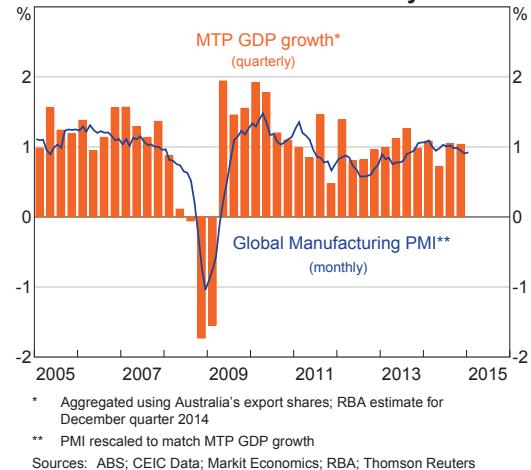


1. International Economic Developments

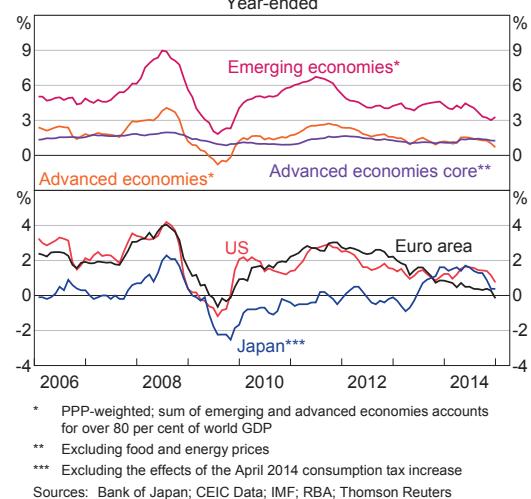
Overall, growth of Australia's major trading partners (MTPs) was around its long-run average in 2014. Global PMIs have moderated a little recently, but still point to MTP growth continuing at around its average pace in the near term (Graph 1.1). Prices of a range of commodities have fallen over the past six months. This largely reflects an increase in global supply, in response to commodity prices having risen to historically high levels over more than a decade. However, in recent months, weaker-than-expected growth in global demand for some commodities is also likely to have been a factor. Most notably, there has been a gradual easing in the growth of demand for commodities in China, which accounts for a large share of internationally traded commodities and of Australia's resource exports. A decline in the growth in Chinese steel production has contributed to falling iron ore prices, which are particularly relevant to the current conjuncture and forecasts of the Australian economy (see 'Box A: The Effects of Changes in Iron Ore Prices').

Growth in the rest of east Asia has also eased a little while the Japanese economy has been weaker than expected. Growth in the euro area has been modest but the US economy has been growing at an above-trend pace over recent quarters. The sharp fall in oil prices since September 2014 is expected to provide additional support to growth in most of Australia's major trading partners given that they are net energy importers (see 'Box C: The Effects of the Fall in Oil Prices'). Lower oil prices are also putting downward pressure on global inflation (Graph 1.2).

Graph 1.1
Global Economic Activity



Graph 1.2
Global Inflation
Year-ended

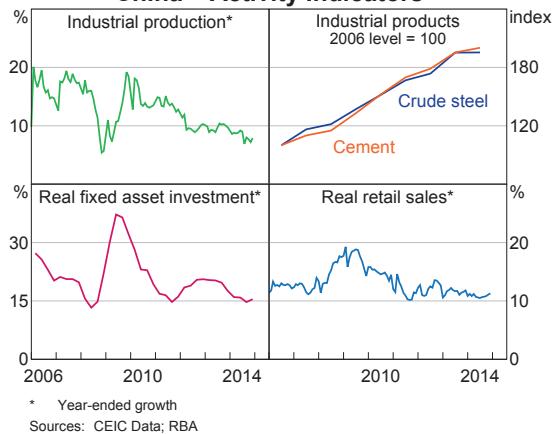


Asia-Pacific

In China, economic growth has eased a little but was still very close to the authorities' target for 2014. GDP increased by 1.5 per cent in the December quarter, to be 7.4 per cent higher in 2014 (Graph 1.3). Consumption expenditure has accounted for around half of this growth in the past year, consistent with the resilient growth of retail sales (Graph 1.4). Growth of real fixed asset investment – which contributes significantly to the demand for commodities – moderated in 2014, particularly for manufacturing and real estate investment. In contrast, infrastructure investment growth has remained elevated, and the authorities have signalled that this type of investment will continue to be strong in 2015, particularly in utilities, clean energy, oil and gas pipelines, and healthcare infrastructure. Growth of industrial production has also moderated over the past year. Weak conditions in the property market have affected the output of construction-related industrial products; growth of crude steel and cement production, in particular, look to have slowed noticeably in 2014.

Conditions in the Chinese residential property market remain subdued. Prices and sales volumes have continued to fall in recent months, although the rate of decline has moderated following the easing of house purchase restrictions and the introduction

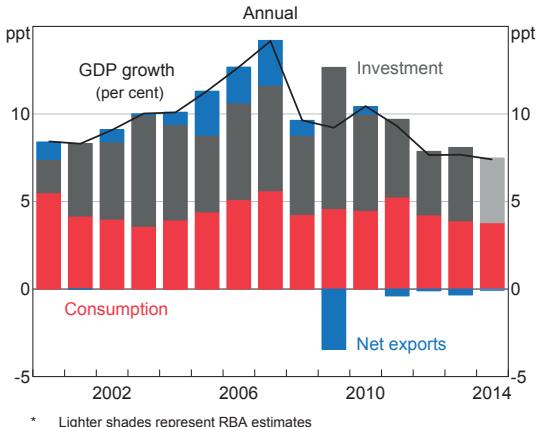
Graph 1.4
China – Activity Indicators



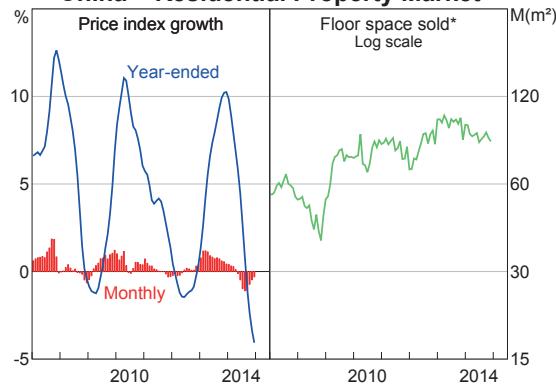
of measures to support the market (Graph 1.5). There is evidence that part of the earlier reduction in the floor on mortgage rates has been passed through to the majority of home buyers, and some jurisdictions have introduced additional measures to encourage property sales. Growth of real estate investment has weakened in recent months but the level is likely to be supported by further construction of social housing; the government has announced a target of 4.8 million completions in 2015, which is comparable to the target for 2014.

The flow of total social financing has increased in recent months, with increases in both bank loans and other financing. While non-bank and off-balance

Graph 1.3
China – Contributions to GDP Growth*



Graph 1.5
China – Residential Property Market



sheet financing increased in the December quarter, they have moderated over the past year, which is consistent with policy changes designed to reduce their share in overall financing activity (Graph 1.6). Growth of trust loans and bank accepted bills – which have contributed significantly to growth in non-bank and off-balance sheet financing in recent years – has slowed noticeably over the past 12 months.

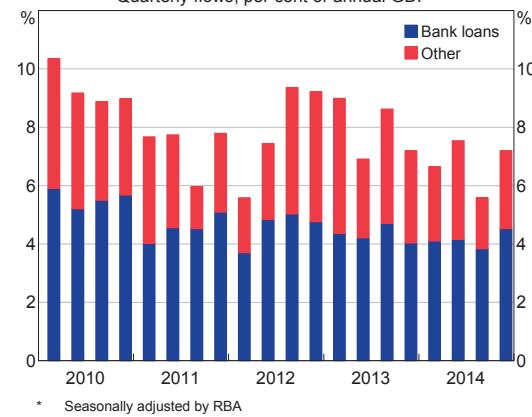
The People's Bank of China (PBC) cut benchmark interest rates in November and injected liquidity through a range of lending facilities. In early February, the PBC cut the reserve requirement ratio by 50 basis points, with additional cuts for institutions focused on lending to the agricultural sector and smaller firms. This is likely to provide some offset to the effects of modestly higher real interest rates (which have come about via lower inflation) and restrictions on the growth of non-bank and off-balance sheet financing activity. The move is also likely to provide some offset to the reduced pace of reserve accumulation in recent months (see the 'International and Foreign Exchange Markets' chapter).

Chinese exports increased substantially in 2014, although growth eased towards the end of the year (Graph 1.7). Growth in imports has also moderated, consistent with slower growth of investment. Following a sharp increase in iron ore imports over the year to June 2014 (much of which was sourced from Australia), iron ore imports have been little changed over the past six months.

Inflationary pressures in China remain weak. CPI inflation was well below the authorities' target of 3.5 per cent in 2014 (Graph 1.8). Non-food inflation has eased in recent months. Producer prices have been falling in year-ended terms for almost three years, consistent with widespread reports of manufacturing overcapacity and declining commodity prices. To date, the impact of lower oil prices has been more pronounced for producer prices than consumer prices. This reflects the much smaller weight of petrol prices in the CPI, as well as administrative controls on retail petrol prices and several increases in the fuel consumption tax since November.

Graph 1.6
China – Total Social Financing

Quarterly flows, per cent of annual GDP*

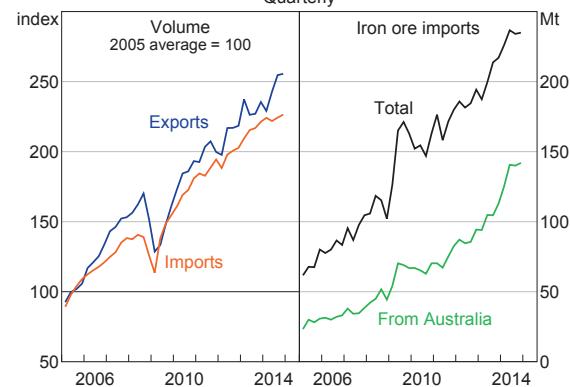


* Seasonally adjusted by RBA

Sources: CEIC Data; RBA

Graph 1.7
China – Merchandise Trade*

Quarterly

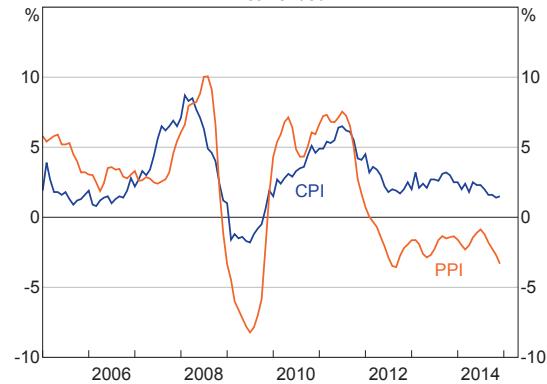


* Seasonally adjusted by RBA

Sources: CEIC Data; RBA

Graph 1.8
China – Inflation

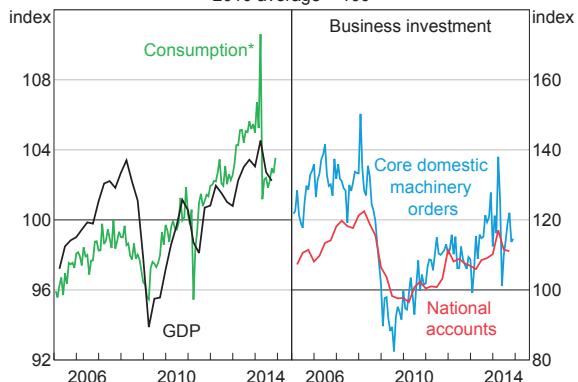
Year-ended



Sources: CEIC Data; RBA

In Japan, economic activity has been weaker than expected since the increase in the consumption tax in April last year. Growth looks to have resumed in the December quarter, following significant declines in output in the previous two quarters. Industrial production and consumption indicators picked up in the December quarter, and increases in machinery orders over the past six months suggest that business investment is likely to increase in the December quarter (Graph 1.9). Export volumes also picked up in the December quarter, following little growth over the previous 12 months. Japan's recently re-elected government has delayed the second increase in the consumption tax until April 2017 and announced additional temporary fiscal stimulus measures in response to weaker-than-expected economic activity.

Graph 1.9
Japan – Economic Indicators
2010 average = 100



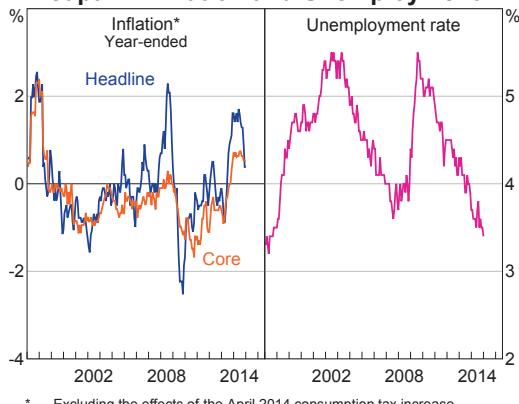
* The Cabinet Office's monthly measure of real private consumption

Sources: CEIC Data; Thomson Reuters

Inflation in Japan picked up in mid 2013, largely as a result of higher import prices following the earlier depreciation of the yen from late 2012. But as the effects of the earlier depreciation have faded and oil prices have fallen, inflation has eased over the past few months (Graph 1.10). Market measures of medium- and long-term inflation expectations have eased back to around 1 per cent.

Meanwhile, the Japanese labour market remains tight. The unemployment rate is around its lowest

Graph 1.10
Japan – Inflation and Unemployment



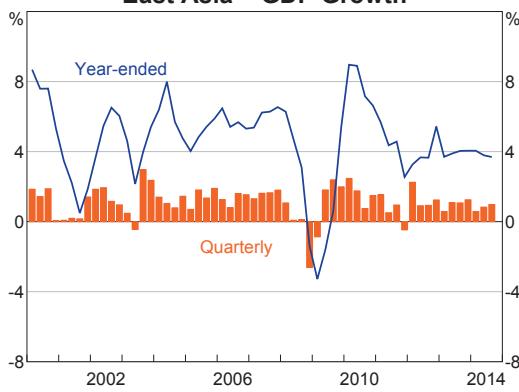
* Excluding the effects of the April 2014 consumption tax increase

Sources: Bank of Japan; RBA; Thomson Reuters

level in 17 years, and the ratio of job vacancies to applicants is high. Reflecting this tightness, wages have recently picked up a little, although they have not kept pace with the increase in prices over 2014. The government recently announced that it will lower the corporate tax rate over the next few years, and that it anticipates this will give companies scope to increase wages.

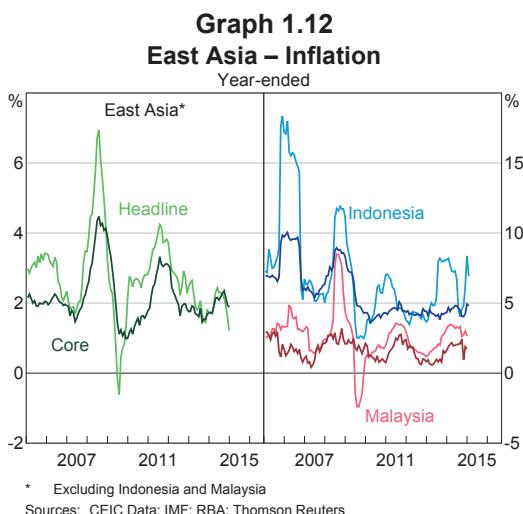
In the rest of east Asia, the pace of growth over 2014 was a little slower than in recent years (Graph 1.11). Growth in the December quarter slowed in Korea, picked up in Taiwan and remained relatively strong in the Philippines. Overall, the region is a net importer of oil, so activity will benefit from the decline in oil prices (see 'Box C: The Effects of the Fall in Oil Prices').

Graph 1.11
East Asia – GDP Growth



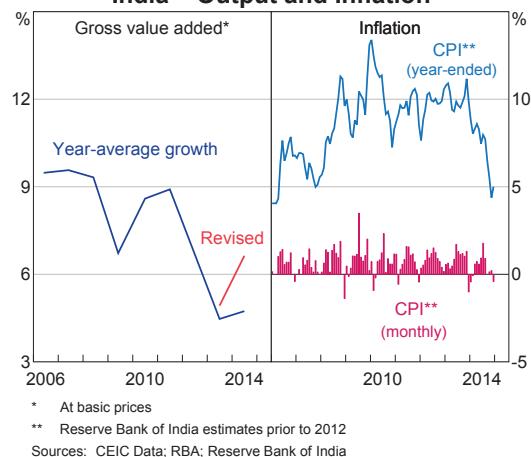
Sources: CEIC Data; IMF; RBA

In general, falling global oil prices have led to declines in headline inflation across the region (Graph 1.12). The exceptions are Indonesia and Malaysia where consumer prices have risen in response to reductions in government fuel subsidies. These actions will ease pressure on both governments' budgets and leave them less exposed to future increases in world oil prices.



In India, economic growth has picked up over the past couple of years. Revisions to national accounts data point to more of an improvement than had been implied by earlier estimates (Graph 1.13). Investment growth has been quite volatile for some time, but in recent months a number of new investment projects have been announced by both the government and the private sector. There is some evidence that the government is beginning to make progress on a range of reform initiatives. Areas of focus include introducing a national goods and services tax, raising foreign investment limits in the insurance sector, making it easier to purchase land and improving transport and energy infrastructure. Meanwhile, inflation has continued to moderate in recent months, largely due to lower food and oil prices, although underlying inflation has also eased. The rate of consumer price inflation in December was well below the Reserve Bank of India's goal,

**Graph 1.13
India – Output and Inflation**



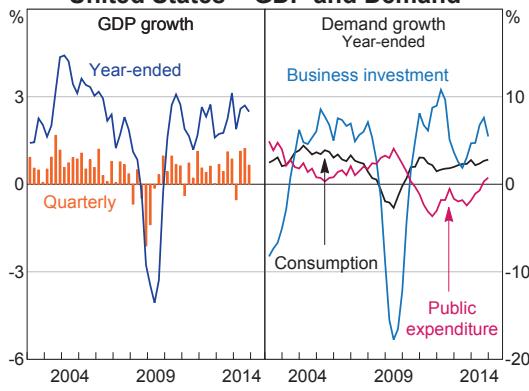
prompting it to ease policy in mid January, although inflation is expected to rise somewhat in year-ended terms given the low outcomes in early 2014.

New Zealand's economy has experienced strong growth of domestic demand, particularly private investment, which has been supported by rebuilding following the Canterbury earthquakes of 2010 and 2011. The Reserve Bank of New Zealand has responded by raising the cash rate by 100 basis points over 2014. Labour market conditions have strengthened in recent quarters, although wage and price inflation remain subdued. Despite the fall in New Zealand's commodity export prices, the New Zealand dollar exchange rate has remained elevated.

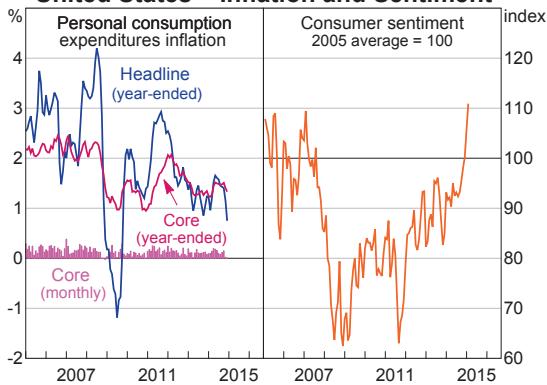
United States

The US economy has strengthened recently, with output growing above its trend pace over the second half of 2014. Growth of consumer and business spending have led the pick-up, while public expenditure increased modestly over 2014, after detracting from GDP growth since 2010 (Graph 1.14). Residential investment remains very low as a share of GDP.

Falling energy prices have lowered headline inflation in the United States and boosted real household incomes (Graph 1.15). The Federal Reserve has

Graph 1.14**United States – GDP and Demand**

Source: Thomson Reuters

Graph 1.15
United States – Inflation and Sentiment

Source: Thomson Reuters

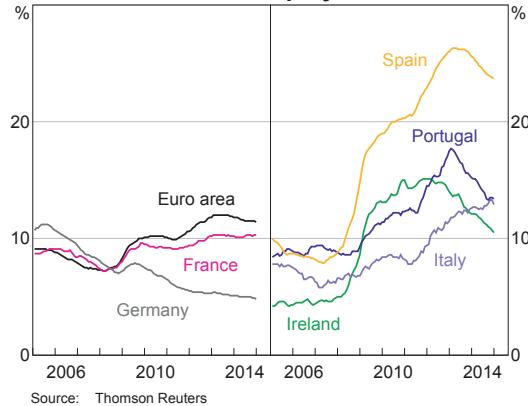
indicated that it will look through oil-related falls in headline inflation; core inflation over the year to December 2014 was 1.3 per cent. Lower gasoline prices and ongoing strength in labour market outcomes appear to have contributed to a sharp rise in consumer sentiment over the past few months, following an increasing trend over the past few years. The pace of job creation has picked up further and the unemployment rate declined to 5.6 per cent in December. Wage growth, as measured by the employment cost index, has picked up to be slightly below its long-run average since the middle of last year.

Survey-based measures of business activity improved over most of 2014 and remain above

average, despite declining a little around the turn of the year. In line with this, growth of industrial production has picked up in recent months and over 2014 recorded its fastest pace in four years.

Europe

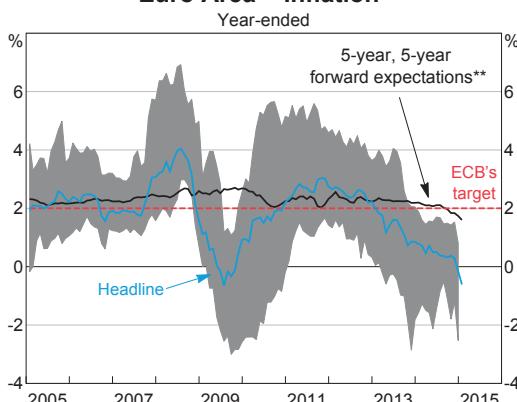
In the euro area, economic activity continues to recover slowly. GDP grew for six consecutive quarters to the September quarter 2014, but the cumulative expansion over this period was only 1.3 per cent. Timely indicators, including the PMIs, have softened a little over the past couple of months but are still consistent with modest growth. The unemployment rate has declined by around $\frac{1}{2}$ percentage point from its peak of 12 per cent in late 2013 (Graph 1.16). Some of that decline has been associated with declining participation rates in most economies in the region. Nevertheless, in some economies – particularly Spain, Portugal and Ireland – GDP growth has been above trend and employment growth has lifted, so they have seen more marked declines in their unemployment rates, albeit from high levels.

Graph 1.16
Euro Area – Unemployment Rates

Source: Thomson Reuters

Consumer prices declined over the year to January (Graph 1.17). This was partly the result of falling oil prices, although core inflation of 0.6 per cent is also well below the European Central Bank's (ECB's) target. Long-term inflation expectations have declined by around $\frac{1}{2}$ percentage point over the past six months. The ECB responded to low inflation and declining

Graph 1.17
Euro Area – Inflation*



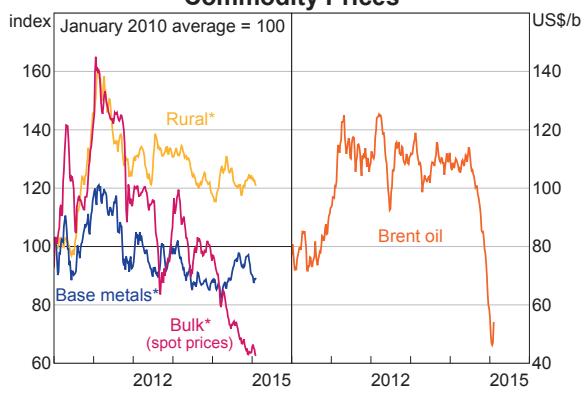
* Shaded area represents range of individual euro area economies
** Inflation expectations from inflation swaps for 5–10 years into the future
Sources: Bloomberg; RBA; Thomson Reuters

inflation expectations by announcing an expanded asset purchase program at its recent meeting (see the 'International and Foreign Exchange Markets' chapter).

Commodity Prices

The RBA index of commodity prices (ICP) continued to decline in recent months, driven by substantial falls in the prices of iron ore and oil (Table 1.1; Graph 1.18). Falling iron ore prices underpinned a

Graph 1.18
Commodity Prices



* RBA ICP sub-indices, SDR
Sources: Bloomberg; RBA

4 per cent decline in the Australian terms of trade in the September quarter.

Increases in the global supply of iron ore, together with weaker growth in demand from China, have led to a decline in the spot price of iron ore of around 50 per cent over the past year (in US dollar terms; Graph 1.19). The decline in iron ore prices has coincided with a period of slowing growth of global steel production. At the current spot price of around US\$60 per tonne, most Australian iron ore

Table 1.1: Commodity Price Growth^(a)
SDR, 3-month-average prices, per cent

	Since previous Statement	Contribution to change since previous Statement ^(b)	Over the past year
Bulk commodities	-6	-3.5	-34
– Iron ore	-12	-3.9	-45
– Coking coal	4	0.6	-12
– Thermal coal	-2	-0.2	-20
Rural	2	0.3	4
Base metals	-3	-0.2	6
Gold	1	0.1	4
Brent oil ^(c)	-35	-2.0	-44
RBA ICP	-5	-	-20
– using spot prices for bulk commodities	-5	-	-20

(a) Prices from the RBA index of commodity prices (ICP); bulk commodities prices are spot prices

(b) Contributions (in percentage points) do not sum to total change in RBA ICP because not all components are included in the table

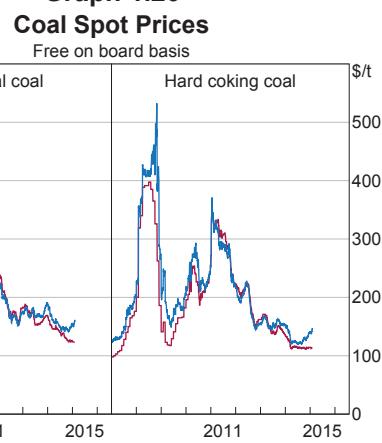
(c) In US dollars

Sources: Bloomberg; IHS Energy Publishing; RBA

Graph 1.19



Graph 1.20



production is estimated to be profitable. Indeed, some of the impact of declining prices on mining company margins has been offset by the recent depreciation of the exchange rate (see 'Box A: The Effects of Changes in Iron Ore Prices'). In addition, the declining oil price has helped to reduce the cost of extracting and shipping iron ore. To date, there has only been a limited response of global supply to lower prices, despite estimates suggesting that a significant share of global production is unprofitable at current prices. In China, data suggest that there has been a modest decline in iron ore production in recent months.

The spot price of coking coal has been little changed over recent months and remains around its lowest level since 2007 (Graph 1.20). In contrast, thermal coal prices have continued to drift lower. The decline in thermal coal prices over the past year largely reflects new capacity expansions, together with weaker demand growth. At current prices, a substantial share of global coal production is likely to be unprofitable. In response, some companies have opted to close mines (including several coal mines in North America and some smaller, higher-cost mines in Australia) or reduce production. In addition, a number of potential projects have been delayed. As with iron ore, the depreciation of the Australian

dollar will offset some of the impact of declining prices for Australian producers. Bank liaison suggests that mining companies are increasingly focused on reducing costs, including through lowering labour costs and increasing productivity.

The Brent oil price has now fallen to a bit above US\$50 per barrel, and is around its lowest level since early 2009. Strong growth in 'unconventional' oil supply from the United States and resilient OPEC production have pushed down prices (see 'Box C: The Effects of the Fall in Oil Prices'). At current prices, higher-cost oil producers, particularly some of those using unconventional sources in North America, are likely to be unprofitable. Weaker-than-expected growth of demand has also contributed to the decline in oil prices. The sharp fall in crude oil prices is expected, in time, to feed through to the prices received by Australian liquefied natural gas (LNG) producers, given that most LNG contracts are linked to the price of oil.

Base metal prices have decreased on average in the past three months, reflecting revisions to prospects for global economic growth, notably for China. Prices have declined particularly sharply for copper and nickel. ☐