Overview

The global outlook remains clouded by the sovereign debt problems in Europe. Notwithstanding this, there has been a general improvement in sentiment over the past month or so following further measures by the European Central Bank and European governments. Equity and commodity prices have picked up after earlier falls, and bond yields in a number of European countries have declined. Nonetheless, further measures by European policymakers will be required over the months ahead for public finances in a number of countries to be placed on a sustainable path.

Largely reflecting developments in Europe, official forecasts for global growth have been revised lower, with growth in the world economy now expected to be below trend in 2012, but nothing like as weak as 2008–09. As has been the case over recent years, a significant share of overall growth is expected to come from the emerging market economies, particularly those in Asia. In contrast, in many of the advanced economies a broadly synchronised fiscal consolidation is taking place at a time when both households and financial institutions are also deleveraging, which is likely to be contractionary for growth. As a result, limited progress is expected over the next couple of years in reducing unemployment in these countries.

In Europe, the economy appears to be in recession. In contrast, the US economy has improved over recent months after a soft patch in mid 2011, with the unemployment rate declining and tentative signs of improvement in housing activity. In east Asia, growth has slowed, partly reflecting weaker export demand as well as the earlier policy tightening. Growth in China has moderated, as was intended by the Chinese authorities, and is now running at a more sustainable pace. Inflation in China has also moderated, and the authorities are continuing with measures to contain property prices, which is having a dampening effect on the real estate industry.

While spreads on bonds issued by a number of European governments remain elevated, they are noticeably lower than they were in late 2011. In the major bond markets, yields remain near their historic lows and, in Australia, yields on 10-year government bonds recently fell to 50-year lows, with significant purchases by non-residents, including sovereign asset managers. The Australian dollar has appreciated against major currencies over the past couple of months and is currently not far below the multi-year peaks reached last year, even though commodity prices have declined since then.

Bank debt markets globally were particularly dislocated in the latter part of 2011, with minimal issuance, partly reflecting concerns about the European banking system. Over the past month, conditions have improved, with issuance picking up markedly, but spreads on bank debt are significantly higher than they were in the middle of last year. Indeed, some large corporates are now able to raise funds in the capital markets more cheaply than banks with a higher credit rating. These global developments have had an effect in Australia, where there has been a step-up in the banks' overall cost of funding relative to the cash rate.

The recent improvement in sentiment is reflected in commodity prices, which have risen over the past couple of months after falling over the second half of last year. The price of iron ore has picked up, reflecting ongoing strength in Chinese demand, although global steel production has softened. Energy commodity prices have remained at high levels, partly due to geopolitical factors. Australia's terms of trade reached a record high in the September quarter, and are estimated to have declined somewhat in the December quarter.

The Australian economy continues to record moderate growth, with GDP estimated to have increased by around 2¾ per cent over 2011, which is a little below average, partially reflecting the extreme weather events early in the year. Conditions continue to vary significantly across industries, with the economy undergoing considerable structural change in response to high commodity prices and the accompanying high exchange rate. Real incomes in Australia have received a significant boost over recent years as a result of the rise in the terms of trade, but the effects are being felt unevenly across the economy.

Overall measures of business conditions and confidence are at, or slightly below, average levels, after recovering from their falls around August. Business credit has also increased slightly over the second half of 2011 after falling over the previous year. Credit conditions, however, remain quite tight for the commercial property industry.

In the resources sector, investment is expanding at a rapid pace. As a result, it is likely that over the next year the level of business investment in the economy will reach its highest level, relative to GDP, in at least half a century. Since the previous *Statement*, another large liquefied natural gas (LNG) project has received final investment approval, bringing the total value of LNG projects approved or under construction to around $180 billion.

In contrast, conditions in a number of other sectors remain subdued, with the high exchange rate, soft consumer demand for goods, the scaling back of public investment and weak building construction all weighing on activity. The recovery in coal production from the Queensland floods has also taken longer than initially expected, with Queensland coal exports yet to return to pre-flood levels.

Retail spending remains subdued, although demand for services has been growing relatively strongly. Over the past year, household consumption has increased broadly in line with incomes, with the household saving ratio steady at around 10 per cent. The ratio of household debt to income has declined modestly over the past couple of years, with household debt increasing at an annual rate of 5 per cent, slightly below the growth in aggregate household income.

The housing market remains soft, with turnover rates around the lowest they have been over the past two decades. Nationwide measures of prices recorded modest declines over 2011, although there were signs of stabilisation in some markets at the end of the year. Building construction activity remains subdued, in part due to the earlier pull-forward of demand from the boost to first home buyer grants, slower population growth, tight access to credit for developers and lowered expectations of capital gains.

The unemployment rate has been steady at 5¼ per cent over recent months, after increasing slightly around mid year. Measured employment growth has slowed noticeably, following the strong growth in 2010. Employment has declined in a number of industries, including manufacturing, retail and real estate, but has increased strongly in others, particularly in mining. At the aggregate level, additional demand for labour appears to have been met largely through existing employees working longer hours, rather than an increase in hiring. The forward-looking indicators point to moderate growth in employment over the period ahead, although the Bank's liaison suggests that some firms are looking for greater certainty about the economic environment before hiring additional workers.

Growth in private sector wages is running at around its medium-term average pace, while public sector wage growth has slowed over the past year. Outside of industries exposed to the mining boom, there is little evidence of upward pressure on wage inflation, with the moderation in labour market conditions over the past year reducing the likelihood of an acceleration in wages.

The recent inflation data were broadly in line with expectations, with the various measures showing underlying inflation of around ½ per cent in the December quarter. On a year-ended basis, underlying inflation is running at around 2½ per cent, the midpoint of the medium-term target range, with the outcomes over the second half of the year lower than in the first half.

On a seasonally adjusted basis, the headline CPI rose by 0.2 per cent in the quarter, to be 3.1 per cent higher over the year. The outcome was again affected by the price of bananas, which subtracted around 0.3 percentage points from inflation in the quarter as supply recovered from disruptions caused by Cyclone Yasi. The price of tradables (excluding food, fuel and tobacco) fell by ½ per cent in the quarter, with noticeable falls in the prices of cars and major household appliances. Outside of these items, however, most other tradable items recorded smaller price declines than in the recent past, partly reflecting higher world prices.

In contrast, the prices of non-tradables continue to increase at a fairly firm pace, rising by 0.9 per cent in the quarter and by 3¾ per cent over the year. There were slightly above-average increases in the prices of a range of non-tradables, including rents, communication, restaurant & takeaway meals and childcare. While non-tradables inflation has slowed significantly since 2008, some further moderation is likely to be required for overall inflation to be consistent with the midpoint of the target range once the effect of the appreciation of the exchange rate on tradables prices fades.

The Bank's central forecast for the aggregate economy remains for around trend GDP growth over 2012 and 2013. Demand is expected to continue to increase more quickly than output, with a significant share of the growth in investment met through imports. Employment growth is expected to remain fairly subdued in the near term, with a further small increase in the unemployment rate forecast over 2012, before the unemployment rate declines again over the later part of the forecast period.

The very strong growth in investment in the resources sector remains a key element in the forecasts. This investment is expected to have positive spin-offs to a number of other sectors, although the high exchange rate, fiscal consolidation and subdued consumer spending on goods mean that overall growth outside the resources sector is expected to remain below trend.

The major uncertainty regarding these forecasts stems from developments in Europe, where there is still some possibility of an intensification of the sovereign debt problems. While the likelihood of such an outcome seems to have lessened a little recently, if it did occur, Europe would be likely to experience a severe recession with spillover effects to the rest of the world through trade, financial and confidence linkages. Australia is better placed than many other countries to deal with this downside risk, given the scope to adjust macroeconomic policy, the flexible exchange rate and the strong banking system. Nevertheless, if this downside risk did eventuate, growth in Australia would be weaker than in the Bank's central scenario.

In terms of domestic factors, it remains difficult to judge the net impact on the economy of, on the one hand, a once-in-a-century investment boom in the resources sector and, on the other, a high real exchange rate. With the exchange rate having been at a high level for some time, a number of businesses are reassessing their business models and medium-term prospects. Other businesses are benefiting from the boom in the resources sector and from the lift in national income from the high terms of trade. Given the historically unusual nature of these events, there is, inevitably, considerable uncertainty about how these factors will ultimately play out, with plausible upside and downside scenarios for domestic growth.

The broad outlook for inflation is little changed from the forecasts published in the November *Statement*. In underlying terms (excluding the introduction of the price on carbon) inflation is forecast to remain around the midpoint of the target range for most of the next couple of years, before increasing late in the forecast horizon as the disinflationary effects from the exchange rate appreciation diminish. In headline terms, inflation is expected to fall below underlying inflation in the near term as the earlier spike in fruit prices continues to unwind. Then, from the September quarter 2012, inflation will be boosted by the introduction of the carbon price, which is expected to add 0.7 percentage point to headline inflation and around ¼ percentage point to underlying inflation over the following year. This outlook for inflation incorporates a modest slowing in domestic cost pressures. It also assumes that the introduction of the price on carbon does not lead to second-round effects on prices through higher margins or wage claims.

With the inflation outlook having improved late last year, the Board lowered the cash rate by a cumulative 50 basis points at its November and December meetings, after having maintained a mildly restrictive stance of monetary policy through most of 2011. These reductions in official interest rates were largely passed through to borrowers, so that most lending rates in the economy are now close to their medium-term averages. At its February meeting, the Board judged that it was appropriate, for the moment, to hold the cash rate steady at 4.25 per cent, given that the central forecast was for close to trend growth in GDP and inflation being close to target. The current inflation outlook would, however, provide scope for easier monetary policy should demand conditions weaken materially. Over the months ahead, the Board will continue to monitor information on economic and financial conditions and adjust the cash rate as necessary to foster sustainable growth and low inflation.