5. Economic Outlook

Global economic growth is forecast to be slower and inflation higher than forecast a few months ago. Inflation has been persistently high because many advanced economies are at or close to full employment, commodity prices have risen sharply and there are ongoing supply disruptions. High inflation has prompted a faster withdrawal of monetary policy accommodation and is also clouding the growth outlook. Despite low unemployment, wages growth has been much slower than consumer price inflation across a range of economies, resulting in significant declines in real wages and consumer sentiment. Following a strong recovery from the depths of the pandemic, growth in the global economy is forecast to slow in the year ahead, to a little below the average rate of growth in the decade prior to the pandemic (see chapter on 'The International Environment').

A strong expansion in the Australian economy is underway. This is expected to continue over the forecast period, despite the slowdown in global growth. The domestic outlook is supported by the substantial boost to national income from high commodity prices and growth in private consumption and investment. After slowing in the March quarter in response to the Omicron outbreak, activity is forecast to regain momentum over 2022 as saving and spending patterns continue to normalise and a further tightening in the labour market supports real household income. Growth is then forecast to moderate in 2023 as extraordinary policy support is withdrawn, rising prices weigh on real income and consumption growth slows to more typical rates. GDP is forecast to grow by 4¼ per cent over 2022, and by 2 per cent over 2023; these forecasts are little changed from three months ago (Table 5.1). Strong ongoing demand for labour is expected to see the unemployment rate decline to around 3½ per cent in early 2023, a little below the previous forecast, and remain around this level for the rest of the forecast period. This is anticipated to result in labour costs picking up faster than previously expected.

As observed in other advanced economies, consumer price inflation in Australia has picked up markedly since the middle of 2021 and the outlook for inflation has again been revised higher. Headline inflation is forecast to peak around 6 per cent in the second half of this year. Underlying inflation has also risen strongly and is forecast to increase further to 4¾ per cent in the second half of 2022, largely reflecting further pass-through of upstream cost pressures. As some of the current cost pressures reflect supply bottlenecks domestically and abroad and are likely to moderate over time, headline and underlying inflation are forecast to return to the top of the 2 to 3 per cent target range by the end of the forecast period. Higher labour costs in response to a tight labour market are expected to become the primary driver of inflation outcomes later in the forecast period.

Key sources of uncertainty for the domestic outlook include the future evolution of COVID-19, changes in price- and wage-setting behaviour at historically low levels of unemployment, and the response of households, firms and asset prices to higher inflation and interest rates.

Table 5.1: Output Growth and Inflation Forecasts[(a)]

Per cent

	Year-ended					
	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023	June 2024
GDP growth	4.2	3½	4¼	3	2	2
(previous)		(5)	(4¼)	(2½)	(2)	(2)
Unemployment rate[(b)]	4.7	3¾	3¾	3½	3½	3½
(previous)		(4)	(3¾)	(3¾)	(3¾)	(3¾)
CPI inflation	3.5	5½	6	4¼	3¼	3
(previous)		(3¾)	(3¼)	(2¾)	(2¾)	(2¾)
Trimmed mean inflation	2.6	4½	4¾	3½	3¼	3
(previous)		(3¼)	(2¾)	(2¾)	(2¾)	(2¾)
	Year-average					
	2021	**2021/22**	**2022**	**2022/23**	**2023**	**2023/24**
GDP growth	4.7	3¾	4½	4½	2¾	2
(previous)		(4½)	(5½)	(4¾)	(2½)	(2)

(a) Forecasts finalised on 4 May. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing, and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the May 2022 Board meeting. Other forecast assumptions (February *Statement* forecasts in parenthesis): TWI at 63 (60); A$ at US$0.71 (US$0.71); Brent crude oil price at US$101bbl (US$85bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government Budget 2022–23. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter.

Sources: ABS; RBA

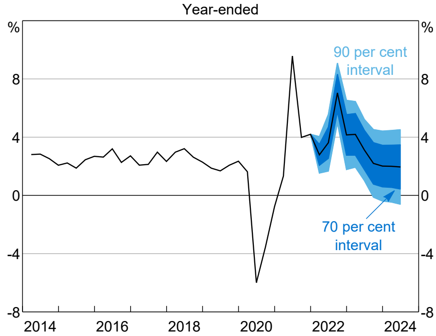
A strong expansion in the Australian economy is under way and inflation will increase further

The outlook for economic activity in Australia is underpinned by growth in private consumption and investment (Graph 5.1). Household consumption is forecast to grow strongly over 2022 as spending on services picks up; this outlook is supported by rising labour income, fiscal measures and the large increase in wealth over recent years. Increases in interest rates and consumer prices are anticipated to weigh on households' budgets over the forecast period, but the effect on consumption is expected to be cushioned by a decline in the household saving ratio. An upswing in business investment continues to be in prospect, supported by strong corporate balance sheets and the broader recovery in demand. Commodity price developments are forecast to result in the terms of trade reaching a record high in the June quarter, boosting national income.

Graph 5.1

GDP Growth Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

Employment is forecast to grow strongly during 2022, consistent with the ongoing strength in leading indicators of labour demand, before moderating thereafter in line with activity. Participation in the labour force is expected to be sustained at historically high levels over the forecast period, supported by the cyclical strength in labour market conditions and the longer-term trend toward increased participation among females and older Australians. The unemployment rate is forecast to decline to around 3½ per cent in early 2023 – the lowest level since 1974 – and remain around this level thereafter (Graph 5.2). Broader measures of labour underutilisation that include workers who are underemployed are also forecast to decline to their lowest level in many years as firms increase staff hours to meet demand. The reopening of the border could, over time, help to alleviate labour shortages in some industries, while also adding to demand in the economy.

The forecast profile for underlying inflation has been revised up substantially compared with a few months ago. A shift in the sources of inflation over the forecast period is still expected. The upstream cost pressures that have boosted the prices of consumer durables and new dwellings since the latter part of 2021 are now expected to persist for longer than previously anticipated, reflecting the impact of the war in Ukraine (including the effect of higher oil prices on costs faced by firms) and renewed lockdowns in parts of China. The effects of these cost increases on consumer prices have also broadened over recent months. A significant share of firms in the Bank's liaison program have increased prices or expect to increase their prices over coming months as a result of the sustained rise in input costs.

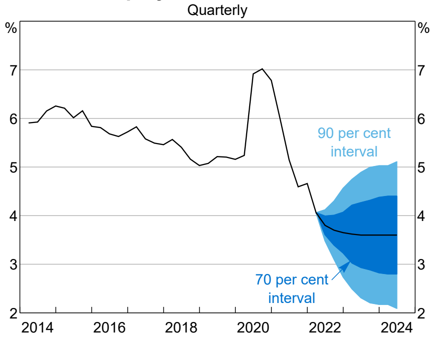
Reflecting these developments, underlying inflation is forecast to increase to around 4¾ per cent in the second half of 2022 before easing back towards the top of the inflation target range as international and domestic supply chain pressures subside (Graph 5.3). Later in the forecast period, the main contributor to inflation is expected to be the increase in labour costs resulting from a tight labour market. Headline inflation is forecast to be well above trimmed mean inflation in the near term (mainly due to the prices of fuel and new dwellings) but to be broadly in line with underlying inflation thereafter.

The forecasts are based on some technical assumptions. The assumed path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing, with a cash rate of 1¾ per cent in the December quarter of 2022 and 2½ per cent in

Graph 5.2

Unemployment Rate Forecast*

Quarterly

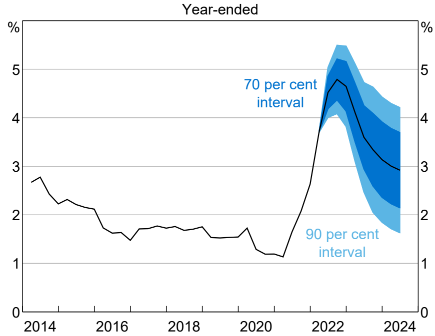


* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

Graph 5.3

Trimmed Mean Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

the December quarter of 2023. The exchange rate and oil price are assumed to remain unchanged at current levels. Population growth projections have been revised up, reflecting the assumptions used in the Australian Government Budget 2022–23. The forecasts are also based on the assumption that future waves of COVID-19 variants will mostly have a temporary impact on the economy, with limited restrictions on economic activity required and the labour market adjusting mainly through a reduction in hours worked. The risk of a more harmful variant of the virus with more serious economic consequences is one of several uncertainties for the outlook (see 'Key domestic uncertainties', below).

Household consumption, income and saving

Household consumption remained resilient in the March quarter despite the Omicron outbreak and floods in New South Wales and Queensland, and is forecast to grow strongly over the rest of the year as spending on discretionary goods and services, including travel, continues to recover (Graph 5.4). The consumption forecast is underpinned by strong household balance sheets and higher household disposable income; this partly reflects strong growth in labour income, supported by the tight labour market. Non-labour income is also forecast to be significantly higher this year, reflecting pandemic-related social assistance payments, flood disaster payments, and other policy measures announced in the Australian Government Budget 2022–23, including cost-of-living support payments for low-income households. High commodity prices are forecast to boost financial income via dividend payments from the resources sector, as well as returns on superannuation.

Further ahead, consumption growth is forecast to ease as rising prices and higher net interest payments weigh on real income growth, and housing prices moderate. After increasing in the March quarter to levels significantly above pre-pandemic norms, the household saving ratio is expected to decline over the remainder of the forecast period.

Investment

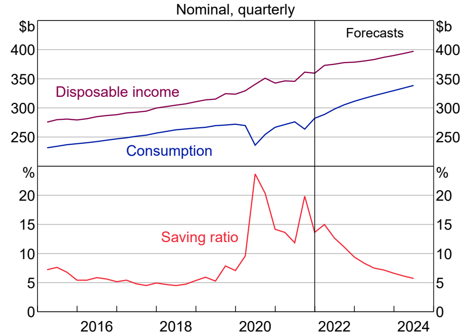
The outlook for investment remains positive with a large pipeline of public and private projects expected to sustain activity over coming years (Graph 5.5). However, construction activity declined in the December quarter due to capacity constraints relating to shortages of materials and skilled labour. The recent flow of data and information from the Bank's liaison program indicate that these pressures have intensified and are likely to be a constraint on output for some time, resulting in a lower level of construction activity across the forecast period compared with earlier projections.

Though demand for new dwellings appears to be easing after strong growth over the past few years, a large pipeline of residential construction work is anticipated to sustain a high level of activity for several years. Capacity constraints and the recent floods in eastern Australia have, however, led to longer construction times, which will limit the pace of work in the near term. Prospects for higher density residential projects are expected to improve following the decline in vacancy rates in Sydney and

Graph 5.4

Household Consumption and Income

Nominal, quarterly



Sources: ABS; RBA

Melbourne and the reopening of the international border.

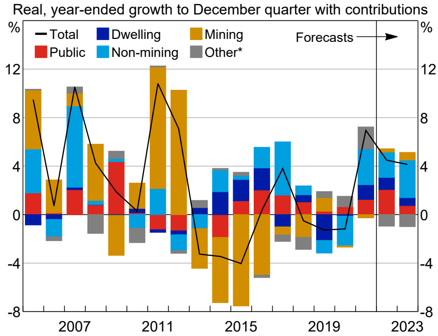
The strong upswing in non-mining business investment that was underway over the first half of 2021 has paused since then but is expected to regain momentum over the next two years. This growth is forecast to exceed that of the overall economy and so lift the non-mining investment share of GDP from historically low levels. Investment in machinery & equipment declined late last year, after earlier strong growth as some firms brought forward investment in response to tax incentives. Supply chain disruptions also persisted into the March quarter and, alongside shortages of skilled labour, are expected to restrain growth in the near term. However, over coming years, a tight labour market and higher labour costs are likely to encourage some firms to lift their investment in machinery & equipment and software. A rebound in non-residential construction investment is expected, but the timing has been pushed out in response to delays as higher costs and capacity constraints restrain growth across the construction industry. Private non-residential building approvals have also trended lower over recent months.

Mining investment is forecast to increase a little over coming years, though shortages of skilled labour and some materials are anticipated to weigh on growth in the near term. There is little evidence to date that recent large moves in bulk commodity prices have affected the investment plans of the major miners, though higher prices for some other commodities such as gold and battery minerals are stimulating additional investment in exploration and production.

Graph 5.5

Investment

Real, year-ended growth to December quarter with contributions



* Includes ownership transfer costs, net purchases of second-hand assets, and other items.

Sources: ABS; RBA

Public demand

Public consumption is forecast to have increased further in the March quarter from an already high level, after a pause in growth in the December quarter. Governments' health spending remains elevated due to Omicron, and the response to the floods will add to public consumption. Beyond 2022, consumption is forecast to decline a little as these measures are partly unwound.

Growth in public investment is forecast to be strong over 2022 as more infrastructure projects get underway. The pipeline of public engineering work is anticipated to support a high level of public capital expenditure for several years, but the speed of the rollout will be constrained by labour and materials shortages for some time.

External sector

Growth in exports will be supported by a recovery in travel and education exports now the international border has reopened. Resource export volumes declined over the second half of 2021 as maintenance and weather-related disruptions weighed on production; these disruptions are forecast to persist in coming quarters. The recent strength in rural exports is expected to be sustained in the near term; this reflects favourable growing and pasture conditions, and strong global demand for grains following disruptions to agricultural trade due to Russia's invasion of Ukraine. Manufactured exports are forecast to remain below their pre-pandemic level over 2022 due to ongoing global supply chain disruptions.

Import volumes are forecast to increase in line with domestic demand and the reopening of the international border. Strong global goods price inflation is expected to lift import prices further over the forecast period.

The outlook for the terms of trade has been boosted by higher commodity prices. Global energy prices have risen sharply in response to Russia's invasion of Ukraine, and there has been considerable volatility in energy markets. It is likely that the terms of trade in the June quarter of 2022 will exceed their previous peak in late 2021 (Graph 5.6). Commodity prices are projected to decline over the forecast period but to remain higher than previously anticipated, contributing to an elevated level in the terms of trade compared with three months ago.

Labour market

Labour market conditions improved further in early 2022 and leading indicators suggest this will continue for some time. The labour market adjustment to Omicron-related disruptions earlier in the year occurred mostly through hours worked and the effects have been short lived. Employment growth is forecast to remain strong in 2022 before moderating thereafter in line with slowing activity growth (Graph 5.7). The participation rate is forecast to reach a historic high later this year, supported by strong labour demand and longer-run structural drivers, such as higher participation rates among females and older Australians.

A broad range of measures of labour market spare capacity suggest the labour market is the tightest it has been in many years. The unemployment rate is forecast to decline to around 3½ per cent in early 2023 and stay around this level for the remainder of the forecast period; an unemployment rate this low has not been observed in Australia since 1974. An increase in average hours worked is also expected to be a key margin of adjustment in response to strong labour demand. Average hours worked are forecast to rise to around the pre-pandemic level over the course of 2022, leading to further declines in broader measures of labour underutilisation.

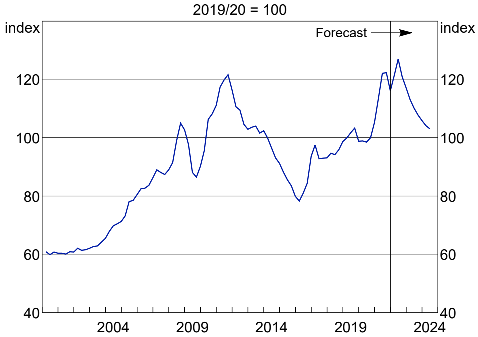
Wages

Wages growth is forecast to pick up further as labour market conditions continue to tighten. The outlook for private sector wages growth is stronger than a few months ago, reflecting the upgrades to the labour market and inflation forecasts; firms in the Bank's liaison program expect materially higher wages growth over coming quarters than they were anticipating

Graph 5.6

Terms of Trade

2019/20 = 100

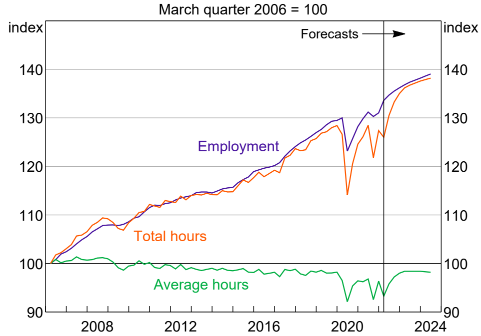


Sources: ABS; RBA

Graph 5.7

Employment and Hours Worked

March quarter 2006 = 100



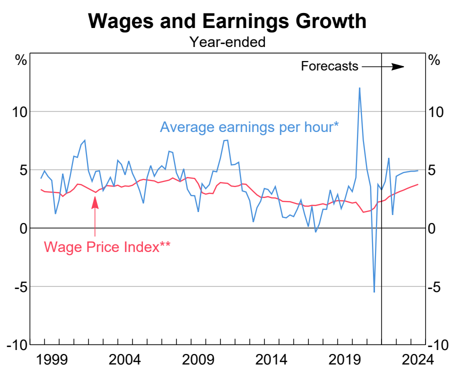
Sources: ABS; RBA

just a few months ago. Business surveys also indicate that labour costs are picking up. The outlook for broader measures of employee earnings growth has been upgraded as firms use bonuses, allowances and other non-base wage payments to attract and retain workers in a tightening labour market. As multi-year enterprise agreements expire and private-sector benchmarks flow through to public sector wage policies, some of the increase in aggregate wages growth outcomes will occur with a lag.

Growth in the Wage Price Index (WPI) is forecast to pick up to around 3 per cent by the end of 2022. Wages growth is then forecast to strengthen further as the unemployment rate declines, to be 3¾ per cent by mid-2024; this would be the fastest pace since 2012 (Graph 5.8).

The forecasts for broader measures of earnings imply more upward pressure on firms' labour costs than the narrower measure of base wages captured in the WPI. Average earnings are expected to increase at a faster pace than the WPI over the forecast period due to scheduled increases in the Superannuation Guarantee, along with increases in bonus payments and as more hours are worked at overtime rates. This will also be supported by a pick-up in job turnover as workers are more willing to move jobs for higher pay.

Graph 5.8



* Non-farm; includes social contributions.
** Excluding bonuses and commissions.
Sources: ABS; RBA

Inflation

The outlook for inflation is much stronger than anticipated a few months ago. In the near term, underlying inflation is forecast to be significantly boosted by the pass-through of upstream cost pressures to consumers, continuing the pattern observed in recent quarters. The war in Ukraine (and associated sanctions on Russia and Belarus) and renewed lockdowns in parts of China are expected to delay the easing of these cost pressures until later this year. High energy prices will also put pressure on margins for many firms, although it is uncertain how much or how quickly these cost increases will pass through to consumer prices. Additional demand for household goods and building materials induced by the flooding along the east coast is also forecast to contribute to inflationary pressures in the near term.

Inflationary pressures have broadened in recent months beyond energy, consumer durables and the prices of newly constructed homes. Many firms in the Bank's liaison program and business surveys, across a range of industries, have increased selling prices over recent months or indicated that they expect to increase prices over the months ahead. Price increases for new dwelling construction have been very strong, and are likely to persist in the near term. The treatment of HomeBuilder and similar state government grants will boost measured new dwelling inflation a little further over the year ahead. Momentum in rental prices has picked up and is forecast to continue over 2022 as the uplift in advertised rents observed over the past year or so works its way into the stock of outstanding rental agreements.

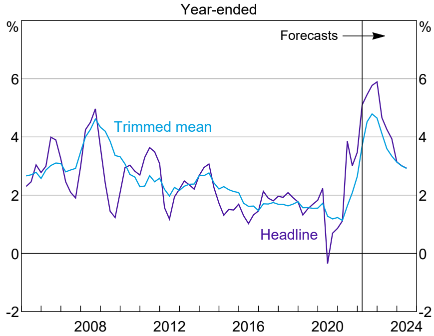
The primary driver of inflation outcomes is expected to change during the forecast period, though there is uncertainty about the timing of this transition. The pass-through of upstream non-labour cost pressures is anticipated to wane alongside an easing in supply bottlenecks, while growth in labour costs is forecast to pick up further out in the forecast period. Relative to the February *Statement*, the easing of non-labour input cost pressures is forecast to occur later, while the pick-up in domestically generated inflationary pressures from a tight labour market is forecast to occur sooner – this is anticipated to keep inflation above the target range for much of the forecast period.

Year-ended headline inflation is forecast to be well above underlying inflation over the coming year, largely reflecting the impact of higher prices for fuel and new dwellings (Graph 5.9). While new dwelling costs are expected to rise further in the June quarter, fuel prices will subtract from June quarter CPI if they remain around recent levels; however, the expiration of the fuel excise cut will boost headline inflation again in the December quarter. Headline inflation is forecast to converge back to underlying inflation later in the forecast period as the effect of recent fuel price movements dissipates. While the outlook for inflation has been revised higher, it remains below the headline inflation rate currently being experienced in many advanced economies.

Graph 5.9

Inflation Forecasts

Year-ended



Sources: ABS; RBA

Key domestic uncertainties

The economic effects of future COVID-19 variants

An ongoing uncertainty for the economy is the way governments, firms and households will respond in the event of a new variant of COVID-19 that has more severe health effects than Omicron. Renewed restrictions and/or precautionary behaviour would pose a downside risk to activity and labour market outcomes, although lockdowns as stringent as those implemented earlier in the pandemic appear much less likely now. The effect on inflation of any future restrictions is more uncertain than for activity; lower household consumption and higher unemployment would weigh on inflation but further disruptions to supply could sustain upstream cost pressures and stronger inflation outcomes for longer than currently expected.

The outlook for household consumption

Many households have benefited from large increases in housing wealth over recent years as prices have risen, which has supported growth in consumption. Many Australians have also built considerable savings buffers during the pandemic. If the willingness of households to spend from these liquid savings is higher than from other forms of wealth, consumption (or dwelling investment) would be stronger than expected.

However, consumption growth could also be weaker than forecast if rising interest rates and inflation were to weigh on asset prices and discretionary spending by more than anticipated. The sensitivity of asset prices to rising interest rates is uncertain, particularly in the case of housing where prices are high relative to incomes; a sharp decline in asset prices is a downside risk for consumption. More broadly, while many households would be well placed to absorb higher interest costs without sharp adjustments to spending, some households have low savings buffers and high debt relative to incomes, and their spending may fall more sharply than others. The additional pressure on household budgets from rising prices could exacerbate these downside risks to consumption, particularly for lower-income households.

The impact of supply shocks on price pressures

An important source of uncertainty is the speed of resolution of the various supply-side issues facing the economy and how prices respond. While COVID-19 was the initial source of disruption domestically and abroad in early 2022, the war in Ukraine, lockdowns in China and the east coast flood recovery effort are expected to exacerbate these issues in the near term. That said, the available evidence suggests that supply constraints – such as in construction, food and durable goods markets – are partly related to the combination of strong demand and the inability of supply to respond in a timely way. These constraints could intensify or persist for longer than forecast (as they have in some other economies), and firms have indicated in liaison that they are now more willing to pass on input cost pressures to consumer prices. In time, businesses will be able to invest to expand their capacity to deliver goods and services, but in the interim there could be a period of stronger-than-forecast growth in prices, and less output growth, while capacity constraints bind.

On the other hand, these constraints could ease more quickly than expected if production capacity can respond sufficiently or global demand growth slows more rapidly than forecast; this could result in price declines for some goods, which would weigh on inflation outcomes. Price pressures could also reverse more quickly than expected if oil and other commodity prices were to decline. In addition, businesses may refrain from passing on higher costs (by accepting margin compression) if they observe upstream price pressures resolving more quickly than currently indicated.

The evolution of labour costs and supply

The unemployment rate is forecast to decline to around 3½ per cent – its lowest level since the 1970s – and remain around this level for the rest of the forecast period. The participation rate is also forecast to remain at historically high levels. But with little recent relevant experience to draw on, it is possible that wage and price pressures build more quickly or slowly than expected. The pace and composition of net overseas migration following the reopening of the international border is also a source of uncertainty for the labour market outlook and could have different effects on labour supply across regions, industries and occupations. Depending on the interaction of these factors, it is plausible that unemployment falls even further, or that it begins to drift up towards the end of the forecast period as activity slows and the cost of labour increases.

The longer-term effects of the pandemic and changes in the pattern of globalisation on potential growth and full employment are uncertain but tilted towards capacity being more limiting than in the years prior to 2020. It is possible that some of the recent changes in spending and production patterns are long-lasting and that these constrain the efficient allocation of resources and, in turn, productivity. In this event, any given rate of growth could be more inflationary than before the pandemic.

The effect of high inflation and cost-of-living pressures on price-setting behaviour

Inflation in Australia and internationally is now forecast to be elevated for much of the forecast period. As well as dampening real incomes, a period of higher inflation could change how governments, businesses and households respond to actual and expected movements in prices. Given the labour market is already quite tight, workers might be more able to demand and achieve higher wages to compensate for the increased cost of living even in the absence of a lift in productivity; if employers pass these increased wage costs on to consumers, this could result in inflation being sustained at a higher rate than currently anticipated. ✠