

Overview

The global economy grew at an above-trend pace in 2010 and a continuation of strong growth is expected over the next couple of years, albeit with some moderation in the pace. There are, however, large differences in the amount of spare capacity across economies. In many advanced economies, output remains around, or below, pre-crisis levels and unemployment rates are still very high. In contrast, most emerging market economies have experienced very strong recoveries and spare capacity is limited.

In Asia, growth looks to have picked up again recently, after softening in the middle of 2010. The Chinese economy is growing strongly and this is benefiting other economies in the region, with international trade and industrial production recording significant increases in the final months of 2010. Across the region, inflation rates have picked up, with food prices in particular rising strongly. In response, policy interest rates have been increased in most countries, although real interest rates generally remain quite low. Authorities have also taken measures to slow credit growth and short-term capital inflows, which are putting upward pressure on exchange rates.

In the United States, the near-term outlook has improved, with household consumption stronger than earlier expected and indicators of investment showing a gradual improvement. The euro area as a whole continues to experience a modest recovery, although conditions vary significantly across countries.

The improvement in the global economy, together with some weather-related disruptions to supply, has led to generalised strength in global commodity prices over recent months. The spot price of iron ore is around its record high and there have been substantial increases in food prices and the prices of a range of base metals. The price of oil has also risen, although it remains substantially below its mid-2008 peak. This increase in commodity prices is adding to global inflationary pressures and, in the case of Australia, is leading to a further increase in the terms of trade from their already elevated level.

Despite global growth having generally surprised on the upside over the past 18 months, one ongoing downside risk is that the sovereign debt problems in some euro area economies escalate again, triggering another round of very high risk aversion. More generally, the need for continuing repair of both private- and public-sector balance sheets in a number of advanced economies means that the winding back of spare capacity in those countries is likely to be protracted. In Asia, a continuation of strong growth is expected in the short term, although rising inflation pressures have increased the risk of a significant slowdown over a somewhat longer horizon.

In financial markets, sentiment has generally improved over recent months. Globally, equity markets and bond yields have risen, although the latter remain low overall. Bond market issuance has also picked up further, including in Australia, where the issuance of residential mortgage-backed securities has increased. The Australian dollar, in

real terms, remains at around its highest level in the post-float era, reflecting the high level of commodity prices and the interest differential between Australia and the rest of the world.

The main exception to this general improvement in sentiment is in Europe, where concerns about the sustainability of public finances in a number of countries have increased. While the primary focus recently has been on Ireland and Portugal, the borrowing costs of Spain and Belgium have also risen significantly over recent months. Given the considerable task of improving the state of public finances in a number of European countries, it is likely that concerns about sovereign creditworthiness will remain elevated for some time.

The Bank's medium-term outlook for the Australian economy remains broadly unchanged from that in the November *Statement*, although the floods in eastern Australia will have a temporary effect on GDP outcomes over coming quarters. Cyclone Yasi is also likely to have an effect although, at the time of writing, an assessment of the magnitude was not yet possible. These recent extreme weather events have damaged parts of the capital stock in the affected regions and disrupted production, with the biggest effect on GDP likely to arise from swings in coal production.

While the full extent of the disruption and damage is not yet known, the Bank's preliminary estimate (made prior to an assessment of the impact of Cyclone Yasi) is that the level of output in 2010/11 as a whole will be around ½ per cent lower than would otherwise have been the case, with most of the negative effect in the December and March quarters. The pace of the recovery will vary by industry and region but the overall level of GDP in the June quarter is likely to be back close to the level it would have been in the absence of the floods. This assessment assumes that there are no substantial economic effects of further extreme weather events. Following the June quarter, rebuilding efforts are expected to add modestly to aggregate demand, with the exact size of the boost depending on the extent of the

damage, the speed of rebuilding and the extent to which other private and public spending is deferred.

Over recent months there have been further indications that the forecast pick-up in private investment is occurring, with the announcement of a number of large resource-sector projects. Broader measures of business conditions and overall capacity utilisation remain around average, although conditions differ significantly across industries. While the resources sector and some service industries are expanding strongly, parts of the manufacturing, education, retail and tourism sectors are experiencing difficult trading conditions. Business credit remains weak, with much of the expansion of the resources sector being financed through internal funds. Commercial property construction also remains at low levels.

The household sector has continued to exhibit considerable caution in its spending and borrowing behaviour. With growth in income over recent years significantly outstripping growth in consumption, the household saving ratio has increased substantially. Nominal retail sales remain weak and retailers report that consumers continue to be very value-conscious. Housing credit growth is also subdued compared with the standards of previous years, although it is only a little below the pace of growth in household income. Nationwide measures of housing prices have been broadly flat since mid 2010. Overall, many households appear to be taking a more cautious approach to their finances than was the case in earlier years. With business investment expected to grow strongly, this more cautious approach, if it is maintained, would reduce the pressures on capacity that are likely to arise over the period ahead.

The labour market continues to be strong, with employment increasing by nearly 200 000 persons over the second half of 2010, the participation rate increasing, and the unemployment rate ending the year at 5 per cent. Employment growth has been particularly strong not only in the mining industry, but also in a number of service industries. Forward-

looking indicators of the labour market – including job vacancies, job advertisements and business surveys – all suggest continued solid employment growth over coming months, though most likely at a slower pace. Businesses are reporting that the labour market has tightened, although most are not experiencing significant difficulties in hiring employees. The labour market appears tightest for some mining-related and skilled occupations.

Wage growth increased over 2010, consistent with the strengthening in labour market conditions. This pick-up reflects stronger wage growth in the private sector, following low outcomes in 2009, and continued solid growth of public-sector wages. Overall, however, labour costs appear to have grown at around their average pace over 2010. Looking ahead, a gradual increase in wage growth is expected as the labour market tightens further.

Consumer price inflation has continued to moderate from its peak of just over 4½ per cent in September 2008. In underlying terms, inflation was a little under ½ per cent in the December quarter and around 2¼ per cent over the year. In headline terms, the CPI increased by 0.4 per cent in the December quarter, to be 2.7 per cent higher over the year. Most of the difference between the year-ended rates of underlying and headline inflation is due to the increase in tobacco excise in 2010, which is estimated to have increased the CPI by nearly 0.4 per cent.

These recent inflation outcomes were lower than expected. While food prices recorded a large increase in the December quarter – following a period of low outcomes – there were sizeable price declines for a wide range of consumer goods. These price declines largely reflect the pass-through of both the exchange rate appreciation and the tariff cuts in early 2010, which appears to have been a little faster than suggested by earlier experience, most likely reflecting weak consumer demand. Growth in rents and the prices of utilities slowed in the December quarter, although the latter reflects the timing of utility tariff adjustments.

The Bank's central forecast for the economy over the next few years is largely unchanged from the November *Statement*. However, as noted above, the recent floods will have a material effect on the near-term profile of GDP, with growth in the December and March quarters notably lower than would otherwise have been the case, followed by a strong recovery in the June quarter as coal production picks up and the rebuilding effort gets under way. Over the four quarters to December 2011, GDP is expected to increase by 4¼ per cent. This is higher than was expected at the time of the November *Statement*, but this revision reflects the lower starting point as a result of the flooding in December 2010. Beyond 2011, GDP is forecast to grow by 3¾–4 per cent.

This medium-term outlook continues to reflect the expected strong growth in mining investment and high commodity prices, which have been providing a substantial boost to incomes in Australia. With GDP growth expected to be above trend over much of the forecast horizon, pressures on capacity are likely to emerge in parts of the economy as the structural adjustment to the large change in relative prices takes place. The substantial increase in the price of Australia's exports has meant that the real exchange rate is higher than it would otherwise have been, and this is contributing to differences in growth prospects across industries.

The near-term forecast for year-ended underlying inflation has been revised down a little since November, reflecting the base effects of the recent outcome. While the exchange rate appreciation and soft retail spending are expected to continue to place downward pressure on the prices of many consumer durables, the floods have temporarily boosted the prices of some commodities. In terms of headline inflation, the floods are expected to add around ¼ percentage point to CPI inflation in the March quarter – mainly through higher fruit and vegetable prices – with much of this being reversed in the following quarter. Some additional effects can also be expected from Cyclone Yasi, but at the time of writing not enough information was available to quantify these.

The medium-term outlook for inflation is broadly unchanged. In underlying terms, inflation is expected to be around 2½ per cent later in 2011, before picking up gradually to 3 per cent by late 2012. In the next few quarters, year-ended CPI inflation is likely to remain above underlying inflation, largely due to the effects of the earlier increase in tobacco excise and significant increases in the prices of utilities.

In addition to the international factors discussed earlier, one uncertainty surrounding these forecasts is the economic impact of the recent severe weather events, and the possibility of further such events. The outlook for consumption and the timing of the pick-up in resource sector investment are two other important influences on the outlook. The household saving ratio is forecast to remain broadly unchanged over the forecast period, after having increased significantly since the mid 2000s. There are, however, plausible scenarios in which the saving ratio increases further, and others in which it declines. On investment, while confidence in the broad outlook has increased, the exact timing and scale of projects

remain difficult to forecast. Given the size of the large projects, changes in timing can have a material effect on the quarterly profile of aggregate demand and GDP.

Over late 2009 and 2010, the Board gradually removed the monetary stimulus that was put in place during the global downturn. In late 2010, it concluded that given the medium-term outlook for the economy and inflation, it was prudent to make a further modest adjustment to monetary policy. As a result of this move, and the subsequent adjustments by lenders, most loan rates are now a little above their average levels of the past decade or so.

In setting monetary policy over the period ahead, the Board will, as on past occasions when natural disasters have occurred, look through the estimated short-term effects on output and prices. The focus of monetary policy will remain on the medium-term prospects for economic activity and inflation. At its recent meeting, the Board judged that in view of the general macroeconomic outlook, the current setting of monetary policy remained appropriate. ✦