

# 1. International Economic Developments

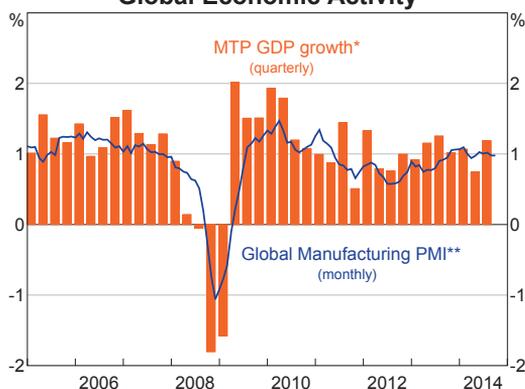
Overall, growth of Australia's major trading partners (MTPs) was around its long-run average over the past year. In the September quarter, MTP growth looks to have picked up following below-average growth in the June quarter, which largely reflected the sharp fall in Japanese economic activity after the consumption tax increase in April. The global manufacturing PMI has been steady over recent months, at levels consistent with average growth (Graph 1.1). Output growth in China eased marginally, while the US economy continued to grow at, or a little above, trend. Economic activity in the euro area has expanded only modestly since the start of the year and the recovery there remains fragile. Global inflation remains low, particularly in the advanced economies, and monetary policy is expansionary in all major regions. Commodity prices, particularly for the bulk commodities that dominate Australia's

exports, have declined over the past year, reflecting a combination of increased supply and, more recently, some softening in the growth of Chinese demand for steel. Oil prices have also fallen in recent months, which largely reflected higher global supply.

## Asia-Pacific

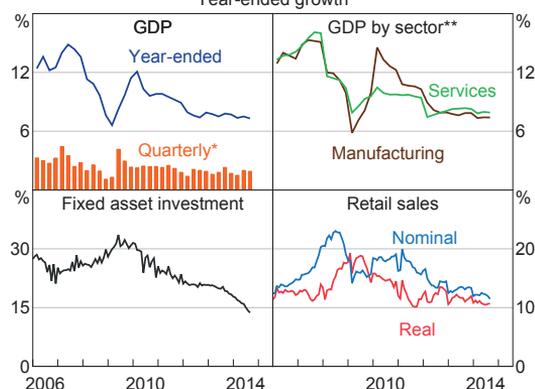
In China, GDP growth was little changed at 1.9 per cent in the September quarter, to be 7.3 per cent in year-ended terms (Graph 1.2). Growth of industrial production was also steady in the quarter. Growth has continued to shift gradually away from the agricultural and manufacturing sectors towards the services sector. The composition of growth has also evolved on the expenditure side, as consumption growth has held steady while the contribution of investment to growth appears to have eased further.

**Graph 1.1**  
Global Economic Activity



\* Aggregated using Australia's export shares; RBA estimate for September quarter 2014  
 \*\* PMI rescaled to match MTP GDP growth  
 Sources: ABS; CEIC Data; Markit Economics; RBA; Thomson Reuters

**Graph 1.2**  
China – Activity Indicators  
Year-ended growth



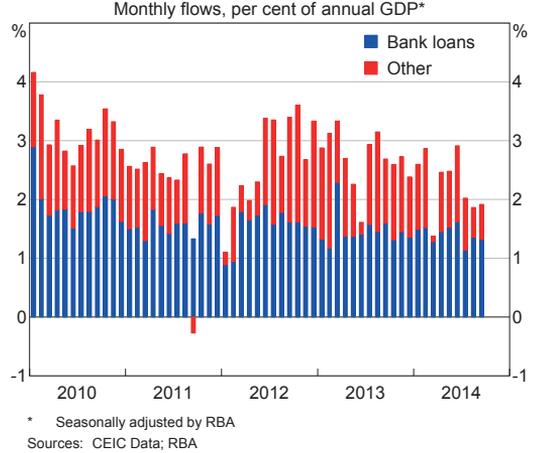
\* RBA estimates prior to the December quarter 2010  
 \*\* Year-to-date; manufacturing and services sectors refer to secondary and tertiary gross value added  
 Sources: CEIC Data; RBA

The pace of GDP growth is close to the authorities' 7.5 per cent target for 2014, while employment growth in 2014 appears to have exceeded the target of 10 million new urban workers. The limited stimulus measures over the past year have generally been targeted at the rural sector, small businesses and housing purchasers and developers. A number of new infrastructure investment approvals have also been issued in recent months, but there has been no evidence yet of a substantial pick-up in infrastructure investment growth. Although the authorities have sought to limit overall financing flows given the already high levels of debt in the economy, they have adjusted policies to promote financing for home purchases and provided additional funds to financial institutions through the People's Bank of China's standing facilities (see the 'International and Foreign Exchange Markets' chapter).

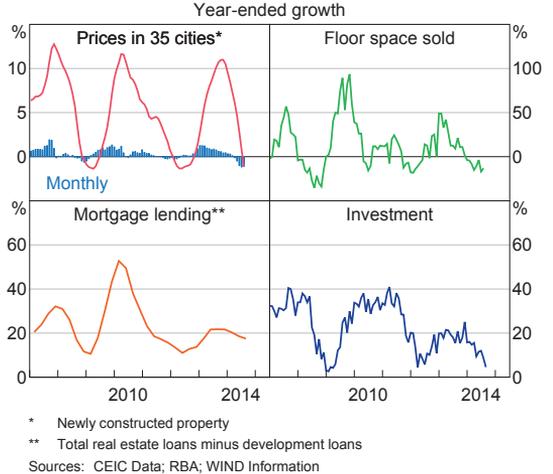
The flow of new total social financing (TSF) has eased in recent months, continuing its trend decline over the past 18 months or so (Graph 1.3). Flows related to non-bank and off-balance sheet financing activity were noticeably lower. This is likely to reflect recent regulatory changes intended to moderate these flows, including: limiting banks' activities in the interbank market to reduce their ability to circumvent loan-to-deposit ratios; requiring assets purchased under repurchase agreements to be kept on balance sheet and incur a capital charge; and restricting banks' ability to reduce the risk-weighting of assets underlying trust company loans.

The Chinese residential property market has continued to weaken. Prices of new properties have declined by about 4 per cent since April, which is a larger decline than was experienced in other downturns over the past ten years or so (Graph 1.4). Transaction volumes and investment growth have also declined further over recent months. Restrictions on the purchase of residential property have been eased in most locations apart from the four largest cities and, in some local jurisdictions, measures to encourage property sales have been introduced. In September, the central government made changes to support the property market.

**Graph 1.3**  
**China – Total Social Financing**



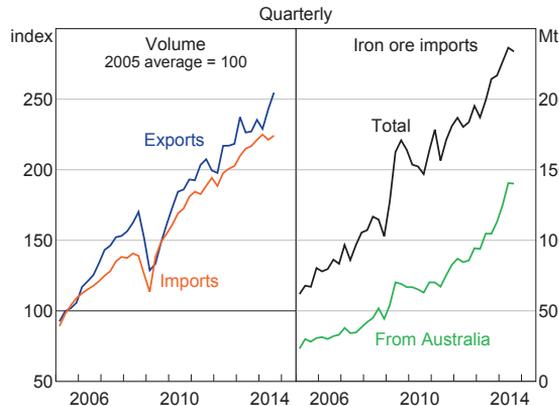
**Graph 1.4**  
**China – Residential Property Market Indicators**



Lending policies for homebuyers were eased by lowering the floor on mortgage interest rates relative to the benchmark rate and increasing the maximum loan-to-valuation ratio applying to second properties for homebuyers without an outstanding mortgage. Real estate developers' access to finance was also broadened, and banks have been actively encouraged to lend to financially sound projects.

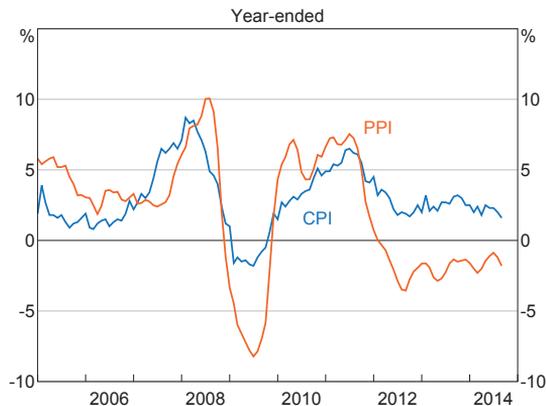
Export growth was strong in the September quarter, particularly to the United States, euro area and east Asia (excluding Japan) (Graph 1.5). However, an unusually sharp rise in exports to Hong Kong has renewed speculation among commentators that

**Graph 1.5**  
**China – Merchandise Trade\***



\* Seasonally adjusted by RBA  
Sources: CEIC Data; RBA

**Graph 1.6**  
**China – Inflation**



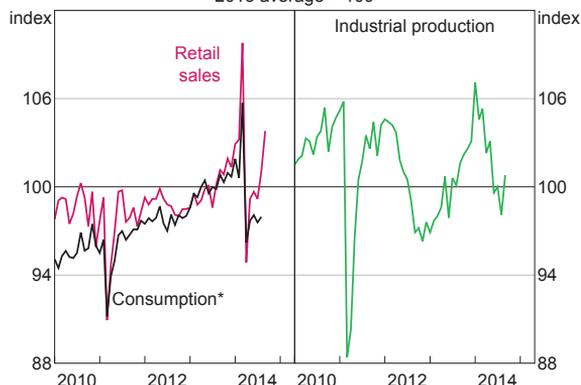
Sources: CEIC Data; RBA

growth of Chinese exports has been overstated due to the false invoicing of exports to disguise illicit capital flows. Imports have not grown as strongly as exports, which is consistent with slower growth of domestic activity, and investment in particular. Following earlier substantial increases, the volume of iron ore imports declined a little, including those from Australia.

Inflationary pressures in China remain subdued (Graph 1.6). Year-ended CPI inflation in September declined to 1.6 per cent, well below the authorities' target of 3.5 per cent. The easing in CPI inflation has been driven by lower food price inflation. Producer prices continued to decline in year-ended terms, albeit not as rapidly as was the case a year or more ago.

In Japan, GDP contracted sharply in the June quarter. A decline was widely anticipated after consumers brought consumption forward ahead of the increase in the consumption tax rate on 1 April.<sup>1</sup> Consumption fell sharply in the quarter. More recent consumption indicators, including retail sales, suggest that there has been a pick-up in the September quarter (Graph 1.7). Investment also fell sharply in the June quarter. Business surveys suggest conditions have improved in recent months and industrial production rose a little in September following several months of decline.

**Graph 1.7**  
**Japan – Economic Indicators**  
2013 average = 100



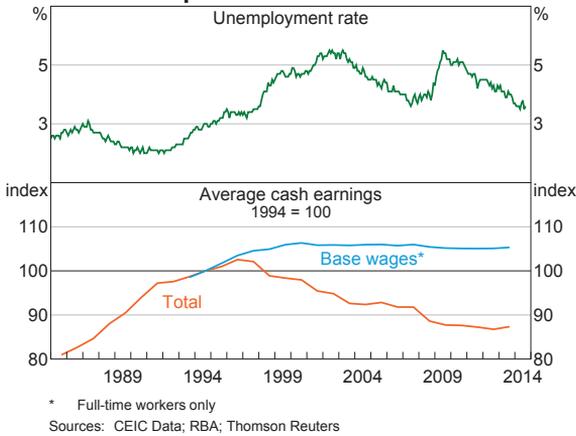
\* The Cabinet Office's monthly measure of real private consumption  
Sources: CEIC Data; Thomson Reuters

Despite the recent weakness in activity, the labour market has continued to tighten. The unemployment rate is around its lowest level in 15 years and there are more job vacancies than applicants (Graph 1.8). The tightness in the labour market has been associated with the first increase in average earnings in some years. To date, this has been driven by increases in bonus and overtime payments, suggesting that businesses remain cautious about the durability of the improvement in economic conditions seen over the past two years.

Headline inflation has eased over recent months, as the effect of the earlier depreciation of the yen on

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

**Graph 1.8**  
**Japan – Labour Market**

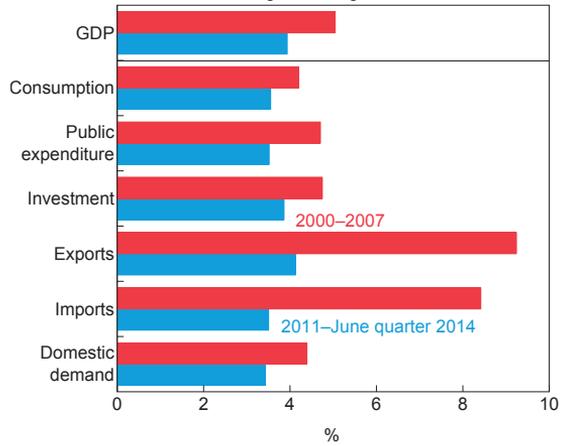


import prices has faded. The easing has been most evident in energy prices, which have also been affected by lower world oil prices more recently. Core inflation has been relatively stable in year-ended terms of late. Excluding the effects of the consumption tax increase, year-ended core inflation was around 0.7 per cent in September and core services prices, which give a clearer indication of domestic price pressures, have been unchanged over the past year. The Bank of Japan eased monetary policy further in late October, citing declining oil prices and weakness in demand (see 'International and Foreign Exchange Markets' chapter). Market expectations of inflation for the next few years are a little above 1 per cent, after increasing following the election of Prime Minister Abe in late 2012.

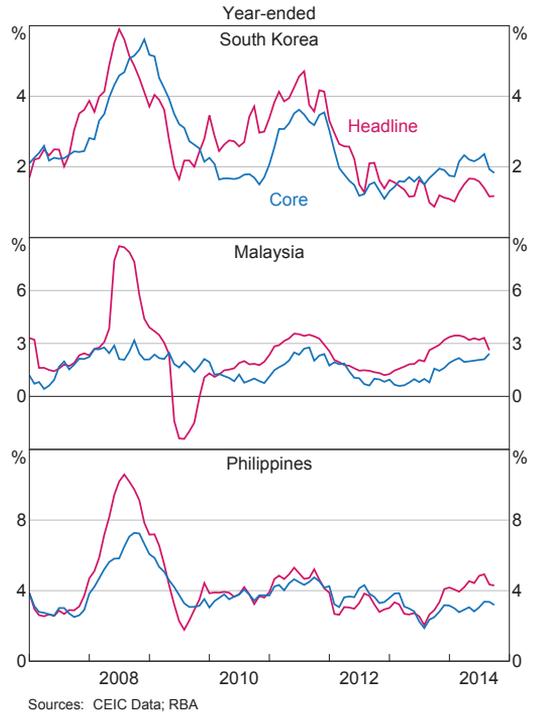
In the rest of east Asia, GDP growth in the September quarter looks to have picked up a bit from its pace in the first half of 2014, to around the average of recent years. Nevertheless, growth has been slower on average across the region than prior to the global financial crisis. In particular, export growth has been less than half of its pre-crisis rate, while GDP and domestic demand growth have both slowed by around 1 percentage point (Graph 1.9).

Monetary policy was eased in Korea in August and October following weak growth in the June quarter and a decline in inflation (Graph 1.10). In contrast,

**Graph 1.9**  
**East Asia – Expenditure on GDP**  
Average annual growth rates

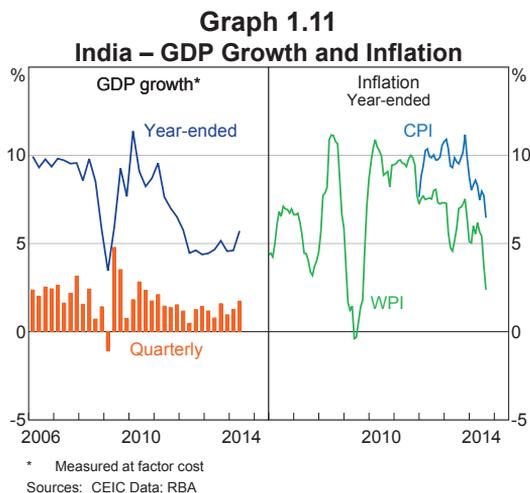


**Graph 1.10**  
**East Asia – Inflation**



monetary policy was tightened earlier this year in Malaysia and the Philippines in response to a pick-up in inflation and improved growth prospects.

Growth in the Indian economy improved in the June quarter, although it remains well below the pace seen prior to the global financial crisis. GDP (at factor cost) increased by 5.7 per cent over the year, reflecting a pick-up in growth in industrial production and construction output (Graph 1.11). Investment grew relatively strongly in the quarter, and the Government has announced its intention to promote investment by reducing supply-side bottlenecks and improving infrastructure. In response, indicators of business confidence have strengthened in recent quarters and there have been tentative signs of a pick-up in investment approvals. However, recent legal developments, including a ruling in India's Supreme Court that since 1993 most coal mining licences have been awarded illegally, have also presented obstacles to some investment.



Consumer price inflation over the year to September declined to 6.5 per cent, which is below the Reserve Bank of India's (RBI's) goal of 8 per cent by the beginning of 2015.<sup>2</sup> However, the RBI has suggested that there is a significant chance that CPI inflation will exceed the 6 per cent goal for January 2016.

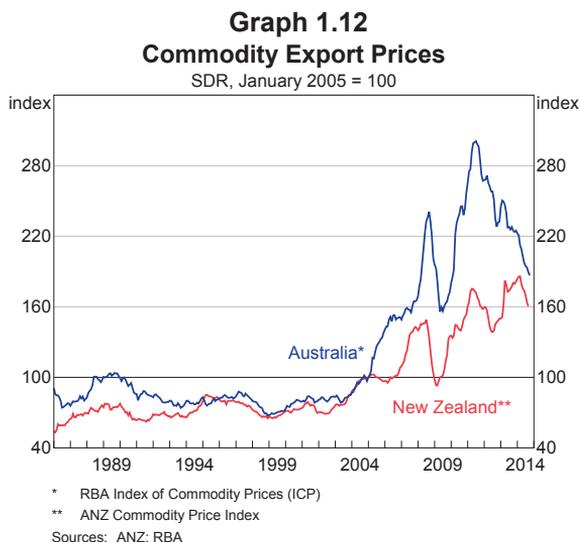
<sup>2</sup> See White G (2014), 'Measures of Inflation in India', *RBA Bulletin*, September, pp 39–46.

Food price inflation has continued to ease of late, but it remains high.

New Zealand's economy has grown strongly over the past year. Private investment has contributed substantially to growth, supported by rebuilding following the Canterbury earthquakes in 2010/11. The labour market has strengthened in recent quarters, with strong employment growth and further declines of the unemployment rate.

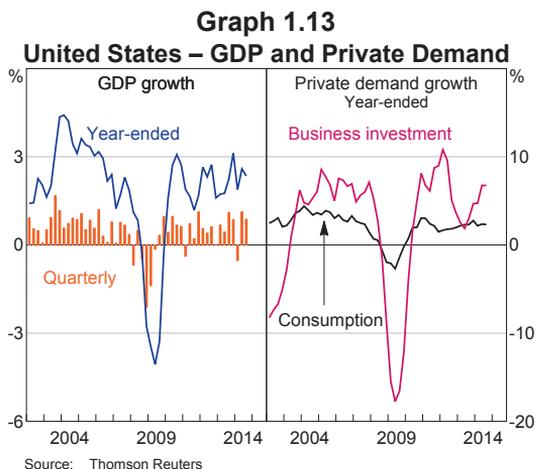
Wage and price pressures have remained subdued so far, with wage growth and inflation below 2 per cent over the year to the September quarter. Nevertheless, the Reserve Bank of New Zealand expects that non-tradables inflation will increase and has raised the cash rate by 100 basis points over 2014. Housing prices growth appears to have moderated following the increases in mortgage rates associated with the tightening of monetary policy and implementation of restrictions on mortgage lending to borrowers with high loan-to-valuation ratios.

Dairy prices have fallen sharply and the prices for New Zealand's commodity exports are 14 per cent below their recent peak. This compares with the 38 per cent decline in Australia's commodity prices since their peak in July 2011 (Graph 1.12).



## United States

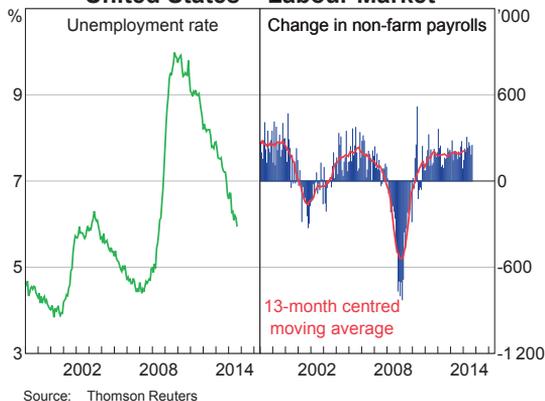
The US economy has been expanding at a pace that is close to, or even a little above, trend (Graph 1.13). Business investment has picked up noticeably of late, and firms have stepped up the pace of hiring. Consumption has continued to grow steadily, in line with growth of incomes. Public demand is no longer weighing on growth, in contrast to recent years.



The increase in non-farm payrolls growth has been accompanied by a steady decline in the unemployment rate (Graph 1.14). A range of labour market indicators suggest that spare capacity is gradually being absorbed, although not as rapidly as the declining unemployment rate suggests. In particular, the shares of the labour force that are marginally attached workers, long-term unemployed and people working part-time for economic reasons have declined more slowly than the unemployment rate, and remain elevated relative to history. Wage growth, as measured by the economic cost index, has picked up over recent quarters to 2.8 per cent in six-month-ended annualised terms, a little below its long-run average pace.

Inflation has declined a little over recent months, after picking up earlier in 2014. In year-ended terms, personal consumption expenditure inflation remains below the Federal Open Market Committee's (FOMC)

**Graph 1.14**  
**United States – Labour Market**



goal of 2 per cent. At its October meeting, the FOMC ended its asset purchase program (see 'International and Foreign Exchange Markets' chapter).

## Europe

The recovery in the euro area remains fragile. GDP was little changed in the June quarter and most indicators of activity suggest modest growth in the September quarter at best. Retail sales grew moderately over the past year but industrial production has been unchanged over the same period (Graph 1.15). Business surveys and measures of consumer confidence have declined a little in the September quarter, although they are still consistent with some growth.

**Graph 1.15**  
**Euro Area – Activity Indicators**



Unemployment rates have declined since late 2013 in most euro area countries but they remain high. Headline inflation declined further in recent quarters, to be 0.4 per cent over the year to October, in large part due to lower energy prices and moderating food price inflation (Graph 1.16). Core inflation remained stable at 0.7 per cent.

In response to weak growth and low and declining inflation, the European Central Bank announced further stimulatory measures at its September meeting (see 'International and Foreign Exchange Markets' chapter). Despite this, measures of inflation expectations have declined a little further.

In the United Kingdom, GDP growth has picked up over the past year, with contributions from both private consumption and investment. Housing prices have grown strongly over the past 18 months, although there are signs that price growth has been easing more recently. The unemployment rate has decreased markedly alongside the increase in activity, while wage growth remains subdued and year-ended inflation remains below the Bank of England's target of 2 per cent.

## Commodity Prices

The RBA index of commodity prices has declined (in SDR terms) on average in the past three months, driven by noticeable falls in the spot price for iron ore (Table 1.1; Graph 1.17). Increases in the supply of iron ore, particularly from Australia and Brazil, have weighed on spot prices, which fell to their lowest level since 2009 (Graph 1.18). In recent months, softer growth in demand for steel production from China is also likely to have contributed, consistent with slowing growth of real estate investment. This has also weighed on the demand for coking coal.

At current spot prices of a bit below US\$70 per tonne, most Australian iron ore production remains profitable. Although margins for Australian miners have contracted, the recent depreciation of the exchange rate has partially offset the impact of

**Graph 1.16**  
**Euro Area – Inflation**  
Year-ended



**Table 1.1: Commodity Price Growth<sup>(a)</sup>**  
SDR, 3-month-average prices, per cent

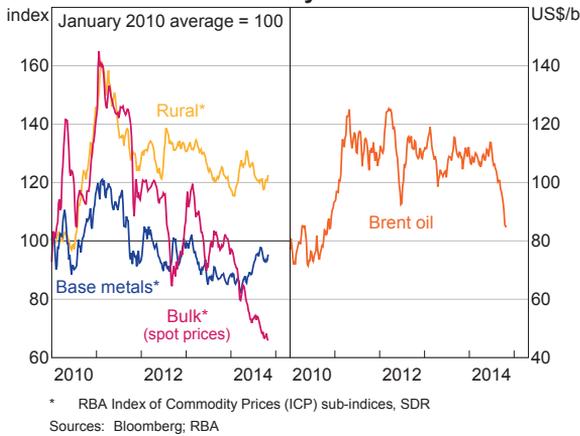
	Since previous Statement	Over the past year
Bulk commodities	-8	-31
– Iron ore	-12	-38
– Coking coal	1	-21
– Thermal coal	-5	-15
Rural	-4	-2
Base metals	4	7
Gold	-1	-6
Brent oil <sup>(b)</sup>	-14	-15
RBA ICP	-4	-16
– using spot prices for bulk commodities	-4	-18

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

(b) In US dollars

Sources: Bloomberg; IHS Energy Publishing; RBA

**Graph 1.17**  
**Commodity Prices**



**Graph 1.18**  
**Steel Prices and Production**



the falls in global prices. To date, there has been some reduction of supply in response to the price falls from higher-cost producers outside of China, although determining the exact magnitude is difficult. In China, there has been a small decline in iron ore production in recent months, with some market analysts suggesting that privately owned Chinese production has declined.

Prices for thermal and coking coal remain well below their levels of a year ago. In September, Chinese authorities announced a ban on the transport, import and local sale of coal with a high ash and sulphur content. In their current form, these measures are likely to have a relatively limited impact on Australian coal export volumes as the majority of Australian coal production meets the required standards. In addition, those producers that do not meet the standards can either substitute to other markets or improve the quality of their coal, including by washing or blending it, although this would incur additional costs. The Chinese authorities also re-introduced tariffs on coal imports in mid October. While this is likely to reduce Chinese demand for imported coal, it is too early to determine the impact on Australian coal exports.

Oil prices have fallen sharply in recent months, declining to below US\$85 per barrel in recent weeks, the lowest level since late 2010. The increase in supply, which owed to a pick-up in OPEC production, and the strong growth in unconventional oil supply from the United States in recent years have weighed on prices despite geopolitical tensions in the Middle East that would have historically led to higher oil prices. The weakness in oil prices has been exacerbated by an easing in demand from Europe and slower growth of demand from China, causing downward revisions to expectations for oil demand growth in 2014 and 2015.

Base metal prices have increased a little on average in the past three months. Nickel prices have reversed around half of the increase associated with Indonesia's announcement of export bans in January 2014, partly as a result of higher exports from the Philippines. Prices for rural commodities have declined modestly, driven by falls in wheat prices due to an increase in global supply. In contrast, beef prices have continued to rise, driven by low beef production in the United States and strong global demand. ↗