1. International Economic Developments

GDP growth in Australia's major trading partners increased a little over recent quarters, and is within the range of estimates of potential growth (Graph 1.1). Economic growth picked up in China in mid 2016, supported by accommodative financial conditions and fiscal policy, following slower growth at the beginning of the year. Growth in east Asia has been little changed over the past year or so, and growth in New Zealand and India has been relatively strong. GDP growth in the advanced economies has been at or above potential. This is expected to continue over the next couple of years, which should reduce excess capacity further. Potential growth in Australia's major trading partners is estimated to have declined relative to previous decades, reflecting factors such as population ageing as well as lower growth in productivity and capital accumulation since the global financial crisis. This decline is most notable in China, the major advanced economies and the higher-income economies in east Asia.

Growth in global industrial production and merchandise trade picked up in late 2016, albeit from relatively low rates. Surveyed business conditions have also increased noticeably since late 2016, and conditions in the global manufacturing sector are now at a three-year high. Consumer sentiment has risen sharply in some of the major advanced economies, and has been at or above average levels for a few years.

Graph 1.1
Global Economic Activity*

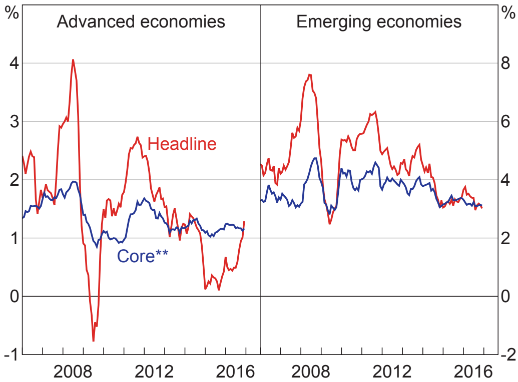
* PMIs are diffusion indices; non-PMI series are year-ended growth rates; GDP is weighted by Australia's export shares; dot indicates RBA estimate; non-GDP series are weighted averages at market exchange rates

Sources: ABS; Bloomberg; CEIC Data; CPB; IMF; Markit Economics; OECD; RBA; Thomson Reuters; United Nations

The increase in oil prices over 2016 has contributed to global inflationary pressures. Headline inflation has picked up in the major advanced economies, and is now close to the central bank's target in both the United States and euro area (Graph 1.2). Core inflation edged higher in the United States over 2016, but remains low in the euro area and Japan. In emerging market economies, headline inflation was broadly unchanged over 2016 as food price inflation eased and increases in consumer energy prices were constrained by administrative controls. Globally, a range of measures of inflation expectations increased in late 2016. Market-based measures of expected inflation largely reversed their declines over the previous few years, reflecting the prospect of more expansionary fiscal policy in the United States at a time of limited spare capacity in the labour market.

Graph 1.2
Global Inflation*

Year-ended



* PPP-weighted; sum of advanced and emerging economies accounts for around 80 per cent of world GDP

** Excludes food and fuel

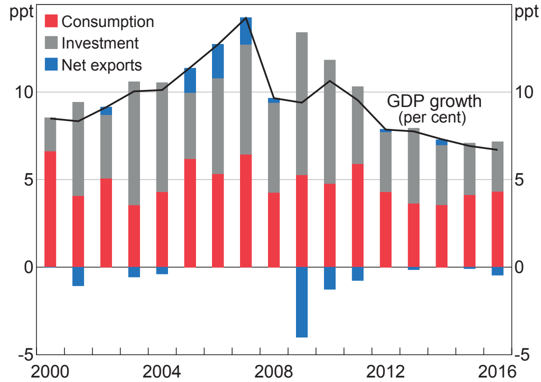
Sources: CEIC Data; IMF; RBA; Thomson Reuters

China and Asia-Pacific

In China, economic growth picked up in mid 2016, following slower growth at the beginning of the year, as the authorities conducted expansionary fiscal policy and permitted rapid growth in financing to meet their annual GDP growth targets. The accompanying rebound in property construction and continued strength in infrastructure investment boosted conditions in the manufacturing sector and growth in the output of a range of construction-related materials, including steel. For the year as a whole, GDP growth moderated a little further (Graph 1.3). Investment growth slowed slightly, while consumer spending was resilient.

To date, the recent resurgence in residential investment has been concentrated in cities near the eastern seaboard. A considerable overhang of inventory has persisted in inland cities. Tightening measures introduced by city-level authorities through 2016 to dampen speculative activity and keep prices in check (including housing purchase restrictions and reduced loan-to-value ratios) have placed downward

Graph 1.3
China – Contributions to GDP Growth



Sources: CEIC Data; RBA

pressure on growth in sales in those cities in recent months (Graph 1.4). Although residential property prices have continued to rise, price inflation has generally eased since October, especially in the cities where tightening measures have been introduced; these cities account for 23 per cent of floor space sold and 33 per cent of residential investment.

The acceleration in residential investment through 2016 contributed to stronger growth in the manufacturing sector, including industries that supply inputs to construction. This has helped support demand for iron ore and coal.

Graph 1.4
China – Residential Property Indicators

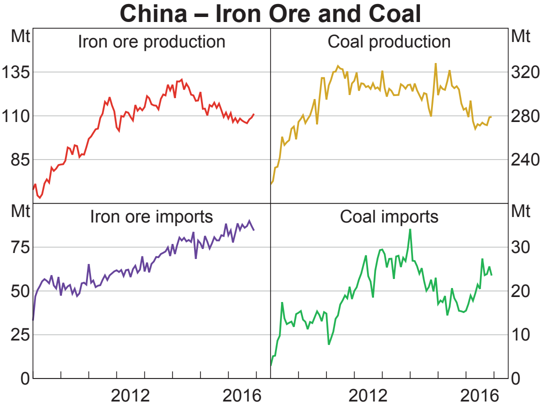
Year-ended growth

* Cities that introduced tightening measures in 2016

Sources: CEIC Data; CRIC; RBA

Resource imports (including from Australia) grew strongly, offsetting earlier cuts to Chinese production of these commodities (Graph 1.5). More recently, however, resource imports have declined a little. This is consistent with the stabilisation in Chinese production of coal and iron ore, as earlier restrictions on production have been loosened and global bulk commodity prices have risen.

Graph 1.5
China – Iron Ore and Coal

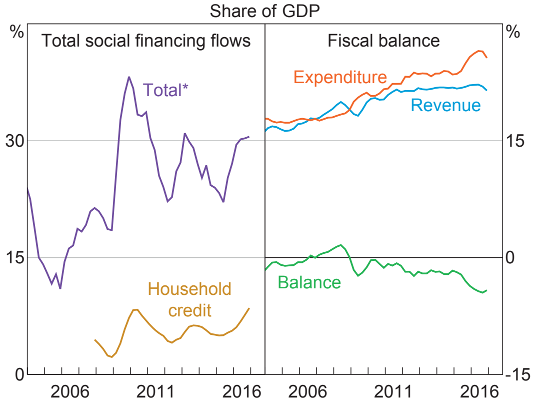


Sources: CEIC Data; RBA

Higher commodity prices have also contributed to a steady pick-up in Chinese producer price inflation in recent months. To date, this is yet to pass through appreciably to CPI inflation, which remains contained overall. However, some sectors, such as transportation services, that are exposed to commodity prices via fuel costs have reported slightly higher inflation. To the extent that continued official efforts to restrict property price growth lead to lower growth in residential investment and weigh on Chinese demand for construction materials, there may be less upward pressure on steel production, iron ore prices and coking coal prices in coming quarters.

Chinese fiscal policy and financial conditions remain highly accommodative (Graph 1.6). The fiscal deficit widened through 2016 as revenue growth slowed sharply, partly due to the replacement of the business tax with a value-added tax. On average, growth in total social financing (TSF) continued at almost double the pace of GDP growth over 2016, implying an ongoing rise in China's debt-to-income ratio. However, TSF growth eased a little in December because net corporate bond issuance contracted sharply following tighter money market conditions in November and December (see the 'International and Foreign Exchange Markets' chapter). Rapid lending to households (mainly mortgages) has been partly offset in recent months by falling growth in corporate credit.

Graph 1.6
China – Growth of Finance
Share of GDP

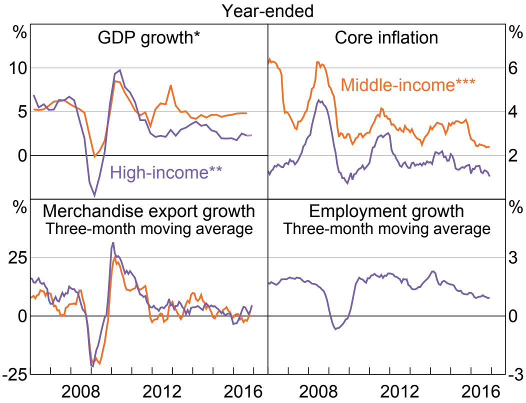


* Upper bound estimate adjusting for impact of local government bond issuance to pay off debt previously included in TSF

Sources: CEIC Data; RBA

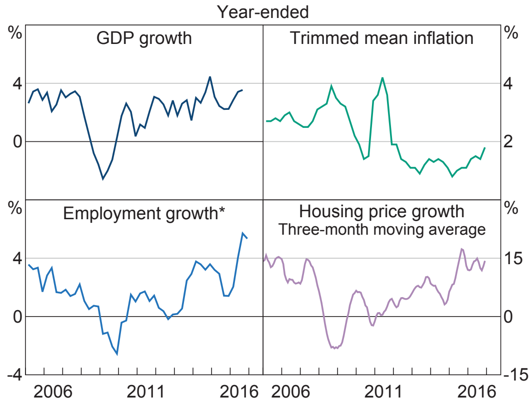
Developments in China continue to influence outcomes in other Asian economies, which account for a significant share (20 per cent, excluding Japan) of Australia's exports. GDP growth has picked up a little in the high-income east Asian economies recently, consistent with the pick-up in global trade, as these economies are relatively exposed to trade (Graph 1.7). This follows subdued growth over the previous couple of years. In particular, business investment growth has declined, although strong construction investment in Korea and more accommodative monetary and fiscal policies

Graph 1.7
East Asia – Economic Indicators



* Estimate for December quarter 2016
** Hong Kong, Singapore, South Korea and Taiwan
*** Indonesia, Malaysia, Philippines and Thailand
Sources: CEIC Data; IMF; RBA; Thomson Reuters

Graph 1.8
New Zealand – Economic Indicators



* Break adjusted by RBA
Sources: RBA; REINZ; Statistics New Zealand; Thomson Reuters

have provided some offset. Employment growth has also slowed, and consumption has grown only modestly in more recent quarters. In the middle-income east Asian economies, growth has edged higher over recent years. Domestic demand remains resilient, despite slowing a little over 2016, and will continue to be supported by accommodative monetary and fiscal policies.

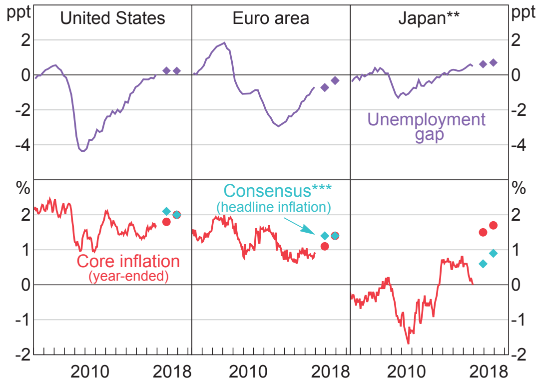
The New Zealand economy grew at an above-average pace in 2016 (Graph 1.8). Growth has been supported by record high net immigration and accommodative monetary policy. The policy rate has been reduced by 175 basis points since mid 2015. Employment growth has been very strong and the unemployment rate is around an eight-year low. Despite this, wage growth has been subdued because record net immigration has contributed to strong growth in labour supply. Housing price growth has stabilised following the tightening of tax and regulatory measures, but remains high. Inflation has increased, but remains low. Non-tradables inflation has picked up since mid 2015 and rising petrol prices have also contributed to inflationary pressures recently.

The exchange rate appreciation in 2016 has put downward pressure on the prices of traded items. The economic consequences of the strong earthquake centred near the South Island in November appear to be limited, as the most severely affected areas are sparsely populated.

Major Advanced Economies

GDP growth in the major advanced economies has been at or a little above estimates of potential over recent years, supported by accommodative monetary policies and, more recently, less contractionary fiscal policies. This has led to a gradual absorption of spare capacity and the US, Japanese and some euro area economies are now around estimates of full employment (Graph 1.9). With growth in the major advanced economies expected to be above potential over the period ahead, inflationary pressures should increase. Policymakers in the United States expect to reach their inflation goal in 2018. The projected pick-up in Japanese inflation is slower, despite the already-tight labour market, because inflation expectations and wage growth remain low following the earlier prolonged period of

Graph 1.9
Major Advanced Economies – Unemployment Gaps and Inflation
Central bank forecasts*



* Unemployment rate forecasts from central banks; NAIRU estimates from the CBO and OECD

** Inflation forecasts are for CPI excluding fresh food in 2017 and 2018; inflation data exclude the effects of the consumption tax increase

*** Adjusted for the difference between CPI and PCE in the United States

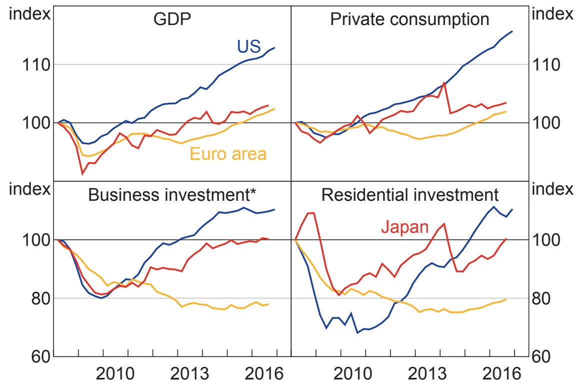
Sources: Bank of Japan; CBO; Consensus Economics; ECB; FOMC; OECD; RBA; Thomson Reuters

deflation. The projected pick-up in core euro area inflation is less pronounced, given the higher degree of spare capacity. Inflation in the euro area and Japan is expected to remain below their central banks' targets until at least 2018.

Year-ended GDP growth picked up over 2016 in Japan and over the second half of the year in the United States, while in the euro area it remained above potential and around the rates of recent quarters. Private consumption has been a key driver of growth in the United States and the euro area over the past two years, while in Japan it has remained subdued following the consumption tax increase in early 2014 (Graph 1.10). Household consumption in the major advanced economies will continue to be supported by low borrowing costs, recovering housing prices, strong employment growth and above-average consumer confidence.

Private investment growth in advanced economies has been weak in recent years. There has been a broad-based slowing in US business investment growth since late 2014, including a

Graph 1.10
Major Advanced Economies – GDP and Components
March 2008 = 100



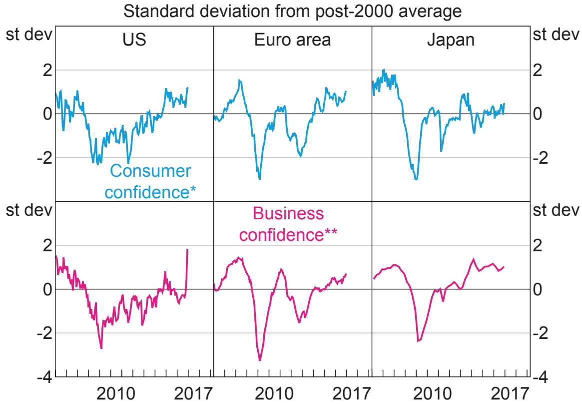
* Non-residential public and private investment shown for euro area

Sources: RBA; Thomson Reuters

sharp fall in energy sector investment. The rise in oil prices provided some support to energy sector activity over the second half of 2016, and should continue to do so in the near term. Residential investment growth also slowed in the United States in 2016. In the euro area, investment remains well below pre-crisis levels, but has grown modestly since early 2015, driven by machinery and equipment investment. Japanese residential investment has grown strongly since 2015, reflecting accommodative monetary policy, internal migration and a pull-forward of activity in anticipation of the now-delayed consumption tax increase in 2017. Large revisions to Japanese GDP – particularly to the measurement of research & development and construction investment – indicate that business investment growth was stronger than previously thought, especially around 2013 and 2014. Business investment in Japan has been little changed recently, although the recent yen depreciation should provide some support to investment and net exports. More broadly, business investment in the major advanced economies could be boosted by further tightening of labour markets and, if sustained, the recent pick-up in consumer and business confidence (Graph 1.11).

Fiscal policy in the United States has become less of a drag on economic activity since 2015, and indications from both the new administration and the Congress are that it is likely to provide additional support to activity in the period ahead. Fiscal policy has also become less contractionary in the euro area and Japan.

Graph 1.11
Major Advanced Economies – Survey Indicators



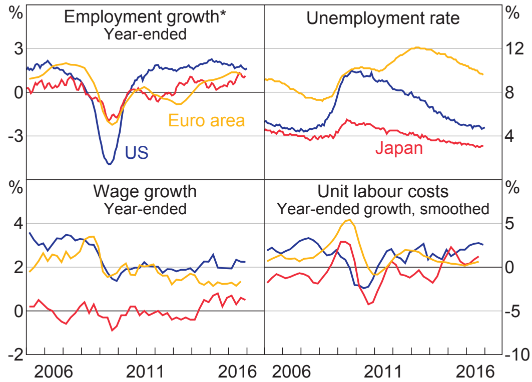
* University of Michigan composite index for US; European Commission consumer sentiment index for Euro area; Cabinet Office consumer confidence index for Japan

** NFIB small business optimism for US; European Commission manufacturing, trade, construction and services sentiment for Euro area; Bank of Japan Tankan – all industries for Japan

Sources: CEIC Data; RBA; Thomson Reuters

Labour markets have improved considerably over recent years across the major advanced economies (Graph 1.12). Employment growth has been robust and workforce participation has increased modestly, providing some offset, at least temporarily, to the effects of population ageing on labour supply. Unemployment rates have declined considerably in the major advanced economies, and are currently around estimates of full employment in the United States and Japan. While tightening labour markets in these two economies have been accompanied by moderate growth in some measures of labour compensation, overall nominal wage growth

Graph 1.12
Major Advanced Economies – Labour Markets



* Three-month moving average for Japan

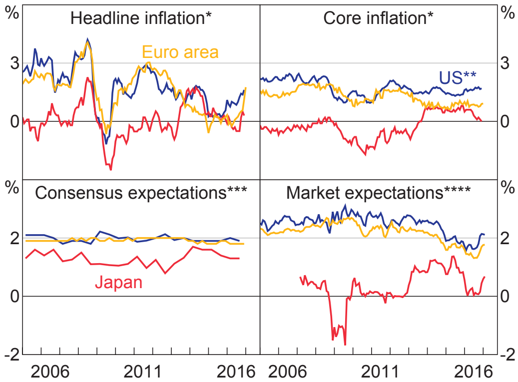
Sources: Eurostat; RBA; Thomson Reuters

remains low. However, low productivity growth has resulted in above-average growth in unit labour costs. The improvement in the euro area labour market has been less pronounced, but unemployment has still declined to its lowest rate in over seven years.

Headline inflation in the major advanced economies increased noticeably in 2016 as oil prices rebounded, and is now close to the central bank's target in both the United States and euro area (Graph 1.13). Core inflation has been more stable. In the United States, core inflation has edged higher in year-ended terms and is close to the Federal Reserve's inflation goal. In the euro area, core inflation has remained low for three years, at or a little below 1 per cent. In Japan, core inflation has fallen to its lowest rate in three years as the effects of the yen depreciation between mid 2012 and 2015 have faded and domestic inflationary pressures are yet to emerge.

In the United States and the euro area, short-term measures of inflation expectations have rebounded, coinciding with movements in oil prices and prospects of higher inflation following the US election. Longer-term market-based measures of inflation expectations have

Graph 1.13
Major Advanced Economies – Inflation and Long-run Expectations
Year-ended



* PCE inflation for the US; CPI for the euro area and Japan; Japan data exclude the effects of the consumption tax increase in April 2014

** US expectations adjusted to reference PCE inflation

*** Euro area series is from the Survey of Professional Forecasters

**** Monthly average of inflation expectations from 5 and 10-year inflation swaps; latest observation is an average of the month to date

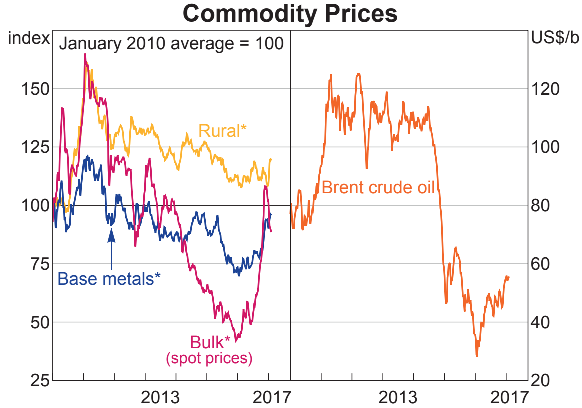
Sources: Bloomberg; Consensus Economics; ECB; RBA; Thomson Reuters

also picked up from record lows, although these measures can also reflect financial market developments, such as changes in risk premia. Economists' longer-term expectations have been relatively steady and remain close to each central bank's inflation target, suggesting that their expectations remain relatively well anchored. In Japan, inflation expectations declined in early 2016 and remain low, at around levels that prevailed shortly before the Bank of Japan started its quantitative easing and announced its inflation target in 2013.

Commodity Prices

Commodity prices have declined a little since the previous *Statement*. Large declines in coal prices from very high levels have been partly offset by significant increases in the prices of iron ore, oil and base metals (Graph 1.14; Table 1.1). The increases in commodity prices over 2016

Graph 1.14
Commodity Prices



* RBA Index of Commodity Prices (ICP) sub-indices; SDR

Sources: Bloomberg; RBA

Table 1.1: Commodity Price Growth[(a)]
SDR, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	–7	94
– Iron ore	33	88
– Coking coal	–34	126
– Thermal coal	–24	70
Rural	6	12
Base metals	12	31
Gold	–3	8
Brent crude oil[(b)]	18	67
RBA ICP	16	55
– using spot prices for bulk commodities	–2	55

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodities prices are spot prices

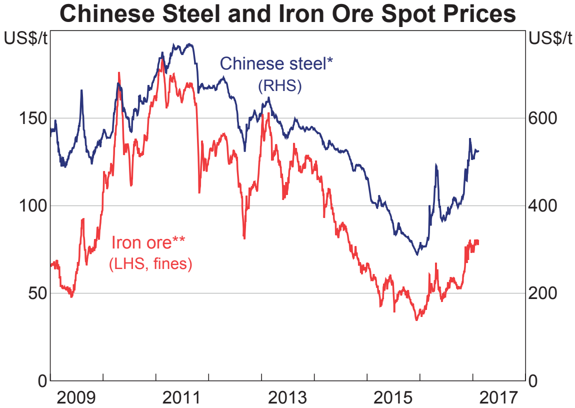
(b) In US dollars

Sources: Bloomberg; IHS; RBA

have driven Australia's terms of trade higher. As discussed in the 'Economic Outlook' chapter, the terms of trade are expected to be higher over the next couple of years than previously envisaged and are expected to remain above their recent trough.

The spot price of iron ore has increased noticeably since the previous *Statement*, partly due to a pick-up in Chinese steel production and increased demand for high-quality iron ore in steel production to minimise coking coal inputs, for which prices increased sharply over 2016 (Graph 1.15). The iron ore spot price has more than doubled since its low in December 2015, but it is expected to decline gradually as additional low-cost production from Australia and Brazil comes on line.

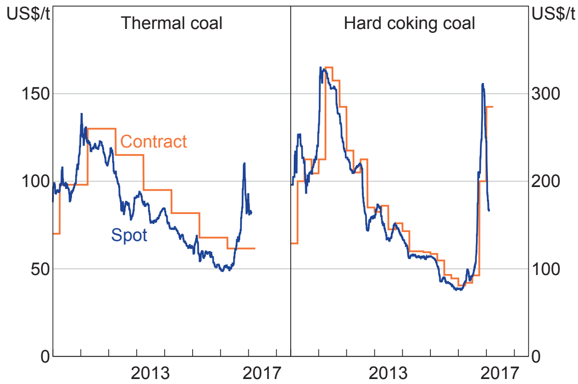
Graph 1.15
Chinese Steel and Iron Ore Spot Prices



* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; RBA

The spot prices of both hard coking coal and thermal coal have declined sharply since the previous *Statement*, from very high levels (Graph 1.16). Coking and thermal coal prices are around 45 per cent and 25 per cent lower than their mid-November highs because temporary disruptions that affected seaborne coal supply in late 2016 have been largely resolved and Chinese authorities have loosened

Graph 1.16
Coal Prices
Free on board basis



Sources: Department of Industry, Innovation and Science; IHS; RBA

some of the production restrictions that have been in place since April. In both cases, prices are still significantly higher than they were at the beginning of 2016. Coking coal contracts for the March quarter settled at US$285 per tonne, an increase of more than 40 per cent from the December quarter benchmark price. Most of Australia's coal exports are still sold under contract at prices that currently differ substantially from those in the spot markets. While the profitability of Australian coal miners has improved, the Bank's liaison suggests that prices would need to remain elevated for some time to induce any noticeable increase in Australian production.

Oil prices have increased over the past few months, after OPEC and non-OPEC members agreed to reduce oil production by around 1.8 million barrels per day for six months, effective from January (Graph 1.14). Prices are currently around their highest levels in over a year, but still remain well below their highs of early 2014. The increases in oil prices since the start of 2016 have started to feed through to higher liquefied natural gas export prices. The increase in base metals prices over recent months has been broad based.