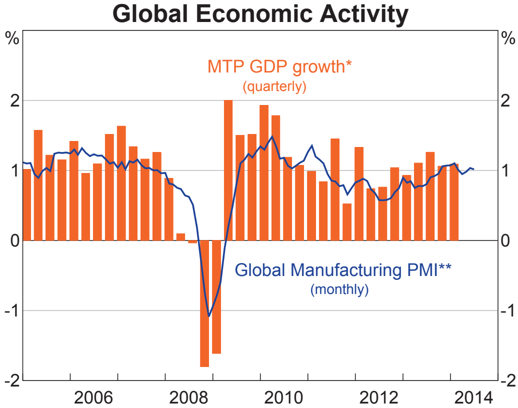
1. International Economic Developments

While there are differences across countries, the pace of economic growth of Australia's major trading partners (MTPs) over the past year has been a little above its historical average (Graph 1.1). Despite this, growth of MTP GDP in the June quarter is likely to have been a little below average as a result of a contraction in Japanese output following the increase in its consumption tax rate in April. At the same time, economic growth in China has picked up, while in the rest of east Asia it has moderated a little from the strong pace seen in late 2013. The US economy is showing signs of returning to moderate growth after an unusually harsh winter, and activity in the euro area is picking up gradually.

Graph 1.1
Global Economic Activity

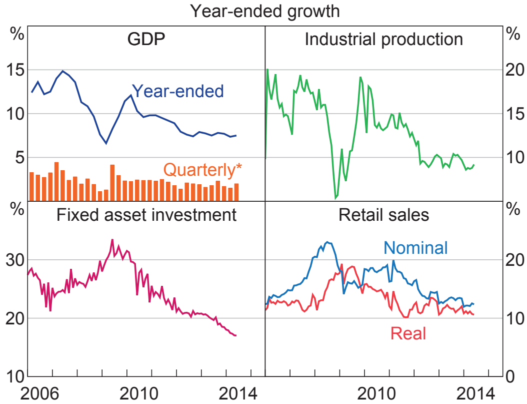


* Aggregated using Australia's export shares
** Level of PMI rescaled to match MTP GDP growth
Sources: ABS; CEIC Data; Markit Economics; RBA; Thomson Reuters

Asia-Pacific

In China, GDP grew by 2.0 per cent in the June quarter, following growth of 1.5 per cent in the March quarter, to be 7.5 per cent higher over the year (Graph 1.2). The stronger growth looks to have been driven by a pick-up in the growth of investment and a rebound in exports, with available indicators suggesting that growth of household consumption has moderated a little. Monthly indicators including the PMIs have shown signs of improvement, while output growth of key industrial products has been mixed. The production of cement and plate glass (used extensively in construction) has declined, while crude steel production and electricity generation have picked up in recent months.

Graph 1.2
China – Activity Indicators
Year-ended growth

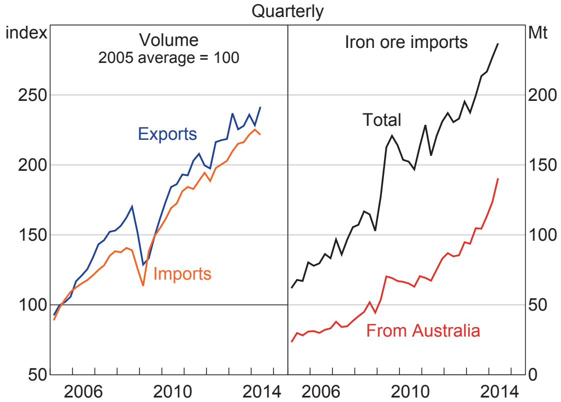


* RBA estimates prior to the December quarter 2010
Sources: CEIC Data; RBA

The improvement in economic conditions is consistent with efforts by policymakers to keep GDP growth in line with the target of 7.5 per cent for 2014. In recent months, fiscal spending has picked up at both the local and national levels of government, which has helped to support activity. The authorities have also continued a targeted easing of monetary policy for banks that lend to the rural sector and small businesses, although the effect of these measures on overall monetary conditions is likely to be moderate (see the 'International and Foreign Exchange Markets' chapter).

Merchandise exports rebounded in the June quarter, following a weak first quarter (Graph 1.3). The increase was broad based by destination, although exports to the United States, Europe and east Asia grew most strongly. Total imports in the June quarter were little changed, notwithstanding the pick-up in the growth of domestic investment. The value of imports from Australia was considerably lower, reflecting lower global iron ore prices; the volume of total iron ore imports has continued to trend higher in recent months, particularly from Australia.

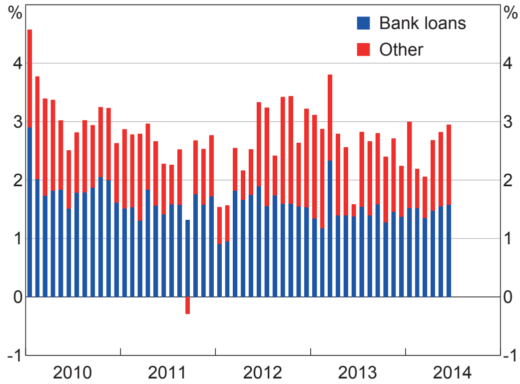
Graph 1.3
China – Merchandise Trade*
Quarterly



* Seasonally adjusted by RBA
Sources: CEIC Data; RBA

The flow of new total social financing has increased in recent months, with stronger growth in both bank lending and various forms of non-bank financing (Graph 1.4). This pick-up is consistent with the targeted easing of monetary policy and recent signs of stronger economic growth. Prior to this recent increase in the flow of financing, the non-bank share of new total social financing had declined, coinciding with efforts by the authorities to limit the growth of banks' off-balance sheet business and the financing activities of non-bank financial institutions.

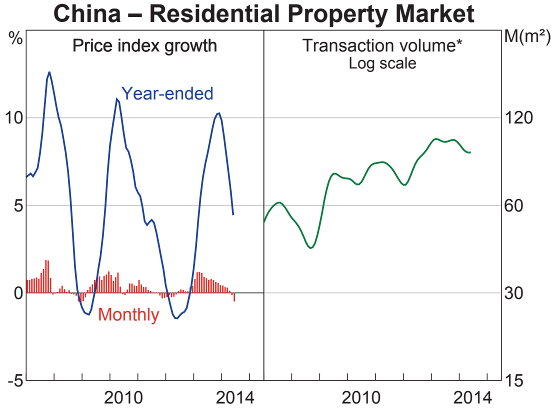
Graph 1.4
China – Total Social Financing
Monthly flows, per cent of annual GDP*



* Seasonally adjusted by RBA
Sources: CEIC Data; RBA

Conditions in the residential property market have continued to weaken in recent months (see 'Box A: The Chinese Residential Property Market'). Transaction volumes have moderated somewhat since late 2013 and, since May, prices have declined in larger cities, though they are still higher than a year ago on average (Graph 1.5). Some local governments have eased restrictions on property transactions, but many restrictions implemented over 2013 and earlier remain in place.

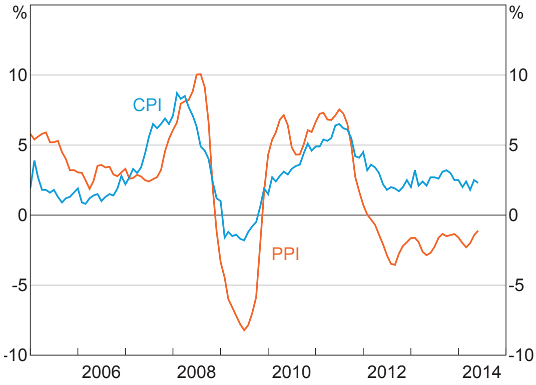
Graph 1.5
China – Residential Property Market



* Trend
Sources: CEIC Data; RBA

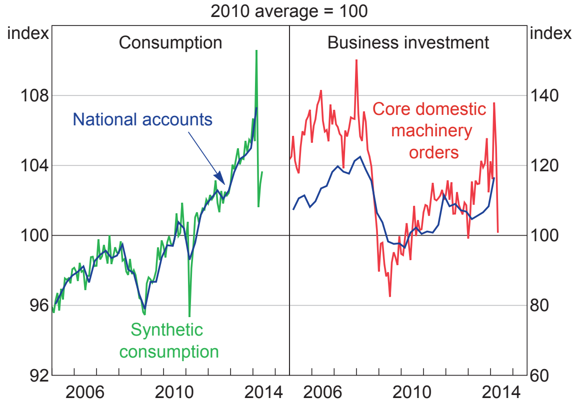
Inflationary pressures in China remain contained, with year-ended CPI inflation running at 2.3 per cent (Graph 1.6). Food price inflation has edged a

Graph 1.6
China – Inflation
Year-ended



Sources: CEIC Data; RBA

Graph 1.7
Japan – Consumption and Investment
2010 average = 100



Sources: CEIC Data; RBA; Thomson Reuters

little higher in recent months, but non-food price inflation has remained low and stable. Producer prices have declined over the past year, though they have picked up a little in recent months.

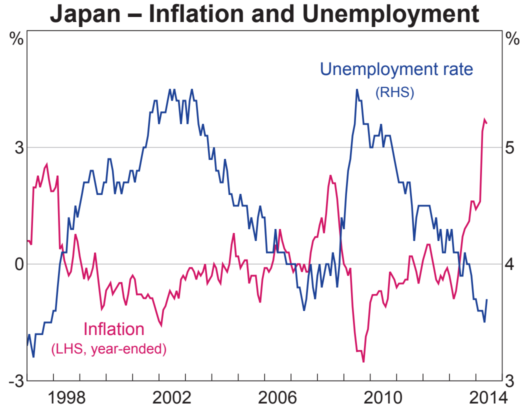
In Japan, GDP grew strongly in the March quarter as consumption had been brought forward ahead of the increase in the consumption tax rate on 1 April.[1] Business investment also grew strongly in the quarter.

As expected, consumer demand fell sharply in April following the tax rate increase (Graph 1.7). Most consumption indicators rebounded a little in May and June, but notwithstanding the temporary fiscal stimulus, GDP looks to have contracted substantially in the June quarter. Moreover, machinery orders also fell sharply over the two months to May, suggesting that the strength in business investment seen earlier in the year has not continued. Given the recent volatility in economic activity more broadly, there is considerable uncertainty regarding the underlying pace of growth.

The consumption tax rise contributed around 2 percentage points to CPI inflation in April and May. Year-ended headline inflation is currently above 3½ per cent, although the Bank of Japan has indicated that it will look through the effects of the tax increase when assessing inflation against its 2 per cent target.

Most indicators suggest that the Japanese labour market has tightened considerably. The ratio of jobs to applicants has risen noticeably and the unemployment rate has fallen by 0.6 percentage points over the past 18 months, to be at 3.7 per cent in June, around the lowest level since mid 2007 (Graph 1.8). Labour shortages have been reported in construction, health and hospitality services. Notwithstanding tighter labour market conditions, wage growth remains modest. The Bank of Japan judges that supply and demand in the economy are roughly in balance following the strong growth in demand since late 2012, and that growth is likely to be above trend over the coming quarters.

Graph 1.8
Japan – Inflation and Unemployment



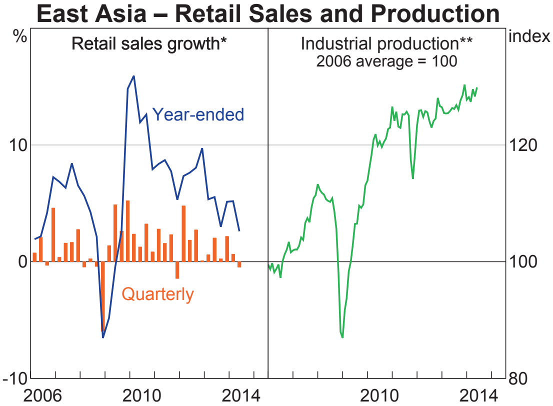
Source: Thomson Reuters

1 See RBA (2014), 'Box A: Japan's Consumption Tax Increase', *Statement on Monetary Policy*, February, pp 12–13.

The Japanese Government released an update of its growth strategy in June. Key reforms that have been put forward to date include: policies to increase female labour market participation; lowering the corporate tax rate; improving corporate governance; and introducing National Strategic Zones – covering Tokyo, Osaka and other parts of the country – with each zone to trial specific measures of deregulation.

In the rest of east Asia, economic growth over the first half of 2014 has slowed from the strong pace seen in late 2013. Growth in consumption and retail sales has eased across the region and output has fallen in Thailand amid ongoing political tensions there (Graph 1.9). Abstracting from recent volatility, industrial production and export volumes across the region have continued to grow at a similar pace to that of the past couple of years.

Graph 1.9
East Asia – Retail Sales and Production

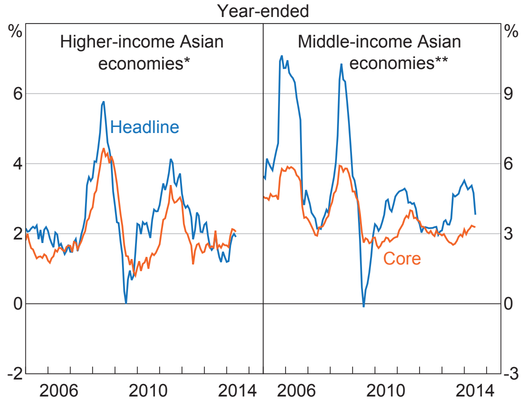


* Excludes Malaysia and Philippines
** Excludes Hong Kong and Indonesia
Sources: CEIC Data; IMF; RBA

Core inflation remains low in most economies, although it has picked up modestly in the region (Graph 1.10). Headline inflation has eased in the middle-income economies, as food price inflation has moderated and the effect of earlier reductions in fuel subsidies in Indonesia has dropped out of inflation in year-ended terms.

Monetary policy remains expansionary in the region. However, policy has been tightened recently in Malaysia and the Philippines owing to improved growth prospects and increasing inflationary pressures. In Indonesia, monetary policy was tightened in the second half of 2013 in response to high inflation, volatility in the rupiah and concerns about the current account deficit. Accommodative financial conditions have contributed to a period of rapid growth in debt and property prices in several east Asian economies. More recently, property price growth has moderated in some economies in line with the slower growth of economic activity and a tightening of macroprudential policies.

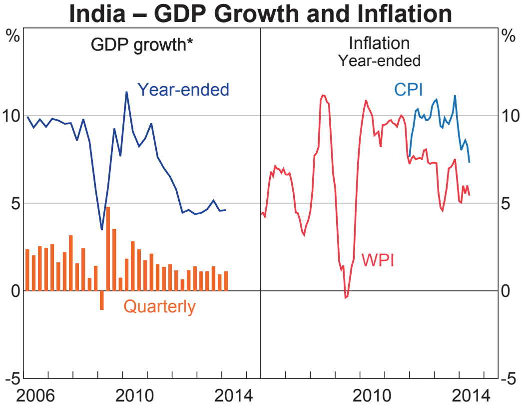
Graph 1.10
East Asia – Consumer Price Inflation
Year-ended



* Hong Kong, Singapore, South Korea and Taiwan
** Indonesia, Malaysia, Philippines and Thailand; Malaysian data for July are RBA estimates
Sources: CEIC Data; IMF; RBA; Thomson Reuters

The Indian economy has grown at an annual rate of a little under 5 per cent over the past couple of years, well below the rates of 8 to 10 per cent prior to the global financial crisis (Graph 1.11). The weaker growth in recent years has reflected a range of interconnected factors, including slower growth of investment, supply constraints that have limited the productive capacity of the economy, and persistently high inflation that had prompted a tightening of monetary policy. In the March quarter, growth of consumption increased, although investment remained weak. More recent indicators suggest that economic conditions remain relatively subdued. Growth of industrial output has been weak, and imports and exports both increased at a moderate pace. The new government recently released the budget for 2014/15, announcing a target for the fiscal deficit of 4.1 per cent of GDP (compared with an outcome of 4.6 per cent in 2013/14), and flagging some initiatives aimed at raising investment, including in infrastructure.

Graph 1.11
India – GDP Growth and Inflation



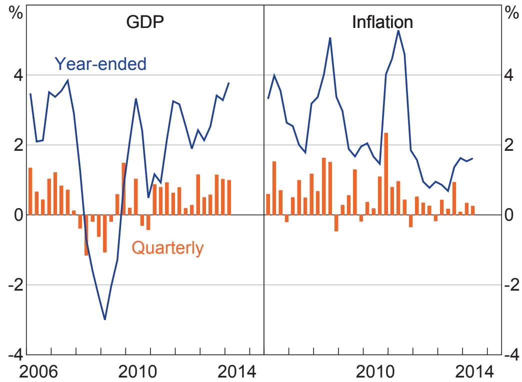
* Measured at factor cost
Sources: CEIC Data; RBA

Year-ended consumer price inflation has declined and was 7.3 per cent over the year to June, which was below the Reserve Bank of India's near-term goal of 8 per cent. The recent reduction in inflation has been relatively broad based. However, early indications suggest that rainfall in the current monsoon season has been below average, which may lead to higher food prices later this year.

In New Zealand, GDP has grown at an above-average pace over the past year, buoyed by strong growth in exports and the reconstruction that has followed the Canterbury earthquakes (Graph 1.12). Consumption and residential investment have also been supported by a pick-up in net immigration.

Inflation has been relatively stable of late, with prices rising by 1.6 per cent over the year to the June quarter. Nevertheless, the Reserve Bank of New Zealand increased its policy rate to 3.5 per cent at its July meeting, citing considerable momentum in economic growth and increased capacity utilisation adding pressure to non-tradables inflation.

Graph 1.12
New Zealand – GDP Growth and Inflation

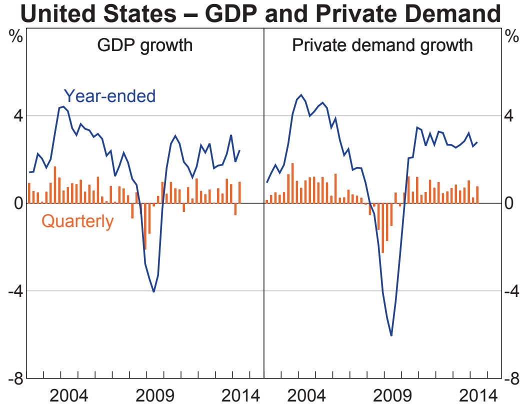


Source: Thomson Reuters

United States

The US economy grew strongly in the June quarter, following a contraction in the March quarter that appears to have been mainly related to transitory factors, including unusually severe winter weather. Investment and consumption growth picked up, to be around the pace seen through 2013 (Graph 1.13). Indicators of consumer sentiment and business surveys have improved noticeably since the start of 2014.

Graph 1.13
United States – GDP and Private Demand



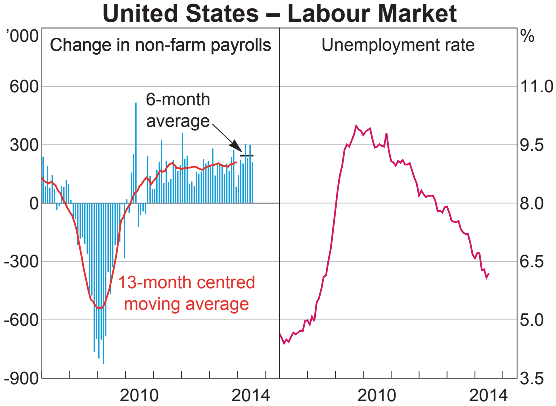
Sources: RBA; Thomson Reuters

The pace of recovery in the housing market appears to have slowed since the middle of 2013, even though dwelling investment (as a share of GDP) remains below previous cyclical lows. Permits and starts in the first half of 2014 were around their 2013 average and other forward-looking indicators of activity remain below their levels of a year ago. Housing prices have continued to grow, rising by around 9 per cent over the past year, although the pace of growth has slowed recently.

The labour market looks to have strengthened noticeably over the six months to July (Graph 1.14). Growth in non-farm payrolls has been a bit above its average pace of the past couple of years, with over 1.6 million jobs created since January this year. Over this period, the unemployment rate has continued to fall and the participation rate has stabilised after having declined substantially since the start of the global financial crisis. Other indicators also suggest that labour market conditions have improved; the number of part-time employees seeking full-time work and the rate of long-term unemployment have fallen over the year, although both indicators are still high relative to history. Wage growth has ticked up but remains moderate (Graph 1.15).

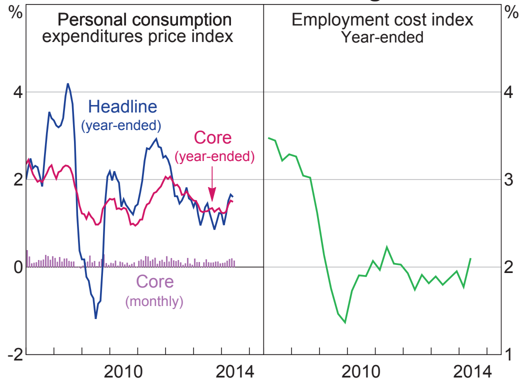
Inflation remains below the Federal Open Market Committee's long-run goal of 2 per cent, although a number of measures of inflation have picked up over the past few months. Core personal consumption expenditure inflation was 1.5 per cent over the year to June.

Graph 1.14
United States – Labour Market



Source: Thomson Reuters

Graph 1.15
United States – Price and Wage Inflation



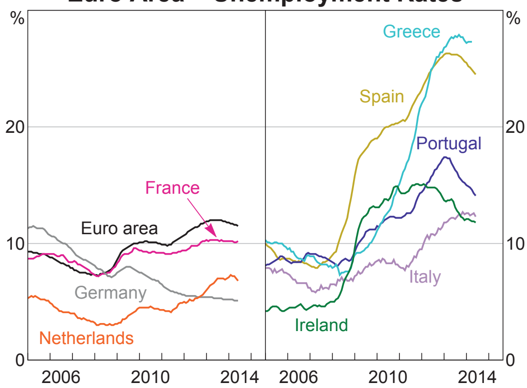
Source: Thomson Reuters

Europe

The gradual recovery of economic activity in the euro area continued in the March quarter. GDP expanded modestly for the fourth consecutive quarter, although growth was concentrated in Germany, with euro area GDP outside Germany generally little changed. Investment in the euro area has picked up in recent quarters, but it remains almost 20 per cent below its peak in 2008. More timely data suggest that the economic recovery continued into the June quarter.

The unemployment rate peaked in mid 2013, but it remains high and is declining only slowly (Graph 1.16). Substantial spare capacity in the economy has contributed to the decline in inflation over the past two years. Inflation is currently well below the European Central Bank's (ECB) target, which is for inflation to be below, but close to, 2 per cent (Graph 1.17). The ECB judges that inflation expectations remain anchored at the inflation target, although short- and medium-term market expectations have drifted below 2 per cent. In response to low inflation, at its June meeting the ECB announced a number of new policy measures to increase the degree of monetary stimulus (see the 'International and Foreign Exchange Markets' chapter). Some of these measures are aimed at supporting business credit, which has been declining since 2012.

Graph 1.16
Euro Area – Unemployment Rates



Source: Thomson Reuters

Graph 1.17
Euro Area – Inflation
Year-ended

* Break-even inflation rates from inflation swaps
** Inflation expectations for 5–10 years into the future
Sources: Bloomberg; Thomson Reuters

In the United Kingdom, the pace of economic recovery has picked up since mid 2013, with GDP expanding by 3.1 per cent over the year to the June quarter. Both consumption and investment look to have contributed to the strengthening. Residential investment has been growing particularly strongly alongside a marked pick-up in house price growth. In response, the Bank of England's Financial Policy Committee introduced new prudential measures in June.

The economic recovery has led to a steady decline in the unemployment rate, which was 6½ per cent in May. Inflation has declined, despite the recent pick-up in employment and output growth. Inflation is currently below the 2 per cent inflation target, after being well above it during the previous four years.

Commodity Prices

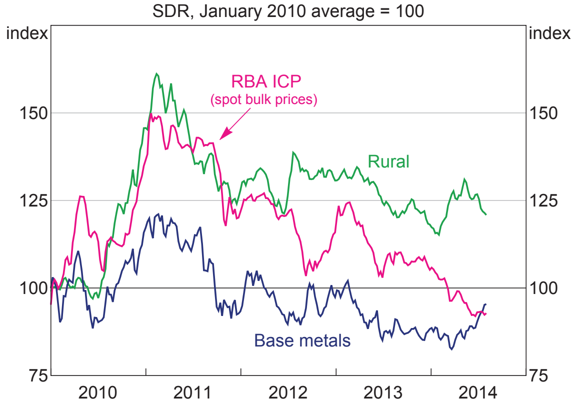
The RBA index of commodity prices (in SDR terms) has moved a little lower on average in the past three months, as falls in iron ore and coal prices have been partially offset by increases in the prices of base metals and oil (Table 1.1; Graph 1.18). During this period, changes in commodity prices appear to have mainly reflected supply-side developments. The index, based on spot prices for iron ore and coal, is now 13 per cent lower in the past three months than a year ago and close to 40 per cent lower than its peak in 2011.

Table 1.1: Commodity Prices Growth[(a)]
SDR, 3-month-average prices, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	–12	–23
– Iron ore	–17	–25
– Coking coal	–3	–21
– Thermal coal	–4	–15
Rural	0	–1
Base metals	6	3
Gold	–1	–5
Brent oil[(b)]	1	4
RBA ICP	–5	–12
– Using spot prices for bulk commodities	–6	–13

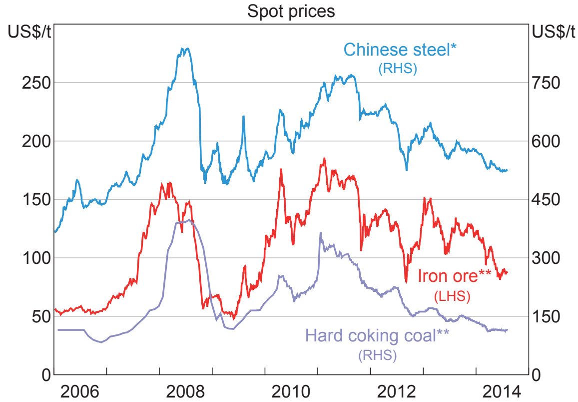
(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodities are spot prices
(b) In US dollars
Sources: Bloomberg; IHS Energy Publishing; RBA

Graph 1.18
Commodity Prices*
SDR, January 2010 average = 100



* RBA Index of Commodity Prices (ICP) sub-indices
Source: RBA

Graph 1.19
Steel, Iron Ore and Coking Coal Prices
Spot prices



* Average of hot rolled steel sheet and steel rebar prices
** Free on board basis
Sources: Bloomberg; Citigroup; IHS Energy Publishing; Macquarie Bank; RBA

The spot prices of iron ore and coking coal – the key commodities used in steel making – have fallen sharply since the start of the year. This has been associated with a slowing in the growth of Chinese steel production and, more importantly, significant additions to global supply of these commodities. There has been a significant increase in the supply of iron ore and coking coal in the internationally traded market over the past year, particularly from lower-cost producers, which has weighed on prices (see 'Box B: Iron Ore and Coal Cost Curves'). Growth in Chinese steel production (seasonally adjusted) has also slowed to an annualised pace of around 4 per cent over the first half of the year, compared with 11 per cent over the previous six months. The slowing reflects softer conditions in the real estate sector, as well as Chinese authorities' attempts to reduce output among the less efficient and more polluting steel producers. There is also some evidence that credit conditions have tightened in the steel sector since early 2014, with restrictions imposed on the availability of credit to firms that do not meet environmental standards.

More recently, the prices of both iron ore and coking coal have stabilised, in line with movements in Chinese steel prices (Graph 1.19). The contract price of premium hard coking coal is unchanged from the June quarter at US$120 per tonne. However, the Newcastle spot price for thermal coal has moved lower over recent months and is now at its lowest level since September 2009. At current spot prices for thermal and coking coal, it is widely estimated that a substantial share of internationally traded coal is unprofitable. As a result, there have been a number of announced closures of higher-cost mines around the world (including some smaller Australian operations) and delays to investment projects, while coal producers continue to focus their efforts on reducing costs.

The price of Brent oil increased a little over May and June in response to geopolitical concerns in the Middle East, but has since moved lower. Over the past year, the oil price has fluctuated around US$110 per barrel. Base metals prices have also moved higher on average over the past three months. Nickel prices have increased sharply since Indonesia – previously the leading supplier of nickel ore – announced a ban on exports of unprocessed minerals from January 2014. Aluminium prices have started to rise as declines in production in countries other than China begin to take effect. Rural prices have been mixed; wheat prices have moved lower as an earlier weather-related increase in prices in the United States has unwound, while meat prices have increased over recent months.