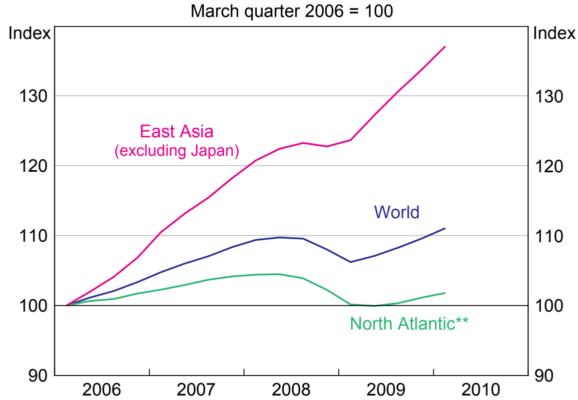
International Economic Developments

The global economy is continuing to recover following the sharp contraction recorded in late 2008 and early 2009, although the extent of the recovery varies considerably across regions. Available data suggest that growth was firm in most regions in the March quarter – the major exception being the euro area – taking world output back above its previous peak in mid 2008 (Graph 1). The recovery in Asia has been particularly strong, and growth has also picked up noticeably in a range of other emerging economies. In contrast, the recovery is much less advanced in the major North Atlantic economies, with aggregate output for these countries still nearly 3 per cent below its previous peak. Conditions remain particularly subdued in Europe. This partly reflects a later turn in the inventory cycle than in east Asia and the United States, although domestic demand also remains weak and there are only tentative signs of the turnaround in private consumption and investment required for recovery to become self-sustaining.

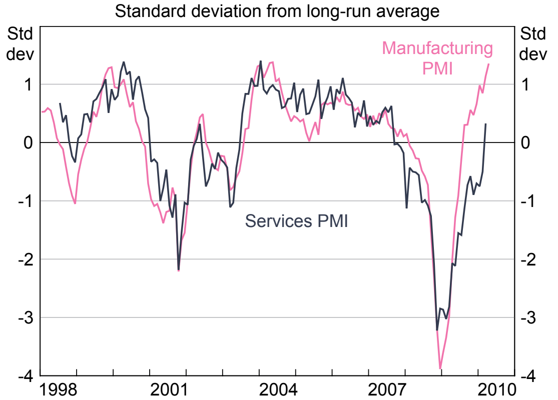
Reflecting the general improvement in global conditions, indicators of business conditions and aggregate demand have picked up over recent months. Globally, both the manufacturing and services PMIs have recently risen further, to above-average levels (Graph 2). Consistent with these developments, private sector and official forecasts for the world economy have generally been revised upwards since the February *Statement*, although the pace of revision has moderated from that seen in the second half of 2009 and early 2010. The IMF now forecasts world output to expand by around 4¼ per cent in 2010, 0.3 percentage points stronger than it expected in January, with a similar expansion in 2011 (Table 1).

Graph 1
World Output*
March quarter 2006 = 100



* Aggregated using PPP exchange rates; RBA estimates for March quarter 2010
** Canada, euro area, the UK and US
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 2
Global PMIs
Standard deviation from long-run average



Sources: JPMorgan Chase & Co. and Markit; RBA

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

	2008	2009	2010	2011
			IMF forecasts(b)	
United States	0.4	–2.4	3.1	2.6
Euro area	0.6	–4.1	1.0	1.5
Japan	–1.2	–5.2	1.9	2.0
China	9.6	8.7	10.0	9.9
Other east Asia(c)	2.8	0.0	5.3	5.2
India	7.3	5.7	8.8	8.4
World	**3.0**	**–0.6**	**4.2**	**4.3**
Australia's trading partners(d)	2.7	–0.1	4.9	4.9

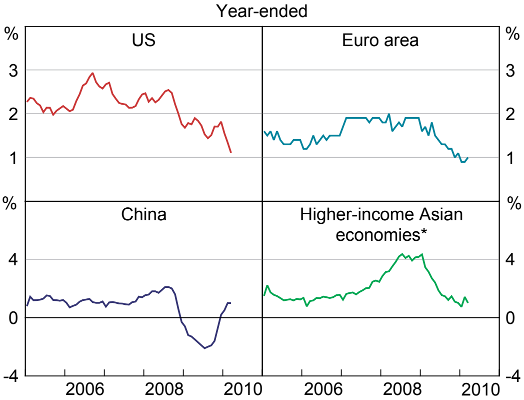
(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified
(b) Forecasts from the April *World Economic Outlook*
(c) Weighted using GDP at market exchange rates
(d) Weighted using merchandise export shares
Sources: CEIC; IMF; RBA; Thomson Reuters

In many east Asian economies (excluding Japan), where activity and demand have recovered most strongly, year-ended core inflation has stabilised or increased (Graph 3). In contrast, core inflation continues to drift lower in the euro area and the United States, where spare capacity is substantial, private demand is well below earlier levels and consumer sentiment remains weak.

Momentum in the Chinese economy remains strong and has shown few signs of slowing recently. GDP is estimated to have grown by around 3 per cent in the March quarter and by 12 per cent over the year (Graph 4). Monthly indicators suggest that recent growth in activity has been broad-based. Retail and car sales data suggest that consumption spending grew solidly in the early part of 2010 (Graph 5). Nominal urban fixed-asset investment increased by more than 10 per cent in the March quarter, after falling in the December quarter. The renewed strength in investment is evident in the manufacturing and real estate sectors. Infrastructure spending was also robust, reflecting ongoing effects of the fiscal stimulus. Chinese export volumes are estimated to have grown by 7 per cent in the March quarter and now exceed their peak in mid 2008. Exports to all major destinations have increased, driven primarily by exports of machinery and electrical equipment. Import volumes rose by around 4 per cent in the March quarter, with the value of imports rising by 11½ per cent, mainly due to higher commodity prices. As a result, in March China recorded its first monthly trade deficit since 2004, with the trade surplus for the quarter falling to 2 per cent of GDP.

Consistent with ongoing strong growth, inflation is rising in China, albeit from a low level. Consumer prices rose by 2.4 per cent over the year to March and

Graph 3
Core Consumer Price Inflation
Year-ended



* Hong Kong, Singapore, South Korea and Taiwan
Sources: CEIC; RBA; Thomson Reuters

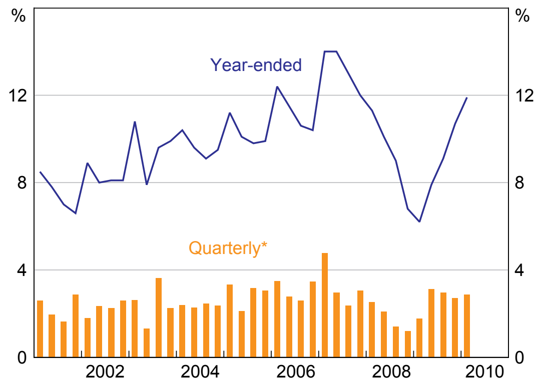
producer prices have accelerated in recent months, suggesting increased upstream price pressures. Official data indicate that nationwide property prices rose by around 12 per cent over the year to March – the fastest rate in at least five years – with significantly larger increases in some regions. In response to these developments, the Chinese authorities have taken a range of steps to cool the property market, including increasing the minimum deposit required by investors and repeat home buyers and by those purchasing larger apartments. The State Council has also required banks to increase mortgage rates on lending to people purchasing a second property.

Since the February *Statement*, data for other east Asian economies (excluding Japan) have also been positive, suggesting these economies carried considerable momentum into early 2010. Malaysia and Thailand reported December quarter growth of more than 3 per cent, and Taiwan of more than 4 per cent, while preliminary estimates for Korea and Singapore suggest March quarter growth of 1¾ per cent and 7¼ per cent respectively. These robust quarterly outcomes have been driven by broad-based strength in industrial production and exports (Graph 6).

Rebounding production has generated corresponding improvements in labour demand across most countries in the region, and a tightening of capacity more generally. Consistent with this, consumer price inflation has picked up somewhat in a number of economies. Asset prices, particularly house prices, have also risen sharply in several countries over the past year, after earlier falls. Policy-makers in some economies have begun to take steps towards normalising financial conditions through a range of channels, including: increasing policy rates (Malaysia); tightening of macroprudential regulations, particularly in relation to mortgage lending (all of the higher-income Asian economies); and nominal exchange rate appreciation (Singapore).

Graph 4

China – GDP Growth

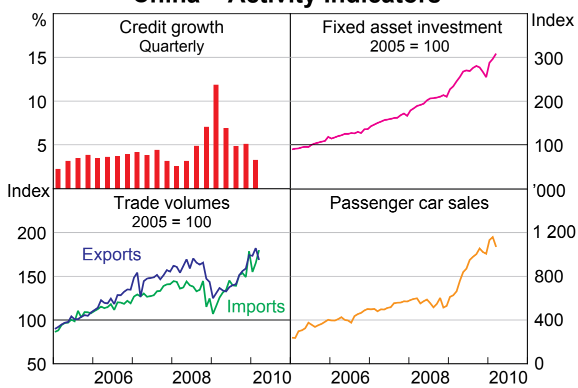


* RBA estimates

Sources: CEIC; RBA

Graph 5

China – Activity Indicators*



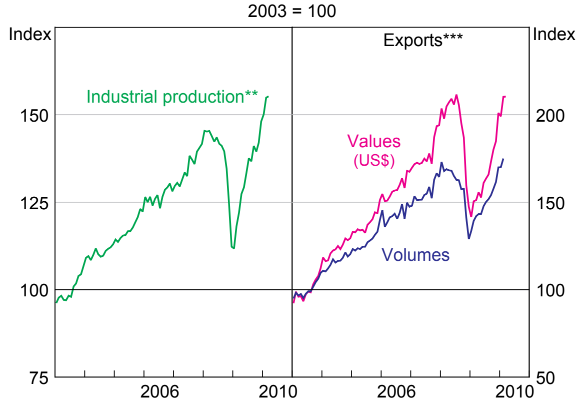
* RBA estimates

Sources: CEIC; RBA

Graph 6

East Asia* – Production and Exports

2003 = 100



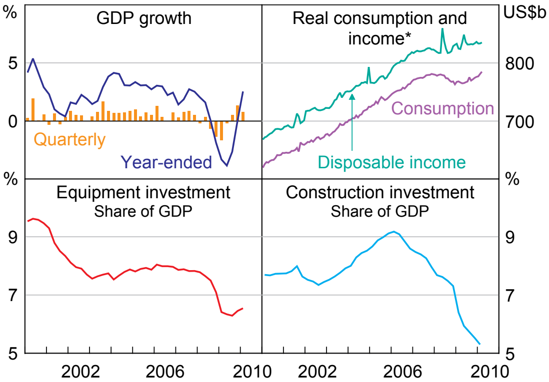
* Excludes China and Japan

** GDP-weighted; excludes Hong Kong and Indonesia; RBA estimate for March 2010

*** Excludes Malaysia and the Philippines; volumes are weighted using US$ export values

Sources: CEIC; RBA

Graph 7
United States – Activity Indicators



* Monthly
Source: Thomson Reuters

years is likely to weigh on demand growth in many developed economies.

Conditions remain healthy in the Indian economy, although year-ended growth in real GDP slowed to 6 per cent in the December quarter due to the effects of an unusually dry summer monsoon. A range of information suggests that economic activity in early 2010 has been robust, with industrial production, the services PMI and external trade pointing to solid growth in the non-farm economy and agricultural output expected to have stabilised in the March quarter. Wholesale price inflation has continued to rise, to around 10 per cent over the year to March. Citing growing concern about inflation developments, the Reserve Bank of India raised its policy interest rates by 25 basis points in both March and April. In addition, the cash reserve ratio was increased by 25 basis points in April, after increases totalling 75 basis points earlier this year.

In the advanced economies, activity continues to recover, although output remains well below earlier levels and medium-term prospects are clouded by significant structural challenges. One of these is reversing the substantial decline in national net saving in many countries, with net saving having turned negative in the United States and Japan for the first time in many decades primarily reflecting developments in government budget positions. The need for national saving to increase over coming years is likely to weigh on demand growth in many developed economies.

In the United States, recent data suggest that the significant monetary and fiscal stimulus has now helped to generate an expansion in private final demand. Consumption and equipment investment are growing, with output growth less dependent upon the inventory cycle. GDP expanded by 0.8 per cent in the March quarter, following growth of 1.4 per cent in the December quarter, to leave output 1¼ per cent below its peak in the June quarter 2008 (Graph 7). Household consumption recorded a third solid quarterly rise, although real personal disposable income remained unchanged in the face of ongoing slow wage growth and only a limited recovery in labour demand (as measured by aggregate hours worked, which increased by 0.4 per cent in the March quarter). Machinery & equipment investment also rose solidly for a second quarter, with core capital goods orders suggesting further growth is in prospect.

In contrast, construction investment (both residential and non-residential) remains depressed, declining in the March quarter to a new low of only 5¼ per cent of nominal GDP, down around one-third from the average share seen over recent decades. The commercial real estate market remains weak, with commercial property prices down by more than 40 per cent from their early 2008 peak and delinquency rates on commercial property lending continuing to rise. In the housing market, after increasing modestly through mid 2009, measures of house prices have broadly tracked sideways since September, while new and existing home sales are only slightly above their earlier troughs (Graph 8). New home starts remain depressed, the vacancy rate is still elevated, and the stock of foreclosed homes rose further in the December quarter, albeit more slowly than in the two previous quarters.

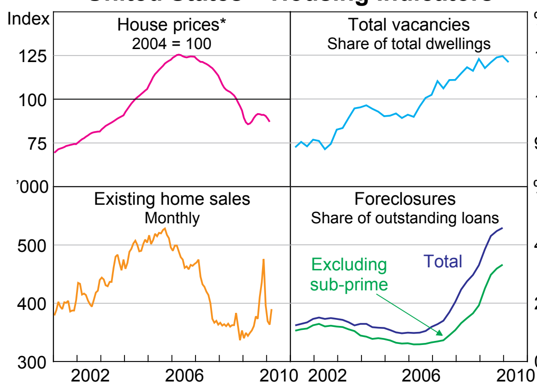
Weakness in construction spending, both residential and non-residential, also continues to constrain activity in Europe, where the recovery to date remains least advanced. In the December quarter, a faltering in the pace of expansion in Germany and Italy saw the euro area record no growth, with consumption and investment declining further. Overall, available data suggest little if any growth in the euro area in the March quarter, although recent data on euro area industrial production suggest some recovery in the manufacturing sector in early 2010. In the United Kingdom, December quarter growth was revised up by 0.3 percentage points from the preliminary estimate, to 0.4 per cent, while output is estimated to have expanded by a further 0.2 per cent in the March quarter, underpinned by growth in manufacturing and in business services & finance.

Concerns over fiscal sustainability in Greece (and to a lesser degree Portugal, Ireland and Spain) continue to weigh on confidence across Europe. As discussed further in the 'International and Foreign Exchange Markets' chapter, investor concerns about the Greek Government's deficit and debt levels remain high despite announcements of emergency lending support from the euro area and IMF (Graph 9). Greece's debt servicing ability is being impaired by ongoing declines in output, with limited prospect of a strong recovery in growth given its loss of competitiveness over many years compared with other euro area economies (and inability to restore international competitiveness through currency devaluation while remaining within the euro area).

In Japan, the strong December quarter GDP outcome and the recovery over recent months in consumer confidence and business surveys (such as the Economy Watchers and Shoko Chukin surveys) have eased earlier fears about the durability of the recovery. Export volumes continue to grow strongly, and have now recovered nearly two-thirds of their decline, while the pace of industrial production growth has been solid (although it may be beginning to moderate, with production little changed over February and March following almost a year of rapid monthly increases).

Graph 8

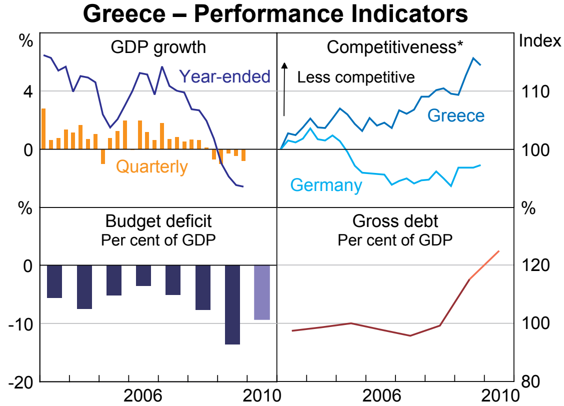
United States – Housing Indicators



* LoanPerformance house price index
Sources: First American CoreLogic; Thomson Reuters

Graph 9

Greece – Performance Indicators



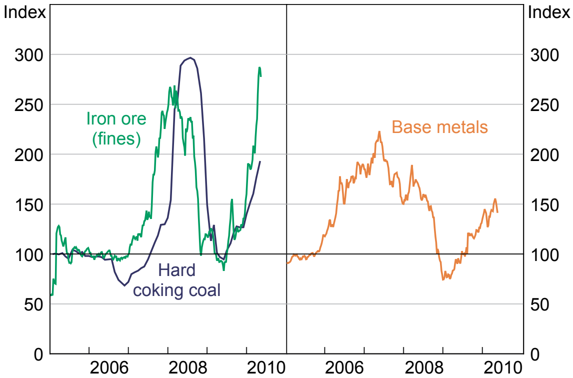
* ECB harmonised competitiveness index; March quarter 2003 = 100
Sources: European Central Bank; European Commission; Thomson Reuters

Commodity Prices

Commodity prices have continued to rise in recent months, supported by increased global industrial production and the relative strength of the recovery in Asia. The RBA's index of commodity prices has risen by around 25 per cent since the February *Statement* (in SDR terms), to be nearly 45 per cent above its trough in mid 2009. The increases in commodity prices are feeding through into a significant increase in the terms of trade and nominal incomes, as discussed further in the 'Economic Outlook' chapter.

Graph 10
Commodity Spot Prices

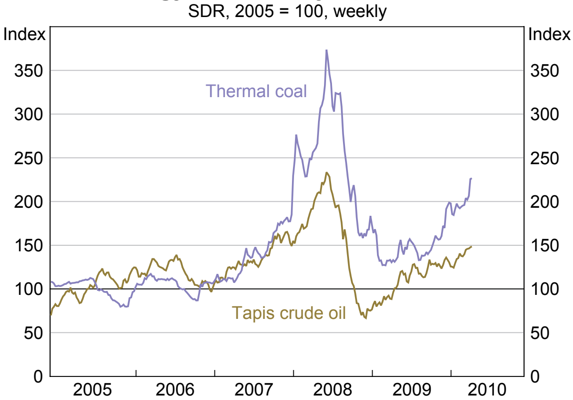
SDR, 2005 = 100, weekly



Sources: Bloomberg; Citigroup; Energy Publishing; Macquarie Bank; RBA

Graph 11
Energy Commodity Spot Prices

SDR, 2005 = 100, weekly



Sources: Bloomberg; RBA

Contract prices for bulk resource commodities have settled well above 2009/10 benchmarks, and much higher than was expected a few months ago. These settlements have seen a significant shift in the pricing regime for iron ore and coking coal, away from annually negotiated benchmarks toward more frequent resetting of prices. It appears that the new arrangements will result in quarterly contract prices that broadly follow spot market prices. While there is some uncertainty, for the June quarter, Australian producers look to have negotiated increases (relative to the previous annual contracts) of around 100 per cent for iron ore fines, and between 55 per cent and 100 per cent for various grades of coking coal. Since these quarterly agreements were reached, spot prices for iron ore and coking coal have continued to rise to be around 40 per cent and 25 per cent above the estimated new prices (Graph 10). A more detailed discussion of the recovery in iron ore and coking coal prices is provided in 'Box A: The Boom in the Prices of Steel-making Commodities'.

The recovery in industrial activity and improved sentiment about the global economic outlook have also supported base metals prices. The RBA index of base metals prices has risen by around 10 per cent since the time of the February *Statement*, to be 80 per cent higher than its December 2008 low. A rebound in stainless steel production has driven a particularly large rise in the price of nickel, which is more than 30 per cent higher since the start of the year.

Prices of energy commodities have also risen strongly since the February *Statement*. Spot prices for thermal coal have strengthened, owing to strong demand from China as drought conditions in the country's south have restricted hydro power generation, and contract prices for 2010/11 have been settled between 36 and 40 per cent above last year's benchmark (Graph 11). Oil prices have risen to around their highest level since October 2008.

Rural commodity prices are broadly unchanged since the February *Statement*. Wheat prices have risen slightly, although they remain at low levels owing to ample global supply, while sugar prices have fallen by more than one-third from their January peak on expectations of improved supply over the coming year.