Box B

# Has the Economic Outlook Evolved as Forecast a Year Ago?

Each year, a review of the RBA staff economic forecasts is undertaken to assess what we have learned about the economy and the forecasting approach, with a view to continuous improvement. For last year's review, see RBA (2022), 'Box C: What Explains Recent Inflation Forecast Errors?', *Statement on Monetary Policy*, November.[1]

Headline inflation and the unemployment rate have evolved broadly as expected a year ago. But underlying inflation has been higher than anticipated, as high services inflation has persisted in an environment of strong domestic cost pressures and still-robust levels of aggregate demand. Population growth has been substantially stronger than expected following the reopening of the border; however, the net effects on the aggregate inflation outlook and the unemployment rate have been relatively small because the increase in population has added to both aggregate supply and aggregate demand in the economy.

## Headline inflation has evolved broadly as expected a year ago

Headline inflation over the past year has been broadly in line with the Reserve Bank's expectations a year ago; inflation peaked at 7.8 per cent in late 2022 and has eased by 2½ percentage points since then (Graph B.1). This is in contrast to 2022, when inflation was significantly higher than Bank staff and most other forecasters had anticipated, reflecting in large part the unexpected imbalance between supply and demand during the pandemic.

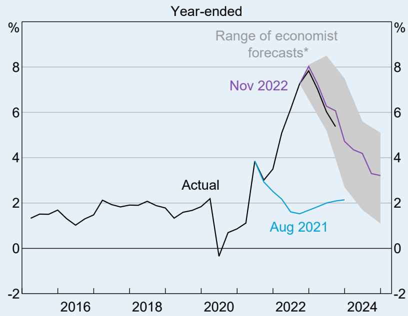
## Underlying inflation has been stronger than expected, reflecting an environment of elevated domestic cost pressures and still-robust levels of demand

Trimmed mean inflation peaked in late 2022 as forecast, but it has subsequently eased by less than expected (Graph B.2). The forecast miss on underlying inflation reflected higher-than-expected services inflation.

Domestic cost pressures (both labour and non-labour) have remained robust, contributing to stronger-than-expected underlying price pressures. Liaison with firms indicates that a range of domestic business

**Graph B.1**

**Headline Inflation Forecasts**




* Based on the November 2022 RBA Survey of Market Economists.
Sources: ABS; RBA.

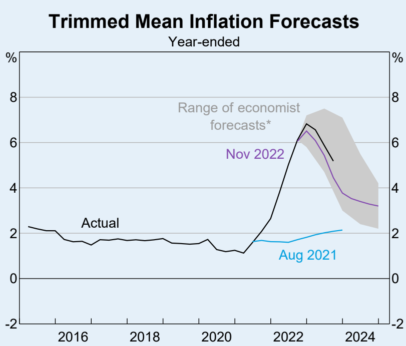
costs such as energy, rent, insurance and labour costs remain elevated (see Box A: Insights from Liaison). For goods price inflation, the downward pressure on import prices following the resolution of global supply chain issues has more than offset these domestic cost pressures. By contrast, services price inflation has been more persistent, as has been the case in many overseas economies. Ongoing robust levels of demand have allowed firms to pass on cost increases to final prices.

While it is difficult to assess underlying trends in productivity growth over short time periods, weak productivity outcomes have contributed to high labour costs. This has a larger impact on services inflation because services production has a higher labour component than goods production. Unit labour costs – which are labour costs (average earnings per hour in the national accounts) adjusted by labour productivity – are the measure of labour costs most relevant to inflation over the medium run. Although wages growth evolved broadly in line with the forecasts, growth in unit labour costs was materially higher, driven by weaker productivity outcomes than had been assumed a year ago. Non-farm labour productivity has declined to be around the levels recorded several years ago, as total hours worked increased by considerably more than output.

## Population growth has been stronger than anticipated, driven by a large increase in net overseas migration following the reopening of the border …

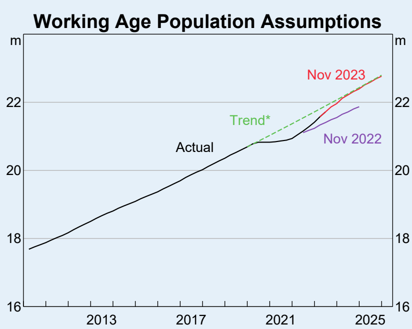
The faster-than-expected return of international students and working holidaymakers coupled with low rates of departures has driven a large increase in net overseas migration over the past year. As a result, the working age population is set to return to its pre-pandemic trend much earlier than previously thought (Graph B.3). As new information came to light, the population assumption used by the Reserve Bank in its forecasts was upgraded materially with implications for some other economic variables.[2]

### Graph B.2




* Based on the November 2022 RBA Survey of Market Economists.
Sources: ABS; RBA.

### Graph B.3




* Calculated using average quarterly growth from 2010–2019.
Sources: ABS; RBA.

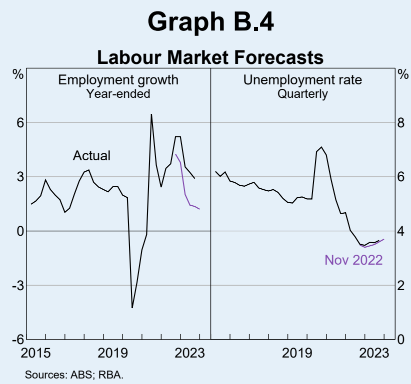
## … but the net effect on the unemployment rate and on aggregate inflation has been relatively small because the increase in population has added to both supply and demand in the economy

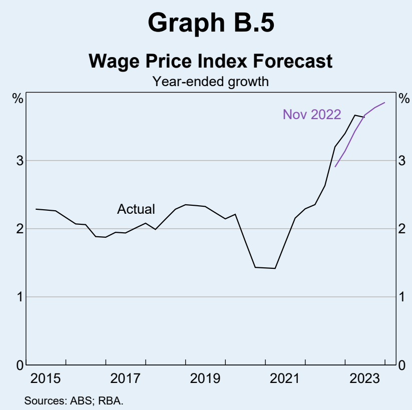
The upside surprise on population growth over the past year has added to both supply and demand in the economy and so the effects on aggregate inflation have been largely offsetting.

In the labour market, the increase in migration has contributed to faster-than-expected employment growth, while the employment-to-population ratio has remained around a record high, buoyed by the very high level of job vacancies. Consistent with this, the evolution of the unemployment rate has been broadly in line with expectations over the past year (Graph B.4). Both the unemployment rate and broader measures of spare capacity suggest that the labour market has become less tight since late 2022. Relatedly, wages growth has evolved broadly in line with the forecasts a year ago (Graph B.5). The supply and demand effects of stronger-than-expected population growth appear to have roughly offset in aggregate, while helping to alleviate labour shortages in specific sectors, such as hospitality. This has helped to contain wage pressures in some affected industries and geographic areas, though increased migration has not materially affected aggregate wages growth.

As discussed in Chapter 5: Economic Outlook, recent outcomes for GDP growth have surprised to the upside, suggesting that the economy is more resilient than was thought a few months ago. However, relative to a year ago, aggregate GDP growth and the level of GDP have evolved broadly as expected (the outlook for growth was downgraded in the first half of 2023 due to weak incoming data) (Graph B.6). The increase in population has offset softer-than-expected GDP per capita compared with expectations a year ago. The weaker-than-expected outcomes for GDP per capita are consistent with the poor outcomes for productivity growth over recent years. It also takes time for the capital stock to adjust to an unexpected pick-up in population.

While aggregate GDP has evolved broadly as expected, there have been some offsetting misses at the component level (Graph B.6). Weaker-than-expected consumption has been partly offset by the stronger-than-expected rebound in education and tourism exports, which has supported overall

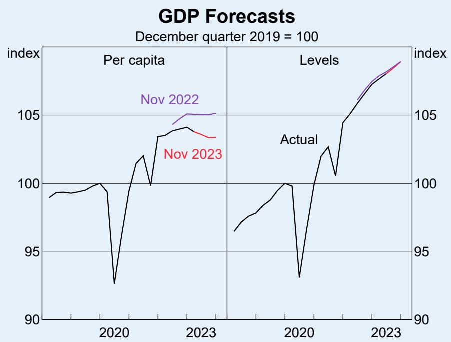


demand conditions for domestic consumer-facing businesses. Capacity constraints in the construction sector, particularly related to labour availability for certain trades, have remained binding for longer than was expected and have weighed on residential construction. By contrast, outcomes for public and private business investment have been stronger than forecast, in part due to the faster-than-expected improvement in materials and equipment availability as supply chain issues have eased.

While the impact on aggregate inflation has been relatively small, the net effects of a surge in population growth can be somewhat inflationary for a period in sectors where capacity utilisation is already tight because the capital stock generally takes time to adjust to higher demand. Stronger-than-expected population growth has added to demand for housing in an already-tight environment of low rental vacancy rates. Rental market tightness has been underpinned by a decline in average household size during the pandemic and robust nominal income growth, with dwellings already in short supply due to planning restrictions. The combination of stronger-than-expected demand factors have contributed to rent inflation being stronger than anticipated as housing supply usually adjusts in response to changes in demand with a significant lag. Tightness in the rental market is in turn supporting demand to purchase established properties and is one factor supporting the earlier-than-expected rebound in housing prices seen over the past year.

**Graph B.6**



Sources: ABS; RBA.

## The evolution of inflation and economic activity in Australia has been similar to international experience

Australia's experience over the past year has been broadly similar to that in other advanced economies, though Australia has lagged many peer economies throughout the current inflation cycle. This was the case during the phase of increasing inflation and has contined as inflation has declined, and so the earlier experience of peer economies has helped inform the forecasts. Headline inflation outcomes and growth in economic activity for Australia's major trading partners in aggregate have been broadly in line with Consensus expectations a year ago, although core inflation has typically surprised advanced economy central banks to the upside.

## Endnotes

[1] See also RBA, 'Historical Forecasts'.

[2] The population assumption is underpinned by a range of sources, including projections from the Australian Government's Centre for Population (CPOP), partial indicators from the ABS and liaison with the education sector. A year ago, the weight of evidence available suggested that a rebound in international student numbers was underway but a complete recovery was not imminent and there was substantial uncertainty about when China would remove its pandemic restrictions.