1. The International Environment

Global economic growth picked up in the second half of 2021, supported by the widespread lifting of activity restrictions following increases in vaccination coverage. While there have been and continue to be challenges arising from the rapid spread of the Omicron variant of COVID-19, the impact on economic activity is less than in earlier outbreaks. The recovery is most progressed in advanced economies, underpinned by strong household balance sheets, a rapid recovery in labour markets, and supportive fiscal and monetary policies. Economies in the Asian region have also resumed growing in recent months, following the disruptions associated with the outbreak of the Delta variant in the middle of last year. Economic growth in China picked up in the December quarter, though headwinds remain. The Chinese authorities have eased monetary policy, and domestic economic policy settings are expected to be less of a drag in 2022 as greater emphasis is placed on supporting growth. However, broader and more frequent lockdowns in response to COVID-19 outbreaks could disrupt growth, and longer-term policy challenges in China remain. More generally, GDP in Australia's major trading partners is forecast to grow strongly in the coming year, before slowing to slightly below average rates in 2023.

Global supply chains remain under pressure, particularly as the spread of COVID-19 disrupts labour supply and transportation networks. Inventories remain low across a number of commodity and non-commodity sectors, including in the retail supply chain. Even so, some sources of upstream price pressures, such as shipping costs and semiconductor prices, appear to have peaked. While wages growth has picked up sharply in only a few countries, inflation has generally been higher, more persistent and more broad-based than central banks previously expected.

Central banks in advanced economies generally expect inflation to moderate in 2022; however, a number forecast inflation to exceed their targets for a time and for labour markets to continue to tighten. Given this, central banks in most advanced economies have ceased or reduced the pace of asset purchases. Some have also increased their policy rates and market pricing suggests that a number of others are expected to do so soon. Yields on government bonds have increased in advanced economies; financial conditions have tightened but overall remain accommodative. In emerging market economies, a number of central banks outside Asia have continued to tighten policy in response to inflation that remains persistently above target.

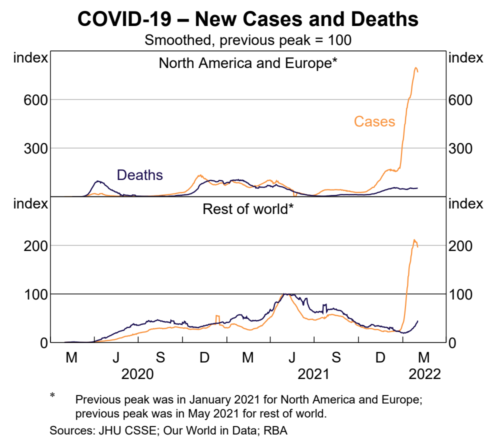
Economic activity has been relatively resilient to the Omicron outbreak …

The emergence of the Omicron variant in November 2021 has led to declines in population mobility in many advanced economies over recent months (Graph 1.1). However, these declines have generally been smaller than during previous outbreaks, reflecting the lighter role for state-mandated lockdowns during this current wave. This can be traced to Omicron infections generally resulting

in lower rates of hospitalisations and deaths, compared with earlier strains of COVID-19. Surveys of business conditions and other timely indicators signal an ongoing but slower expansion in economic activity in most advanced economies around the turn of the year (Graph 1.2). Mobility in India declined in January, though by much less than it did during its mid-2021 Delta outbreak. Economic activity in much of east Asia has continued to recover from that region's Delta outbreaks, with Omicron infections only recently beginning to increase. In China, where authorities have continued to impose intermittent localised lockdowns in an effort to suppress the virus, overall mobility has been resilient in recent months.

Global economic activity had generally been robust prior to recent Omicron outbreaks. GDP in North America and Europe increased strongly over the second half of 2021 following the easing of activity restrictions around midyear (Graph 1.3). Likewise, economic growth rebounded in Japan, India and most of east Asia in the December quarter, after contracting or slowing sharply in the June and September quarters due to the effects of the Delta outbreaks in those areas. Chinese economic activity was subdued by historical standards throughout most of 2021 (as discussed below), but GDP in China recovered to pre-pandemic trends more quickly than other large economies. In a few large emerging market economies outside Asia (such as South Africa and Russia), GDP contracted or grew only modestly in the latter part of 2021. Output in most advanced economies is now back to or above its pre-pandemic level, though trends in activity in emerging markets have been more disparate.

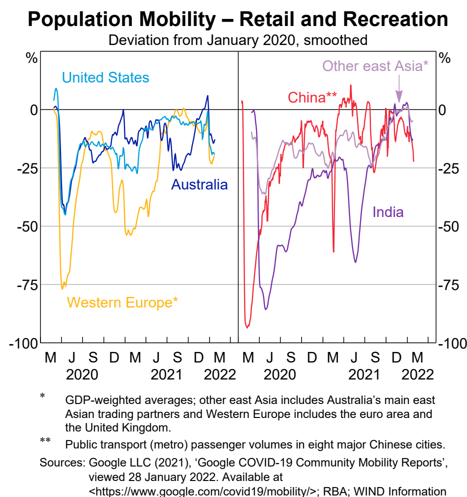
Graph 1.2



* Previous peak was in January 2021 for North America and Europe; previous peak was in May 2021 for rest of world.

Sources: JHU CSSE; Our World in Data; RBA

Graph 1.1

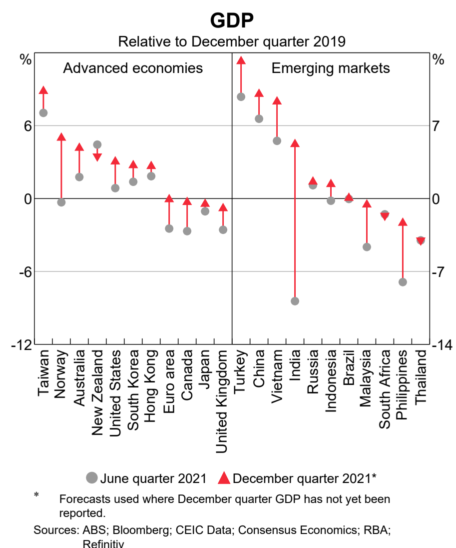


* GDP-weighted averages; other east Asia includes Australia's main east Asian trading partners and Western Europe includes the euro area and the United Kingdom.

** Public transport (metro) passenger volumes in eight major Chinese cities.

Sources: Google LLC (2021), 'Google COVID-19 Community Mobility Reports', viewed 28 January 2022. Available at <https://www.google.com/covid19/mobility/>; RBA; WIND Information

Graph 1.3



* Forecasts used where December quarter GDP has not yet been reported.

Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

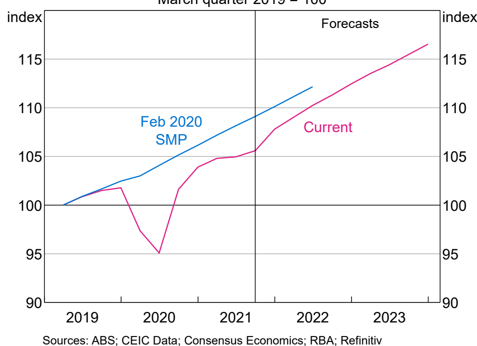
… and is expected to grow strongly in 2022

GDP in Australia's major trading partners is projected to exceed its historical average in 2022 (with year-average growth of 4½ per cent), before easing to a slightly-below-average rate in 2023 (Graph 1.4). The overall GDP forecast for Australia's major trading partners remains broadly the same as in the November *Statement*, with limited near-term impact from the spread of Omicron.

In most advanced economies, GDP is forecast to return to its pre-pandemic trend path by mid-to-late 2022. The Chinese economy is also forecast to continue expanding around its pre-pandemic trend during 2022, though a gradual slowing in potential economic growth in China is expected over coming years. By contrast, the strong growth forecast for many emerging market economies over coming years is not expected to be sufficient to make up for the significant loss of output during the pandemic. This is especially evident for Asian emerging markets, in part because of their reliance on international tourism.

The global economic outlook is subject to a range of risks that are broadly balanced. On the upside:

- Household consumption could be stronger than anticipated over the next few years, given healthier household balance sheets, expansionary financial conditions and pent-up demand.
- It is also possible that the health impacts of COVID-19 in the period ahead are more benign than currently assumed in the forecasts, further supporting growth in private demand.



On the other hand, there are a number of downside risks to the global economic outlook, including:

- Health-related developments could be worse than assumed. Though Omicron infections tend to be less severe than earlier strains, very high case numbers could affect mobility substantially as more people become ill, have to self-isolate or choose to restrict their activities to avoid infection. Tighter restrictions on activity could also be reintroduced. If the current Omicron wave persists, or a more dangerous strain of COVID-19 emerges, supply chains, labour supply and economic growth would all be disrupted.
- The upswing in global inflation could be larger and/or more persistent than currently forecast. If so, it would be likely to trigger an earlier and more significant tightening in global monetary policy than forecast. A sharp rise in policy rates, particularly in the United States, could in turn prompt a sharp rise in global bond yields and a broader tightening in global financial conditions via a range of channels, including higher financial market risk premiums and an increase in capital outflows from emerging market economies. Such an outcome could occur if demand remains strong and the productive capacity of the global economy is lower than assumed as a result of various changes induced by the pandemic, particularly to labour supply and product supply chains.

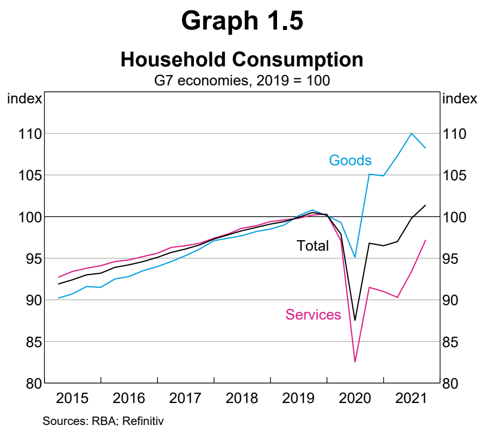
- Authorities in China may find it challenging to balance various policy trade-offs. There is the challenge of lifting the pace of economic growth through less-restrictive policy settings while continuing to address concerns about excessive leverage, particularly in the property sector. There are also risks to the economy if authorities struggle to control outbreaks of COVID-19, given China's current approach of seeking to suppress the virus through localised lockdowns.

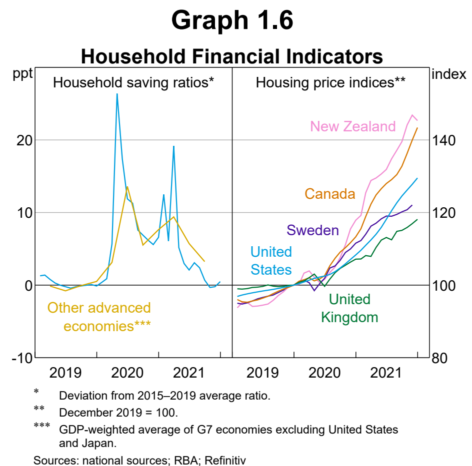
Households are driving the recovery

Consumer spending maintained a strong pace of growth through the second half of 2021. Aggregate household consumption in advanced economies surpassed its pre-pandemic level in the September quarter of 2021, after falling by more than 10 per cent in the first half of 2020 (Graph 1.5). The recovery in consumption has been strongest in the United States. Goods consumption has remained very strong in advanced economies, even as services consumption has picked up.

Household finances are supporting continued strong consumption growth in advanced economies. Many households accumulated significant savings during the pandemic as incomes rose and consumption opportunities were constrained. Outside the United States, saving ratios are still generally elevated (Graph 1.6). As a result, consumption could grow faster than income for a period while saving ratios return to historically normal levels; indeed, households might dip into the substantial extra savings they have accumulated over the pandemic, leading to even stronger consumption growth. Over the past year, strong growth in labour income in advanced economies has offset the effect of the unwinding of pandemic-related fiscal support to households. In addition, household wealth has risen strongly. Household income in Japan will be boosted further by the recently announced economic support package, which provides cash transfers to low-income households.

Business investment has increased only modestly in recent quarters, and remains well below pre-pandemic levels in a number of advanced economies. However, investment growth has been very strong in high-income Asian economies, as companies have expanded the capacity of semiconductor and other consumer goods manufacturing. Global business investment is likely to increase more robustly in 2022, supported by expectations for strong global growth and because the higher prices induced by supply constraints will





encourage an expansion in capacity to address those constraints. Fiscal policy is also shifting towards supporting investment. For instance, in the United States, the recently legislated Bipartisan Infrastructure Package will provide substantial support for infrastructure investment. Funding associated with the Recovery Plan for Europe and accelerated depreciation tax incentives in the United Kingdom should also contribute to a favourable environment for European business investment.

Chinese economic growth has stabilised but policy challenges remain

Economic growth in China was solid in the December quarter, after slowing considerably in the September quarter. Strong external demand continued to support manufacturing activity and exports (Graph 1.7). In addition, some earlier headwinds eased – specifically, automobile, steel and concrete production have all stabilised in recent months as supply constraints eased a little, targets for lower steel production were met and authorities relaxed the stance of fiscal policy. While the Chinese authorities have maintained a strategy of suppressing the virus, household consumption held up reasonably well through much of 2021 despite a number of localised COVID-19 outbreaks and the targeted lockdowns applied in response; these lockdowns have nonetheless slowed the pace of recovery in some parts of the services sector.

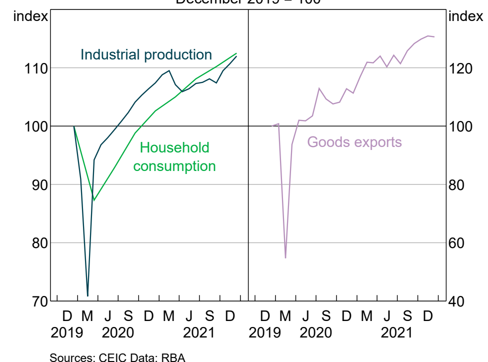
Conditions in China's residential property sector remain weak following a period of regulatory tightening. However, property sales have been steady since August, at around 2019 levels (Graph 1.8). Authorities have also eased financial conditions slightly to limit further falls in sales, by encouraging a modest relaxation of bank financing restrictions for healthy property developers, taking actions to assure buyers that pre-sales will be honoured and providing direct support to first home buyers. Regardless, the authorities have maintained their commitment to reducing leverage in the sector (sustaining pressure on developers' finances) and are not seeking to engineer a sharp recovery. Construction activity is still likely to fall over coming months, given sustained weakness in construction starts recently and a reduced pipeline of work. Nonetheless, expectations of a modest recovery in construction activity later this year appear to be providing some support to current demand for steel and, in turn, iron ore.

Fiscal policy has weighed on growth in China over the past year. The consolidated fiscal balance of Chinese governments was around 3 percentage points tighter in 2021 than in 2020 (Graph 1.9). The impact of fiscal tightening has been most apparent in infrastructure

Graph 1.7

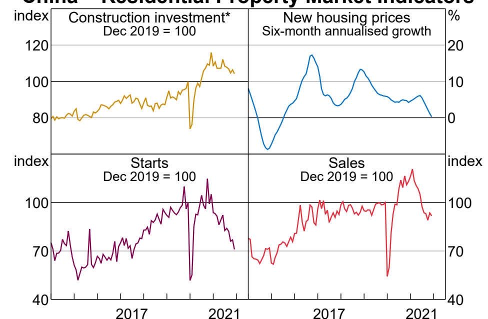
China – Activity Indicators

December 2019 = 100



Graph 1.8

China – Residential Property Market Indicators



* Residential real estate investment excluding the purchase of land.

Sources: CEIC Data; RBA

investment, which has declined steadily since late 2020. However, fiscal expenditure has increased notably in recent months and issuance of infrastructure-linked government bonds has accelerated. Statements from Chinese authorities point to a further recovery in fiscal spending and infrastructure-related construction over the first half of this year, adding further support to demand for Australia's commodities exports.

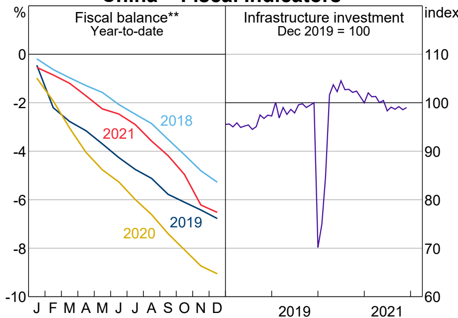
Chinese authorities have eased financial policies

Since the previous *Statement*, the People's Bank of China (PBC) has eased monetary policy in several ways. It has lowered the reserve requirement ratio for most banks by 50 basis points and reduced several of its main policy interest rates – the one-year medium-term lending facility (MLF), and the seven-day and 14-day reverse repurchase agreements – by 10 basis points (Graph 1.10). The policy rate reductions have passed through into Chinese Government bond yields, particularly at shorter maturities (Graph 1.11). There have been modest declines in lending rates to households and businesses, as reflected in reductions in the one-year and five-year Loan Prime Rates (LPRs) quoted by banks. The PBC also began some targeted funding programs in December, such as issuing low-cost loans to banks to fund projects that reduce carbon emissions, and it announced new tools to support small and micro enterprises by converting pandemic-related loan deferrals into longer-term funding. These measures have been accompanied by statements from officials emphasising the need for greater support for the economy.

The recent easing in Chinese financial conditions will support credit growth, which slowed a little over the past year (Graph 1.12). Indeed, growth in total social financing (TSF) has stabilised in year-ended terms since September, and over recent months has been supported by stronger government bond issuance after local authorities were encouraged to bring forward

Graph 1.9

China – Fiscal Indicators*



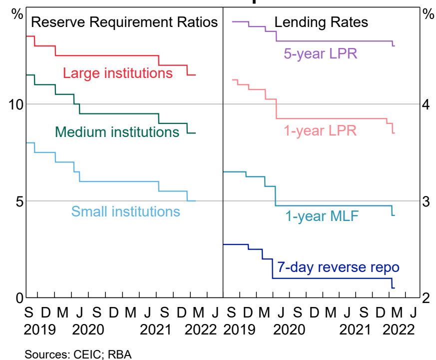
* Seasonally adjusted by the RBA.

** Consolidated measure that includes central government, local government and government funds; as a share of annual GDP.

Sources: CEIC Data; RBA

Graph 1.10

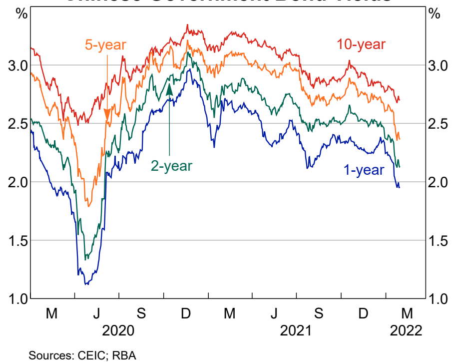
Chinese Lending Rates and Reserve Requirements



Sources: CEIC; RBA

Graph 1.11

Chinese Government Bond Yields



Sources: CEIC; RBA

their fiscal expenditure plans. Overall, TSF growth over 2021 was consistent with authorities' target for growth to be in line with nominal GDP.

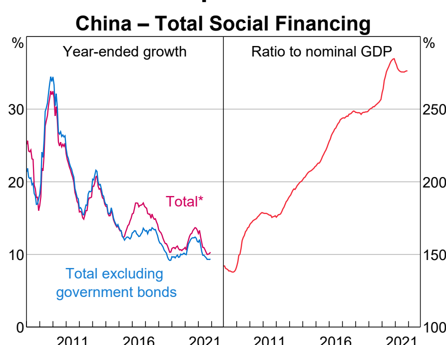
The Chinese renminbi remains around its highest level in recent years against the US dollar, having appreciated by over 8 per cent on a trade-weighted basis since the beginning of 2021 (Graph 1.13). In December, the PBC increased the reserve requirement for foreign currency deposits for the second time that year. This requires banks to hold more foreign currency in reserve instead of converting it into renminbi, which should slow the renminbi's appreciation. Trade surpluses and foreign investment continue to support the renminbi, with significant foreign inflows to China's securities markets in the December quarter.

Private Chinese property developers remain under stress

Financial conditions have remained very tight for many private Chinese property developers. A number of major developers defaulted on US-dollar bonds (including Evergrande and Kaisa), extended maturities of bonds or defaulted on trust loans in recent months. To date, these developments have had limited effect on broader financial markets. The larger developers experiencing stress have around 40 per cent of their outstanding bonds coming due in 2022. Bond yields had increased sharply for several privately owned developers, including some of the country's largest developers, but retraced some of this increase on reports that authorities may relax restrictions on developers' access to deposits on pre-sold properties (Graph 1.14). Bond yields have remained stable for most state-owned developers. The PBC has indicated a preference for using project mergers and acquisitions to reduce risks in the sector, whereby more financially stable developers acquire projects from stressed developers. Equity prices for banks and state-owned property developers have increased amid signals of potential policy easing, while the broader equity indices have declined in line with global equity indices (Graph 1.15).

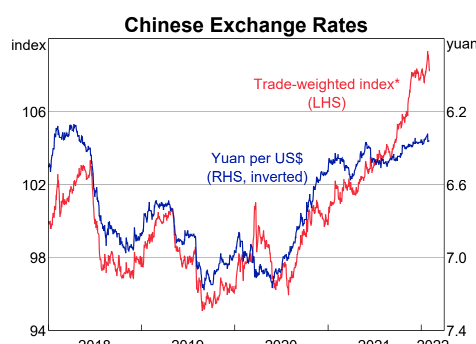
Upstream price pressures in the global economy remain strong, but may have peaked in some cases

Some non-labour input costs are showing signs of stabilising at elevated levels. This is particularly evident in shipping costs and the price of semiconductors, both of which rose rapidly in the year or so following the onset of the pandemic (Graph 1.16). Slowing growth of input costs will, over time, alleviate upstream



* Measure targeted by authorities, which incorporates net government bond issuance; includes local government bonds issued to refinance and substitute for state-backed corporate debt; RBA estimates prior to 2016.

Sources: CEIC; RBA



* Indexed to 1 January 2018 = 100.

Sources: Bloomberg; China Foreign Exchange Trade System; RBA

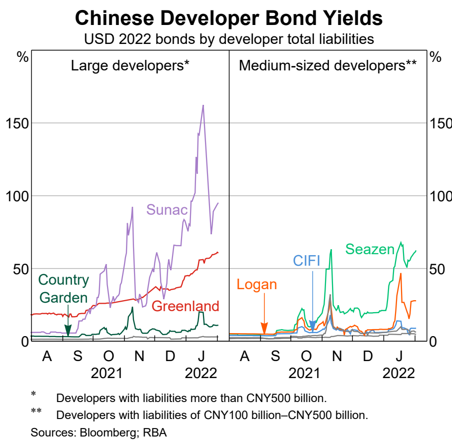
inflationary pressures for firms. However, some firms retain considerable pricing power because of the ongoing strength in goods demand and the persistence of supply chain bottlenecks; supplier delivery times remain stretched, and manufacturing output remains disrupted in sectors such as automobiles, where production has been relatively slow to recover. Retail inventory-to-sales ratios in the United States also remain very low (Graph 1.17). Low inventory levels would amplify the effects of any additional disruptions in global supply chains – including those arising from the Omicron outbreak – and prolong the resolution of supply bottlenecks as firms seek to rebuild inventories while simultaneously meeting ongoing strong demand for goods.

Energy prices remain elevated (Graph 1.18). The sharp increase in global gas prices over the past year has been driven primarily by developments in Europe, where strong demand and an inability to increase imports of gas has caused inventories to fall from already low levels. This has lifted prices globally, as LNG suppliers have diverted shipments from Asia, despite Chinese demand continuing to grow. Thermal coal prices also increased sharply in mid-2021, in response to a substantial increase in Chinese electricity demand and some disruptions to Chinese domestic supply. However, Chinese authorities

Graph 1.14

Chinese Developer Bond Yields

USD 2022 bonds by developer total liabilities



* Developers with liabilities more than CNY500 billion.
** Developers with liabilities of CNY100 billion–CNY500 billion.
Sources: Bloomberg; RBA

Graph 1.15

Chinese Equity Prices

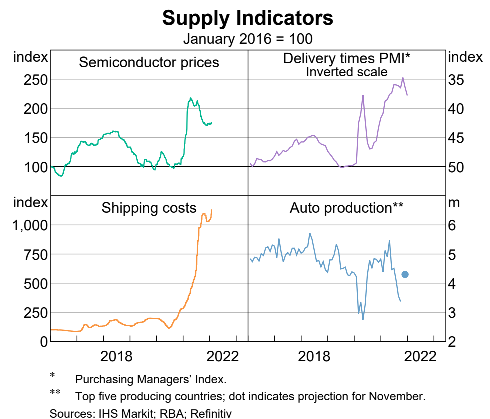
4 Jan 2021 = 100

* Excluding Skshu Paint.
** Excluding China Merchants Bank.
*** Largest developers excluding those that have defaulted on bonds.
Sources: Bloomberg; Macquarie Research; RBA

Graph 1.16

Supply Indicators

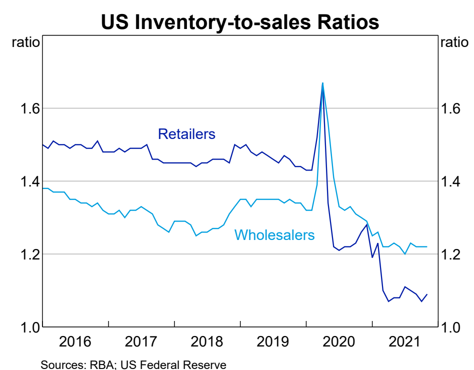
January 2016 = 100



* Purchasing Managers' Index.
** Top five producing countries; dot indicates projection for November.
Sources: IHS Markit; RBA; Refinitiv

Graph 1.17

US Inventory-to-sales Ratios



Sources: RBA; US Federal Reserve

Table 1.1: Commodity Price Growth[(a)]

SDR terms; percentage change

	Since previous *Statement*	Over the past year
Bulk commodities	41	46
– Iron ore	58	–17
– Coking coal	10	343
– Thermal coal	57	219
Rural	3	29
Base metals	12	36
Gold	0	–2
Brent crude oil[(b)]	10	69
RBA ICP	8	26
– Using spot prices for bulk commodities	23	44

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

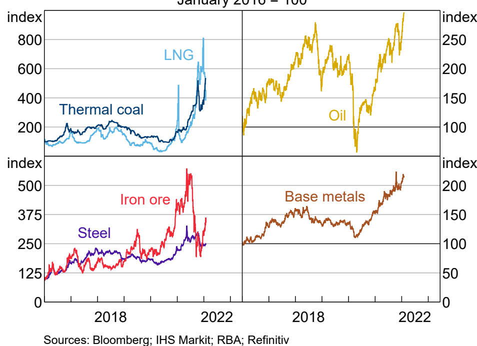
(b) In US dollars.

Sources: Bloomberg; IHS; RBA

subsequently facilitated an increase in coal production that has partially alleviated this pressure. Oil prices have similarly been volatile. Russia–Ukraine tensions and tight supply have contributed to prices climbing further, offsetting an earlier fall in November as reports of the Omicron variant emerged. Oil prices are currently at their highest level since 2014 and around 60 per cent higher than a year ago.

Iron ore prices have also been very volatile in recent months but, in contrast to energy commodities, remain well below the historically high level they reached in early 2021 (Table 1.1). Iron ore prices fell early last year as Chinese authorities enforced steel production curbs. However, prices have retraced about half of this in the past month or two as the outlook for steel demand from the real estate and infrastructure construction sectors strengthened. Base metal prices remain elevated due to strong demand and rising energy prices. Prices for rural commodities overall are well above pre-pandemic levels.

Graph 1.18



Sources: Bloomberg; IHS Markit; RBA; Refinitiv

Labour markets are generally tight, but the strength of wages growth varies

Employment growth remains strong and broad-based in most advanced economies. Unemployment rates typically fell by 1–3 percentage points over 2021, and are back around the levels prevailing before the onset of the pandemic (Graph 1.19). By contrast, in a few economies participation rates have recovered only modestly over the past year and remain notably below pre-pandemic levels. This is particularly the case

in the United States where health concerns and an increase in retirements have been prominent. Labour supply is also currently being disrupted in many countries by record high numbers of people isolating because of exposure to COVID-19. Job vacancies are likewise at record highs in many economies, exacerbated by labour-matching challenges such as higher-than-normal rates of retirements and resignations, changes in the composition of labour demand, vaccine mandates and reduced immigration.

Wages growth has picked up sharply in a few countries, notably in the United States and the United Kingdom (Graph 1.20). In these economies, participation rates remain well below pre-pandemic levels, while labour demand is strong. Wages growth has been broad-based across industries, though strongest in hospitality. In addition to paying higher wages, firms in these countries report paying hiring and performance bonus payments more commonly than before the pandemic. By contrast, wages growth has remained stable at low levels in a number of other countries where unemployment rates are low but labour supply has largely recovered, such as in the euro area, Canada and Australia.

Inflation has remained high as services inflation has picked up

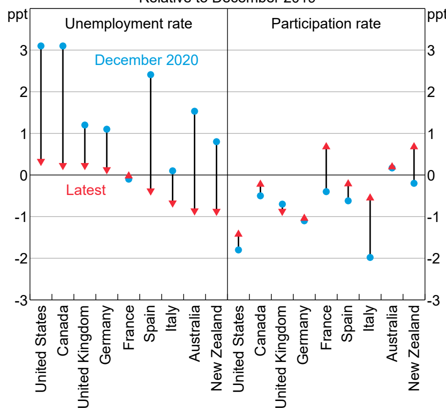
Consumer price inflation is well above central banks' inflation targets in a range of advanced and emerging economies (Graph 1.21). The substantial pick-up in both headline and underlying inflation in advanced economies was initially driven by higher goods price inflation. However, inflation in services has lifted significantly in recent months, driven by stronger housing services inflation and a recovery in the demand for, and prices of, some pandemic-affected services (Graph 1.22). The acceleration in services inflation has been a little faster in economies that are recording high wage inflation, but has also picked up strongly in economies where wages growth is contained. Headline inflation has increased more than core inflation, typically as a result of large increases in global fuel prices and electricity costs.

Asia has generally been an exception to these developments in global inflation. Underlying inflation in most Asian countries remains below its pre-pandemic average, especially in middle-income Asian economies where output remains depressed. Nonetheless, inflation has lifted to be above historical average rates in those economies where economic activity has rebounded more strongly, such as Taiwan, Korea

Graph 1.19

Labour Market Indicators

Relative to December 2019

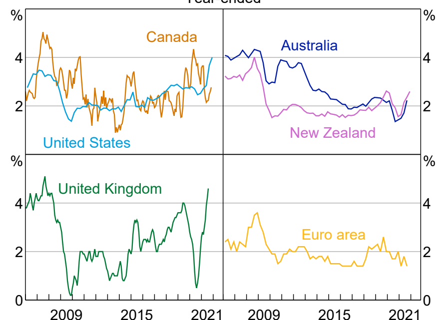


Sources: Destatis; RBA; Refinitiv

Graph 1.20

Wages Growth*

Year-ended



* Labour cost indices used where available; compositionally controlled average earnings for Canada and the United Kingdom.

Sources: BoE; RBA; Refinitiv; Statistics Canada

and Singapore. The rise in inflation in these countries has been driven by services prices.

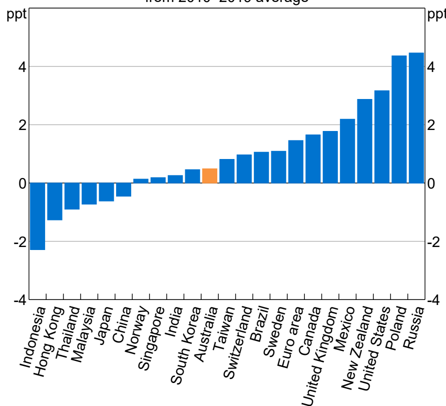
Central banks in most advanced economies have tapered or ceased asset purchases …

Central banks in advanced economies have provided significant monetary policy stimulus to support the economic recovery. But many central banks have tapered or ceased their asset purchases as employment has grown strongly and larger, more persistent inflationary pressures than initially expected have led central banks in

Graph 1.21

Core Inflation*

Year-ended, deviation of current three-month average from 2010–2019 average



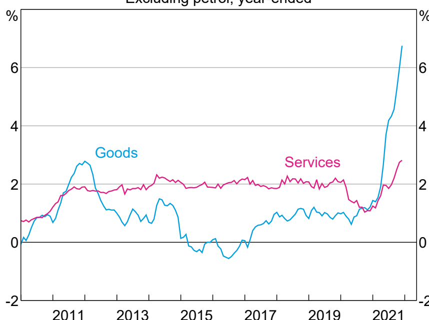
* Headline measure used for Hong Kong.

Sources: CEIC Data; RBA; Refinitiv

Graph 1.22

Goods and Services Inflation – G7

Excluding petrol, year-ended



Sources: RBA; Refinitiv

most advanced economies to lift their inflation forecasts for 2022. Most central banks expect inflation to continue to exceed their targets for a time, but to moderate to be closer to their targets by the end of 2022 as supply constraints ease, aided in some cases by the modest withdrawal of monetary policy stimulus.

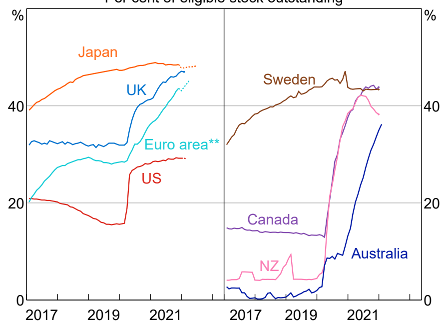
The Bank of England (BoE) and Sveriges Riksbank concluded net asset purchases in December 2021 as planned, while the Reserve Bank of New Zealand (RBNZ) and the Bank of Canada (BoC) ended their purchases earlier in 2021 (Graph 1.23; Graph 1.24). The US Federal Reserve (Fed) is now widely expected to complete net purchases in March, several months earlier than had been previously expected. At its December meeting, the Fed announced a doubling of the speed of its tapering process in response to an increased risk that elevated inflation outcomes will persist as well as further improvement in the labour market. The European Central Bank (ECB) also confirmed that it will cease purchases under its pandemic-era program in March 2022. In contrast, pre-pandemic-era asset purchase programs at the ECB and Bank of Japan (BoJ) are expected to continue for some time.

Even though central banks are tapering, or have concluded their pandemic-related asset

Graph 1.23

Central Bank Government Bond Holdings*

Per cent of eligible stock outstanding



* Central government debt only for all countries except the euro area. Dashed lines represent forecasts based on announced purchase programs or recent pace of purchases.

** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.

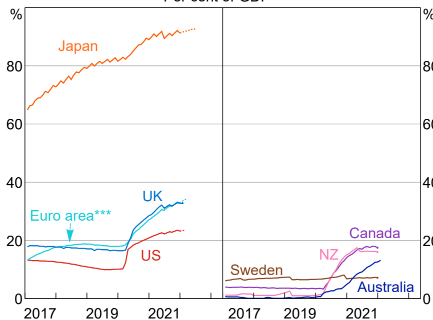
Sources: Central banks; debt management offices; RBA; Refinitiv

purchases, their large holdings of assets will continue to contribute to accommodative financial conditions (alongside low policy rates and term funding schemes). Several central banks have announced plans to keep the total size of their asset holdings steady for a time by reinvesting proceeds from maturing bonds. For example, both the BoC and the BoE will maintain a roughly stable level of bond holdings until they increase their policy rate to a certain threshold. Fed Chair Powell has indicated that the Fed will use at least one meeting after it first raises the policy rate to make decisions about its plans for reinvestment and run-down of the balance sheet, suggesting that the Fed could begin reducing the size of its balance sheet from the middle of this year. This approach is in contrast to 2014–2017, when the Fed maintained a constant level of asset holdings until the policy rate had increased more substantially. Fed policymakers have noted that, relative to the past, the economy is starting from a position of higher inflation and a tighter labour market, and the Fed has a higher level of asset holdings.

Graph 1.24

Central Bank Government Bond Holdings*

Per cent of GDP**



* Central government debt only for all countries except the euro area. Dashed lines represent forecasts based on announced purchase programs or recent pace of purchases.

** Four-quarter rolling sum; forecasts are based on the IMF's World Economic Outlook.

*** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.

Sources: Central banks; IMF; RBA; Refinitiv

… while some have increased their policy rate or are expected to do so later this year

Central banks in advanced economies either began increasing policy rates in the second half of last year or market pricing suggests they are expected to do so in 2022 (Graph 1.25). Those central banks that had moved earlier to increase their policy rates have retained the approach of setting policy rates in response to their forecasts for inflation. This is in contrast to the Fed and the Reserve Bank, which have both indicated they will base the increase in their policy rate on actual inflation. Market pricing continues to suggest that policy rates are expected to peak at historically low levels in most advanced economies over the next few years.

Over recent months, the following policy rate movements have taken place:

- In November, the RBNZ increased its policy rate by 25 basis points to 0.75 per cent, noting that capacity constraints in the economy had been much greater than expected despite COVID-19-related restrictions. The RBNZ revised up its projected path of the policy rate and now expects it will reach 2 per cent by the end of 2022 and peak at around 2½ per cent by mid-2023.
- In December, the BoE increased its policy rate by 15 basis points to 0.25 per cent. Most members of the Monetary Policy Committee saw the decision as finely balanced given uncertainty surrounding the economic impact of the Omicron variant, but emphasised that the labour market continued to tighten and that domestic cost and price pressures had been more persistent than expected. The BoE indicated that it expects some modest tightening of policy is likely to be necessary over the next three years. Market pricing suggests that the

BoE will raise its policy rate by a further 25 basis points in February.

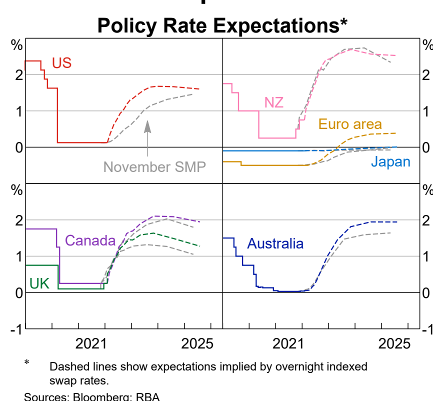
- In December, Norges Bank increased its policy rate by 25 basis points to 0.5 per cent. It noted that above-normal capacity utilisation, rising wages growth and higher imported goods costs are expected to increase underlying inflation. In January, Norges Bank reiterated that it expects to increase the policy rate further in March.
- In January, the Bank of Korea (BoK) increased its policy rate by 25 basis points to 1.25 per cent, following an increase of the same size in November. The BoK expects inflation to run above the target level for a considerable period and expects to continue to raise its policy rate over time.

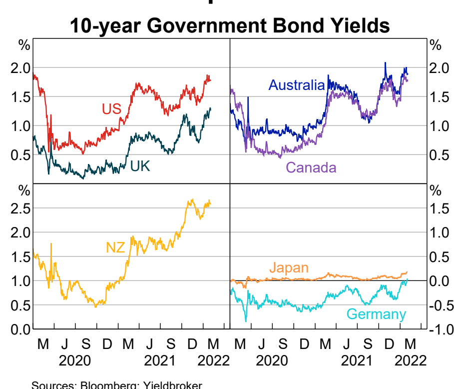
Beyond those central banks mentioned above, the Fed will consider lifting its policy rate in March, shortly after the time that bond purchases cease. Market pricing suggests that the Fed is expected to raise rates at least four times this year. The BoC is also expected to begin increasing its policy rate from March. The ECB said it is very unlikely that it will raise the policy rate this year, in contrast to market participants' expectations that the ECB will raise rates in the second half of 2022. The Riksbank expects to leave its policy rate unchanged until late 2024. Likewise, market participants expect the BoJ to leave its policy rate unchanged until at least 2025.

Government bond yields have risen notably

Longer-term government bond yields in most advanced economies have risen over recent weeks to be around their highest level since the onset of the pandemic (Graph 1.26). This reflects improved confidence that the effect of the Omicron variant on economic activity will be relatively modest and short lived, as well as the expectations of market participants that the Fed will reduce its asset holdings earlier, and then more rapidly, than previously anticipated. The rise in longer-term yields has not reflected an increase in compensation for inflation (see below). Shorter-term government bond yields have also increased in a number of advanced economies, most notably in the United States and the United Kingdom, alongside a shift higher in market-implied expectations for the path of central bank policy rates (Graph 1.27).

The rise in longer-term yields has primarily reflected a rise in real yields, while longer-term inflation compensation has been steady, and generally remains around the level consistent with central bank inflation targets (Graph 1.28). Even so, real yields remain around historically





low levels across advanced economies and negative in most cases.

Private sector funding conditions have tightened but remain accommodative

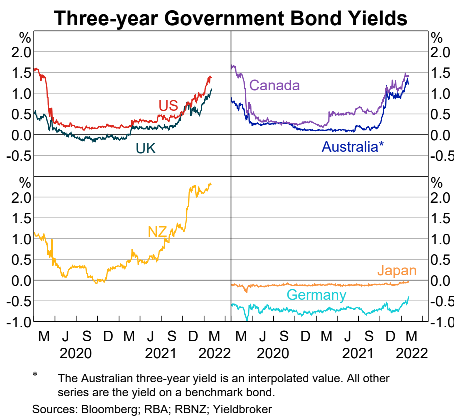
Conditions in corporate bond markets remain accommodative. Over recent months, corporate bond yields have risen a little alongside increases in government bonds yields (Graph 1.29). Credit spreads on sub-investment grade bonds initially increased late last year following the emergence of the Omicron variant, but have since remained steady in the United States and Europe. Corporate default rates have declined to low levels relative to history after rising noticeably through 2020. Corporations continue to take advantage of low borrowing costs and have issued debt at a steady pace in recent months.

Equity prices in most major markets have fallen sharply since early January in response to market participants' expectations that the Fed will cease asset purchases and raise rates sooner than previously expected, as well as rising geopolitical tensions between Ukraine and Russia (Graph 1.30). Share prices of some companies that have had relatively high valuations – including some technology stocks – have been more sensitive to the rise in interest rates, in part because this increases the discount rate applied to their high expected earnings growth. More broadly, initial fourth quarter corporate earnings results have not grown by as much as expected, particularly in the United States where some financial and media companies reported a rise in earnings but by less than market expectations. Equity issuance in the United States and Europe has remained steady in recent months.

The US dollar is little changed

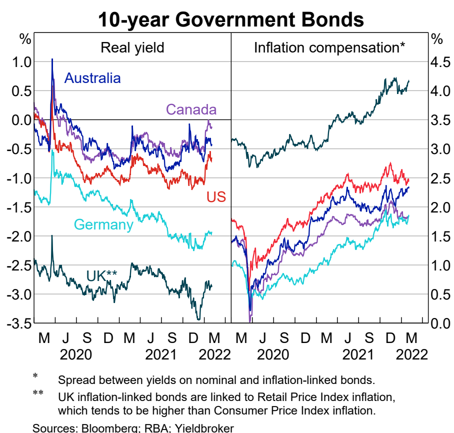
The US dollar has been little changed on a trade-weighted (TWI) basis since early November and is around 3 per cent higher than at the beginning of 2021 (Graph 1.31). The euro has

Graph 1.27



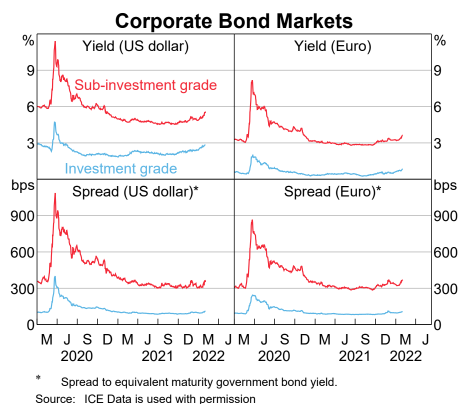
* The Australian three-year yield is an interpolated value. All other series are the yield on a benchmark bond.
Sources: Bloomberg; RBA; RBNZ; Yieldbroker

Graph 1.28



* Spread between yields on nominal and inflation-linked bonds.
** UK inflation-linked bonds are linked to Retail Price Index inflation, which tends to be higher than Consumer Price Index inflation.
Sources: Bloomberg; RBA; Yieldbroker

Graph 1.29



* Spread to equivalent maturity government bond yield.
Source: ICE Data is used with permission

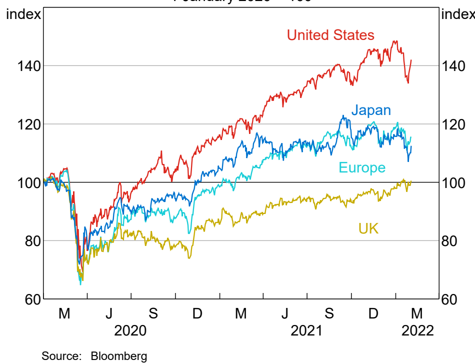
depreciated on a TWI basis over the past three months. The UK pound appreciated on a TWI basis following the BoE's decision in December to increase its policy rate. The currencies of other advanced economies, including the Australian dollar, have generally depreciated since November on a TWI basis (see chapter on 'Domestic Financial Conditions' for recent developments in the Australian dollar).

Some emerging market economies outside Asia have continued to tighten monetary policy in response to rising inflation

Some central banks in emerging markets have continued to tighten policy in response to

Graph 1.30

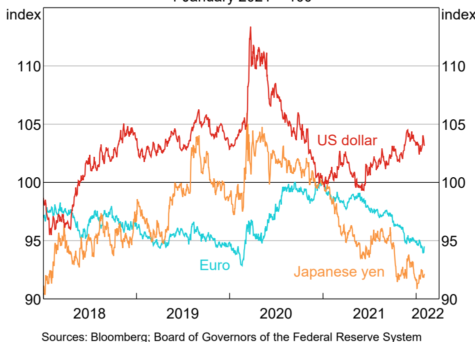
Equity Prices



Source: Bloomberg

Graph 1.31

Trade-weighted Exchange Rates



Sources: Bloomberg; Board of Governors of the Federal Reserve System

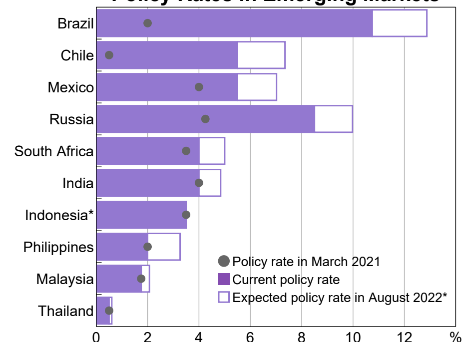
persistently high rates of inflation. A number of central banks, particularly those in Latin America, have increased policy rates several times in recent months. Market pricing suggests that further sizeable policy rate increases are expected across Latin America and emerging Europe, consistent with inflationary pressures and forward guidance from those central banks (Graph 1.32).

Higher policy rates and rising inflation expectations have contributed to an increase in local currency government bond yields and tighter financial conditions more broadly outside Asia (Graph 1.33). Spreads between yields on US-dollar denominated government bonds and US Treasury bonds have also widened amid concerns of rising geopolitical risks and expectations for tighter monetary policy in advanced economies. Equity prices have been little changed, and there have been net portfolio outflows from emerging market bond and equity funds, particularly from Latin America.

By contrast, inflationary pressures have been limited in middle-income economies in Asia, which has allowed the central banks of the Philippines, Thailand, Malaysia and Indonesia to leave policy rates unchanged. Most central banks across the region continue to characterise inflation as subdued or transitory, although

Graph 1.32

Policy Rates in Emerging Markets



* Based on market-implied policy rate paths; expected policy rate unavailable for Indonesia.

Sources: Bloomberg; Refinitiv

some have noted risks to inflation are now tilted to the upside. Market-implied paths of policy rates in Asia have been little changed and continue to indicate that some central banks will start raising rates gradually this year. Financial conditions have remained broadly unchanged in the region, and net portfolio inflows have continued.

Despite changes in market expectations for the policy outlook in advanced economies, the currencies of most emerging market economies have been little changed against the US dollar since the November *Statement*.

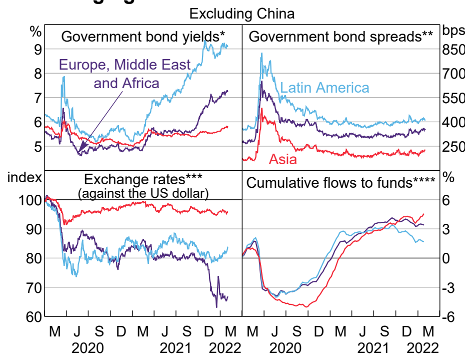
Financial stress in Turkey has so far had limited spillover effects on other economies

In contrast to other emerging market central banks, the Central Bank of the Republic of Turkey (CBRT) has lowered its policy rate by 500 basis points since August 2021 even though inflation is well above target and has continued to increase, taking the real interest rate deeply negative (Graph 1.34). The Turkish lira has depreciated by around 45 per cent against the US dollar since the beginning of 2021, despite CBRT intervention in the foreign exchange market. In response to the sharp depreciation, the Turkish Government introduced measures to compensate households and businesses holding liras for further depreciation in the currency.

Financial stress in Turkey has not spread to other emerging markets. Direct exposures to Turkish assets by foreign investors and banks is limited. The Spanish banking system is most exposed but these claims account for only 3 per cent of Spanish banks' total foreign claims. Share prices of Spanish banks with Turkish exposures initially fell as volatility in the lira increased, but have since risen in line with other European banking stocks. ✠

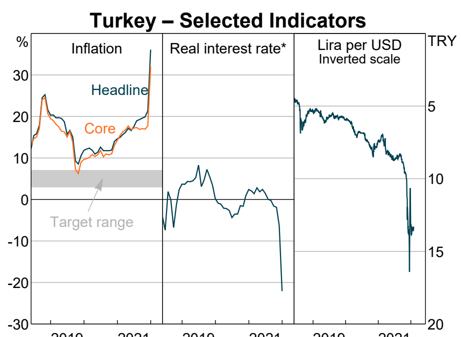
Graph 1.33

Emerging Markets – Financial Conditions



* Local currency bonds, weighted by market value.
** US-dollar denominated bonds; spreads to equivalent US Treasury.
*** 1 January 2020 = 100.
**** Per cent of assets under management; includes flows to bond and equity funds.
Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 1.34



* Constructed by subtracting headline inflation from the policy rate (one-week repo rate).
Sources: Bloomberg; Refinitiv