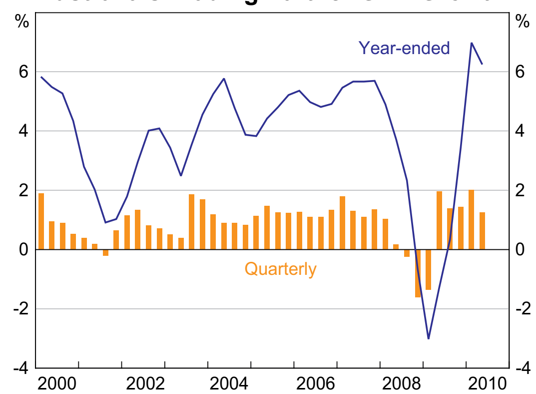
International Economic Developments

The recovery in the world economy continued in the June quarter, including in Europe where available data suggest activity accelerated after a half year of little growth. GDP growth in Australia's major trading partners is estimated to have been around 1¼ per cent in the June quarter and a robust 6 per cent over the year, a stronger outcome than had been expected earlier (Graph 1). However, uncertainty about the future pace of global expansion has increased since the May *Statement*, due chiefly to increasing concern about the fiscal positions of a range of advanced economies, and the associated decisions by various governments to commence or accelerate fiscal consolidation. In addition, growth is moderating in east Asia to more sustainable rates following the V-shaped recovery over the preceding year. Global industrial production has continued to expand at a robust rate (Graph 2).

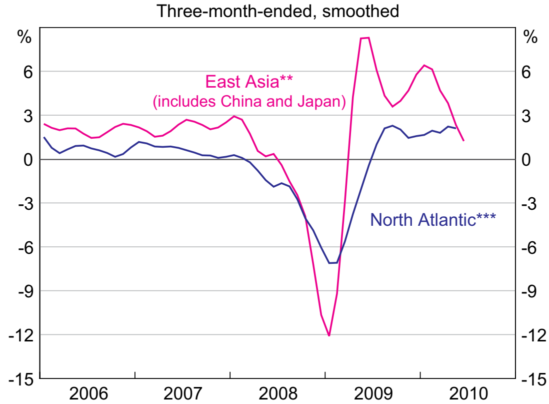
While the recent economic data in Europe have been better than earlier in the year, concerns about medium-term fiscal sustainability increased significantly over recent months. In an effort to address these concerns, a large number of European governments have recently announced fiscal consolidation programs of varying degrees of austerity, as discussed further in 'Box A: Public Finances in Europe'. This represents a marked shift in attitude from earlier this year, when most of these governments were indicating a preference to wait until the recovery was more firmly entrenched before commencing discretionary tightening. The announced programs are expected to exert downward pressure on aggregate demand in the euro area, through weaker public spending and

Graph 1
Australia's Trading Partner GDP Growth*



* Weighted using merchandise export shares at market exchange rates; RBA estimates for June quarter 2010
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2
Industrial Production Growth*
Three-month-ended, smoothed

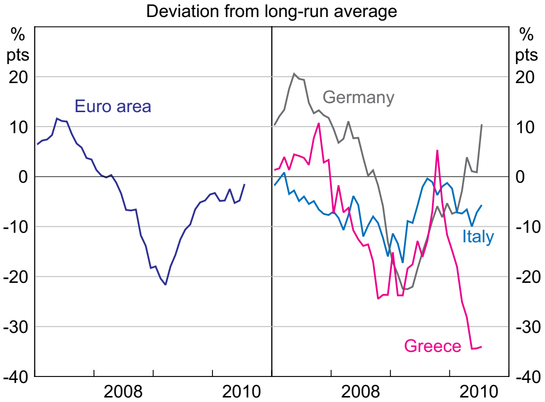


* Aggregated using shares of world output at market exchange rates
** RBA estimates for June 2010
*** Canada, euro area, the UK and US
Sources: CEIC; RBA; Thomson Reuters

reduced transfers. Given the timing of the announced measures, and the ongoing impact of some previously enacted stimulus measures, the direct effect of discretionary fiscal changes on demand and output growth is expected to be modest in 2010 for the euro area as a whole (although substantial for some countries), but to build in 2011 and 2012. This dampening influence should be partly offset by a boost to external demand from the depreciation of the euro over the past year.

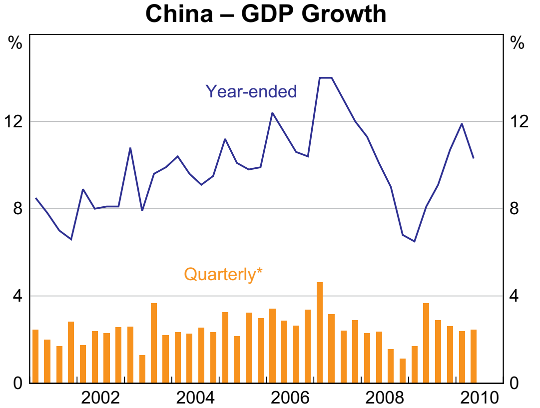
In moving to a tighter fiscal policy than previously planned, European governments are seeking to strike a delicate balance. On the one hand, in a number of cases failure to begin consolidation risked a further loss of market confidence, with potentially large downside consequences. On the other hand, with household spending in Europe still weak, overly rapid fiscal retrenchment could be counterproductive if it were to depress demand and weaken growth significantly.

Graph 3
Euro Area – Consumer Sentiment
Deviation from long-run average



Source: Thomson Reuters

Graph 4
China – GDP Growth



* RBA estimates
Sources: CEIC; RBA

At this stage it is too early to tell what the impact of the recent market uncertainty and policy announcements will be on the euro area economy. However, euro area sentiment measures have thus far held up well, even though there has been some deterioration in the more forward-looking components relating to the general economic situation. Consumer confidence is at an extremely low level in Greece, and has fallen somewhat in France, Italy and Spain since the start of the year, but the declines in these countries have been limited and confidence has picked up strongly in Germany (Graph 3). As a result, aggregate consumer sentiment for the region has risen slightly since the start of the year, while industrial sentiment has continued to improve to above-average levels.

The recent resilience of consumer and business sentiment in the euro area partly reflects the momentum in activity that was beginning to build in some countries in the region prior to the heightening of concerns over the fiscal situation and associated response by governments. Available indicators suggest that output growth was firm in the June quarter, especially in Germany. Both industrial production and exports appear to have risen strongly in the quarter, while indicators of equipment investment increased solidly. Likewise, in the United Kingdom, GDP rose by 1.1 per cent in the quarter, a marked step-up from the pace of expansion seen in the December and March quarters.

Activity in China has been very strong, although there are signs that growth is now slowing to a more sustainable rate. GDP is estimated to have expanded by around 2½ per cent in the June quarter and by 10¼ per cent over the year (Graph 4). The rapid expansion in the economy through 2009 and early 2010 was the result of very stimulatory fiscal and monetary policies, which the Chinese government implemented to counter the effects of the global financial crisis. Over the coming year, fiscal policy is expected to be less expansionary as the stimulus measures wind down, including the increase in the sales tax rate on certain vehicles back to its pre-stimulus level and the expiry of the car scrappage scheme. Monetary policy remains mildly accommodative, with the People's Bank of China maintaining benchmark interest rates at low levels, although the authorities have increased the required reserve ratio by 150 basis points so far this year and credit conditions have been tightened.

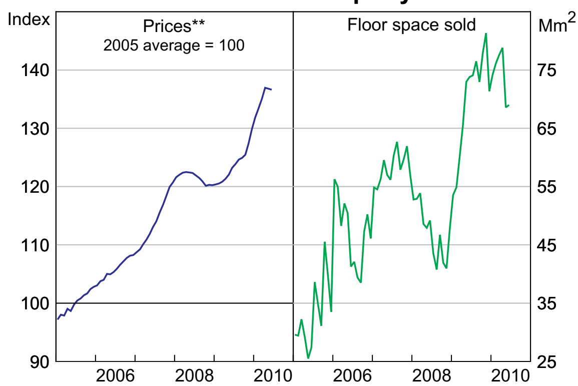
The recent moderation in growth appears to have been broadly based although activity in secondary industry (mostly manufacturing and construction) has decelerated noticeably. Data for industrial production show a marked slowing since the surge in March, consistent with the slowing in manufacturing investment. The PMI data for China, which earlier this year were at very strong levels, also suggest some moderation in growth.

The policy measures adopted by the authorities in China to address developments in the property market look to be having the desired effect of cooling the high end of the property market. Monthly growth in residential property prices, as measured by the National Bureau of Statistics, has slowed since April, with average nationwide prices estimated to have fallen slightly in June (Graph 5). There has also been a noticeable decline in turnover in the residential property market, with monthly sales of residential floor space having fallen by 12 per cent since April when the most recent set of measures was introduced. In cities such as Beijing, where local governments have implemented additional measures to cool their local property markets, turnover has fallen by around 40 per cent. New construction activity looks to be slowing, although the government has taken steps to boost construction of housing for lower-income households.

In contrast to some slowing in the production indicators, growth in household consumption and infrastructure spending has been strong (Graph 6). Real retail sales grew by 15 per cent over the year to June, with continued growth expected to be underpinned by rising wages. Recent months have seen large increases in minimum and other wages in many parts of China. While this partly represents compensation for wage freezes through 2009, it is also consistent with some structural adjustment towards higher real wages and higher household consumption as a share of GDP. Investment in infrastructure also remains strong, despite growth

Graph 5

China – Residential Property Market*

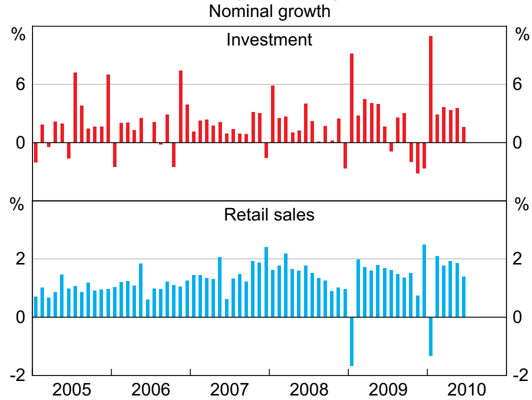


* RBA estimates
** Average of new and existing residential property prices
Sources: CEIC; RBA

Graph 6

China – Monthly Activity Indicators*

Nominal growth



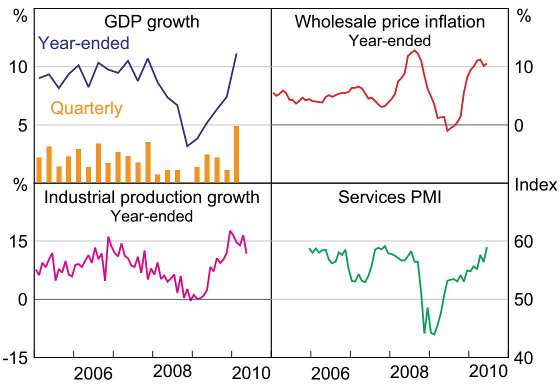
* RBA estimates
Sources: CEIC; RBA

slowing from its extraordinary pace through 2009, with a sizeable pipeline of work still outstanding.

China's export growth has also been robust, with volumes increasing by around 10 per cent over the six months to June. Growth has been broad-based, with exports to the European Union and the United States surprisingly strong. Nevertheless, the subdued outlook for activity in the major advanced economies may see some slowing in export growth over the period ahead.

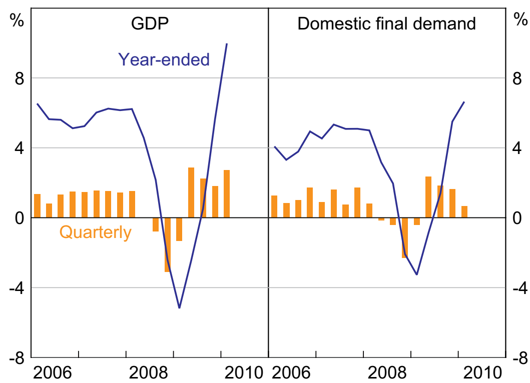
Economic conditions in India remain robust, although they look to have softened in some sectors. GDP at market prices grew very strongly in the March quarter to be 11 per cent higher over the year (Graph 7). Much of the growth in the quarter was

Graph 7
India – Economic Indicators



Sources: CEIC; JPMorgan Chase & Co. and Markit; RBA

Graph 8
East Asia* – GDP and Demand Growth



* Excludes China and Japan
Source: CEIC

due to private investment, associated with strength in construction activity. In contrast, conditions in the manufacturing sector have softened over the first half of 2010, with industrial production having fallen since the beginning of the year. This is consistent with softer merchandise exports, which were also broadly unchanged over the first half of the year after growing strongly in late 2009. The services PMI for June, however, suggests that conditions in the services sector – the largest sector of the Indian economy – remain firm.

The strong growth in India has been associated with a pick-up in the inflation rate, with year-ended wholesale price inflation hovering around 10 per cent since the beginning of the year. Although food prices have contributed to higher inflation, price pressures have been widespread, with year-ended growth in non-food manufactured prices rising to around 7 per cent. Citing inflation concerns, the Reserve Bank of India has increased its policy rates by 75-100 basis points and its cash reserve ratio by 100 basis points since January.

In east Asia (excluding China and Japan) growth appears to be moderating to more sustainable quarterly rates, after a year of very rapid expansion. Output growth was strong in the March quarter – exceeding 1¼ per cent in all of the ASEAN-4 and higher-income economies, and double that pace in four economies (the Philippines, Singapore, Taiwan and Thailand). However, the proportion of this strong growth attributable to inventory rebuilding was unusually large for this stage of the cycle. Quarterly domestic final demand growth, by contrast, continued its moderation since mid 2009 in the March quarter, with growth of around ¾ per cent for the region as a whole (Graph 8).

In recent months, overall growth in industrial production and exports has been solid, although outcomes have been mixed across countries. Excluding Singapore, industrial production in the region was little changed over April and May – partly due to a notable fall in production in Thailand associated with unrest in the country during this period – but available data suggest a firm increase in June. In Singapore, industrial output soared by 16 per cent in the June quarter – contributing to a second consecutive quarter of exceptionally rapid GDP growth according to the advance estimate. In Korea, GDP growth eased somewhat but remained robust in the June quarter, with the quarterly rise of 1½ per cent driven by strength in the manufacturing and services sectors.

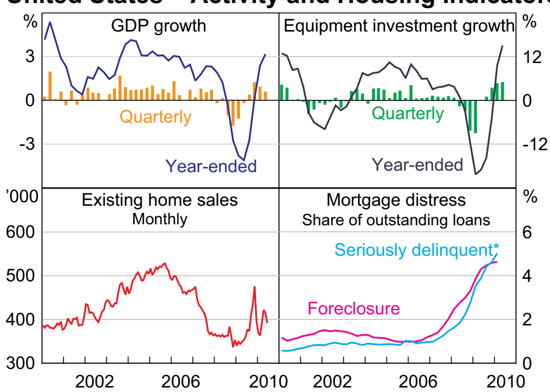
Japanese output also appears to have increased in the June quarter but at a more moderate pace than in the preceding half year, when quarterly expansions in excess of 1 per cent were recorded. Export growth was robust in the quarter, consumer confidence has continued to rise, and business surveys remain modestly positive (although the latest Tankan survey suggests conditions for non-manufacturing firms are still subdued). Indicators of labour market conditions, however, have become more mixed in recent months after earlier improvement. Housing starts also remain depressed, and the Cabinet Office's monthly consumption indicator points to more moderate household spending growth after several quarters of solid increases in purchases (especially of large durable goods).

In the United States, the recovery continued in the June quarter at a solid pace. Output rose by 0.6 per cent, to be 3¼ per cent higher over the year, but the level of GDP was still around 1 per cent below its previous peak recorded in late 2007 (Graph 9). Equipment investment again contributed strongly to growth, driven by the continuing need for firms to renew or replace equipment following the period of very weak investment in 2008 and early 2009. Robust growth in spending by firms also reflects positive business conditions, as measured by the manufacturing and non-manufacturing ISMs, and strong profitability in the first half of the year. For a number of sectors, however, the current environment remains difficult. Non-residential construction is still weak despite a modest rise in the June quarter, and builders report ongoing difficulties in obtaining credit. Small businesses, which account for 60 per cent of gross job creation in the United States, also report that they continue to face weak demand and restrictive credit conditions.

Household consumption grew at a moderate pace in the June quarter, but downward revisions have noticeably weakened the profile of consumption over the past three years, so that it is still some way below its late-2007 quarterly peak. The household saving rate has been revised up substantially, to stand above 6 per cent in the quarter, its highest level since the early 1990s (abstracting from the spike in the June quarter 2009 associated with the one-off payments and tax cuts put in place as part of the 2009 stimulus package). Retail sales values fell in May and June, and renewed weakness in the housing market may also weigh on household demand over coming months through confidence and wealth effects. Following the expiry of the federal government's home-buyer tax credit at the end of April, monthly existing home sales fell in May and June. The proportion of home loans in foreclosure also continues to rise, despite evidence of greater forbearance by lenders before foreclosing on seriously delinquent borrowers.

Graph 9

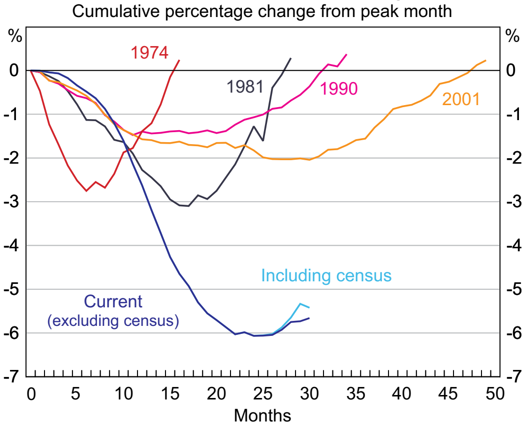
United States – Activity and Housing Indicators



* 90 days or more past due
Source: Thomson Reuters

While conditions in the labour market have improved from those prevailing last year, firm growth in output is yet to translate to a significant bounce-back in employment. Private payrolls rose by less than 100 000 jobs per month in the first half of the year, with only 60 000 jobs added on average in May and June. Total payrolls were boosted in the three months to May by government hiring associated with the running of the ten-yearly census, which generated over half a million short-term jobs, but the bulk of these jobs have now come to an end (Graph 10). Near-term indicators of labour market conditions are mixed. The employment component of the manufacturing ISM continues to be strong, but weekly initial jobless claims remain elevated and the median duration of unemployment is very high.

Graph 10
United States – Non-farm Payrolls
Cumulative percentage change from peak month



Sources: Bureau of Labor Statistics; Thomson Reuters

Overall, despite signs of some moderation in the outlook for global growth in the near term, official forecasts for growth in 2010 have been revised upwards since the May *Statement* – reflecting both the exceptionally strong GDP outcomes recorded in many Asian economies in the March quarter and the signs of generally solid expansion in most regions in the June quarter. The IMF now expects global output to increase by just over 4½ per cent in 2010 (with countries weighted by GDP at purchasing power parities), 0.4 percentage points stronger than it anticipated in April (Table 1). Year-average growth is then forecast to ease slightly in 2011 to around 4¼ per cent, unchanged from April. These forecasts are broadly consistent with those of the Bank for 2010, but somewhat stronger than the Bank's forecast for 2011, as discussed further in the 'Economic Outlook' chapter.

Table 1: World GDP Growth
Year-average, per cent[(a)]

	2008	2009	2010	2011
			IMF forecasts[(b)]	
United States	0.0	–2.6	3.3	2.9
Euro area	0.6	–4.1	1.0	1.3
Japan	–1.2	–5.2	2.4	1.8
China	9.6	9.1	10.5	9.6
Other east Asia[(c)]	2.8	0.0	6.5	5.0
India	7.4	6.7	9.4	8.4
World	**3.0**	**–0.6**	**4.6**	**4.3**
Australia's trading partners[(d)]	2.7	0.1	5.5	4.7

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Forecasts from the July *World Economic Outlook Update*
(c) Weighted using GDP at market exchange rates
(d) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Reuters

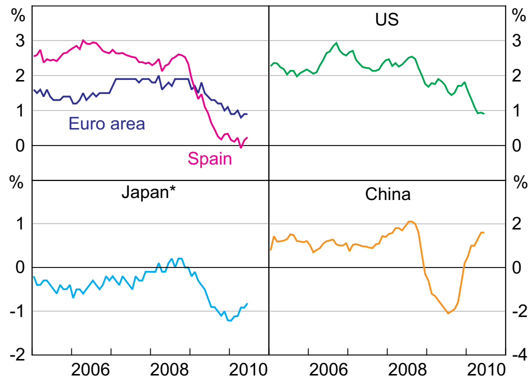
Inflation pressures appear to have eased slightly in east Asia since the May *Statement*, while remaining muted in the large advanced economies. Weak household demand and high levels of spare capacity have seen year-ended core consumer price inflation trend lower in the euro area since late 2008, to be below 1 per cent currently, with noticeably lower outcomes in a number of countries including Spain (Graph 11). To the extent that fiscal consolidation weighs on household confidence and spending, this may place further downward pressure on inflation across the region. Year-ended core consumer price inflation has also fallen below 1 per cent in the United States in recent months.

In Japan, deflation persists although its pace has moderated slightly (after abstracting from the 18 per cent one-time fall in education prices in April associated with the reduction of high school fees by the government). In China, by contrast, year-ended core inflation rose through the second half of 2009 and early 2010. However, inflation has stabilised over the past few months, with core inflation remaining around 1½ per cent over the year to June, which is roughly its average for the years prior to the global downturn. Year-ended headline inflation also appears to have steadied for the present at around 3 per cent, with food prices falling in each of the four months to June.

Commodity Prices

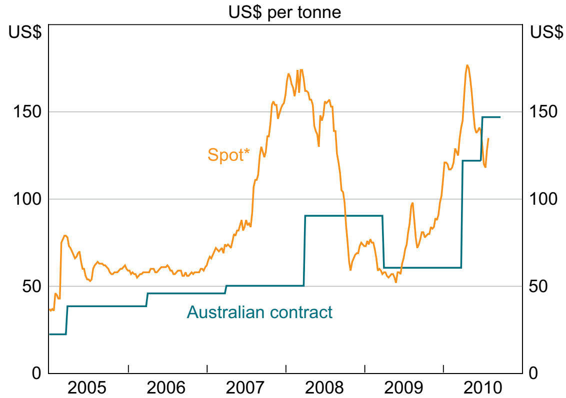
The commodity prices that Australian producers receive have continued to rise in recent months, with large contract price increases in the June quarter for iron ore and coal (Graph 12). Further increases in contract prices are estimated for the September quarter, with iron ore contract prices reaching historically high levels. These increases mean that the contract prices that Australian iron ore and coal producers receive have risen by around 140 and 75 per cent over the past year, reflecting the strong growth in demand from Asia.

Graph 11
Core Consumer Price Inflation
Year-ended



* Excludes impact of policy-induced reduction in school fees in April 2010
Sources: CEIC; RBA; Thomson Reuters

Graph 12
Iron Ore Prices
US$ per tonne



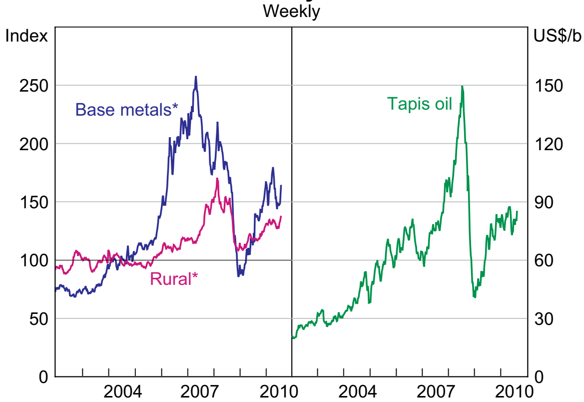
* China landed import price less spot freight rate from Australia to China
Sources: ABARE; Bloomberg; RBA

Table 2: Commodity Price Growth
SDR terms, per cent

	Since end April 2010	Since end July 2009
RBA index	11	54
– Coal and iron ore[(a)]	19	81
– Excluding coal and iron ore	1	28
Rural	3	16
– Wheat	22	5
– Other	–2	20
Base metals	–3	24
Gold	0	27
Tapis crude oil	–3	20

(a) Export prices; RBA estimates for recent months
Sources: Bloomberg; RBA

The sharp rise in bulk commodity contract prices has driven an increase in the RBA's index of commodity prices since the May *Statement* of around 10 per cent, with the index now around 50 per cent above its trough in mid 2009 (Table 2). These increases in commodity prices are feeding through into a significant increase in the terms of trade to a historically high level. The increase in the terms of trade is supporting nominal incomes, as discussed further in the 'Economic Outlook' chapter.



* 2004 average = 100, SDR terms
Sources: Bloomberg; RBA

Spot prices for bulk commodities, which affect contract prices with a lag, have fallen since May, driven by the moderation in growth in China, albeit from a very fast pace. The estimated September quarter contract prices stand at a premium of around 10 per cent relative to recent spot prices for iron ore and coking coal. While spot iron ore and coking coal prices have fallen by around 20 per cent since the May *Statement*, they remain at high levels.

The prices of exchange-traded commodities including crude oil and base metals have also fallen since the May *Statement,* amid greater uncertainty over the global outlook and the broader weakening in financial markets, though they have stabilised more recently (Graph 13). The price of gold has been the exception, being broadly unchanged over the period, underpinned by 'safe haven' demand.

Among the rural commodities, wheat and canola prices have risen strongly as adverse weather conditions in several key northern hemisphere countries have lowered the supply outlook for 2010/11. Sugar prices also increased strongly reflecting some rebuilding of sugar stocks, after weather-related supply disruptions earlier this year.