI inflation. Given the improved growing conditions recently, many of these prices have begun to normalise, and a large fall in banana prices is expected by the end of the year.

Inflation has also been boosted by increases in fuel and utilities prices. In addition, rent inflation has picked up a little, with some rental markets being relatively tight, as the number of dwellings has grown at a slower rate than the population for several years. In contrast, the prices of most consumer goods declined over the past year, although many of these goods experienced surprisingly large increases in the June quarter. It is possible that these increases simply reflect changes in the seasonal pattern of discounting, although global prices for many manufactured goods are rising and retailers face a range of domestic cost pressures.

Over the year to the June quarter, the various measures of underlying inflation ranged between 2½ and 2¾ per cent. On a year-ended basis, this rate of inflation is consistent with the medium-term target, although quarterly rates of inflation have picked up from those in 2010. These recent outcomes confirm that the moderation in inflation that resulted from the 2008–2009 slowdown has now run its course.

From a longer-term perspective, an important influence on both costs and GDP growth is the rate of improvement in productivity. Since around the mid 2000s, the growth in output has been accounted for by growth in factors of production. The slower productivity growth has been offset by the rise in the terms of trade, so that it has not led to a slowdown in the growth of real incomes in Australia. With the terms of trade expected to decline somewhat over the next few years as additional global commodity supply comes on line, a return to faster rates of productivity growth is likely to be required if living standards are to continue to rise at the average rate of the past two decades.

In the short term, the GDP outcomes for the next few quarters are expected to be boosted by a recovery in coal production. The Bank's forecast for GDP growth in 2011 has, however, been lowered to 3¼ per cent. A little more than half of this downward revision reflects the slower-than-expected recovery in the Queensland coal industry, with most of the remainder reflecting slower expected growth in consumption. Domestic demand is, however, forecast to continue to grow strongly, with a large increase in mining investment expected. Overall, GDP growth is expected to be at, or above, trend in 2012 and 2013. The unemployment rate is expected to remain at around 5 per cent for some time, before declining a little towards the end of the forecast period.

Conditions are likely to remain very different across industries, as the Australian economy continues its structural adjustment to historically high commodity prices. Conditions are expected to remain very strong in the mining industry, as well as those parts of the economy benefiting from high rates of resources-sector investment and output, and from the income effects from high commodity prices. In other sectors, the high exchange rate and subdued levels of retail spending mean that the trading environment is likely to remain difficult. Another important factor affecting the outlook is the tightening in fiscal policy, with the Australian Government forecasting a turnaround in the budget position of around 4 per cent of GDP between 2010/11 and 2012/13.

In underlying terms, year-ended inflation is expected to pick up over the forecast period. While some moderation in quarterly rates of inflation is expected, it now looks likely that underlying inflation will be at, or above, 3 per cent in 2011. The high exchange rate and subdued consumer spending are putting downward pressure on some prices, although increases in global prices for food and manufactured goods as well as a range of domestic cost pressures are working in the other direction. Based on the central scenario for the Australian economy, and the technical assumption of unchanged interest rates, underlying inflation is expected to remain relatively high in 2012 and 2013, with the 2012 outcome boosted by around ¼ percentage point by the introduction of a price on carbon.

In headline terms, inflation is expected to fall back below 3 per cent by early 2012 as the effects of the extreme weather events earlier in the year are reversed. It is then expected to pick up in the latter part of 2012, back to around current rates, with the carbon price estimated to add 0.7 per cent to the general price level. Provided that inflation expectations remain well anchored and that there are no second-round effects through higher wage claims, headline inflation is then expected to decline again in 2013 as the once-off effects of the introduction of the carbon price fall out of the figures.

While these forecasts represent the Bank's central scenario, at the global level the risks to economic activity are weighted to the downside. There remains a possibility that the sovereign debt problems in Europe and the United States play out in a disorderly and disruptive manner, and that this leads to a marked rise in global risk aversion and uncertainty. While the exposures in the financial system are better understood than they were in 2008, the scope for easing monetary and fiscal policies in most major economies is very limited. In contrast to these concerns, there are upside risks to inflation in Asia, with the effects of high capacity utilisation and elevated commodity prices evident in a number of countries.

Domestically, the main uncertainty continues to relate to the behaviour of the household sector. The Bank's forecasts have been prepared on the basis that the current caution continues for a while, leading to a further modest increase in the household saving ratio over the next year. There are, however, plausible scenarios in which the saving ratio increases by a larger amount, and others in which it declines as confidence improves. Other important issues shaping the outlook are the rate of productivity growth, the response by businesses to the high exchange rate, and how wage outcomes evolve in a period in which the unemployment rate is expected to remain at relatively low levels.

Since November last year the Board has held the cash rate steady at 4.75 per cent. The various financial indicators suggest that this setting of monetary policy is exerting a degree of restraint on the economy. Interest rates on most loans are a little above average, credit growth is very subdued, asset prices have generally declined and the exchange rate is high. While each of these variables is affected by other factors as well, together they point to financial conditions being tighter than normal.

In view of the medium-term outlook for inflation, at its recent meeting the Board considered whether it was appropriate to tighten monetary policy further. On balance, its judgment was that it was prudent to maintain the current setting of the cash rate, particularly in view of the acute sense of uncertainty in global markets, which has contributed to heightened downside risks to global growth. In setting monetary policy over the months ahead, the Board will continue to look through the volatility in inflation resulting from the natural disasters at the start of the year, as well as any once-off effects from the introduction of a price on carbon. In what is a challenging environment, the Board is committed to ensuring that inflation remains consistent with the 2–3 per cent medium-term target that has served the Australian economy well over the past two decades.