

# Statement on Monetary Policy

MAY 2021



RESERVE BANK OF AUSTRALIA



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The material in this *Statement on Monetary Policy* was finalised on 6 May 2021. The next *Statement* is due for release on 6 August 2021.

The *Statement* is published quarterly in February, May, August and November each year. All the *Statements* are available at [www.rba.gov.au](http://www.rba.gov.au) when released. Expected release dates are advised ahead of time on the website. For copyright and disclaimer notices relating to data in the *Statement*, see the Bank's website.

The graphs in this publication were generated using Mathematica.

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ISSN 1448–5133 (Print)  
ISSN 1448–5141 (Online)

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# Overview

Strong global growth is expected this year and next as the global economy recovers from the pandemic. Vaccine supply is increasing, which is allowing some economies to ease restrictions and open up. Substantial policy stimulus is also supporting the recovery. But the recovery is expected to remain uneven. Many economies are contending with serious new virus outbreaks and the outlook for some emerging market economies is clouded by slow rollouts of vaccines and limited scope for expansionary fiscal policy.

In Australia, the recent activity data have been significantly better than expected. Since the previous *Statement*, the starting point for the forecasts has been revised higher and the outlook further out has strengthened. GDP growth was faster than anticipated in the December quarter and is expected to have remained solid in the March quarter. GDP growth is now forecast to be 4¾ per cent over 2021 and 3½ per cent over 2022.

Employment outcomes have been strong. Employment increased by around 200,000 between December and March, and in March the unemployment rate declined to 5.6 per cent, although this is still around ½ percentage point above its pre-pandemic level. Other measures of spare capacity in the labour market, including underemployment and the share of workers on reduced hours, are generally around pre-pandemic levels. Some job losses from the end of the JobKeeper program are anticipated, but these are expected to be more than offset by demand for labour elsewhere in the economy. The unemployment

rate is expected to fall further over the forecast period, reaching around 5 per cent by the end of this year and 4½ per cent by mid 2023.

Wages growth and inflation remain subdued and, unlike the real side of the economy, have been broadly in line with earlier expectations. Wages growth has been especially slow in recent times, at 1.4 per cent over 2020. Headline CPI inflation was 0.5 per cent (seasonally adjusted) in the March quarter. Trimmed mean inflation was weak at 0.3 per cent in the quarter, and both measures were 1.1 per cent over the year.

Most of the volatility stemming from the introduction and expiry of pandemic-related subsidies has washed through the quarterly inflation outcomes. However, year-ended CPI inflation for the June quarter will spike above 3 per cent temporarily as the effect of measures such as last year's temporary free childcare program drop out of the calculation. Higher petrol prices will also boost inflation in the quarter.

Despite the stronger outlook for output and the labour market, inflation and wages growth are expected to remain low, picking up only gradually. Underlying inflation is expected to be 1½ per cent over 2021 before gradually increasing to close to 2 per cent by mid 2023. Some pick-up in wages growth is expected as the unemployment rate falls further. However, it is likely to be some years before wages growth is at a rate consistent with achieving the inflation target.

The JobKeeper program and various social assistance measures played an important role in boosting household incomes over the past year. While these programs have largely expired, strong growth in employment has broadly cushioned the effect of the winding down of these programs on household income. Consumption spending has therefore rebounded rapidly as restrictions have eased, and is expected to continue expanding strongly over the next few years.

How far households might draw on their strengthened balance sheets to support their spending represents an important source of uncertainty around the outlook for consumption. This source of uncertainty forms the basis for the 3 forecast scenarios presented in the 'Economic Outlook' chapter. Household wealth has increased strongly of late, mostly because housing prices have risen, but also because households accumulated an unusually large amount of additional savings out of income over 2020. If the spending response to increased wealth is stronger than usual, a stronger economic path than the one envisaged in the baseline forecasts would eventuate. Conditions supporting a faster pick-up in consumption would also support stronger private investment. In this upside scenario, the unemployment rate declines and wages growth rises at a faster pace than in the baseline scenario. Inflation picks up to around 2¼ per cent by the middle of 2023 and remains on an upward trajectory at that point.

Conversely, a weaker path could instead eventuate if higher wealth stimulates spending by less than historical experience implies; households could instead continue to strengthen their balance sheets, by purchasing assets or paying down debt. In this downside scenario, subdued consumption and private investment result in the unemployment rate remaining a little above pre-pandemic levels.

Underlying inflation remains broadly steady, and is still around 1½ per cent by mid 2023.

Globally, there has been a swift recovery in international trade as people switched their spending away from services and towards goods. This has been positive for export-oriented economies including China and some economies in east Asia. It has also boosted demand for many commodities and other inputs to production of final goods, such as semiconductors. Oil prices have reversed the falls of last year. The price of iron ore has increased to be close to its historical peak a decade ago, reflecting strong demand from Chinese steel producers. Australia's terms of trade have increased and are expected to remain high at least until the end of this year, supporting national income.

These shifts in demand, as well as disruptions to production from the pandemic, have resulted in some bottlenecks and cost pressures through supply chains, both globally and in Australia. Some of these are taking time to resolve and firms are reportedly becoming more willing to pass on cost pressures to their output prices. Historical experience suggests that if supply problems are resolved reasonably promptly, pricing pressures will remain transitory; it remains to be seen if this will be the case in the current situation. An offsetting influence on inflation outcomes is the subdued demand conditions in many services industries. More broadly, the current significant spare capacity in the labour market in many economies is likely to take a while to be absorbed. This is likely to weigh on underlying inflation pressures globally.

The major central banks have all maintained highly accommodative monetary policy settings, and reiterated their commitments to keep policy accommodative until sustained progress has been made on employment and inflation. Sovereign bond yields increased earlier in the year in response to the improvement in the economic outlook and an increase in

inflation expectations, which are now more in line with central banks' targets. Even so, financial conditions remain accommodative. Corporate bond spreads remain narrow and equity prices have risen further.

Fiscal policy has played an important role during the pandemic, although the size and composition of this support has varied across economies. The US authorities legislated a large fiscal stimulus in March, and further measures are also likely to be approved later in the year. Several other countries have also announced additional fiscal stimulus in recent months, including to bolster the recovery phase.

In Australia, fiscal policy has supported incomes and encouraged specific categories of spending. Machinery & equipment investment has been responsive to tax incentives and has begun to recover sooner than earlier expected. More generally, strong surveyed business conditions, high commodity prices, low interest rates and tax incentives should all help create the conditions for business investment to recover, after it fell last year to its lowest share of GDP for decades. Business credit has started to increase a little recently, following a period of weakness while lines of credit drawn down earlier in the pandemic were repaid.

Dwelling investment has also been boosted – and possibly brought forward – by accommodative monetary policy and fiscal support, including the HomeBuilder subsidy and various state government programs. The HomeBuilder subsidy closed to new applications at the end of March. The deadline to commence construction was recently extended, however, so activity will remain high over 2021. The strong demand induced by these subsidies has led to cost pressures and some delays to construction timelines. This has pushed base prices for newly constructed detached homes higher, but the effect on measured inflation has been offset by the treatment of government construction grants.

Strong demand is also a feature of the established housing market, consistent with the low level of interest rates, government support programs and the positive outlook for employment. Housing prices are rising in all major markets. Prices in Sydney and Melbourne have now surpassed their earlier peaks, following a period where they lagged the recovery in the smaller cities and regional areas. Price increases have been strongest for detached houses and higher-priced properties. Housing turnover has increased, and many properties are on the market for only a short time before being sold.

In this environment of strong demand for housing, rising prices and low interest rates, it is important that lending standards are maintained. The Bank will be monitoring trends in borrowing closely. Housing credit growth has picked up, with strong demand from owner-occupiers, especially first-home buyers. Investor credit has also been growing, but at a slower pace than credit to owner-occupiers; conditions in rental markets have been quite uneven, which has been weighing on investor demand for properties in some markets. While rents have increased strongly in some parts of the country, vacancy rates remain high in Sydney and are rising sharply in Melbourne. Both markets have been affected by lower inward migration.

The closure of Australia's international border and the related abrupt decline in inward migration has reduced growth in some areas of domestic activity, especially the tourism and education sectors. It has also constrained labour supply in a few sectors where temporary migrants have typically been a relatively large share of the workforce, such as hospitality. While these effects are important in some areas, they are as yet fairly small for the overall economy. The longer border restrictions remain in place, though, the more likely that localised labour shortages could translate into some wage pressures as the economy continues to strengthen.

While the outlook for output and the labour market has improved considerably since last year, the economy remains short of full employment. The baseline scenario in the forecasts still implies that inflation will remain below the target range for some time. And even at the end of the forecast period in mid 2023, wages growth is likely to remain below the rates that would be consistent with inflation being sustainably within the target range. Accordingly, monetary policy will need to remain highly accommodative for some time yet.

The current package of monetary policy measures continues to support the economy in part by keeping financing costs very low. Interest rates on business and housing loans continue to drift down from already low levels, which is positive for the cash flows of firms and households overall. Ample liquidity conditions are also supporting the supply of credit and household and business balance sheets, including through higher asset prices. As well as lowering domestic funding costs, by lowering the structure of interest rates, the policy package is contributing to a lower exchange rate than otherwise. The Australian dollar has moved within a narrow range since the start of the year, a period in which commodity prices have tended to increase. Together, monetary and fiscal policy are supporting the recovery in aggregate demand and the pick-up in employment.

At its recent meetings, the Reserve Bank Board has decided to maintain the targets of 10 basis points for the cash rate and the yield on 3-year Australian Government bonds. In May, the Board announced that it will consider at its July meeting whether to retain the April 2024 bond as the target bond for the 3-year yield target or to shift to the next maturity, the November 2024 bond; in either case, the 10 basis point target will be maintained. At its July meeting, the Board will also consider whether to undertake further government bond purchases following

the completion in September of the second \$100 billion of purchases under the government bond purchase program. The Board is prepared to undertake further bond purchases under this program to assist with progress towards the goals of full employment and inflation.

Also following its May meeting, the Board confirmed that the date for final drawings under the Term Funding Facility is 30 June 2021. The Board had previously indicated that it would consider extending the facility if there were a marked deterioration in funding and credit conditions in the Australian financial system. Financial markets are operating well, so an extension is not called for. Banks have drawn \$102 billion under the facility so far and a further \$98 billion is currently available. Given the facility provides funding for 3 years, it will continue to help keep funding costs in Australia low until mid 2024.

The Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest. ✎

# 1. The International Environment

A durable global economic recovery has become more likely since the February *Statement on Monetary Policy*. Progress with vaccinations, additional fiscal policy support in many economies and ongoing accommodative monetary policy have improved prospects for a strong recovery this year. Even so, the outlook will remain highly uncertain and uneven for some time. GDP is expected to remain well below its pre-pandemic trajectory in many economies and labour market slack will take time to be absorbed. This is likely to keep underlying inflationary pressures contained, although the rebound in commodity and higher input prices more generally will contribute to higher inflation in the near term.

The market-implied path of expected central bank policy rates has shifted a little higher in a number of economies in response to the improved economic outlook. Central banks have responded to these developments by restating their commitment to maintain very accommodative monetary policy settings until there has been a sustainable increase in inflation that is consistent with targets, and by emphasising that this is likely to be some way off. Financial conditions in advanced economies remain very accommodative overall, despite an increase in government bond yields. Corporate bond yields remain around historically low levels, issuance conditions are favourable, and equity prices have increased further.

## The global outlook has firmed up

The global economic recovery is well underway. The outlook for the US economy has picked up

considerably following substantial additional fiscal stimulus, a drop in infection rates and good progress in the vaccination rollout. Ongoing strong demand for goods continues to support the recovery in China and export-oriented economies in east Asia. The prospects for recovery have mostly firmed elsewhere but ongoing activity restrictions will continue to weigh on activity in the near term in some economies and the increase in sovereign yields in advanced economies is likely to hamper the recovery of some emerging market economies.

The speed and strength of recovery have diverged across economies of late because vaccine rollouts are proceeding at different rates and control over the virus more generally has varied widely. Significant shares of the population have been vaccinated in only a few economies (Graph 1.1). While vaccine supplies are expected to increase soon in most advanced economies, they will remain limited in many emerging market economies, hampering their recoveries. In particular, India is experiencing a significant surge in cases and the near-term outlook is highly uncertain.

The GDP of Australia's major trading partners is expected to grow by around 7 per cent in 2021 and by 4½ per cent in 2022 in year-average terms (Graph 1.2). Households and firms have continued to adapt to containment measures. Stronger-than-expected outcomes in some economies in the March quarter have broadly offset the effects of tightened or extended containment measures in a number of other economies. Further out, the economic recovery in Australia's major trading partners is expected

to be sustained by control of the virus through vaccinations, as well as ongoing monetary and fiscal policy support and the rebound in global trade.

Even with a strong recovery, GDP in many economies is expected to remain well below its pre-pandemic trajectory over coming years. Significant spare capacity is therefore expected to persist in these economies. Consistent with this, price pressures should remain contained for some time, with underlying measures of inflation still expected to be below central bank targets for a number of years.

The United States is expected to recover faster and further than other large advanced

economies because of its extensive fiscal support and rapid vaccination rollout. Longer-term US Government bond yields have increased as a result of the improved economic outlook. The latest US fiscal package is expected to boost GDP in the rest of the world by around ½ percentage point, with the strongest effects in economies with the largest direct trade links such as Canada and Mexico.

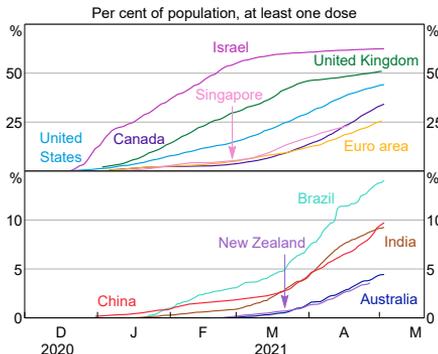
The outlook for the other major advanced economies has improved, although the recovery is likely to be slower than in the United States, partly because fiscal policy is less stimulatory. Good progress on vaccinations has lifted the near-term economic outlook in the United Kingdom, and a similar boost to activity is anticipated for the euro area when more of the population are vaccinated. The outlook for Japan has been bolstered by strong external demand but the recent increase in infections may temporarily slow the recovery.

The outlook in east Asia continues to be supported by two main factors: strong global demand for goods buoying export-oriented economies, and success in lowering infections in some economies in the region. Chinese GDP is expected to remain close to its pre-pandemic trajectory, with growth expected to rebalance away from the industrial sector towards services and household consumption. However, some emerging market economies in the region, including the Philippines and Thailand, are currently facing significant surges in infections and have limited vaccine supplies, which will delay their recoveries. Vaccination rollouts have been slow in many east Asian countries.

The recovery in many other emerging market economies is expected to take longer and be more variable because of limited vaccine supplies, surging infections, limited policy flexibility and tighter global financial conditions (see 'Box A: Emerging Market Vulnerabilities and Financial Conditions in Advanced Economies').

**Graph 1.1**

**Vaccinations\***

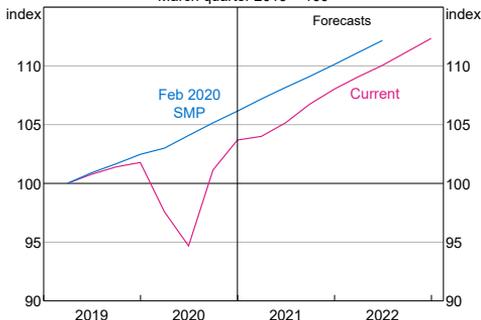


\* Total doses divided by 2 for Australia and China  
Sources: Our World in Data; RBA

**Graph 1.2**

**Australia's Major Trading Partner GDP**

March quarter 2019 = 100



Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

Risks to the global outlook overall have become more balanced, but significant uncertainties remain:

- The speed of vaccine rollouts will affect the speed of the recovery. Slower vaccination rates will require containment measures to fight increases in infections. Conversely, a faster rollout of effective vaccination programs will allow activity to resume more rapidly. The potential emergence and spread of vaccine-resistant COVID-19 virus variants is a key downside risk.
- The stimulatory effects of fiscal policy on activity, particularly in the United States, could be larger than expected. A stronger pick-up in US activity could increase inflationary pressures by more than expected, pushing up US bond yields and leading to a tightening in US and global financial conditions. Global supply chain pressures may also persist if the sharp rebound in demand is sustained longer than expected, which could result in higher inflation persisting for longer than expected.
- The extent of recoveries in consumption will depend on households' response to changes in income and their willingness to spend out of recent increases in wealth and the additional savings accumulated in the past year. Experience from countries where activity restrictions have eased suggests that spending bounces back quickly once consumption possibilities are restored. Reduced uncertainty, stronger wages growth and higher asset prices could also boost consumption by more than expected in the period ahead. But in countries where incomes have fallen or restrictions have persisted for an extended period, precautionary saving could remain high and slow the overall recovery.

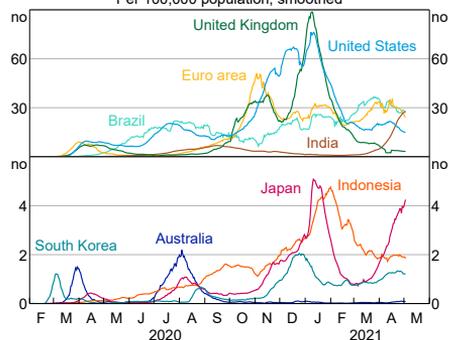
## Recent economic outcomes have varied across countries

Uneven vaccination progress and differences in containment measures have contributed to divergences in activity recently. High vaccination rates have allowed a few economies, including Israel, the United Kingdom and the United States, to start easing restrictions without infections and hospitalisations increasing significantly (Graph 1.3). However, infections have increased sharply in many other countries, which has led to tighter containment measures. Infections have increased rapidly in India, accounting for more than two-fifths of the global increase in reported cases in recent weeks. Authorities in the worst-affected states have introduced restrictions on services activity to reduce the virus's spread, but healthcare systems are under strain.

March quarter activity in the United States has been boosted by the substantial direct payments to households since December. Goods consumption has remained strong and services consumption has started to recover as containment measures have been wound back. Unlike in most other economies, business investment in the United States has rebounded to above pre-pandemic levels as businesses plan for growth in domestic demand.

**Graph 1.3**

**COVID-19 – New Cases**  
Per 100,000 population, smoothed



Sources: Johns Hopkins CSSE; RBA

Strong external demand for goods continued to underpin the recovery in the March quarter in China and export-oriented Asian economies. Domestic demand also picked up in the quarter in South Korea as containment measures were eased, but activity remains subdued in parts of the region where infections have been more widespread.

Elsewhere, the economic recovery stalled in the March quarter (Graph 1.4). Ongoing containment measures have weighed on economic activity in large parts of Europe and Japan. GDP contracted in the March quarter in the euro area, and is expected to have declined in Japan and the United Kingdom. Activity weakened in some large emerging market economies, including Brazil and South Africa, due to a rebound in infections, renewed containment measures and tighter financial conditions in these economies.

Households across many advanced economies substantially increased their savings over the past year, as the consumption of services declined and fiscal policy supported household incomes (Graph 1.5). Households have continued to save more of their income than they did prior to the pandemic, but in most

economies saving ratios have declined from their peak in the June quarter last year as households have purchased more goods and restrictions on services have started to be lifted. US household savings increased strongly in the March quarter following further fiscal support for household incomes.

**Fiscal policy is highly expansionary in the United States and remains supportive in many other economies**

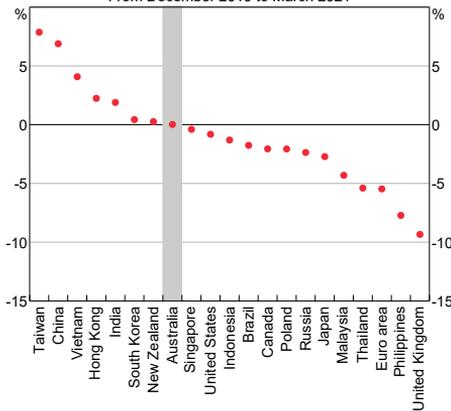
In March, the United States legislated the latest tranche of its very significant fiscal response to the pandemic, focused on further supporting household incomes. This brought the total US fiscal response to about 25 per cent of GDP, which has been by far the largest direct fiscal response to the pandemic (Graph 1.6). Fiscal policy continues to support private incomes and the health responses in a range of other countries. Canada, Germany, the United Kingdom, China and some east Asian economies have extended existing acute-phase fiscal measures and rolled out new initiatives. Some emerging economies have also provided further fiscal support but on a smaller scale.

Fiscal measures this year have generally been smaller than last year since private incomes have needed less support as economic activity has adapted somewhat to containment measures.

**Graph 1.4**

**GDP Growth\***

From December 2019 to March 2021

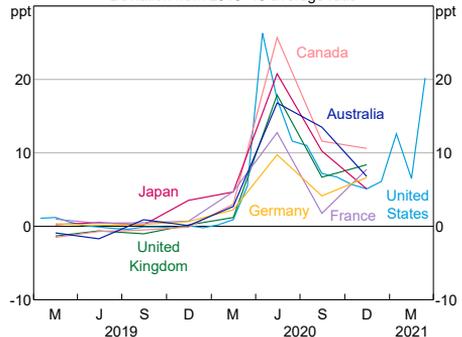


\* Forecasts used where March quarter GDP has not yet been reported  
Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

**Graph 1.5**

**Household Saving Ratio**

Deviation from 2015–19 average ratio



Sources: Cabinet Office Japan; RBA; Refinitiv

As a result, fiscal deficits are expected to be smaller in many economies, with the exception of some large economies like the United States and Germany. Fiscal support in many economies is also expected to begin to shift from supporting incomes during the acute phase of the downturn, towards public investment in infrastructure in the post-pandemic recovery.

Further broad-based fiscal packages involving multi-year spending and tax measures are being pursued in the United States. These include initiatives for infrastructure investment (equivalent to 9 per cent of GDP) and social initiatives (equivalent to 10 per cent of GDP) that will largely be funded over time by increased taxes on corporations and higher-income individuals (Graph 1.7). These packages should further boost US activity and inflationary pressures, although the effects may be drawn out. Over time, the infrastructure spending will expand the capacity of the US economy and some of the social initiatives may increase labour supply, which would dampen inflationary pressures in the future.

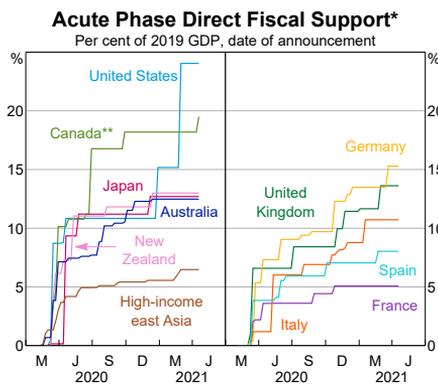
A few other economies have also unveiled further measures to support their post-pandemic recovery. Canada plans to boost childcare and 'green' projects. Most EU member

states announced detailed plans for the EU Recovery and Resilience facility, to be used for infrastructure, 'green' investment and digitisation over the next 5 years.

### The global recovery has been concentrated in goods demand, which has boosted trade in Asia ...

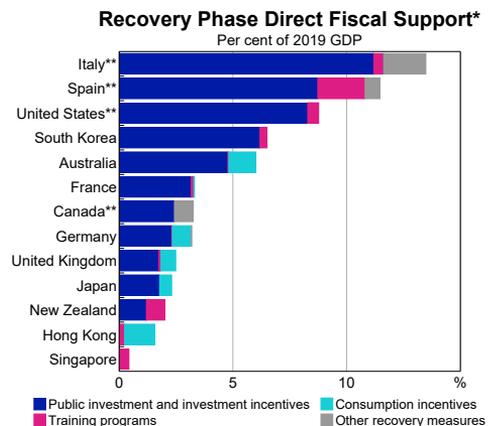
Global goods trade has recovered very quickly, driven by strong durable consumer goods imports in advanced economies as households have substituted away from services consumption during the pandemic. This has supported activity in economies with significant manufacturing and goods exporting sectors, including in Asia and parts of Europe (Graph 1.8). Exports from Asia have surged by 23 per cent since the pandemic started, while global exports are just a little above pre-pandemic levels. The sharp rebound in trade and its unevenness has strained global supply chains (see 'Box B: Supply Chains during the COVID-19 Pandemic'). Supply disruptions have contributed to some upward price pressures in select areas; these are expected to be temporary and ease once bottlenecks are alleviated. Supply shortages of key components have also disrupted some

**Graph 1.6**



\* Includes state government stimulus for Australia, Canada and Germany; excludes loan guarantees, unallocated funds, public investment and consumption incentives  
\*\* April 2021 increase is not yet approved  
Sources: IMF; national sources; RBA; Refinitiv

**Graph 1.7**



\* Fiscal measures aimed for the recovery phase, i.e. after the pandemic has passed; includes state governments for Australia, Canada and Germany; includes EU Recovery and Resilience Facility funds for EU countries where spending plans are available; expected to be spent over multiple years  
\*\* Proposed support not yet approved  
Sources: IMF; national sources; RBA; Refinitiv

**Table 1.1: Commodity Price Changes<sup>(a)</sup>**  
Per cent

	Since previous <i>Statement</i>	Since start of year
Bulk commodities	8	16
– Iron ore	16	18
– Coking coal	–27	9
– Thermal coal	5	10
Rural	5	11
Base metals	19	21
Gold	0	–5
Brent crude oil <sup>(b)</sup>	17	34
RBA Index of Commodity Prices (ICP)	8	10
– Using spot prices for bulk commodities	8	13

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

(b) In US dollars

Sources: Bloomberg; IHS; RBA

upstream production. For example, semiconductor shortages have hampered production in a wide variety of sectors, leading to production delays and temporary closures of motor vehicle assembly lines.

### ... and the recovery continues to support commodity prices

The global economic recovery and ongoing strength in Chinese steel production have continued to support the prices of a number of

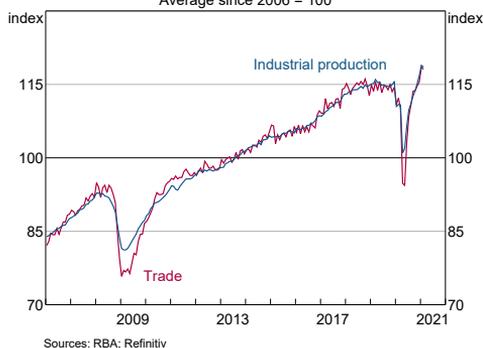
Australia's key commodity exports. Iron ore, thermal coal and oil prices have all increased further since the previous *Statement*, while a number of other commodity prices are also higher (Table 1.1).

The benchmark iron ore price has increased by 16 per cent since the previous *Statement* to be at its highest level in a decade (Graph 1.9). Demand for iron ore has been supported by the continued strength in Chinese steel production, and steel mills continue to build iron ore inventories while profit margins are elevated. Chinese authorities have signalled a desire to keep steel output in 2021 capped at or below 2020 levels, which may put downward pressure on iron ore prices in the second half of this year. Steel mills in some steel-producing cities in China have been instructed to lower production for the remainder of the year to reduce emissions. On the supply side, recent cyclone activity has reduced iron ore production in Western Australia, while market expectations for Brazilian exports for the remainder of this year have been revised down following recent lower-than-expected production.

**Graph 1.8**

#### Global Goods Trade and Production

Average since 2006 = 100



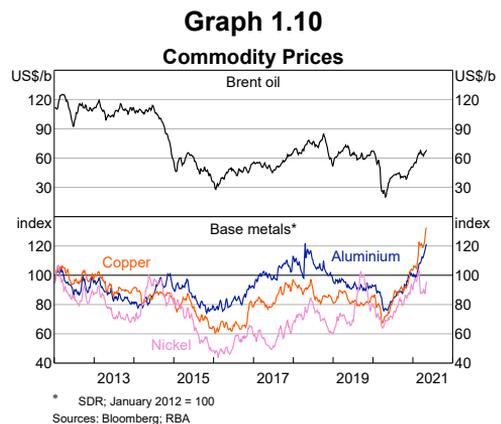
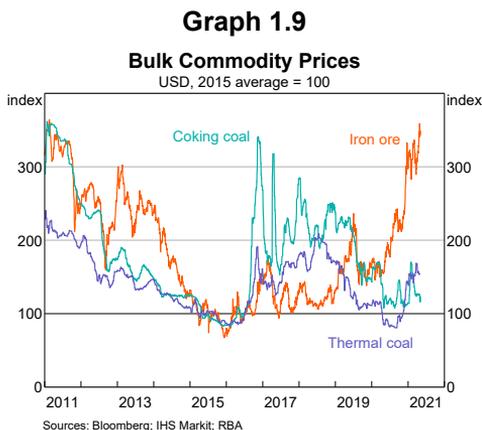
The Newcastle thermal coal spot price has increased to be 10 per cent higher since the start of the year. The price has been supported by a recovery in global demand and supply disruptions from weather-related damage to coal transport infrastructure in New South Wales. Meanwhile, coking coal prices have decreased since the previous *Statement* and remain at a significant discount relative to domestic Chinese prices, in part because of the ongoing uncertainty surrounding Chinese demand for Australian coal.

The price of Brent crude oil has increased further since the previous *Statement* (Graph 1.10). OPEC+ members recently agreed to gradually increase output over the coming months amid a more positive outlook for global demand. The increase in oil prices over recent quarters will also support the price of Liquefied Natural Gas (LNG) received by Australian exporters, which is contractually linked to the price of oil with a lag. The prices of some base metals, notably aluminium and copper, have increased strongly in recent months, supported by the continued recovery in global industrial production.

## Chinese economic activity moderated in the March quarter, but remains around its pre-pandemic trajectory

China has experienced one of the strongest economic recoveries globally. However, renewed outbreaks of COVID-19 temporarily weighed on growth in parts of the economy in the March quarter. Household consumption growth moderated, at least partly as a result of travel restrictions over Chinese New Year in the north and east (Graph 1.11). Household expenditure on services, such as entertainment, tourism and transport, fell in the March quarter even as demand for goods continued to rise. The weakness appears to have been concentrated in January, and retail sales increased in February and March as the restrictions were eased, particularly for eating out.

Industrial production continued to grow strongly over the first quarter as many workers remained in cities over the Chinese New Year holiday period. Similar to other economies in the region, industrial production has been supported by strong global demand for goods. Investment in infrastructure and real estate also continued to grow. These factors have supported an increase in steel production and demand for iron ore imports, including from Australian producers who are the largest



suppliers to China (Graph 1.12). While GDP growth is expected to be strong over the remainder of this year, steel production growth is likely to slow as emissions policies and other factors encourage a shift away from heavy industry towards services.

### Fiscal and monetary policies remain accommodative in China but authorities are alert to financial risks

Policymakers in China have indicated that the moderately accommodative macroeconomic policy settings currently in place remain appropriate. This was reflected in the annual budget released in March, which projected only

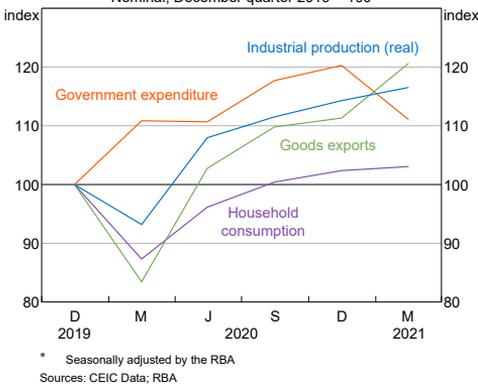
a small fiscal consolidation in 2021. The authorities have also said that any withdrawal of monetary stimulus will be gradual. In particular, support for smaller firms will continue for some time. At the same time, the authorities have emphasised that reducing risks in the financial system remains a priority. Policymakers have set a target of keeping overall debt levels in the economy stable relative to GDP in 2021, following notably higher growth in debt last year.

Chinese financial conditions remain broadly accommodative, which is consistent with policymakers' stated desire for policy stability in 2021. In contrast to developments in other emerging markets, financial conditions in China have been little affected by the rise in sovereign bond yields in advanced economies. Chinese government and corporate bond yields have been broadly stable around pre-pandemic levels in recent months (Graph 1.13). Bank lending conditions also remain favourable: interest rates on business loans remain low, and lending to businesses and households grew strongly in the first quarter of this year despite the implementation of new regulations to limit the flow of credit to the property sector. This has contributed to growth in total social financing slightly outpacing growth in nominal GDP in the first quarter of the year (Graph 1.14). On the other hand, Chinese equity prices have declined sharply since mid February following comments from regulators warning investors of asset bubbles. Conditions have also tightened modestly for Chinese corporations that issue US dollar bonds offshore in the past month, as concerns have risen that a large finance firm (which is majority owned by the Chinese state) might default on its debt in that market.

The Chinese renminbi has been little changed against the US dollar over recent months and remains close to its recent highs (Graph 1.15). This has occurred despite the interest rate differential between government bonds in

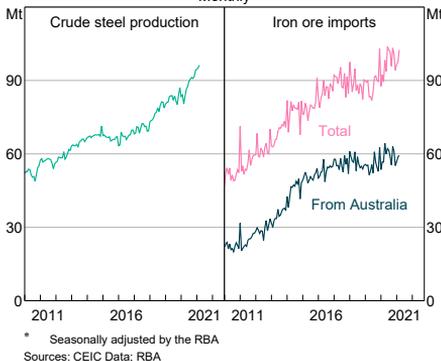
**Graph 1.11**

**China – Activity Indicators\***  
Nominal, December quarter 2019 = 100



**Graph 1.12**

**China – Steel Production and Iron Ore Imports\***  
Monthly



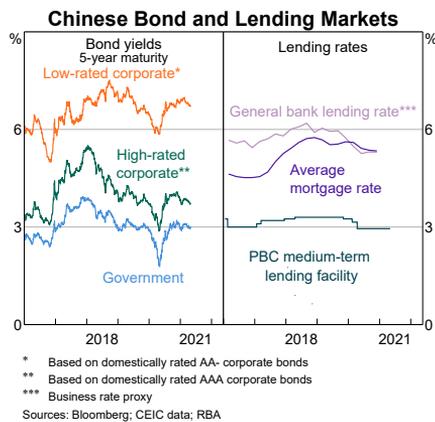
China and those in the United States having declined and foreign inflows to Chinese bond markets easing. Authorities have recently noted potential risks associated with rising yields in advanced economies and the possibility of large capital outflows. However, they also highlighted that risks to domestic markets are low and they will continue to proceed with a gradual opening up of capital flows.

### India is experiencing a new wave of infections and activity will decline over the near term

India is experiencing a rapid increase in COVID-19 cases. In the worst-affected states,

authorities have imposed curfews and partial lockdowns. The measures introduced to date are less restrictive than the measures imposed in early 2020, which is evident in a smaller decline in mobility measures (Graph 1.16). At this stage, the restrictions are targeted at curbing service-sector activity in hospitality, tourism and transportation, with manufacturing and construction activity less affected. Activity is expected to decline in the June quarter. In response to the worsening health situation, the Reserve Bank of India has announced a number of policy measures to help support financial conditions, including a commitment to purchase a set quantity of government bonds and incentives for financial institutions to provide credit to small businesses. Over the medium term, the government's commitment to raise infrastructure investment and continued urbanisation should support Indian economic growth and demand for commodities.

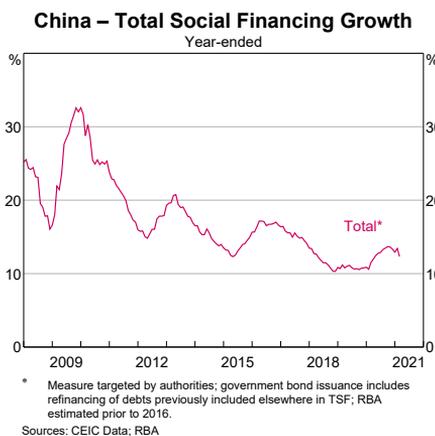
**Graph 1.13**



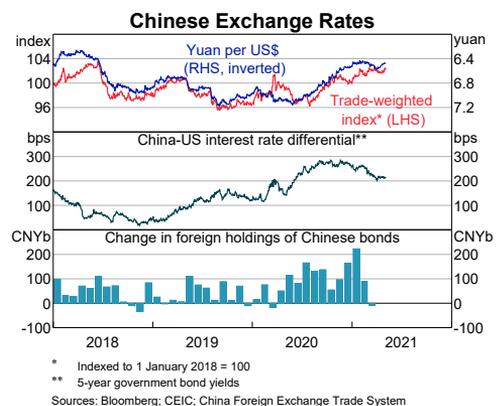
### Significant labour market slack remains and will take some time to be absorbed

Significant spare capacity remains in labour markets in advanced economies despite the rebound in employment over recent quarters. Employment-to-population and participation rates remain well below pre-pandemic levels and unemployment rates are elevated in most

**Graph 1.14**



**Graph 1.15**



advanced economies (Graph 1.17). It will take some time for spare capacity to be absorbed even as containment measures are eased. Wage subsidies continue to preserve employer-employee relationships and support incomes in many economies, and wages growth in some large advanced economies slowed only a little over the past year.

Labour demand has picked up in some advanced economies and survey indicators such as job ads and employment expectations point to a further and broader pick-up in coming months (Graph 1.18). By sector, the

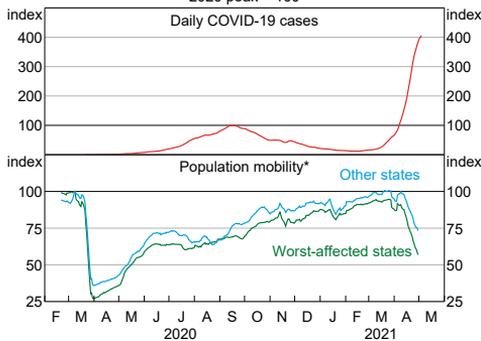
improvement across many economies has been most pronounced in healthcare and manufacturing, consistent with the strength in global goods demand. Hiring intentions have lifted even in economies that are still under strict containment measures as firms anticipate an increase in demand later in the year.

### Underlying inflation is expected to remain below most central bank targets for the next few years

Underlying consumer price inflation in advanced economies remains low. Some measures of inflation will increase in the coming months because of higher commodity prices and cost pressures associated with bottlenecks in global manufacturing and shipping; surveyed measures of inflationary pressures in manufacturing are elevated globally (Graph 1.19). Year-ended inflation rates will be also boosted in the near term by the unwinding of some COVID-19-related price reductions.

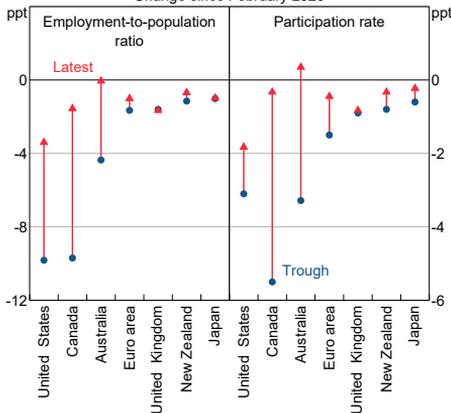
Later in the year, inflation is expected to ease again in most economies as the increase in oil prices washes out and some of the temporary bottlenecks in global supply chains are resolved. In most economies, spare capacity in labour markets is likely to contain inflationary pressures for some time. Spare capacity in the United

**Graph 1.16**  
India – COVID-19 Indicators  
2020 peak = 100



\* Average of Google retail, grocery, workplace and transit station mobility data; worst-affected states are the 10 states with the highest active COVID-19 cases per capita; as of 4 May 2021  
Sources: CEIC Data; RBA

**Graph 1.17**  
Labour Market Indicators  
Change since February 2020



Sources: ABS; CEIC Data; RBA; Refinitiv

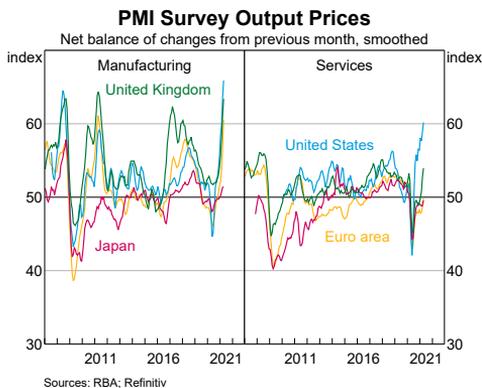
**Graph 1.18**



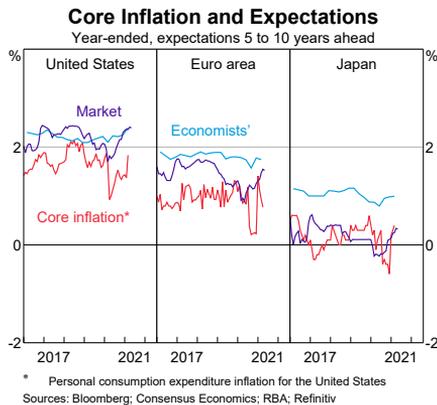
\* Job ads posted on Indeed  
Sources: Indeed; RBA

States is expected to be absorbed more quickly than elsewhere; business surveys suggest that inflationary pressures are already picking up in the US services sector. The US Federal Reserve (Fed) expects its target measure of US inflation to increase and moderately exceed 2 percent in 2021 and then run close to 2 per cent in 2022, which will move inflation towards the Fed’s goal of inflation averaging 2 per cent over time. Measures of US inflation expectations have increased recently to be consistent with the Fed’s goal, while in some other advanced economies financial markets’ and economists’ expectations remain below central bank targets (Graph 1.20).

**Graph 1.19**



**Graph 1.20**

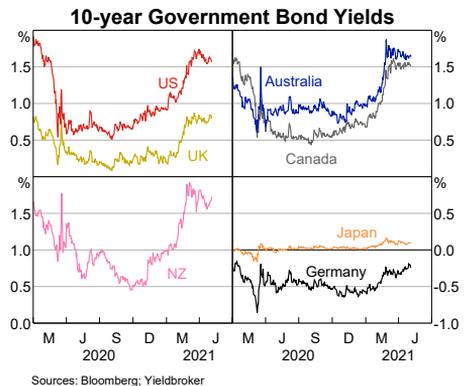


**Government bond yields have increased due to the improved economic outlook and higher inflation expectations**

Longer-term government bond yields have risen noticeably since early February in most advanced economies, following the passage of fiscal stimulus measures in the United States and further improvements in the economic outlook more generally (Graph 1.21). In contrast, government bond yields with maturities of up to 2–3 years have remained low, consistent with market expectations that policy rates will remain low for a prolonged period. Yields on longer-term bonds in most advanced economies experienced heightened volatility in late February amid a decline in market liquidity and significant bond issuance, but bond markets have generally been more stable since March. Yields on New Zealand Government bonds also experienced large moves in March alongside sharp revisions to policy rate expectations following government announcements of measures to curb growth in housing prices (discussed below).

Compensation for expected future inflation has increased across all bond maturities since yields began rising in early November, from near record lows to levels more consistent with central bank inflation targets. Real yields have decreased at the 5-year maturity and have

**Graph 1.21**



increased or remained steady at the 10-year maturity in most advanced economies over the same time frame (Graph 1.22).<sup>[1]</sup> This is consistent with central banks' forward guidance that policy rates will not be raised until there is a substantial and sustained increase in inflation. In the euro area and Japan, real yields have decreased at longer maturities since November, because inflation is expected to remain below central bank targets for longer than in other advanced economies.

### Central banks in advanced economies have restated their commitment to a prolonged period of substantial support

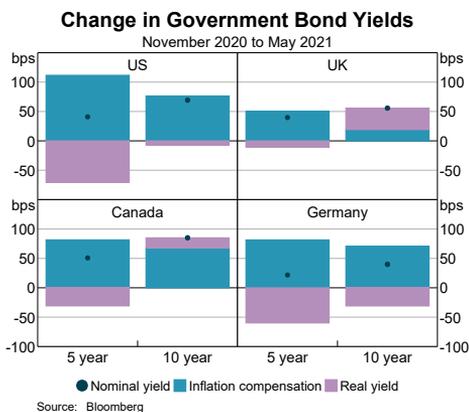
At recent meetings, most central banks have reaffirmed their commitments to an extended period of support through very low policy rates, asset purchases and lending programs. Given announced measures, central bank balance sheets will continue to grow for some time (Graph 1.23). Most central bank officials observed that the rise in longer-term government bond yields is consistent with the improved outlook for economic activity and inflation, but that policy needs to remain very supportive for an extended period to achieve a sustainable increase in inflation.

A couple of central banks have adjusted their guidance on the expected timing of a policy

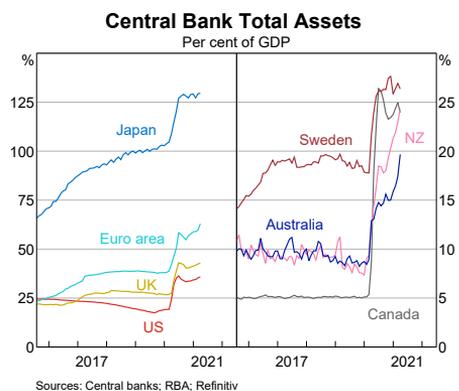
rate increase in response to an improved economic outlook, though in most cases the first policy rate increase is still not expected for some time. Norges Bank stated that it now expects to raise its policy rate in the second half of this year, earlier than previously expected. The Bank of Canada (BoC) has stated that it remains committed to holding the policy rate at its current level until inflation returns to 2 per cent on a sustained basis. The BoC now expects this condition to be met in the second half of 2022, brought forward from 2023. In the United States, most Federal Open Market Committee (FOMC) participants continued to expect the policy rate to remain unchanged until at least end 2023, though a few participants brought forward their expectations of the first policy rate increase to 2022 in response to improved economic forecasts. The FOMC said that the current economic outlook did not warrant policy tightening and that the Fed will be monitoring actual, not forecast, progress towards its employment and inflation goals to judge the appropriate time to raise the policy rate.

The market-implied path of expected policy rates has shifted higher in a number of advanced economies, and the expected timing of the first policy rate increase has been brought forward (Graph 1.24). Current market pricing suggests that the BoC is expected to raise its policy rate in the second half of 2022 and the

**Graph 1.22**



**Graph 1.23**



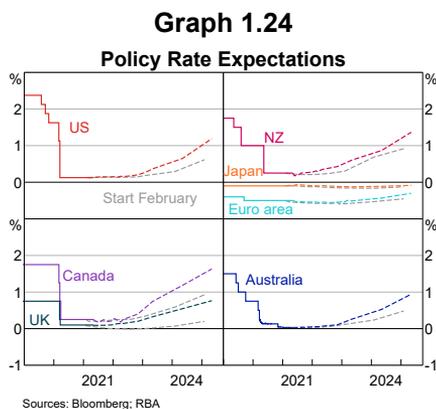
Reserve Bank of New Zealand (RBNZ) is expected to raise its policy rate in late 2022 or early 2023, while the US Fed and the Bank of England are expected to raise policy rates in the first half of 2023. In Australia, market pricing suggests that the cash rate is expected to remain around its current low rate for the coming 2 years and increase to around 50 basis points over 2023. In the euro area and Japan, market pricing continues to indicate investors expect no change to policy rates for at least several years.

Central banks in advanced economies continue to provide substantial additional stimulus through asset purchases, though in recent months some central banks have altered the pace of purchases. The European Central Bank (ECB) announced an increase in the pace of asset purchases under its Pandemic Emergency Purchase Programme (PEPP) in March, and said it will maintain a higher purchase pace in the second quarter of the year. The ECB noted that this was in response to the risk that rising government bond yields could lead to a premature tightening of financing conditions at a time when underlying inflation pressures remain subdued. In contrast, as was widely expected, the BoC reduced its target for government bond purchases from C\$4 billion to C\$3 billion per week to reflect progress made in the economic recovery, including an improved

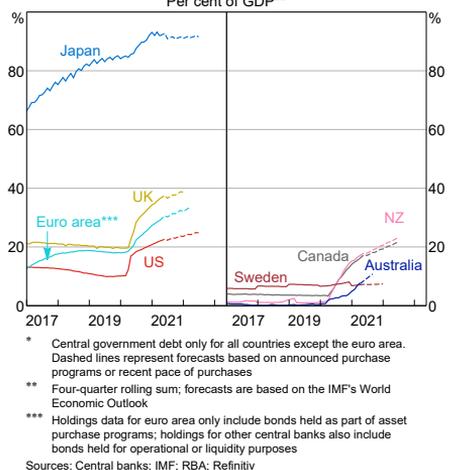
outlook for economic growth and inflation. The BoC noted that further adjustments will be gradual and guided by its ongoing assessment of the strength and durability of the recovery. Other central banks in advanced economies have continued to purchase assets at a steady pace in recent months (Graph 1.25).

The New Zealand Government directed the RBNZ to consider the impact on housing prices when making monetary and financial stability policy decisions. Under these changes, the Monetary Policy Committee's targets will not change, but the RBNZ will outline the effect of its monetary policy decisions on the government's objectives relating to sustainable house prices. The RBNZ's financial stability policies will take into account the government's objectives. The New Zealand Government subsequently announced a range of measures to dampen investor housing demand and boost housing supply.<sup>[2]</sup> In response, market participants scaled back expectations that the RBNZ would increase its policy rate more quickly than other advanced economies.

The Bank of Japan implemented a number of recommendations following a review of the effectiveness and sustainability of its monetary



**Graph 1.25**  
**Central Bank Government Bond Holdings\***  
Per cent of GDP\*\*



policy measures. These included adjustments to its yield curve control framework to improve market functioning and a new interest rate tiering scheme to mitigate the impact of negative interest rates on bank profitability. Some other central banks, including the ECB and the BoC, will undertake or announce the results of reviews of monetary policy frameworks and tools later this year.

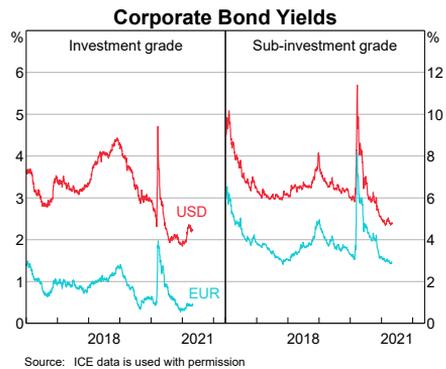
### Corporate funding conditions in advanced economies remain accommodative

Corporate bond yields remain around historically low levels, even though they have increased for some borrowers in recent months as a result of the rise in sovereign bond yields. Yields on investment grade corporate bonds denominated in US dollars increased by around 35 basis points from their recent lows, while yields on euro-denominated investment grade bonds are around 15 basis points higher (Graph 1.26). Sub-investment grade yields remain close to record lows, as higher risk-free interest rates have been offset by a substantial narrowing in credit spreads. Spreads have narrowed most for firms in sectors that were disproportionately affected by the pandemic and which tend to have lower credit ratings, such as energy, travel and leisure, and industrials. Corporate bond issuance has remained robust over the year to date, particularly for sub-investment grade bonds.

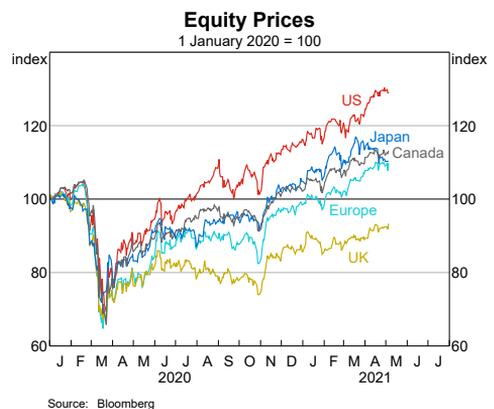
Equity prices have increased further in recent months (Graph 1.27). Expectations that stronger economic growth will lift future earnings have generally outweighed the effect of higher yields on sovereign debt, which reduce the discounted value of those future earnings. Shares of companies that are more sensitive to the economic outlook – such as companies that produce capital equipment – have outperformed the broader market. Bank share prices have also outperformed as the steeper

yield curve and improved economic outlook are expected to support bank profitability. Equity issuance remains elevated in the United States, driven by so-called ‘blank-cheque’ vehicles (Special Purpose Acquisition Companies (SPACs)), which raise funds to identify and invest in private companies to take public. However, SPAC issuance slowed substantially in April. This is possibly linked to an increased risk of regulatory intervention as well as a decrease in funding available from institutional investors that is typically used alongside SPAC funding to help finance acquisitions.

**Graph 1.26**



**Graph 1.27**



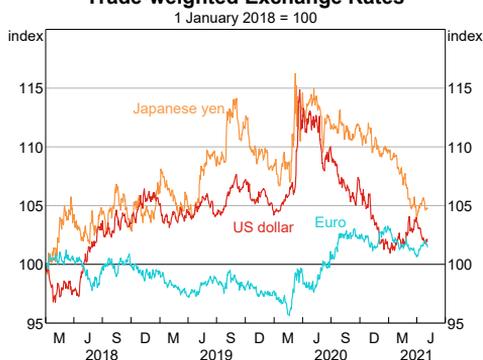
## The US dollar is around its levels earlier in the year

The US dollar appreciated on a trade-weighted (TWI) basis alongside rising US Government bond yields through to March, but has depreciated since then. It is now back around its levels at the start of the year (Graph 1.28). Most other advanced economy currencies have appreciated a bit over the past month or so. However, the Japanese yen, euro and Swiss franc remain lower than their levels earlier in the year. This is consistent with divergences in the near-term outlook for growth stemming from the slower rollout of vaccines and ongoing containment measures in Europe and Japan.

The currencies of commodity-exporting economies, including the Australian dollar, are around or above levels from earlier in the year supported by the high levels of many commodity prices (see ‘Domestic Financial Conditions’ chapter for recent developments in the Australian dollar). However, the New Zealand dollar depreciated through March as yields on New Zealand Government bonds declined and market participants scaled back their expectations about the RBNZ increasing its policy rate following the New Zealand Government’s announcement of measures aimed at curbing housing price growth.

**Graph 1.28**

### Trade-weighted Exchange Rates



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System

## Emerging market financial conditions have tightened, although to varying degrees

Financial conditions in emerging market economies (EMEs) have tightened in recent months, alongside the rise in advanced economy bond yields. Episodes of rising US yields often lead to a tightening of financial conditions in EMEs, which can be problematic if the outlook for these economies remains weaker than for advanced economies. Local currency government bond yields have increased noticeably in many EMEs, though to a lesser extent in Asia, while spreads between EME’s US dollar-denominated bonds and equivalent US Treasury bonds have been little changed (Graph 1.29).

In Asia, the currencies of most emerging economies have depreciated slightly against the US dollar and inflows into bond and equity funds have slowed. In a number of EMEs outside Asia, there have been some large swings in exchange rates over recent months and a pause in portfolio flows to investment funds. In particular, Turkey’s financial markets experienced significant volatility following the removal of the central bank governor there.

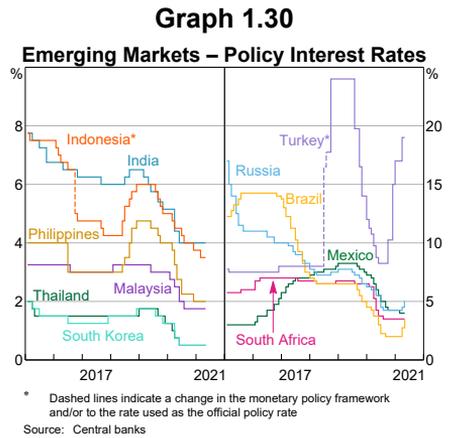
**Graph 1.29**

### Emerging Markets – Financial Conditions



\* Local currency bonds, weighted by market value  
 \*\* US-dollar denominated bonds; spreads to equivalent US Treasury  
 \*\*\* 1 Jan 2020 = 100  
 \*\*\*\* Per cent of assets under management; includes flows to bond and equity funds  
 Sources: Bloomberg; EPFR Global; IMF; J.P. Morgan; RBA

A few EME central banks outside Asia have raised policy rates at recent meetings, while accommodative policy settings have been maintained elsewhere (Graph 1.30). The central banks of Brazil and Russia raised their policy rates at consecutive meetings in recent months due to rising inflation. In Turkey, the central bank raised its policy rate due to concerns about inflation, which was followed by the removal of the governor; rates were held steady at the subsequent meeting. Bank Indonesia left its policy rate unchanged, but signalled concerns about lowering its policy rate further following the recent depreciation of its exchange rate. 🏹



### Endnotes

[1] Nominal bond yields can be thought of as having two components: real yields, which are the yields on inflation-linked bonds, and an inflation compensation component which is the difference between real and nominal bond yields. The inflation compensation

component represents both expected inflation and a risk premium.

[2] See RBA (2021), Financial Stability Review, April. Available at <<https://www.rba.gov.au/publications/fsr/2021/apr>>

## Box A

# Emerging Market Vulnerabilities and Financial Conditions in Advanced Economies

The rise in bond yields in advanced economies since earlier this year has been underpinned by better prospects for the global economic recovery. Stronger global growth will support output in emerging market economies (EMEs) through stronger demand for exports. However, there is a risk that higher yields in advanced economies will lead to tighter financial conditions in EMEs than is justified by their economic fundamentals, which are likely to warrant substantial monetary and fiscal support for some time. In particular, compared with advanced economies many EMEs face protracted recoveries, which will be further delayed because of high and rising rates of COVID-19 cases and relatively slow vaccine rollouts. For example, GDP per capita is not expected to return to its pre-pandemic level for several years in many EMEs, well behind the United States and China (Graph A.1).

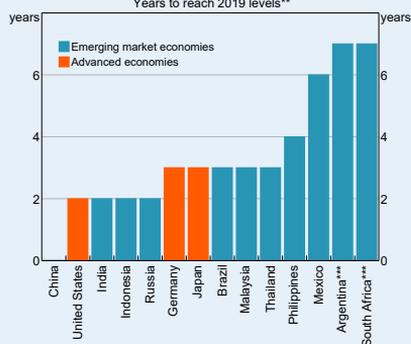
Financial conditions in advanced economies transmit to EMEs through a number of different channels. Many EMEs have current account deficits, which necessarily involve net capital inflows from foreign investors. These net capital inflows are often in the form of lending (through loans and bonds) to corporations and governments. There is a risk that net capital inflows decline if the risk-adjusted return on lending to EMEs becomes less attractive once yields rise in advanced economies. Moreover, net capital inflows could become net capital outflows if foreign investors become concerned about whether they are likely to be repaid.

The risk of a decline in net capital inflows is likely to be particularly problematic in situations where governments have high levels of debt, following years of large fiscal deficits (Graph A.2). EME governments in this situation already have limited fiscal space to respond to weak growth, and further poor outcomes are likely to heighten concerns among foreign investors of losses on the EME debt they hold.

A decline in capital inflows will lead to depreciation pressures on exchange rates. While an exchange rate depreciation typically supports economic growth (at least for a time) by boosting net exports, it can also lead to large and persistent increases in inflation in EMEs where inflation and inflation expectations are less well-anchored.<sup>[1]</sup> A depreciation also increases the cost for local borrowers to service and repay their debts

### Graph A.1

**GDP Per Capita\***  
Years to reach 2019 levels\*\*



\* National currencies, constant prices

\*\* Based on WEO April 2021 forecasts

\*\*\* GDP per capita has not reached 2019 levels by 2026; forecast periods ends at 2026

Source: IMF

that are denominated in foreign currencies if these are unhedged. Many EMEs have historically borrowed abroad in foreign currency, particularly in US dollars, in part because markets to borrow in local currency were under-developed. Moreover, there can be limited opportunities to hedge these foreign currency debts in EMEs where financial markets are less developed or there is less incentive to do so because the exchange rate is managed in a way that reduces exchange rate risk. The value of unhedged domestic assets held by foreign investors also falls when the exchange rate depreciates, possibly prompting further capital outflows. These dynamics can put pressure on EME central banks to raise policy rates to try to stem capital outflows and avoid rising inflationary pressures, even if domestic economic conditions would not warrant a tightening in domestic financial conditions.

In recent decades, many EMEs have taken steps to improve the resilience of their domestic financial systems and institutions to swings in capital flows and exchange rates. Many EMEs have enhanced the independence of their central banks and adopted inflation targets, which has helped

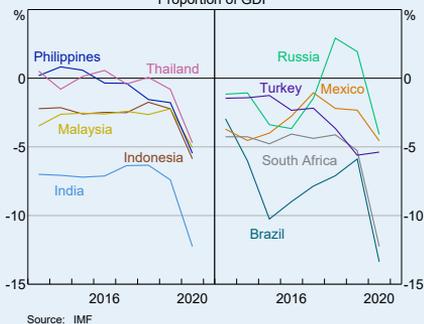
to anchor inflation and inflation expectations more effectively. Some EMEs have developed deeper and more liquid local currency bond markets and financial products that enable foreign exchange risks to be hedged. Many economies in Asia have also increased their foreign exchange reserves, which has given them more capacity to intervene to smooth volatility in foreign exchange markets related to rapid changes in capital flows.

As a result, many EMEs in Asia have experienced a more modest tightening of financial conditions, with bond yields rising and exchange rates depreciating by less than for EMEs in other regions. Compared with EMEs in other regions, most Asian EMEs have lower foreign currency debt obligations, foreign ownership of debt and government debt; they are also running current account surpluses (Graph A.3). These factors, in addition to improved institutional frameworks, reflect efforts by policymakers to build more resilient institutions, economies and financial systems in the two decades since the Asian financial crisis.<sup>[2]</sup>

Financial conditions in EMEs stabilised over March and April, but remain tighter than at the start of the year. If strains in individual EMEs become acute they could spill over to

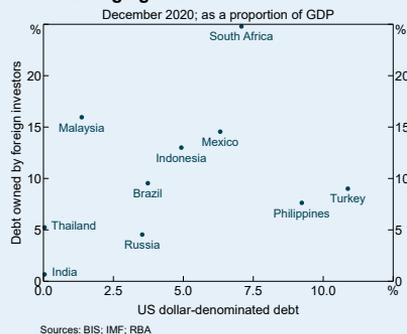
**Graph A.2**

**Fiscal Balances**  
Proportion of GDP



**Graph A.3**

**Emerging Market Government Debt**



other economies. From a trade perspective, EMEs such as Brazil and Mexico are relatively large and have deep trade ties with other economies, including major advanced economies. Disruptions to their economic activity would be felt by their trading partners and affect cross-border investment flows and global supply chains. From a financial perspective, banks and investors in both advanced and emerging economies could be directly exposed to losses on loans to EMEs. If international investors sought to reduce their exposures to EMEs generally, this could result in contagion whereby financial conditions tighten significantly even in EMEs with reasonable fundamentals.

Access to emergency multilateral financial assistance can prevent temporary external funding pressures from spilling over to other economies. Financing from the International Monetary Fund (IMF) is already providing support to low-income countries and some EMEs. There is also broad support for the IMF to proceed with a US\$650 billion allocation of Special Drawing Rights later this year, which, if approved, will boost countries' reserves of foreign currency. Around US\$200 billion is expected to be allocated to EMEs and developing countries, which would increase their total reserves by around 5 per cent. ✎

## Endnotes

- [1] Pass-through from the exchange rate to inflation expectations is often higher in EMEs; see Borio (2019), 'Monetary policy frameworks in EMEs: practice ahead of theory', Speech on the occasion of the Bank for International Settlement's Annual General Meeting, Basel, 30 June. Available at <[bis.org/speeches/sp190630a.pdf](https://bis.org/speeches/sp190630a.pdf)>.
- [2] See RBA (2018), 'Box A: Financial Market Resilience of Emerging Asia', *Statement on Monetary Policy*, August, pp 22–24. Available at <<https://www.rba.gov.au/publications/smp/2018/aug/box-a-financial-market-resilience-of-emerging-asia.html>>

## Box B

# Supply Chains During the COVID-19 Pandemic

To contain the spread of COVID-19, governments across the world restricted individual and commercial activities to varying degrees. These measures, along with some very large shifts in patterns of demand, have strained global supply chains, defined as the sequence of processes involved in the *production* and *transportation* of goods.

Australia has not been immune to these effects. Reports of international supply chain issues have been common in the Bank's Regional and Industry Liaison Program over the past year, with non-food retailers and manufacturers the most affected; ABS surveys show a similar pattern (Graph B.1). However, for the majority of firms these issues have been relatively mild and/or temporary, and have not materially affected their ability to operate. As a result, only a small share of businesses have made major long-term changes to their supply arrangements to date.

### There have been two phases of international supply chain issues

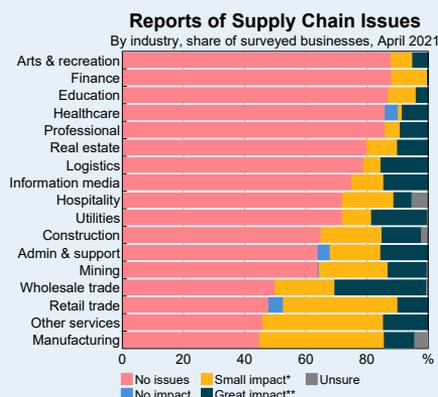
Broadly speaking, there have been two phases of supply chain issues during the pandemic. In the early stages of the pandemic *production* issues due to activity restrictions were most prevalent, first in China and subsequently in other countries. As global demand rebounded from mid 2020, *transportation* issues, particularly the availability of sea freight services, became the major driver of supply chain issues, though

production constraints remain in some countries.

### Phase 1: Global lockdowns result in production constraints

When China entered into lockdown in early 2020, Australian firms across many industries reported delays in deliveries of up to a few weeks and, in some cases, difficulties sourcing products, as factories overseas were either shut down or operating at significantly reduced capacity. The difficulties around sourcing sufficient quantities of products were most pronounced for personal protective equipment (PPE) and other medical and hygiene products in high demand. Chinese factories started returning towards normal production over March and April. At the same time, supply chain disruptions started to emerge in other parts of Asia, the United States and Europe as

Graph B.1



\* E.g. some delays but little impact on revenue

\*\* E.g. major delays or cannot obtain certain items; significant impact on revenue

Sources: ABS; RBA

those economies implemented various restrictions on activity.

### Phase 2: Transportation issues emerge alongside continuing production constraints

With much activity in the travel and services sectors constrained by health-related restrictions and many workers in advanced economies working from home for the first time, global demand shifted from services to goods. This was apparent in the consumption patterns in a range of advanced economies, including Australia (Graph B.2). Fiscal and monetary stimulus supported incomes and helped enable this substitution. Goods manufactured in Asia were particularly affected by stronger demand.

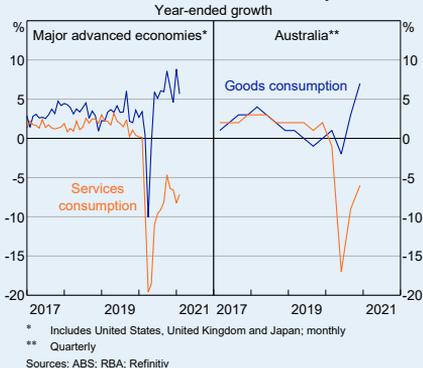
This shift in consumption patterns took suppliers by surprise, and has resulted in transportation issues becoming a major driver of supply chain issues since around mid 2020. This primarily reflects a global shortage of shipping containers, particularly out of China, and a mismatch of the location of containers, which are often full in one direction but empty in the other direction. At various times this has been exacerbated by congestion at some ports around the world

as increased import volumes have coincided with reduced capacity due to restrictions. The lack of shipping containers has resulted in sharp increases in global shipping prices since mid 2020, as well as delivery delays (Graph B.3).

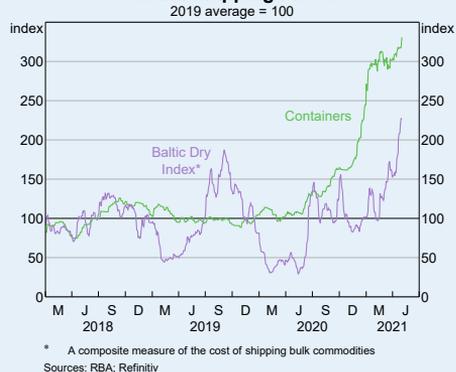
Meanwhile, air freight capacity remains significantly lower than pre-pandemic levels, reflecting far fewer commercial passenger flights due to restrictions on international travel. As a result, delivery times for this form of transport have also increased and costs remain significantly higher than pre-pandemic levels. Nonetheless, air freight accounts for a small share of Australia's total goods trade values.

Global production issues in places such as south and southeast Asia, Europe and the United States eased over the second half of 2020 as commercial activity restrictions were relaxed. However, some factories continue to operate below full capacity because of restrictions, making it harder for them to work through their backlog of orders as well as meet new orders. As a result, production lead times have increased.

**Graph B.2**  
Goods and Services Consumption



**Graph B.3**  
Global Shipping Prices



## For most Australian firms, supply chain issues have not been severe enough to affect operations materially ...

With regards to the experience of Australian firms, the majority of contacts in the Bank's liaison program note that supply chain issues have not materially affected their ability to operate, because issues have generally been relatively mild and/or temporary.<sup>[1]</sup> Survey data indicate around 10 per cent of firms are experiencing severe supply chain issues, with smaller firms more affected than medium and large firms.<sup>[2]</sup> For many firms, the effects of global supply delays early in the pandemic were largely mitigated by drawing down on existing inventories, as well as a significant decline in sales and orders. While some non-food retailers reported that shipping delays had resulted in longer-than-expected times to rebuild inventories since mid 2020, this issue has now largely been resolved with the exception of certain in-demand products, particularly those relying on electronic chips. In addition, apart from some logistical issues, firms have reported limited domestic supply chain issues over the past year, largely reflecting Australia's favourable health outcomes.

However, supply chain issues have resulted in higher costs for PPE and cleaning products, and container and air freight costs have also increased significantly. For most firms these costs are only a small share of total costs, and may be offset by reductions in other costs.

## ... so relatively few firms have made material long-term changes to procurement practices

The ABS' April 2021 'Business Conditions and Sentiments' survey indicates around one-quarter of respondents have made at least

one change to suppliers or supply chains over the past year. However, both liaison and ABS survey data indicate that only a small share of firms have made major changes to their supply arrangements to date:

- The majority of businesses facing supply chain issues have made the relatively small change of altering ordering processes, including submitting orders earlier than previously and, to a lesser extent, seeking to maintain higher inventory levels (Graph B.4). Within the liaison program, this message has been most common for non-food retailers, manufacturing, mining and health and aged care firms. To date, very few contacts have indicated a desire to hold structurally higher inventories over the medium term.
- Around 10 per cent of firms have made moderate changes such as changing their suppliers or operational processes. Changes to suppliers have included purchasing from alternative domestic suppliers, importing from a wider range of overseas countries or suppliers, as well as some switching from overseas to local suppliers. Liaison suggests firms in the manufacturing and construction industries have been most likely to change suppliers.
- Liaison reports of firms making the major decision to bring part of their supply chain onshore have been very rare.

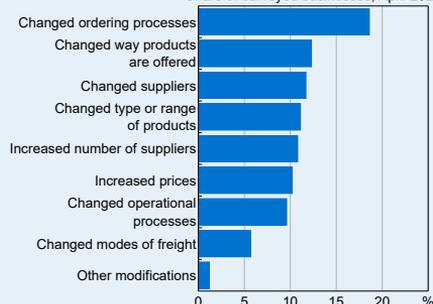
The modest response by most firms to supply chain issues to date is likely because the issues they have experienced have been relatively minor. For industries facing more severe issues, such as non-food retail, and manufacturing, liaison contacts note a range of challenges in switching suppliers, including the complexity, time and higher

costs involved. Higher costs are particularly pertinent for switching to domestic suppliers, and in some instances there are no domestic substitutes at all. ↴

**Graph B.4**

**Response to Supply Chain Issues**

Share of surveyed businesses, April 2021



Sources: ABS, RBA

**Endnotes**

[1] This is consistent with the Productivity Commission’s Vulnerable Supply Chains – Interim Report, which finds that ‘only a small fraction of Australia’s imports are vulnerable to serious supply disruption’, as well as survey data from the Chamber of Minerals & Energy of Western Australia (CMEWA) which indicate that there were initial supply chain impacts, particularly for high-demand items such as sanitiser and other hygiene products, but these had moderated by June 2020. See Productivity Commission (2021), ‘Vulnerable Supply Chains – Interim Report’, 26 March. Available at <[pc.gov.au/inquiries/current/supply-](http://pc.gov.au/inquiries/current/supply-chains/interim)

[chains/interim](http://pc.gov.au/inquiries/current/supply-chains/interim)>. See also CMEWA (2021), ‘The WA Resources Sector: Navigating through COVID-19 and recovery’, 22 March. Available at <<https://www.cmewa.com.au/wp-content/uploads/2021/03/210319-CME-EY-Navigating-COVID-Report-v1.0.pdf>>.

[2] See ABS (2021), ‘Business Conditions and Sentiments’, 30 April. Available at <[abs.gov.au/statistics/economy/business-indicators/business-conditions-and-sentiments/apr-2021#supply-chain-disruptions](http://abs.gov.au/statistics/economy/business-indicators/business-conditions-and-sentiments/apr-2021#supply-chain-disruptions)>.



## 2. Domestic Economic Conditions

The strong recovery in the Australian economy and the labour market has continued. Low infection rates, substantial fiscal and monetary policy support and a lift in confidence have boosted the recovery. Household spending, dwelling investment and exports have all contributed to the snap back in activity. Employment has also bounced back, to be above its pre-pandemic level, and the unemployment rate has declined significantly from its peak in July 2020. Policy measures are supporting the economic recovery, but a rebalancing of public and private demand is underway. The outlook is stronger than expected at the time of the previous *Statement*, but it remains uneven as the pandemic continues to weigh on parts of the economy (see the ‘Economic Outlook’ chapter).

The economy expanded by 3.1 per cent in the December quarter, to be 1.1 per cent smaller than at the end of 2019 (Graph 2.1). Growth in the quarter was broad based across expenditure components. The terms of trade increased by around 5 per cent over the December quarter, to their highest level in nearly a decade, supporting business profits and government revenues.

Timely indicators of economic activity suggest that GDP returned to its pre-pandemic level in the March quarter. Overall household and business balance sheet positions are stronger than prior to the pandemic. The vaccine rollout is progressing, with around 2½ million doses administered so far. However, activity still remains below where it would have been without the pandemic and conditions in some parts of the private economy remain weak.

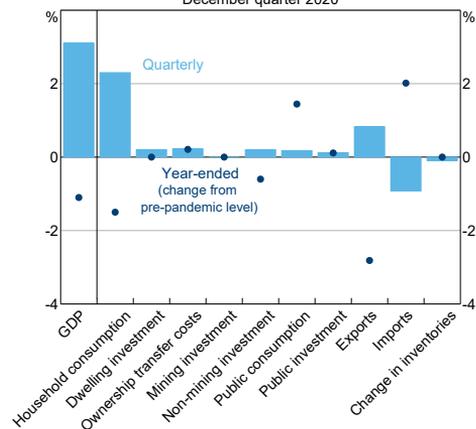
Some industries, including tourism and educational service providers, continue to be affected by the international border closure. Growth in the Australian population has slowed significantly, but the effect this is having on the economy is being offset by the considerable support from policy measures (see ‘Box C: International Border Closures, Slower Population Growth and the Australian Economy’). Given virus cases remain high globally and new strains are circulating overseas, it could be some time before the border is reopened fully.

### Spare capacity in the labour market has declined faster than expected

The unemployment rate has declined rapidly over recent months to reach 5.6 per cent in March. This is almost 2 percentage points below

**Graph 2.1**

**Contribution to GDP Growth**  
December quarter 2020



Sources: ABS; RBA

the peak in July last year, but ½ percentage point above the pre-COVID level (Graph 2.2). The decline in the unemployment rate has been faster than expected at the time of the previous *Statement*, as activity and employment have grown more strongly than anticipated.

Other labour market measures also indicate that spare capacity has reduced further, with the underemployment rate now back around its pre-pandemic level, and the number of people working reduced hours for economic reasons also falling to around pre-pandemic levels. Labour force participation has strengthened, and the participation rate increased to a record high 66.3 per cent in March. Available information suggests that the end of the JobKeeper program in March has had only a muted effect on employment so far.

### The recovery in employment has been broad based

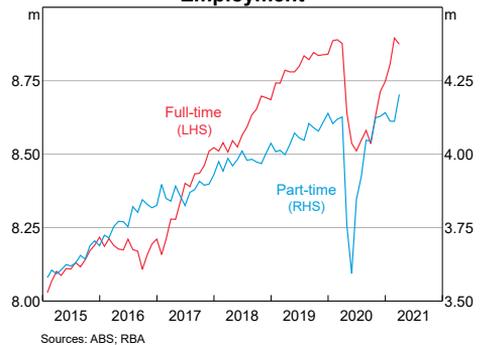
The number of people in employment increased by almost 200,000 between December and March, surpassing the pre-COVID level of employment and taking the employment-to-population ratio back to around 62½ per cent. The initial phase of the recovery in employment was largely driven by increases in part-time employment (Graph 2.3). However, as the recovery has progressed the flow from part-time

to full-time employment has increased, as is typically observed in labour market recoveries; full-time employment has now recovered to around its pre-pandemic level. Employment growth has been widespread across states in recent months.

The faster-than-expected increase in employment has been assisted by the ongoing easing of activity restrictions. Strong demand has also pushed employment beyond its pre-pandemic levels in a number of industries, including retail and professional services (Graph 2.4). In contrast, hospitality employment remains well below its pre-pandemic level, and employment in parts of the economy dependent on international visitors and students (for example, tourism and tertiary education) is also yet to recover fully.

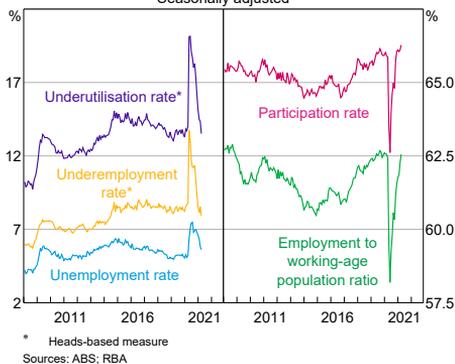
**Graph 2.3**

**Employment**



**Graph 2.2**

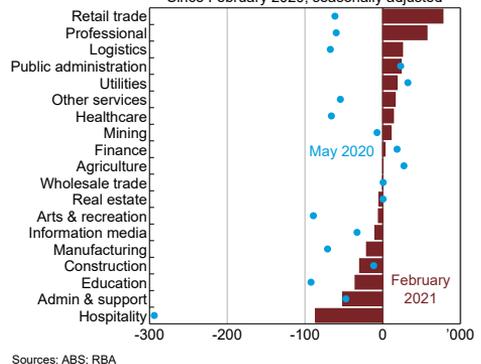
**Labour Market**  
Seasonally adjusted



**Graph 2.4**

**Change in Employment by Industry**

Since February 2020, seasonally adjusted



## Leading indicators of labour demand suggest the near-term outlook for employment is strong

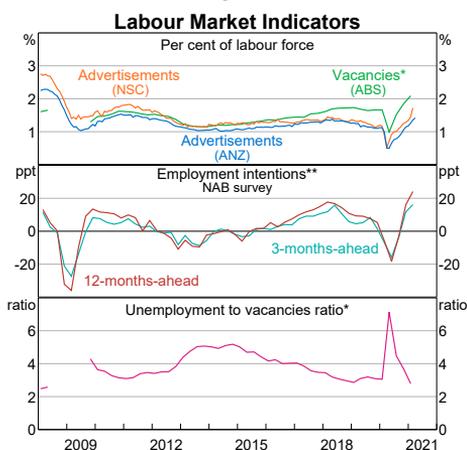
The withdrawal of JobKeeper at the end of March is likely to result in some job losses over the course of the June quarter. However, these job losses are expected to be more than offset by demand for labour elsewhere in the economy. In particular, forward-looking indicators suggest strong demand for labour over coming months. As a share of the labour force, job vacancies and advertisements are at historically elevated levels and employment intentions have continued to pick up (Graph 2.5). A number of factors have been contributing to this, including a return to more usual patterns of job turnover, the re-filling of positions that were cut during the pandemic, ‘catch-up’ of hiring that was put on hold last year, and new hiring in parts of the economy experiencing strong demand.

Vacancies are high in most industries, including those where employment is still below pre-pandemic levels and in industries where employment has risen over the past year (Graph 2.6). A high level of vacancies points to a

positive near-term outlook for employment growth in these industries.

Indicators of near-term labour demand are consistent with information from the Bank’s business liaison program. Around half of the Bank’s liaison contacts expect to increase headcount over the year ahead, with only 10 per cent expecting to decrease headcount (Graph 2.7). This is partly due to firms that reduced headcount over the past year not anticipating a need for further reductions, and partly because firms that have recently expanded headcount are also expecting to increase headcount further.

**Graph 2.5**



\* ABS Vacancies Survey was suspended between May 2008 and November 2009

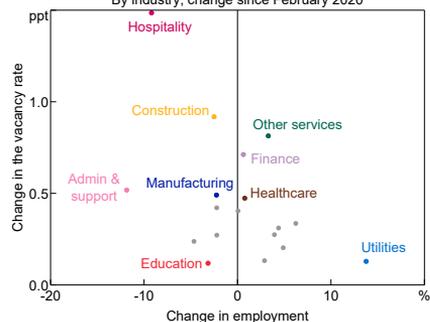
\*\* Net balance for the following period; deviation from average; 12-months-ahead measure seasonally adjusted by the RBA

Sources: ABS; ANZ; NAB; National Skills Commission (NSC); RBA

**Graph 2.6**

### Vacancies and Employment

By industry, change since February 2020

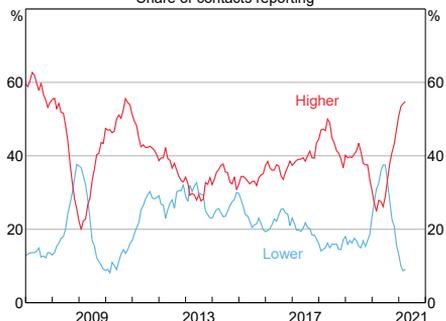


Sources: ABS; RBA

**Graph 2.7**

### Employment Intentions\*

Share of contacts reporting



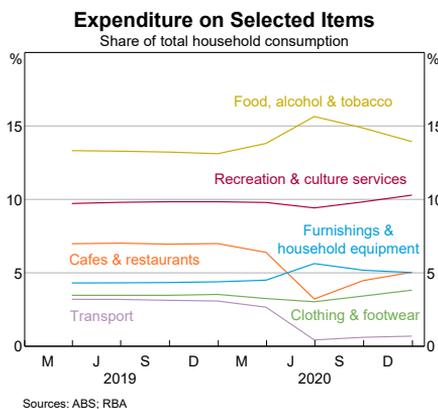
\* Over the year ahead; 7-month centred moving average  
Source: RBA

## Consumption patterns are rebalancing

Household consumption continued to recover over recent months. Timely indicators suggest that spending returned quickly to previous levels after short lockdowns in several states earlier this year. After the initial rebound during the second half of 2020, the recovery in consumption is expected to have continued at a more moderate pace in the March quarter, leaving it a little short of its pre-pandemic level.

As restrictions on activity have been lifted, consumption patterns for many items have started to return to their pre-pandemic shares (Graph 2.8). Reversing earlier shifts in spending behaviour, household spending on food and alcohol to be consumed at home has declined as a share of consumption over recent quarters and spending on discretionary services, such as eating out, entertainment and domestic travel, has increased. However, some consumption patterns will take longer to shift back towards pre-pandemic norms. For example, spending on transport services remains subdued, particularly in the case of public transport. In part this reflects many employees continuing to work from home for at least part of their working week.

**Graph 2.8**



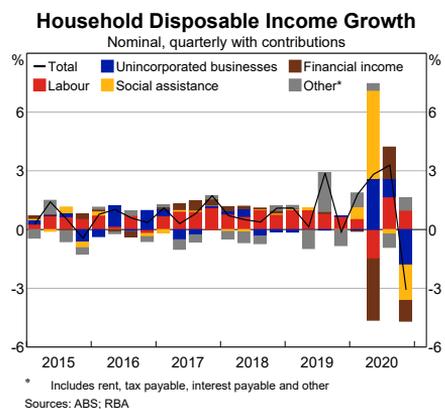
## The earlier large boost to household income has partially unwound ...

There have been large quarterly changes in household income during the pandemic. After receiving a significant boost from government transfers through the middle of 2020, nominal household income declined by 3.1 per cent in the December quarter (Graph 2.9). The decline in social assistance in the quarter reflected a reduction in the value of pandemic-related support payments and a tightening of eligibility requirements, as well as lower unemployment. Financial income also declined. By contrast, labour income increased by 1.4 per cent, supported by the recovery in the labour market. Over the first half of 2021, fiscal transfers have declined further with the expiry of the Coronavirus Supplement and the JobKeeper program but, because employment has recovered strongly, household income is expected to have been broadly unchanged.

## ... but the household sector accumulated extra savings over the course of the pandemic

Following a large increase in saving through the middle of last year, the household saving ratio (net of depreciation) declined 7 percentage points in the December 2020 quarter to 12 per cent. This still high rate of saving is

**Graph 2.9**



consistent with activity restrictions in place at the time. The rate of household saving is expected to decline further over the coming year as uncertainty recedes and opportunities to consume become more available. Some households may also opt to draw down on a portion of their savings accumulated over 2020. All household income groups saved more than usual over 2020, but the bulk of the additional savings were accumulated by the top 40 per cent of the income distribution (Graph 2.10). This is in line with the experience of some other advanced economies.

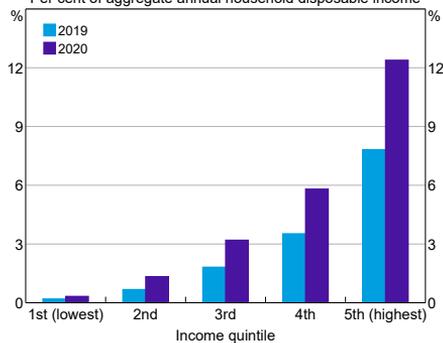
### Conditions in the housing market have picked up strongly

Following 3 per cent growth over 2020, housing prices increased by 5 per cent in the March quarter and strong price growth continued in April (Table 2.1). The broad-based nature of the upswing is in line with housing demand being supported by low interest rates, government support programs, a positive outlook for employment, potentially some pent-up demand during the pandemic and the increase in savings over 2020. Since the previous *Statement*, prices in Sydney and Melbourne have exceeded their previous peaks (in nominal terms) recorded in 2017 and 2020 respectively, and prices have continued to reach new highs in many smaller

cities (Graph 2.11). Price growth for detached houses has continued to outpace units. Prices in all segments of the housing market have increased strongly, but price growth has been particularly strong for the most expensive properties in capital cities over recent months (Graph 2.12).

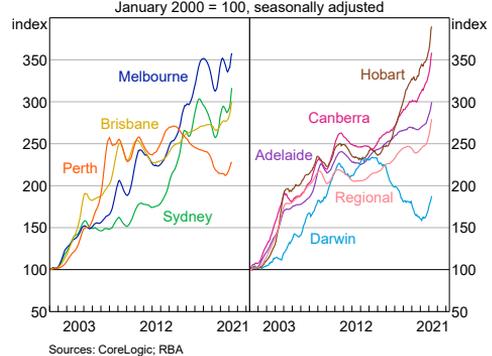
Other indicators also suggest that demand has been strong relative to the supply of housing available for sale. New residential listings have normalised over recent months to be a little above their levels from the past few years. But the stock of total listings in each month has been low, indicating that properties are being sold quickly. Auction volumes in Sydney and

**Graph 2.10**  
**Gross Household Saving by Income Quintile**  
Per cent of aggregate annual household disposable income



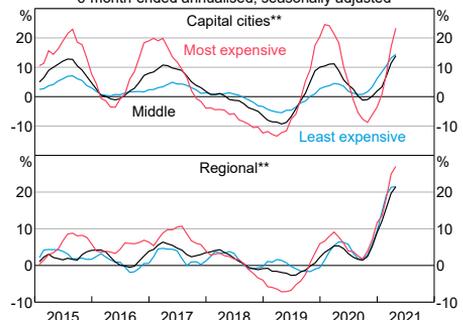
Sources: ABS; RBA; Roy Morgan Single Source

**Graph 2.11**  
**Housing Prices**  
January 2000 = 100, seasonally adjusted



Sources: CoreLogic; RBA

**Graph 2.12**  
**Housing Price Growth by Dwelling Value\***  
6-month-ended annualised, seasonally adjusted



\* Least expensive (5th–25th percentile), middle (25th–75th percentile), most expensive (75th–95th percentile)

\*\* Capital cities price indexes are for the 8 capital cities and regional prices are for the rest of Australia

Sources: CoreLogic; RBA

**Table 2.1: Housing Price Growth**

Percentage change, seasonally adjusted

	April	March	February	January	Year-ended	Past five years
Sydney	2.4	3.4	2.1	0.4	7.5	23
Melbourne	1.2	2.2	1.7	0.2	2.2	22
Brisbane	1.6	2.2	1.3	0.9	8.3	14
Adelaide	1.8	1.5	1.0	0.9	10.3	18
Perth	0.5	1.4	1.2	1.2	6.7	-9
Darwin	2.3	1.6	1.1	2.1	15.3	-10
Canberra	1.6	2.8	1.7	1.4	14.2	36
Hobart	1.0	3.1	2.1	1.5	13.8	56
Capital cities	1.8	2.6	1.8	0.6	6.4	18
Regional	1.9	2.2	1.8	1.4	13.0	24
Australia	1.8	2.5	1.8	0.7	7.8	19

Sources: CoreLogic, RBA

Melbourne also increased to well above average levels and auction clearance rates remained high in recent months. Housing turnover has been around its highest level in several years. Demand for housing and credit over the past year has been primarily driven by owner-occupiers, including first home buyers. Investor activity has picked up a little recently, albeit from a low base.

### Rental market conditions remain uneven

Rental markets tightened for both houses and apartments outside of Sydney and Melbourne in the first part of the year. Rents have grown very strongly in some parts of the country, particularly for houses, and vacancy rates outside of the two largest cities reached their lowest level in around a decade (Graph 2.13). The Melbourne and Sydney rental markets have been the outliers for most of the past year with both affected by lower net overseas migration. In Sydney, growth in advertised rents has recently turned positive, though vacancy rates remain elevated. Vacancy rates remain very high

in Melbourne. Rental eviction moratoria concluded at the end of March, which may contribute to an increase in rents over the June quarter and increased vacancy rates.

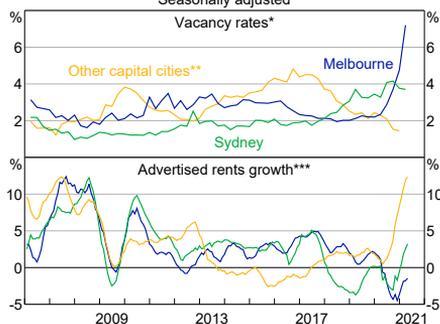
### House construction and renovation activity has been boosted by policy support

Approvals for detached dwellings and alterations & additions increased to record-high

**Graph 2.13**

#### Rental Market Indicators

Seasonally adjusted



\* Quarterly; includes a March quarter estimate for Melbourne and Sydney  
 \*\* Dwelling stock weighted; vacancy rate excludes Adelaide  
 \*\*\* 6-month-ended annualised  
 Sources: CoreLogic; RBA; REIA; REINSW; REIV

levels in the March quarter, which has boosted the pipeline of construction activity over 2021 (Graph 2.14). In addition to the support provided by low interest rates, this increase in approvals has been driven by HomeBuilder and other state-based grants; construction on many of the large number of projects being approved under these programs is only now commencing. Some construction firms in the Bank’s business liaison program have been experiencing supply constraints that have led to cost pressures and some delays to construction timelines. Higher-density construction activity remained subdued in the March quarter. If the increase in approvals for higher-density projects in March is sustained, this will provide a boost to dwelling investment over coming years.

### Policy support and a rebound in activity has supported business conditions

Business investment fell sharply through the middle of last year, as business sentiment collapsed and firms responded to weak demand and heightened uncertainty related to the pandemic. Policy support for firms then stabilised business conditions and appears to have brought forward the beginning of a recovery in business investment. In the recent period, surveyed business conditions have risen further to record-high levels, indicating that

firms are growing more confident in the strength of the recovery.

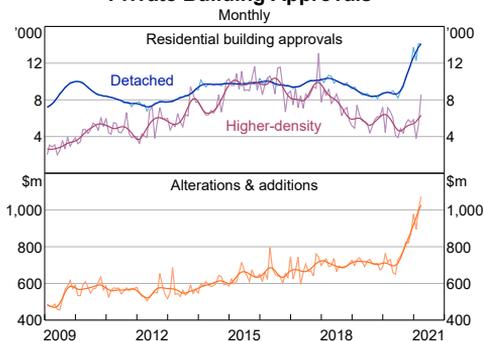
Private non-mining business investment increased by 3 per cent in the December quarter, albeit from a low level (Graph 2.15). The increase was driven by machinery & equipment investment as firms responded to the tax incentives for investment from the Australian Government, as well as to the recovery in demand. Those factors, together with strong growth in profits and a reported increase in capacity utilisation and business confidence, should continue to support non-mining investment in the near term (Graph 2.16, Graph 2.17).

However, the recovery in non-mining investment is still at an early stage – it remains 7 per cent lower than before the pandemic. Non-residential construction investment continued to decline in the December quarter and the pipeline of work fell. The outlook is uneven across sectors, and investment may take longer to recover in those sectors that have been more negatively affected by the pandemic.

In contrast, mining investment has remained relatively resilient during the pandemic and is 2 per cent higher in year-ended terms as firms undertook projects to replace existing capacity

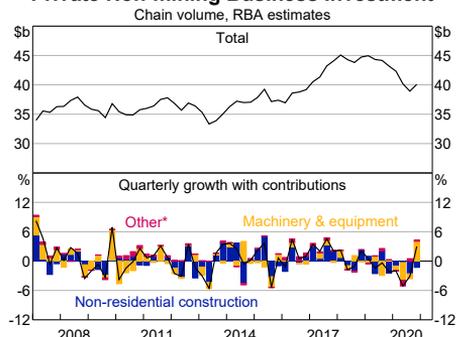
**Graph 2.14**

**Private Building Approvals\***



**Graph 2.15**

**Private Non-mining Business Investment**



\* Includes cultivated biological resources (mainly livestock, vineyards and orchards), computer software, research & development and artistic originals

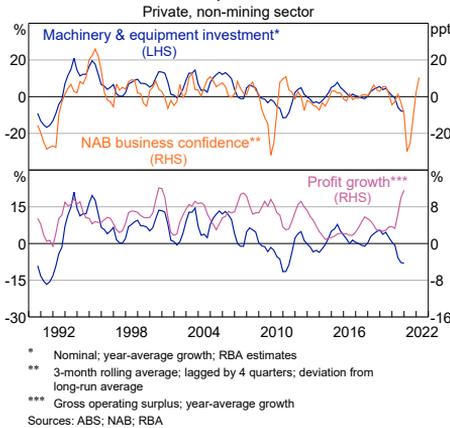
Sources: ABS; RBA

in the iron ore and liquefied natural gas (LNG) sectors.

Surveyed measures of investment intentions have increased from the low levels of mid 2020. The ABS Capital Expenditure (Capex) survey, which was conducted in January and the first half of February, indicates that both mining and non-mining business investment are expected to increase in the 2021/22 financial year (Graph 2.18). Higher current and expected oil prices have made some new LNG projects viable, while a large pipeline of renewable energy projects is expected to support non-mining business investment.

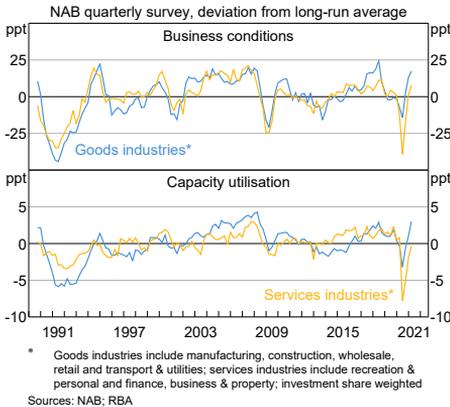
**Graph 2.16**

**Business Confidence, Profits and Investment**



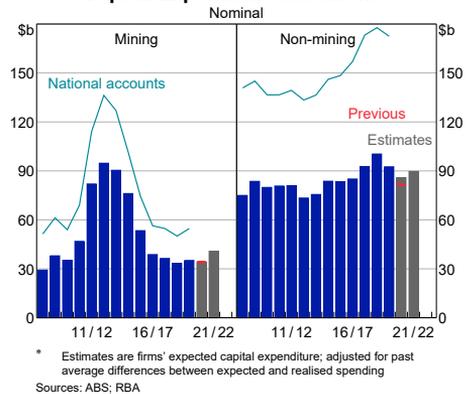
**Graph 2.17**

**Business Sentiment**



**Graph 2.18**

**Capital Expenditure Intentions\***



**Public demand continues to support growth**

Health and other pandemic management spending contributed to a 7½ per cent increase in public consumption over the year to the December quarter 2020. Public investment also increased in 2020, but only modestly, reflecting a slower-than-expected rollout of the large capital expenditure programs announced across all levels of government. Information from the Bank's liaison program suggests that these delays in part reflect capacity constraints and approval processes.

As at March, the Australian Government's underlying cash deficit for the 2020/21 financial year to date was smaller than expected at the time of the Mid-year Economic and Fiscal Outlook (MYEFO) in December (Graph 2.19). Both higher receipts and lower payments, mostly reflecting the faster-than-expected rebound in activity and employment alongside higher commodity prices, contributed to a smaller deficit than previously foreshadowed.

**Rural and resource exports have increased strongly**

Rural exports increased sharply in the December quarter following a strong harvest, and resource exports were also higher, contributing to a

4 per cent increase in total export volumes. The domestic recovery continued to drive increases in import volumes, led by capital and consumer goods. Trade in services remained constrained by ongoing restrictions on international travel. The trade surplus increased in the December quarter, and growth in rural and resource export values continued to support the trade surplus over the March quarter (Graph 2.20). However, the value of both exports and imports remain below pre-pandemic levels as foreign and domestic demand continues to recover.

Rural export volumes increased by more than 20 per cent in the December quarter, led by cereals after the drought broke in parts of Australia last year. The near-term outlook for the

rural sector remains favourable as exporters continue to operate at capacity following the second-highest winter crop harvest on record. Improved pasture conditions will support farmers in continuing to rebuild herds and flocks.

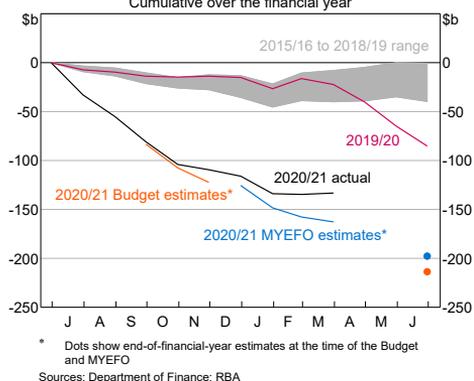
Resource export volumes increased by a little under 2 per cent in the December quarter, and look to have increased further in the March quarter. Partial trade data and information from the Bank's liaison program suggest that iron ore export volumes increased in the March quarter, because fewer weather-related disruptions occurred than is usual over this part of the cyclone season. This was partly offset by maintenance at some mines. Iron ore exports are expected to remain close to capacity as producers respond to decade-high iron ore prices and robust Chinese demand. LNG exports appear to have remained elevated in the March quarter, supported by strong global energy demand as economic activity recovers.

Coal exports to China fell to very low levels in the March quarter (Graph 2.21). However, over recent months this decline has been broadly offset by higher demand from other markets including India, Japan and South Korea as global energy consumption recovers and steel production exceeds pre-pandemic levels. Disruptions to coal mines and infrastructure in the Hunter region in New South Wales from flooding weighed on thermal coal exports in March, including to Japan and South Korea, with some disruptions continuing into April. The recent COVID-19 resurgence in India may weigh on coking coal exports in the near term.

Goods imports have grown strongly in recent months, consistent with the ongoing recovery in domestic demand. Imports of passenger motor vehicles continued to drive the rebound, with strength in sales to businesses supported by the tax incentives for investment from the Australian Government. Capital goods imports have also increased, especially machinery and industrial

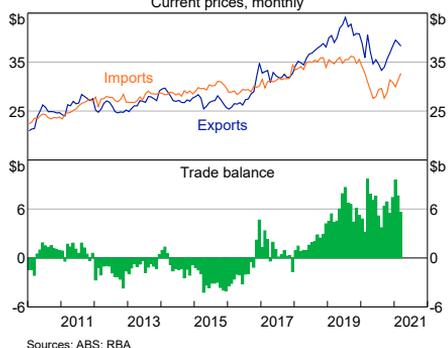
**Graph 2.19**

**Australian Government Underlying Cash Balance**  
Cumulative over the financial year



**Graph 2.20**

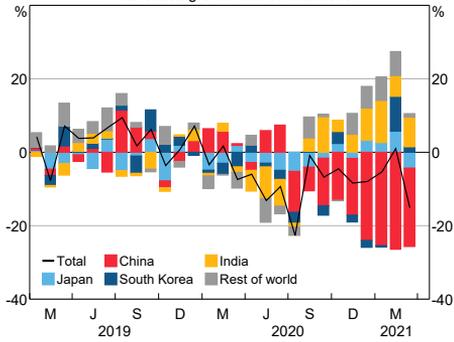
**Trade in Goods and Services**  
Current prices, monthly



equipment, supported by tax incentives and resurgent demand for agricultural equipment in response to improved farming conditions. ✖

**Graph 2.21**

**Coal Exports by Destination\***  
Year-ended growth with contributions



\* Seasonally adjusted by the RBA  
Sources: ABS; RBA

## Box C

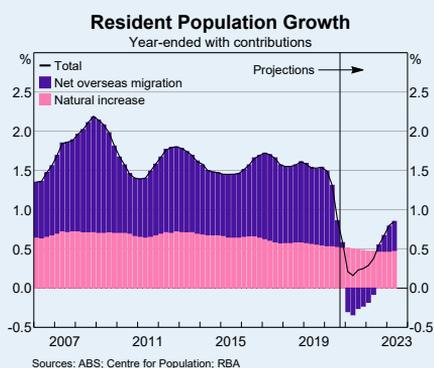
# International Border Closures, Slower Population Growth and the Australian Economy

The pandemic has resulted in an abrupt slowing in Australian population growth (Graph C.1). Since the mid 2000s, the Australian population has grown around 1½ per cent per annum, supported by the ongoing natural increase in the population and strong net overseas migration. However, the closure of international borders in early 2020 resulted in a rapid decline in inward migration; the effect this had on slowing population growth was only partly offset by more Australians returning home and fewer leaving the country than was typical previously. As a result, population growth is expected to be around 0.2 per cent in 2021, its slowest rate in more than a century.

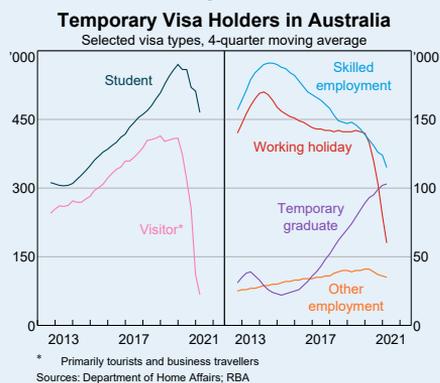
The closure of international borders not only constrained inward migration but also largely halted short-stay international visitor arrivals, who are mainly tourists and business travellers staying less than 12 months

(Graph C.2).<sup>[1]</sup> Together, the decline in migrants and short-term international visitors has had some material economic effects, mainly concentrated on those areas of the economy most reliant on international tourism, temporary foreign workers or international student populations. These effects have been uneven, but overall they have meant less demand in some areas of the economy. The decline in visitors and migrants has also had some implications for housing and labour markets. The extent and duration of these effects, which are discussed below, will depend on how quickly international travel and migration return to pre-pandemic patterns.

**Graph C.1**



**Graph C.2**



## Strong population growth has supported economic growth over recent decades

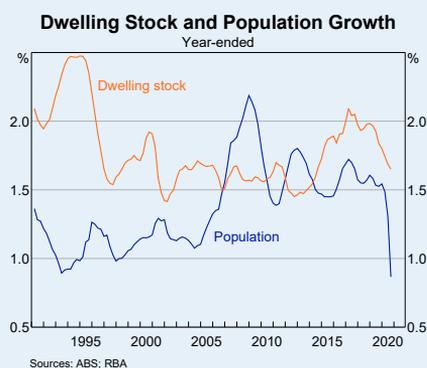
Prior to the pandemic, population growth was noticeably faster in Australia than most other advanced economies. This is a key reason why the rate of economic growth in Australia had exceeded that in many advanced economies at that time.<sup>[2]</sup> Faster population growth was also reflected in employment growth in Australia being stronger than seen in many other advanced economies. In part, immigration had been used in Australia as a way of addressing skills shortages in the labour market, for example, as seen during the mining investment boom. Another significant part of inward migration over the past decade had been the increase in the number of international students, who have contributed to domestic demand and added to the domestic labour supply.

Population growth took a step up in the mid 2000s and this affected the economy in a number of ways. More people meant increasing demands on domestic infrastructure and, over time, private and public infrastructure spending picked up in response. It contributed to increased demand for housing. Initially, this boosted rents and, over time, also housing construction, especially for high-density dwellings (Graph C.3). Strong immigration also influenced Australian demographics. Migrants are typically younger relative to the overall population, which has resulted in Australia becoming one of the youngest countries among advanced economies. This shift in Australia's demographics has had various positive economic effects – including higher labour market participation and slower ageing of the population – that will play out over a long period of time.

## The drop in international arrivals has affected domestic demand and rental demand ...

The decline in international arrivals since the pandemic had some immediate economic effects. The decline in inward migration has been the driving factor behind Australian population growth slowing since the pandemic. Population growth has not fallen to anywhere near the same degree in most other advanced economies; Canada, which also had high levels of net overseas migration in recent years, is the main exception. The decline in international students, tourists and foreign workers more broadly has removed a source of demand for a range of goods and services, such as accommodation, education, food and transport.<sup>[3]</sup> The economic effects have been felt unevenly, with some firms and regions more reliant on these temporary visitors than others. The decline in education exports alone subtracted around ½ per cent from the level of GDP over the first half of 2020, which includes both less spent on living expenses and tuition fees. The overall effects on GDP of fewer international tourists will have been offset to some extent by some of the money Australians would have spent on overseas holidays and business travel now

**Graph C.3**



being spent domestically; this will have included some increase in domestic travel but also some substitution to other types of consumer and business spending.

With fewer international arrivals, the demand for certain types of housing and accommodation has declined. In particular, the decline in international students and other temporary residents, as well as a sharp decline in tourists and business travellers, has reduced demand for long- and short-term rental accommodation. In the first half of 2020, these factors weighed on rental markets, along with others including lockdown measures, work from home arrangements which meant people could now live further from their place of employment, and the initial increase in unemployment. As a result, rental preferences shifted and overall demand declined, especially for inner-city apartments. At this time, rental vacancy rates rose, particularly in inner-city Sydney and Melbourne, and rents declined.

Since this time, the economy has been undergoing a period of change, which has included not only the significant decline in international visitors but also important changes to the way Australians live and work. The economic effects of fewer international visitors on particular industries and regions is evolving, with some firms better able to adapt than others (for instance with an increased focus on domestic tourism). Rental markets have also been adjusting to both these forces.<sup>[4]</sup> Australia's rental market conditions have become highly variable; vacancy rates are very low and rents are increasing strongly in some parts of the country, while rental market conditions remain relatively weak in inner-city Melbourne and Sydney.

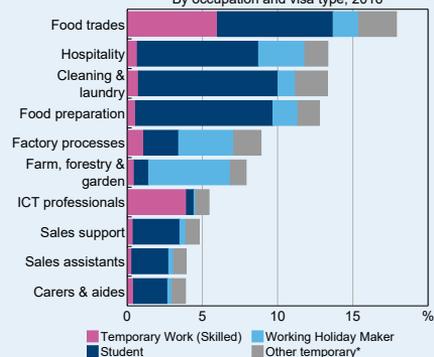
### ... and has affected labour supply

The effects on labour supply have been observed mainly in some labour supply shortages in the industries that typically employ a larger share of migrants. But the overall effect on the Australian labour market has been modest, since temporary foreign workers comprise a small share of the workforce overall. Historically, international students have tended to work primarily in the accommodation & food and administration & support industries, while working holidaymakers have tended to work in the agriculture industry (generally on a short-term basis as a requirement for visa renewal) and in accommodation & food (Graph C.4). Information from the Bank's business liaison program suggests that regional labour shortages have recently been exacerbated in some of these industries.

Given the current domestic availability of labour, strengthening labour demand as the economy transitions from recovery to expansion is likely able to be met from within the domestic population in the near term. However, a sustained period of economic recovery could lead to wages pressures

**Graph C.4**

**Visa Holder Share of Employment**  
By occupation and visa type, 2016



\* Includes other Temporary visas and Bridging visas  
Sources: ABS, RBA

emerging more quickly if new labour supply remains constrained, particularly and foremost in areas of domestic skills shortages

and where substantial time is involved in upskilling domestic workers. ❖

## Endnotes

- [1] An international visitor is not included in the resident population unless they stay in Australia for at least 12 months over a 16-month period.
- [2] See P Lowe (2018), 'Demographic Change and Recent Monetary Policy', Address to Anika Foundation Luncheon, 8 August, viewed 6 May 2021. Available at <<https://www.rba.gov.au/speeches/2018/sp-gov-2018-08-08.html>>.
- [3] For further information on the effects of the pandemic on Australian education and tourist exports, see Grozinger P and S Parsons (2020), 'The COVID-19 Outbreak and Australia's Education and Tourism Exports', *RBA Bulletin*, December, viewed 6 May 2021. Available at <<https://www.rba.gov.au/publications/bulletin/2020/dec/the-covid-19-outbreak-and-australias-education-and-tourism-exports.html>>.
- [4] For further information on the effects of the pandemic on Australian rental markets, see Evans R, Rosewall T and Wong A (2020), 'The Rental Market and COVID-19', *RBA Bulletin*, September, viewed 6 May 2021. Available at <<https://www.rba.gov.au/publications/bulletin/2020/sep/the-rental-market-and-covid-19.html>>.

# 3. Domestic Financial Conditions

The policy measures implemented by the Reserve Bank from the start of the pandemic have lowered funding costs to very low levels across the economy. The measures include the reductions in the cash rate, the use of forward guidance, the target for the yield on the 3-year Australian Government bond, the Term Funding Facility (TFF) and the bond purchase program. Low funding costs have, in turn, flowed through to historically low interest rates on housing and business loans. The measures have also supported the availability of credit to households and businesses. Demand for housing finance has been picking up, while demand for new business loans has increased a little over recent months.

While longer-term government bond yields have risen since earlier this year, in line with global developments, the yield on the 3-year Australian Government bond remains anchored at the 10 basis point target. Conditions in Australian government bond markets were strained in late February and early March 2021 as the improving global economic outlook saw market participants bring forward their expectations of policy rate increases and led to sharp increases in longer-term government bond yields globally. However, the strains were moderate compared with those in early 2020 at the onset of the pandemic, and conditions improved later in March as bond yields stabilised. The Bank brought forward some of its purchases under the bond purchase program to assist with market functioning at that time. Overnight indexed swap prices imply that market participants expect the cash rate to

remain around its current low rate for the coming 2 years and increase to around 50 basis points over 2023.

By lowering the structure of interest rates across the economy, the Reserve Bank's policy measures announced in 2020 have contributed to a lower exchange rate than otherwise. The global economic recovery has continued to support the prices of a number of Australia's key commodity exports, and the Australian dollar has moved within a reasonably narrow range since the start of the year.

## Longer-term AGS yields have risen alongside global bond yields ...

Yields on longer-term Australian Government Securities (AGS) rose sharply through February, alongside a broad increase in global yields associated with the improved global economic outlook (Graph 3.1). Market conditions were strained as yields rose, but improved through March as long-term AGS yields settled (see below). US Treasury yields rose steadily through February and March as positive COVID-19 vaccination developments and the passing of the large US fiscal stimulus package supported the improvement in the economic outlook. As a result, after rising to around 40 basis points at the end of the February, the spread between 10-year AGS and US Treasury yields has narrowed to around zero, where it had been in late 2020 and early 2021 (Graph 3.2).

The increase in medium-term AGS yields over recent months has been driven by an increase in inflation compensation, as investors anticipate a

pick-up in inflation over the next few years. Longer-term yields have increased due to a combination of higher inflation expectations and higher real yields, reflecting the strengthening economic outlook and the associated increases in longer-term policy rate expectations. The expected increase in inflation implied by market pricing is consistent with inflation increasing from the very low levels of 2020 to be broadly in line with the RBA's inflation target.

### ... while the 3-year Australian Government bond yield remains anchored at the target of around 10 basis points

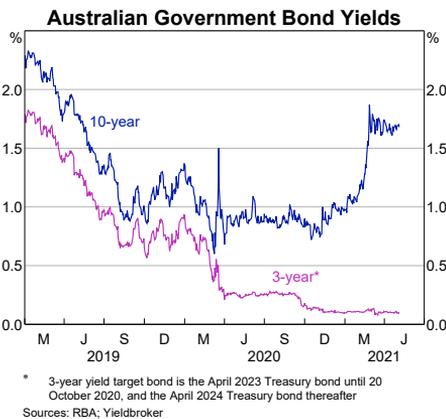
The yield on the 3-year Australian Government bond rose modestly in late February, alongside the more pronounced rise in longer-term AGS yields. Some market participants had thought that the Bank might not maintain the yield target for much longer, and had short-sold the bond in anticipation of this, further contributing to the rise in yield.

The Bank purchased \$7 billion of the April 2023 and April 2024 bonds across 3 auctions in late February to support the yield target, and a speech by the Governor in early March emphasised the Bank's commitment to the 3-year yield target of around 10 basis points. He indicated that the Board would make a decision later in the year to either keep the April 2024 bond as the target bond, or extend the yield target to the November 2024 bond. In early March the Bank also increased the fee that it charges counterparties to borrow the 3-year target bond – from 25 to 50 and then to 100 basis points – which made short-selling the bond more costly. These developments saw an increase in demand for the target bond, and the yield subsequently settled back to the target (Graph 3.3).

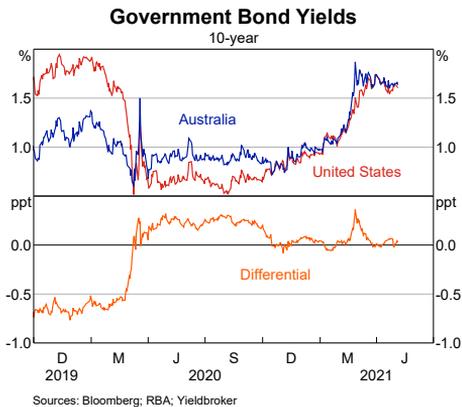
The yield on the November 2024 bond increased in late February, reaching around 45 basis points, compared with around 20 basis points in preceding months, before declining as market conditions stabilised and market functioning improved over the second half of March. Nonetheless, the yield on the November 2024 bond remains around 30 basis points, suggesting that market participants on average do not expect the Bank to extend the yield target to the November 2024 bond.

While the targeted 3-year AGS yield has been little changed, 3-year yields in other domestic

**Graph 3.1**

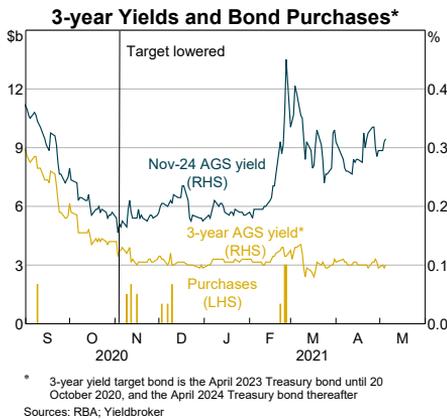


**Graph 3.2**

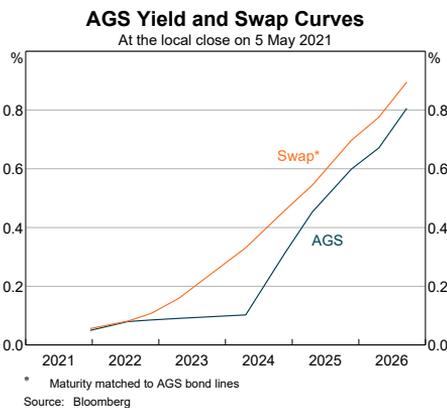


markets rose over the first few months of this year alongside the global sell-off in bond markets (Graph 3.4). In particular, the 3-year swap rate rose and has remained at those higher levels. This higher swap rate has flowed through to other yields which typically price off swaps, including bank and corporate bonds (see below). There is generally a positive spread between swap rates and AGS yields, reflecting greater credit risk, but the larger spread between the swap rates and AGS yields at around the 3-year tenor reflects the different expectations for the cash rate as implied by overnight indexed swap (OIS) rates and the Bank's guidance for the cash rate target at this horizon (see below).

**Graph 3.3**



**Graph 3.4**



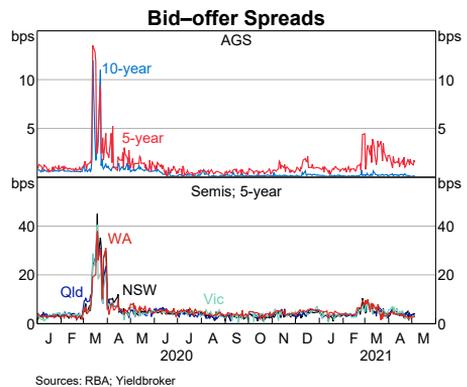
## Market functioning was strained as bond yields rose, but subsequently improved

The functioning of government bond markets in Australia deteriorated in late February and over the first weeks of March as bond yields increased sharply and a number of market participants sold their bond holdings. However, the strains were not as severe as those in early 2020 at the onset of the pandemic, and markets stabilised relatively quickly.

The market strains were apparent in a number of indicators. Bid-offer spreads increased for both AGS and securities issued by the state and territory borrowing authorities (semis), although this increase was less pronounced at the longer end of the curve (Graph 3.5).

Market contacts also noted a worsening in liquidity conditions in bond futures markets. Indeed, the bond futures basis – the difference between the implied yield on a futures contract and the yield on the bonds underlying the contract, adjusted for the cost of financing the bonds – widened sharply in late February and early March (Graph 3.6). The futures basis then narrowed a little as market conditions settled following the stabilisation in AGS yields. The Bank also brought forward some of its purchases under the bond purchase program to assist with

**Graph 3.5**



market functioning, with one larger-than-usual bond purchase operation in early March.

### Government bond issuance continues to be met by strong demand

Demand for securities issued by the Australian Office of Financial Management (AOFM) remains strong, with the mid-April syndication of \$14 billion of a new November 2032 bond attracting an order book of \$48 billion. Semis issuance has also continued to be well-absorbed by markets. Market economists' expectations of the funding needs of the AOFM and state issuing authorities for the remainder of the calendar year have declined given better-than-expected economic conditions.

The AOFM and semi-government issuing authorities responded to the strains in market functioning by temporarily slowing the pace of issuance. The AOFM issued only \$1 billion of nominal bonds in each of the first 2 weeks of March, in contrast to an average of around \$2½ billion per week earlier in the year. State and territory borrowing authorities, which in general remain ahead of their funding schedules, also avoided large tenders through this period.

Spreads between the yields on semis and AGS widened a little, but stabilised over March as market strains eased and demand for semis picked up (Graph 3.7). Semis spreads remain a

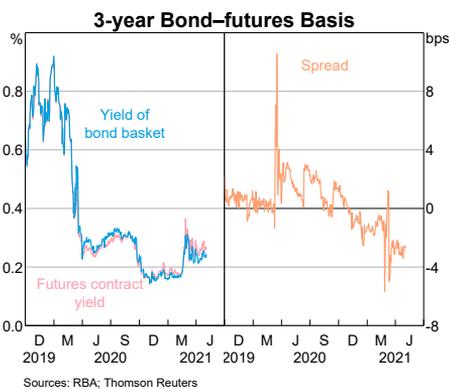
little wider than earlier in the year, consistent with the widening in the spreads of swaps to AGS over this period, particularly at the tenors of 3 to 5 years.

### The first phase of the Bank's bond purchase program has concluded and the second phase is under way

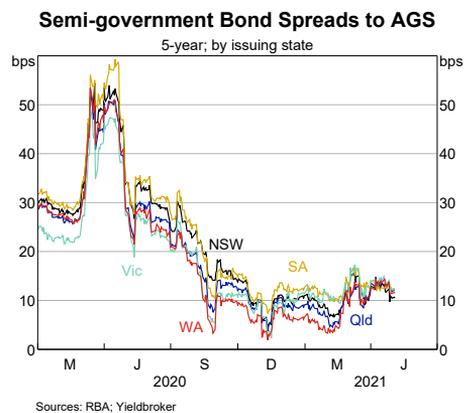
The Bank has purchased \$120 billion of longer-term bonds under the bond purchase program since early November, consisting of \$96 billion of AGS and \$24 billion of semis. The Bank now holds 22 per cent of outstanding AGS and 10 per cent of outstanding semis (Graph 3.8). These shares are projected to increase to around 30 and 15 per cent respectively by early September following completion of the second \$100 billion of bond purchases announced at the February Board meeting. Purchases have been at a pace of around \$5 billion per week, except for one instance in early March when an additional \$2 billion of bonds were purchased to provide further support during the period when market conditions were strained, as discussed above.

Auctions under the bond purchase program have been well subscribed, although coverage ratios moved a little lower in March. The Bank decided to adjust the format of the semis auctions in response to declining coverage in

**Graph 3.6**



**Graph 3.7**



these auctions, with weekly semis auctions now conducted across the 5-10 year tenors, rather than alternating between different segments of the yield curve.

### The TFF continues to provide low-cost term funding to the banking sector

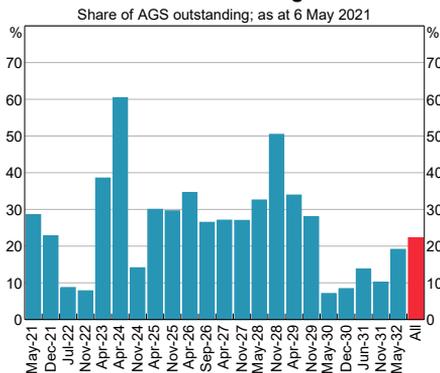
The TFF is providing low-cost term funding to banks and an incentive for banks to increase lending to businesses, particularly small- and medium-sized enterprises (SMEs).<sup>[1]</sup> This funding is helping to keep broader funding costs and lending rates at historic lows.

Total funding available under the TFF is around \$200 billion as of May 2021, which is about 7 per cent of outstanding credit (Graph 3.9). This includes: drawings under the initial allowance; funding available under the additional allowance (linked to banks' new lending to businesses); and the supplementary allowance made available in October 2020. Increases in SME lending by some banks since March 2020 account for the bulk of additional allowances.

In aggregate, banks have drawn around \$102 billion in TFF funding to date. The end of the drawdown window is 30 June 2021 and usage has picked up in recent months, although

at a bit less than the pace prior to the closure of the drawdown window for the initial allowance at the end of September 2020 (Graph 3.10). Nevertheless, many banks have indicated in liaison that they plan to take up most if not all of their remaining allowances. The increase in the swap rate in mid March lowered the cost of hedging TFF drawdowns (from fixed rate to variable rate), increasing the attractiveness of the facility. Given that the facility provides funding for 3 years, it will continue to help keep funding costs in Australia low until mid 2024.

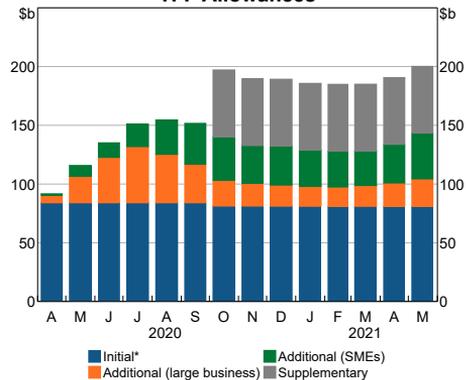
**Graph 3.8**  
**RBA AGS Holdings\***



\* Excludes holdings under repo; excludes linkers  
Sources: AOFM; RBA

**Graph 3.9**

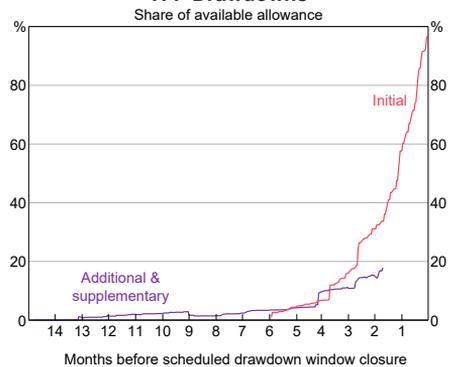
**TFF Allowances**



\* Represents final usage from October 2020 onwards, as the drawdown period for the initial allowance closed on 30 September 2020  
Sources: APRA; RBA

**Graph 3.10**

**TFF Drawdowns**



Sources: APRA; RBA

## The Bank's balance sheet and liquidity in the banking system have continued to increase

The Bank's policy measures have resulted in substantial and ongoing growth in the Bank's balance sheet, which has more than doubled in size since the onset of the pandemic. Growth in the Bank's assets has reflected an increase in holdings of AGS and semis – reflecting the Bank's bond purchases – and an increase in securities provided as collateral under the TFF (Graph 3.11). This has been partly offset by a decline in securities provided as collateral in open market operations (OMO). On the liabilities side, exchange settlement (ES) balances have risen significantly as a result of the Bank's policies (Graph 3.12; discussed below). Australian Government deposits held at the Reserve Bank have also grown since the onset of the pandemic, as net issuance of AGS has exceeded net government spending over this period.

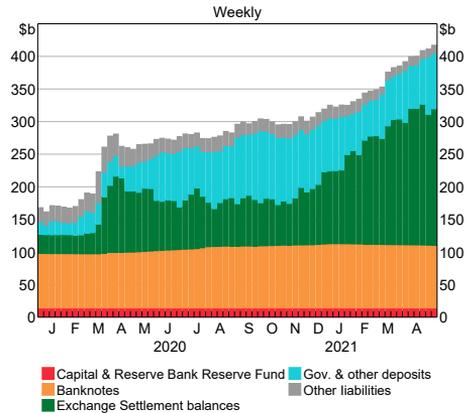
The size of the balance sheet is expected to grow further over the coming months, as banks continue to draw down TFF funding and the Bank's program of bond purchases continues.

Liquidity in the banking system – as measured by ES balances held at the Reserve Bank – has

continued to increase over recent months, reflecting the Bank's purchases of government bonds and lending under the TFF (Graph 3.13). Partly offsetting this, the amount of liquidity provided via OMO has continued to decline, as the high level of system liquidity has reduced demand for this short-term funding. Government flows have also reduced system liquidity, because net issuance of AGS has exceeded net spending by the Australian Government over this period (Graph 3.14).

**Graph 3.12**

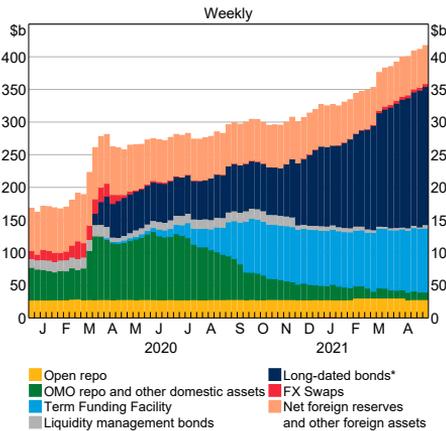
**Reserve Bank Liabilities**



Source: RBA

**Graph 3.11**

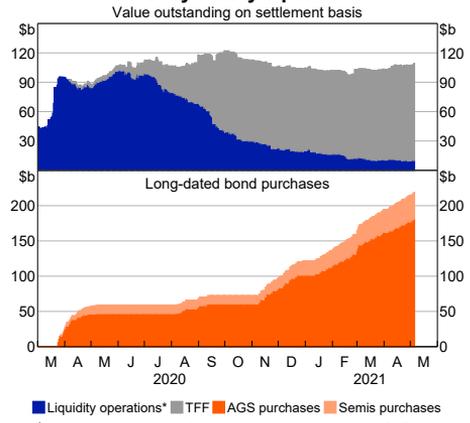
**Reserve Bank Assets**



\* Purchased under programs announced in March and November 2020  
Source: RBA

**Graph 3.13**

**Monetary Policy Operations**



\* Liquidity injections net of drains and maturities; contracted in OMOs, FX swaps and short-dated bond purchases  
Source: RBA

## Market participants expect the cash rate to increase by the end of 2023

The cash rate has remained very low, at 3 basis points in recent months, and activity in the cash market has been subdued, owing to the elevated level of system liquidity. Cash market activity was sufficient to publish a cash rate based on market transactions on around 40 per cent of the days over the past 3 months; on other days expert judgement under the fall-back arrangements was used instead. Prices for OIS contracts imply that market participants on average expect the cash rate will remain at or below 10 basis points this year and next, before rising to around 50 basis points by the end of 2023 and a little over 1 per cent by 2024 (Graph 3.15).

## Money market rates remain very low

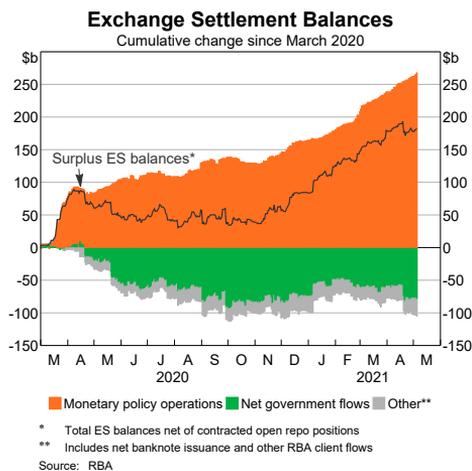
Short-term money market rates remain near historical lows, reflecting the very low level of the cash rate and the large amount of liquidity in the banking system. Bank bill swap rates (BBSW) have risen modestly in recent months, with 6-month BBSW increasing from around 2 basis points in late February to around 10 basis points in early May (Graph 3.16). This was associated with banks raising more funding from this

market. The cost of Australian dollar funding sourced via offshore short-term issuance and the foreign exchange swap market has increased a little, making it relatively more attractive to seek short-term funding from the domestic bank bill market. Repo rates at the Bank's daily OMO remained at 10 basis points; repo rates in the private market are reported to be slightly below this level.

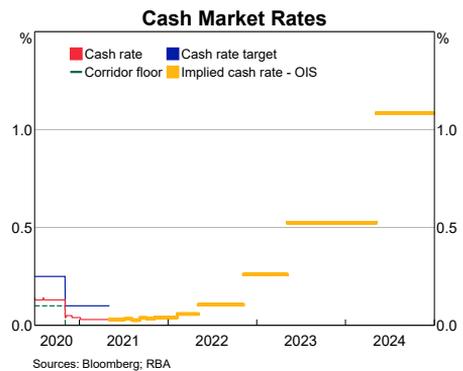
## Banks' bond yields increased recently, while issuance remained low

Secondary market yields on bank bonds with maturities of 3-years have increased by around 15-20 basis points since the beginning of 2021 but remain at very low levels. The rise occurred in line with the increase in 3-year swap

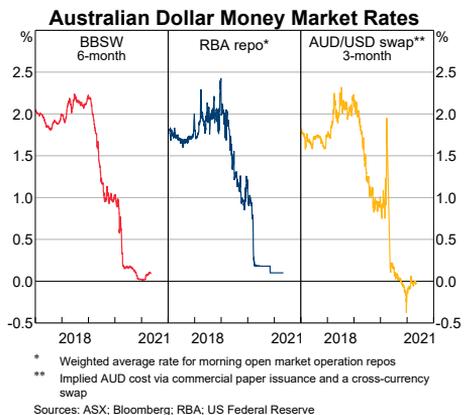
**Graph 3.14**



**Graph 3.15**



**Graph 3.16**



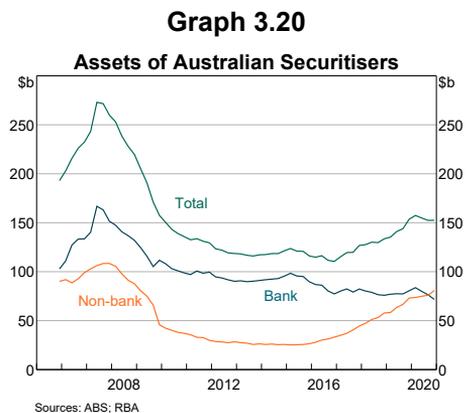
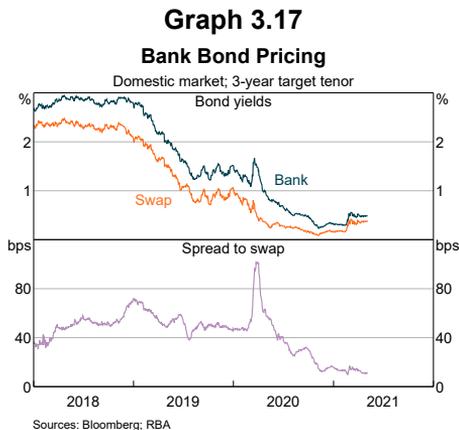
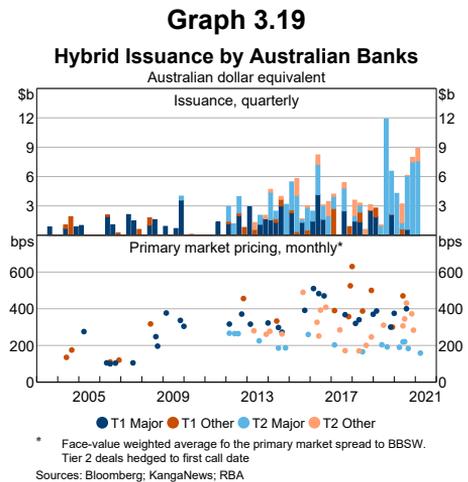
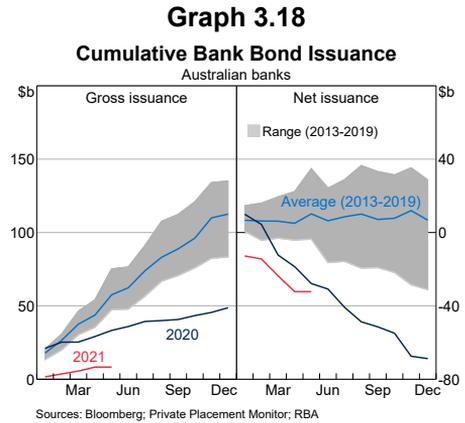
rates in February, with the spread to swap relatively unchanged in 2021 around historic lows (Graph 3.17).

Senior bank bond issuance remained low in 2021 (Graph 3.18). The low level of bond issuance reflected the availability of low-cost funding from the TFF, strong deposit growth and the relatively slow pace of overall credit growth over much of the past year. Meanwhile, Australian banks have continued to issue Tier 2 hybrid securities in 2021, raising \$9.2 billion in domestic and offshore markets. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements, which will increase in January 2024. Spreads on Tier 2 hybrid securities issued by the major banks have narrowed recently and are at the lowest level seen in the past few years (Graph 3.19).

### Strong RMBS issuance by non-banks continued into 2021

Issuance of asset-backed securities (ABS) by non-banks was high over the past year, while issuance by banks was quite low. The high level of non-bank residential-mortgage backed securities (RMBS) issuance has pushed the outstanding stock of Australian non-bank ABS above that of bank ABS (Graph 3.20).

Spreads on RMBS have narrowed significantly for both non-banks and banks in recent months, falling well below pre-pandemic levels. Spreads



on RMBS are at their lowest level since 2007 (Graph 3.21). Market commentary suggests that the low levels of bank bond issuance are contributing to these low spreads, as investors are moving into other securities, including RMBS, viewed as substitute investments for bank bonds.

Since the March 2020 announcement of the Structured Finance Support Fund (SFSF), the AOFM has provided funding to securitisation warehouses and has invested directly in ABS in the primary and secondary markets. These measures supported the improvement of conditions in the ABS market since then. The AOFM has not made any new SFSF investments since November 2020.

### Deposit rates have declined further

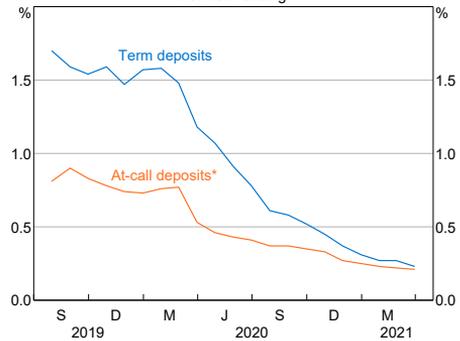
Banks have reduced deposit rates further in response to the plentiful supply of funding at low rates. Interest rates for new term deposits have declined by around 10 basis points since the start of 2021 and by around 135 basis points over the past year or so. Interest rates for at-call deposits have fallen by around 55 basis points over the past year or so (Graph 3.22). The decline in the spread between interest rates on term deposits and other deposit rates is encouraging a shift by customers from term to at-call

deposits. At-call deposits now account for around 80 per cent of total deposits, compared with around 70 per cent at the end of February 2020.

These developments have led to an increase in the share of major bank deposits paying low interest rates (that is interest rates between zero and 25 basis points). A little more than one-third of the debt funding of major banks was in the form of deposits paying interest rates of 25 basis points or less at the end of February 2021 (Graph 3.23). This compares with a little over one-quarter in the September quarter 2020 and around 15 per cent in late 2019.

**Graph 3.22**

**Banks' Deposit Rates**  
For new funding

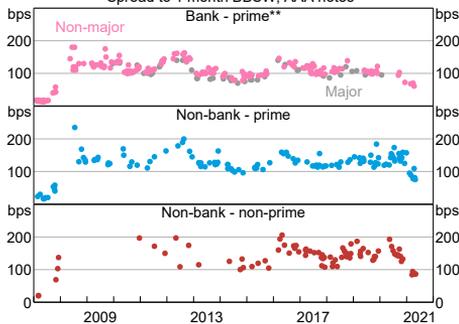


\* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits  
Sources: APRA; RBA

**Graph 3.21**

**Primary Market RMBS Pricing**

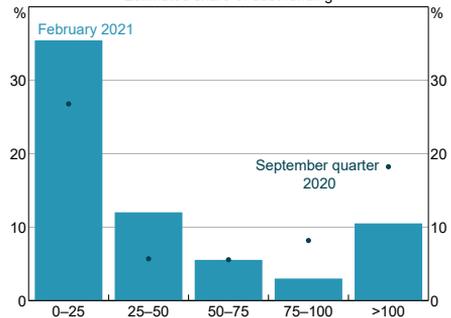
Spread to 1 month BBSW; AAA notes\*



\* Face-value weighted average of the primary market spread to BBSW for AAA-rated notes  
\*\* Prime deals only; excludes a small number of non-prime deals  
Sources: Bloomberg; RBA

**Graph 3.23**

**Major Bank Deposits by Interest Rate\***  
Estimated share of debt funding



\* Includes deposits in housing loan offset accounts  
Sources: APRA; Bloomberg; Major bank liaison; RBA; Refinitiv

## Banks' overall funding costs are at historic lows

The Reserve Bank's policy measures have lowered banks' funding costs to historically low levels (Graph 3.24). Banks' non-equity funding costs are estimated to have declined by slightly more than the cash rate since the end of February 2020. Much of the banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which have declined by around 75 basis points since the end of February last year. As noted above, low-cost funding from the TFF, deposit inflows and modest loan growth have reduced banks' need to seek new wholesale funding, with the cost of new 3-year bank bonds higher than the rate on TFF borrowing. The increase in bank bond yields in February had little impact on major banks' funding costs as new bond issuance remained subdued. Banks' funding costs are expected to decline a little further over the period ahead. This reflects further reductions in banks' deposit rates and wholesale debt costs (as older, more expensive funding matures), as well as expected drawdowns of low-cost TFF funding.

Large deposit inflows have seen the deposit share of banks' total funding (including equity) increase by around 5 percentage points since

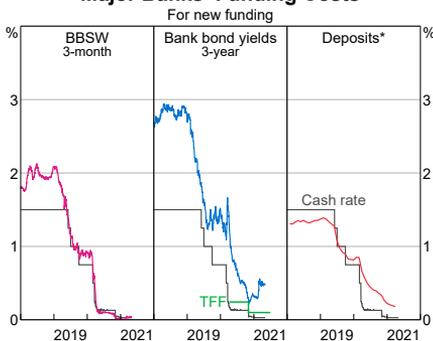
the end of February 2020 (Graph 3.25). The stock of deposits in the banking system has increased significantly over the past year. The Reserve Bank's purchases of government bonds have contributed to deposit growth because payments for bonds purchased from the private (non-bank) sector are credited to the deposit accounts of the sellers of these bonds. The rising share of low-cost funding from the TFF and deposits has been matched by a reduction in the share of wholesale debt funding.

## Interest rates on housing loans have declined further

The decline in funding costs since the end of February 2020 has flowed through to housing interest rates paid by borrowers. The average interest rate on outstanding variable-rate mortgages has declined by around 50 basis points since February 2020 (Graph 3.26; Table 3.1). Much of that decline occurred in March and April of last year, as lenders reduced their standard variable rates (SVRs) in March 2020 following the Reserve Bank's initial package of policy measures. Outstanding variable rates have continued to drift lower since then as new and refinancing borrowers have obtained lower rates. The average interest rate on outstanding fixed-rate mortgages has declined by

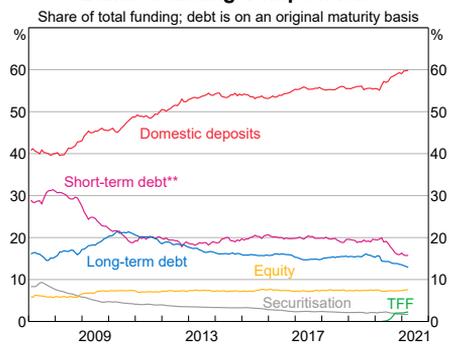
**Graph 3.24**

### Major Banks' Funding Costs



**Graph 3.25**

### Banks' Funding Composition\*



**Table 3.1: Average Outstanding Housing Rates**

March 2021

	Interest rate Per cent	Change since February 2020 Basis points
All housing loans	3.08	-66
Variable-rate loans		
– Owner-occupier	3.11	-47
– Investor	3.45	-51
All variable-rate loans	3.23	-48
Fixed-rate loans		
– Owner-occupier	2.55	-118
– Investor	2.96	-105
All fixed-rate loans	2.71	-115
By repayment type <sup>(a)</sup>		
– Principal-and-interest	2.98	-64
– Interest-only	3.60	-62

(a) Weighted average across fixed- and variable-rate loans

significantly more, to be around 115 basis points below its level at the end of February 2020.

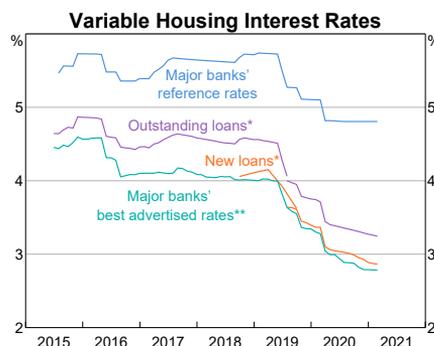
Interest rates on new fixed-rate loans have declined by around 90 basis points since February 2020, to be around 60-75 basis points below new variable interest rates at the end of March 2021 (Graph 3.27). Accordingly, the proportion of new loans funded at fixed interest rates remains high by historical standards, and the stock of fixed-rate housing loans has risen to around 30 per cent of housing credit outstanding, up from 20 per cent at the start of 2020.

The share of fixed-rate loans funded with maturities of longer than 3 years has risen in recent months, as banks offered increasingly attractive interest rates for these loans following the further easing of monetary policy in November 2020. While advertised rates on 4-year and 5-year fixed-rate loans have increased slightly at some banks since mid March, alongside a rise in longer-term fixed interest rates derived from swap rates (the benchmark for pricing fixed-rate loans), on average these

rates are still around historic lows. At the same time, some banks have lowered advertised rates on 1-, 2- and 3-year fixed-rate loans further since mid March.

### Interest rates on business loans also continued to decline gradually

After declining substantially in early 2020, following the Reserve Bank's initial package of policy measures, interest rates on outstanding

**Graph 3.26**

\* Series break in July 2019; thereafter, data based on EFS collection

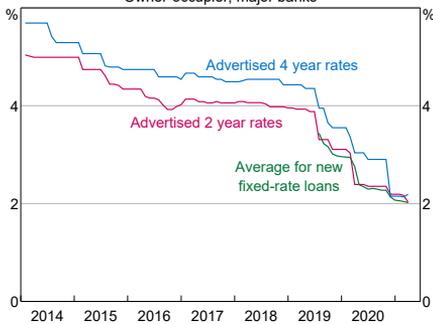
\*\* Including low-cost brands

Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

business loans have continued to drift down. Interest rates on variable-rate loans to SMEs and large businesses have declined by around 90 basis points since the end of February 2020, while interest rates on fixed-rate loans to SMEs and large businesses have declined by around 60 and 50 basis points, respectively (Graph 3.28). The recent declines in outstanding small business lending rates have largely been for fixed-rate loans. Since the start of 2021, several banks have announced reductions in interest rates for small business loans of between 10 and 80 basis points, mostly for loan products that have fixed interest rates.

**Graph 3.27**

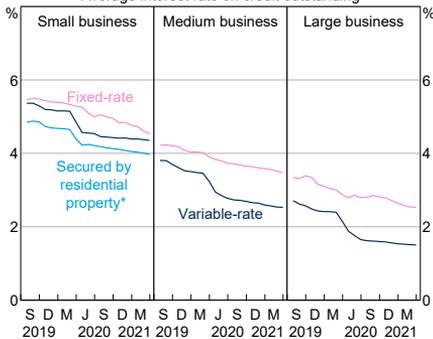
**Fixed Housing Rates**  
Owner-occupier; major banks



Sources: APRA; banks' websites; RBA

**Graph 3.28**

**Business Lending Rates**  
Average interest rate on credit outstanding



\* Small business loans secured by residential property can have fixed or variable interest rate terms and are included in the fixed-rate and variable-rate lines

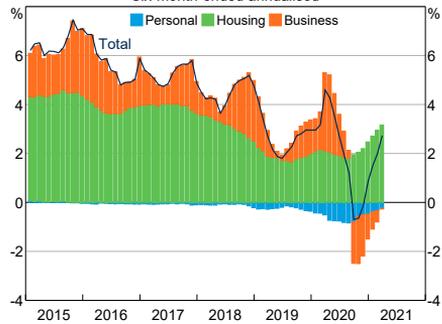
Sources: APRA; RBA

**Growth in total credit has increased over recent months**

In recent months, credit growth has picked up to be around its rate prior to the pandemic. Total credit growth increased in the March quarter to be 2¾ per cent in six-month-ended-annualised terms (Graph 3.29; Table 3.2). The increase has been driven by a pick-up in housing credit, particularly to owner-occupiers. Demand for housing credit is being supported by low interest rates and government policy measures targeted at first home buyers. The HomeBuilder scheme, which was closed to new applications at the end of March, has also contributed. Business credit outstanding has increased a little in recent months, after the sharp run-up and subsequent unwind in 2020. The weak demand for business credit overall is consistent with many businesses still having little need for external funding given the large cash buffers businesses have accumulated over the past year. The pace of decline in personal credit has eased in recent months. Much of this reflects an increase in spending on credit cards alongside the recovery in economic conditions as restrictions to contain the virus were eased.

**Graph 3.29**

**Contribution to Total Credit Growth\***  
Six-month-ended annualised



\* Seasonally adjusted and break-adjusted

Sources: APRA; RBA

**Table 3.2: Growth in Financial Aggregates**

Percentage change<sup>(a)(b)</sup>

	Three-month annualised		Six-month annualised	
	Dec 2020	Mar 2021	Sep 2020	Mar 2021
Total credit	2.0	3.4	-0.7	2.7
– Household	3.6	5.0	1.5	4.3
– Housing	4.5	5.6	3.1	5.1
– Owner-occupier	6.3	7.5	5.3	6.9
– Investor	1.1	2.2	-0.5	1.6
– Personal	-6.2	-3.7	-16.1	-5.0
– Business	-1.0	0.8	-5.1	-0.1
Broad money	8.4	3.2	13.5	5.8

(a) Seasonally-adjusted and break-adjusted

(b) Sources: ABS; APRA; RBA

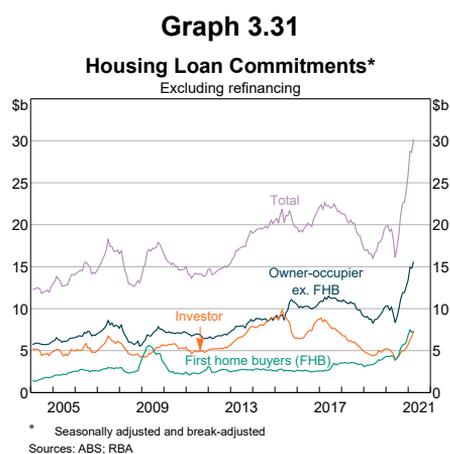
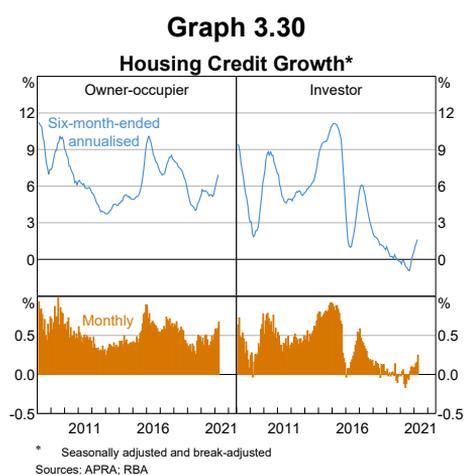
## Demand for housing loans remains strong

Housing credit growth strengthened further in the March quarter to be around 5 per cent on a six-month-ended-annualised basis. Loans to owner-occupiers have mostly driven the increase, but investor housing credit has also increased following a period of small declines (Graph 3.30).

Commitments for new housing loans remain elevated following a period of very strong growth (Graph 3.31). The strong demand for

housing loans from owner-occupiers in part reflects continued strength in demand from first home buyers. The modest pick-up in demand for investor loans has occurred alongside the improved outlook for housing prices. Even so, investor credit growth remains low by historic standards and there are a number of factors that may weigh on investor activity in the period ahead, including lower rental yields, high vacancy rates in some areas and lower immigration.

Construction loan commitments – which picked up strongly following the announcement of the



HomeBuilder program in mid 2020 – will continue to provide some support to housing credit growth over the coming months (Graph 3.32). Borrowers draw down on these loans over the period of construction, so the loan amount is recorded as housing credit incrementally and over that time. This differs from other housing loans, where the full loan amount is drawn down at settlement and is recorded as housing credit at that time. The government recently announced that borrowers have an additional 12 months to commence construction under these loans (now 18 months in total). The HomeBuilder program, which was closed to new applications at the end of March, is likely to have brought forward some demand, so the end of the program is expected to dampen demand for new construction loans for a time.

The availability of housing credit had tightened a little in response to the pandemic. However, banks have since eased some criteria by reducing requirements for additional information and lowering discounts applied to highly variable sources of income (such as bonuses and commissions) when assessing a borrower’s capacity to service a loan.

Overall, the major banks’ market share of housing lending has decreased since 2017, while the shares of other Australian banks and

non-bank lenders have increased (Graph 3.33). While non-major bank lenders have gained most market share since then, non-bank lenders’ market share has surpassed its recent peak of mid 2020. The recent increase in non-bank market share is consistent with the narrowing of the spread between lending rates of non-banks and banks since mid 2020.

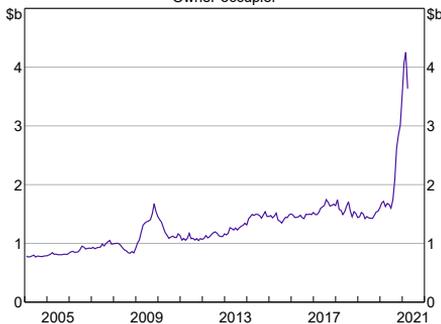
### Payments into housing loan offset and redraw accounts remain higher than prior to the pandemic

Net payments into offset and redraw accounts remained high in the March quarter. Over the past year, mortgage borrowers have made substantial payments into offset and redraw accounts, amounting to 4 per cent of disposable income (around \$55 billion) (Graph 3.34). Payments have eased a little since their peak in mid 2020, consistent with the continued recovery in consumption, a tapering in fiscal payments and a decline in the number of households that accessed early release superannuation leading up to the closure of that option at the end of 2020.

Over the past year, reductions in housing loan interest rates have flowed through to borrowers in the form of lower interest payments (Graph 3.35). Since March 2020, interest payments have declined by around

**Graph 3.32**

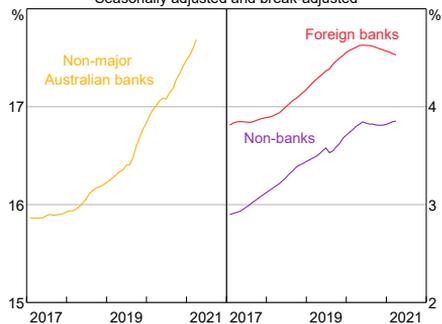
**Housing Loan Commitments for Construction\***  
Owner-occupier



\* Seasonally adjusted and break-adjusted  
Sources: ABS; RBA

**Graph 3.33**

**Market Share of Housing Credit\***  
Seasonally adjusted and break-adjusted



\* Remaining share consists of major banks  
Sources: APRA; RBA

¾ percentage point as a share of disposable income, notwithstanding the rise in housing credit over that period. This reflects the pass-through of the Bank’s policy easing and borrowers refinancing to lower interest rates, as well as the strong growth in disposable income since that time.

Repayment deferral arrangements concluded at the end of March, with almost all borrowers having now resumed repayments. The share of mortgage holders with a deferral in place has declined from a peak of around 8 per cent at the end of June 2020 to less than ¼ per cent at the end of March 2021; of those, most have had

their deferral extended. A small share of loans that have exited deferral – just 3 per cent – are non performing.

### Business lending has increased a little over recent months

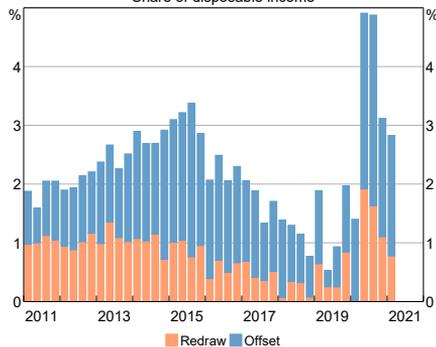
Lending to businesses has increased a little over the past few months, consistent with an improvement in overall business sentiment, after having decreased over much of the second half of 2020. Lending to large businesses has increased a little following its run-up and subsequent unwind in 2020 as the lines of credit that were drawn on early in the pandemic were repaid. Lending to SMEs has remained little changed throughout this period, as it has for some years. Commitments for new business loans have also been steady over recent months.

Liaison with banks suggests there has been a bit more appetite for business borrowing of late given the improved economic outlook. However, many businesses still have little immediate need for borrowing. Improved business operating conditions and policy support have allowed many businesses to maintain much of the large cash buffers that they accumulated in 2020 (see RBA (2021), Financial Stability Review, April). These large buffers have limited the need for many businesses to seek additional finance. Consistent with this, surveys conducted by the ABS between late 2020 and early 2021 have indicated that only a small share of businesses have attempted to access additional funds, with most businesses responding they have sufficient funds at hand.

The total volume of new loan commitments extended to SMEs over the financial year to date has been a little lower than over the comparable period of the year prior (Graph 3.36). However, there have been some pockets of increased activity within overall SME lending. Lending to the agriculture sector remained elevated due to favourable weather conditions over the past

**Graph 3.34**

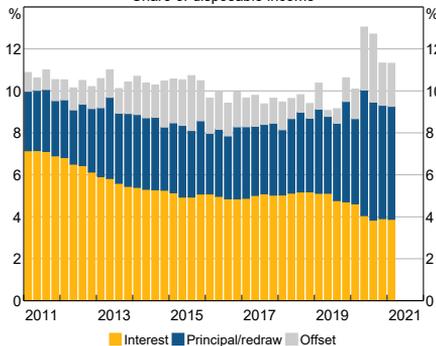
**Flows into Offset and Redraw Accounts\***  
Share of disposable income



\* Seasonally adjusted and break-adjusted  
Sources: ABS; APRA; RBA

**Graph 3.35**

**Flows into Housing Loan and Offset Accounts\***  
Share of disposable income



\* Seasonally adjusted and break-adjusted  
Sources: ABS; APRA; RBA

year or so, and lending activity for plant and equipment has been supported by the Australian Government's enhancements to the instant asset tax write-off scheme. Meanwhile, SME refinancing activity has been higher so far in the 2020/21 financial year compared with the year prior, which suggests that some businesses have been refinancing to the lower interest rates on offer.

Take-up of the Australian Government's \$40 billion SME loan guarantee scheme, which started in late March 2020 and was enhanced in October 2020, has been modest to date. About \$4 billion of loan commitments have been made to around 40,000 businesses under the scheme. In April, the government introduced the SME Recovery Loan Scheme, which is an enhanced and extended loan guarantee scheme for SMEs that had received JobKeeper payments in the March quarter 2021. Under the scheme, those SMEs with annual turnover up to \$250 million (previously capped at \$50 million) can now borrow as much as \$5 million (up from \$1 million previously) for up to 10 years (up from 5 years previously). In addition, the funds borrowed can be used to refinance existing loans (refinancing was not permissible previously), and the Government is increasing the guarantee to 80 per cent (up from 50 per cent). The new scheme will be accessible until the end of 2021. Other businesses eligible

for the original scheme can still access funds until the end of June 2021 based on the terms announced in October 2020. Some banks have started advertising loan products under the new scheme, with interest rates generally lower than comparable products under the original scheme.

Repayment deferral arrangements for small business borrowers concluded at the end of March. Most of the over 200,000 SME borrowers that had arranged loan payment deferrals in 2020 have now resumed repayments. At the end of March 2021, only a very small share of SME borrowers (less than ¼ per cent) had a deferral arrangement in place (down from a peak of around 13 per cent at the end of June 2020) with those remaining made up of borrowers who have had their deferral extended.

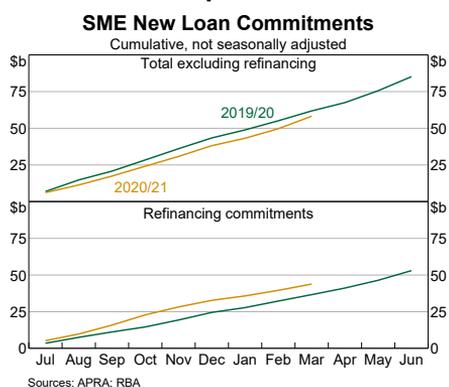
### The supply of business credit has improved a little, but credit remains hard to access for small businesses

Some banks have indicated that they are seeking more opportunities to lend to businesses, including smaller businesses, in part reflecting the improved economic outlook. Consistent with this, surveys of small businesses indicate that access to finance became less difficult towards the end of 2020, after tightening following the onset of the pandemic. However, banks remain cautious about the industries still most adversely affected by the pandemic.

### Australian equity prices have increased

The ASX 200 has increased further over recent months to be around 3 per cent higher than its February 2020 peak on a total return basis, which takes dividends into account. The rebound in global equity prices since March last year reflects the recovery in the global economic outlook, supported by fiscal and monetary stimulus, and as effective COVID-19 vaccines have been developed and administered

**Graph 3.36**



(Graph 3.37). Since the end of 2020, the ASX 200 has underperformed overseas equity markets, which have been well above their pre-pandemic peaks for some time on a total return basis.

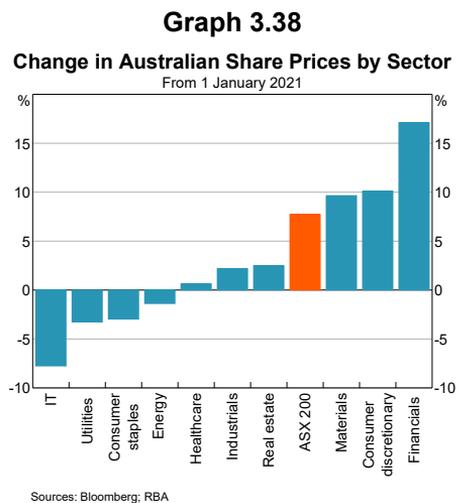
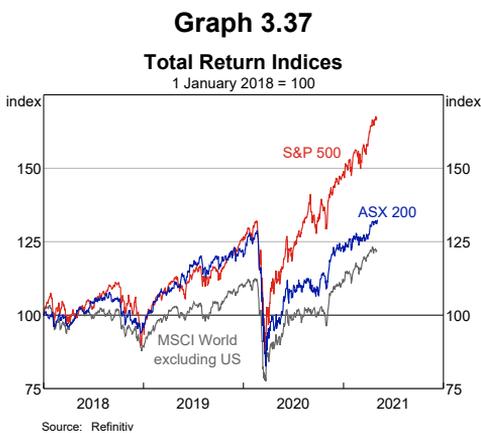
Since the beginning of 2021, financial and consumer discretionary stocks have posted the largest gains, increasing by about 17 and 10 per cent, respectively (Graph 3.38). By contrast, the prices of consumer staples, information technology and healthcare stocks have underperformed the market this year, after seeing large gains throughout 2020. Sectors that tend to be viewed as somewhat substitutable for bonds, like utilities and real estate, have underperformed the broader market alongside the increase in longer-term bond yields since late February.

**Profits of listed companies are generally lower than a year ago, but substantially higher than 6 months ago**

Aggregate underlying profits of ASX 200 companies were 21 per cent lower in the December half of 2020 compared with the same period a year earlier (Graph 3.39). The decline reflected substantially lower earnings across firms in the financial, industrials, utilities and real estate sectors. A number of materials companies recorded higher underlying earnings, benefiting

from elevated iron ore prices. By contrast, the energy sector recorded a decline in earnings on the back of lower demand for oil and LNG. In general, listed company profits in the December half of 2020 were substantially higher than in the June half, as a result of the recovery in economic activity. Overall, results were above analysts’ expectations, with earnings having recovered more strongly than expected after the heavily pandemic-affected June 2020 half. More recently, some financial companies have reported higher profits for the 6 months to March 2021, in line with the continued recovery in economic activity.

At an aggregate level, total dividends announced to be paid in the June half of 2021 increased relative to the December half of 2020, to be similar to the level of a year ago (Graph 3.40). The increase in dividends was driven by a large rise in dividends from mining firms, while dividends from outside the energy and materials sector are lower than one year ago. The dividend payout ratio for energy and materials companies increased marginally compared with the December 2020 half. The payout ratio for all other sectors declined substantially, as dividends increased by much less than underlying earnings. Share buybacks, which tend to be much smaller than dividends,



remained low throughout 2020 compared with recent years.

The assets of Australian listed non-financial corporations decreased by 5 per cent over the December half of 2020. Aggregate gearing ratios declined, predominantly reflecting a decrease in debt levels, consistent with the repayment of lines of credit drawn down in the early stages of the pandemic (Graph 3.41). The decrease in gearing was most pronounced in the consumer staples, consumer discretionary and healthcare sectors, after increasing in prior years. Net gearing in the materials, industrials and utilities

sectors decreased marginally while real estate sector gearing was little changed, remaining at a low level relative to the past 2 decades.

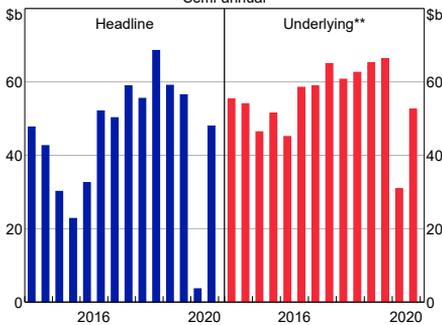
### The Australian dollar remains within its range since the start of the year

The Australian dollar has depreciated a bit from its highs in late February, but is a little above its levels observed earlier in the year on both a trade-weighted basis and against the US dollar (Graph 3.42). This follows the period since November when commodity prices increased markedly, to their highest levels in a number of years, and the Australian dollar appreciated against most currencies. The prices of a number of Australia's key commodity exports have continued to be supported by the recovery in global trade and strength in Chinese steel production this year (see 'The International Environment' chapter).

The differential between shorter-term interest rates on Australian government bond yields and those of the major advanced economies has been little changed over recent months, and the differential between longer-term interest rates has declined from its highs in late February. The lower structure of interest rates in the domestic economy associated with the Bank's policy measures over the past year or so has

**Graph 3.39**

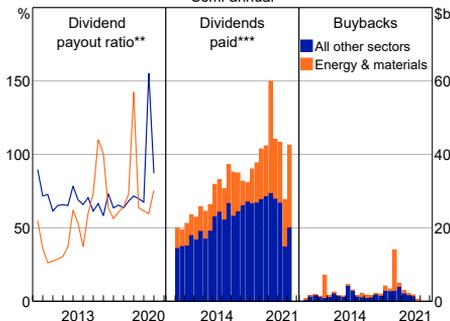
**ASX 200 Profits\***  
Semi-annual



\* Latest data are based on a matched sample of companies that have reported so far in the latest half. Results for companies with reporting dates in the half are rolled forward.  
\*\* Underlying results adjust for one-off items such as asset revaluations.  
Sources: Bloomberg; Company reports; Morningstar; RBA

**Graph 3.40**

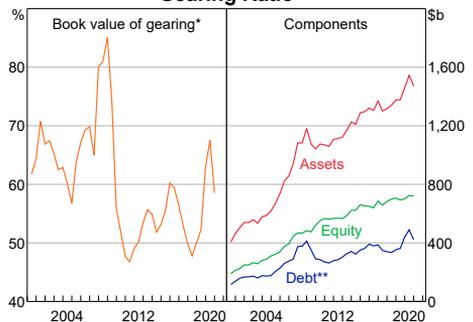
**ASX Dividends and Buybacks\***  
Semi-annual



\* Dividend payout ratio and dividends are for ASX 200 companies; buybacks are for ASX-listed firms.  
\*\* Dividends paid as a percentage of underlying profits  
\*\*\* Last observation is dividends announced  
Sources: Bloomberg; Company Reports; Morningstar; RBA

**Graph 3.41**

**Listed Non-financial Corporations' Gearing Ratio**



\* Ratio of gross debt to equity, excludes foreign-domiciled companies  
\*\* Debt only includes short-term and long-term loans and bonds payable; not equivalent to total liabilities  
Sources: Company reports; Morningstar; RBA

contributed to the exchange rate being lower than otherwise. The level of the Australian dollar is broadly consistent with its fundamental determinants – namely the terms of trade and the differential between interest rates in Australia and those in major advanced economies.<sup>[2]</sup>

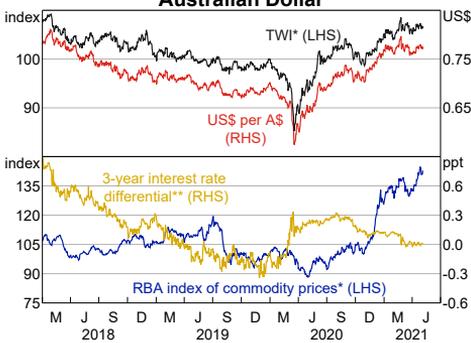
### Australia experienced a net outflow of capital in 2020

Australia was a net lender of capital in 2020 with capital outflows exceeding capital inflows. This is the corollary of Australia’s current account surplus (see ‘Domestic Economic Conditions’ chapter). Net outflows have mainly been associated with the decline in the outstanding stock of debt issued abroad by Australian banks, which has partly reflected access to low-cost funding domestically, including through the TFF, as well as slower credit growth (Graph 3.43). These outflows were partly offset by inflows related to foreign purchases of Australian government debt. Equity outflows exceeded inflows in 2020, reflecting superannuation and investment firms purchasing foreign equities in the second half of the year.

Australia’s net foreign liability position remains lower than in previous years as a per cent of GDP. Over recent years, movements in the net foreign liability position have been largely driven by an increase in the value of Australia’s foreign equity asset position (Graph 3.44). The net income deficit, which is comprised of payments and receipts made on the net foreign liability position, has narrowed to its lowest level as a per cent of GDP since the 1970s. This narrowing reflects a decrease in payments, including dividends and interest payments, on Australia’s foreign liabilities compared with income from Australia’s foreign assets. ✨

**Graph 3.42**

#### Australian Dollar

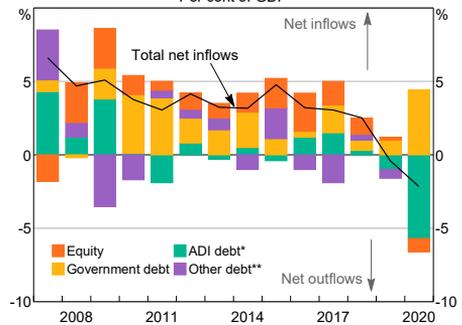


\* Indexed to 1 January 2020 = 100  
 \*\* Spread to the United States, Japan and Germany, weighted by GDP.  
 Includes yields on the April 2024 Australian Treasury bond  
 Sources: Bloomberg; RBA

**Graph 3.43**

#### Net Capital Flows

Per cent of GDP

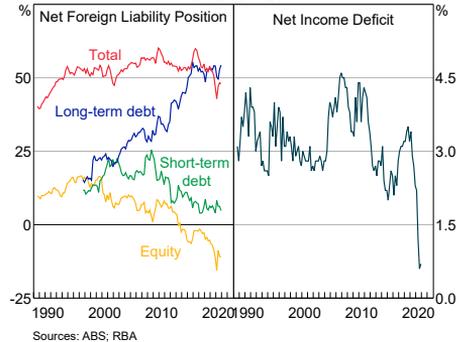


\* Adjusted for the US dollar swap facility in 2008-09 & 2020  
 \*\* Includes public corporations and private sector  
 Sources: ABS; RBA

**Graph 3.44**

#### Net Foreign Position and Payments

Per cent of GDP



Sources: ABS; RBA

## Endnotes

- [1] See Alston M, S Black, B Jackman and C Schwartz (2020), 'The Term Funding Facility', RBA *Bulletin*, December, viewed 28 January 2021. Available at <<https://www.rba.gov.au/publications/bulletin/2020/dec/the-term-funding-facility.html>>
- [2] For more information about the determinants of the Australian dollar over recent years, see Atkin T, I Hartstein and J Jaaskela (2020), 'Determinants of the Australian Dollar Over Recent Years', RBA *Bulletin*, viewed 5 May 2021. Available at <<https://www.rba.gov.au/publications/bulletin/2021/mar/determinants-of-the-australian-dollar-over-recent-years.html>>

## 4. Inflation

Movements in aggregate consumer prices and wages over the past year have been dominated by the impact of responses to the COVID-19 pandemic. This has introduced more volatility than usual to measures of prices and wages, with this mostly reflecting temporary or one-off movements. Looking through this volatility, underlying inflationary pressures in the economy remain subdued, consistent with the considerable spare capacity in the economy.

Around half of the increase in Consumer Price Index (CPI) inflation in the March quarter was driven by higher automotive fuel prices; fuel prices have returned to close to their pre-pandemic levels following sharp declines in early 2020. The large and temporary price changes arising from policy responses to the COVID-19 pandemic have mostly dissipated, and are not expected to influence quarterly inflation outcomes much further. However, the year-ended inflation outcome for the June quarter is expected to spike temporarily above 3 per cent as the effects of last year's temporary free childcare program and fuel price declines drop out of the calculation. Other recent pockets of price pressures are abating, or are expected to do so in coming quarters, because heightened demand for some goods over the past year has eased a little and global supply chain disruptions are being worked through. Housing components of the CPI were broadly flat in the March quarter; strong demand for new dwelling construction pushed prices higher, but this was offset by HomeBuilder and similar state government construction grants.

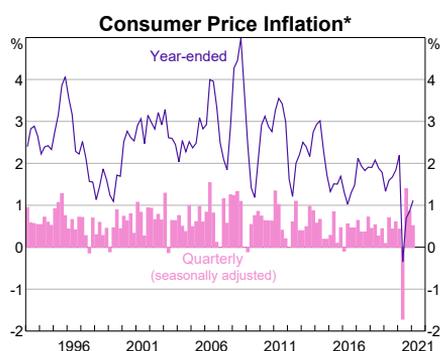
Wages growth picked up a little in the December quarter, boosted by the reversal of some temporary wage cuts in the private sector, which had been implemented in 2020 in response to the economic downturn. Wages growth has also been supported a little by the implementation of award wage increases previously delayed in response to the pandemic. Abstracting from these factors, wage pressures have been subdued across both the private and public sectors.

### CPI inflation moderated in the March quarter

Headline inflation was 0.5 per cent (seasonally adjusted) in the March quarter, boosted by higher automotive fuel prices, and 1.1 per cent over the year (Table 4.1; Graph 4.1).<sup>[1]</sup>

Trimmed mean inflation was 0.3 per cent in the March quarter and 1.1 per cent over the year (Graph 4.2). Other measures of underlying inflation were around 1¼ per cent over the year

**Graph 4.1**



\* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

**Table 4.1: Measures of Consumer Price Inflation**

Per cent

	Quarterly <sup>(a)</sup>		Year-ended <sup>(b)</sup>	
	March quarter 2021	December quarter 2020	March quarter 2021	December quarter 2020
Consumer Price Index	0.6	0.9	1.1	0.9
Seasonally adjusted CPI	0.5	0.9	–	–
– Tradables	1.0	–0.1	0.7	–0.6
– Tradables (excl volatile items) <sup>(c)</sup>	0.4	0.0	1.4	1.4
– Non-tradables	0.3	1.3	1.3	1.5
<b>Selected underlying measures</b>				
Trimmed mean	0.3	0.4	1.1	1.2
Weighted median	0.4	0.5	1.3	1.3
CPI excl volatile items <sup>(c)</sup>	0.3	1.0	1.4	1.5

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median

(c) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

to the March quarter. Spare capacity in the economy and associated low wages growth continue to contribute to subdued inflationary pressures.

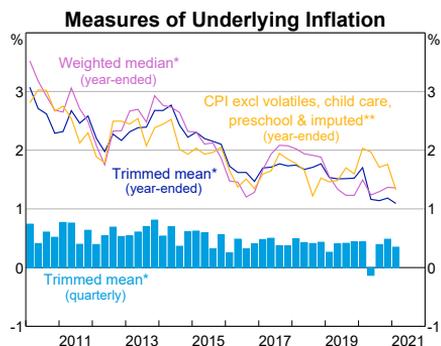
Inflation measures in the March quarter were much less affected by the pandemic than was

the case for much of the past year (Graph 4.3). The large policy-driven swings in administered prices, such as for child care, have now unwound, and the price adjustments induced by changed consumption patterns over the past year (which saw increased spending on groceries and consumer durables) have slowed. While policy measures continue to have a small influence on other price components of the CPI, such as housing and utilities, these effects are likely to diminish further over coming quarters.

### Housing-related prices were unchanged

Following two quarters of modest increases, housing-related inflation slowed in the March quarter. New dwelling prices declined slightly due to the impact of government construction incentives. Rents were unchanged in the quarter and rent inflation remained very weak in year-ended terms. These 2 housing-related

**Graph 4.2**



\* Seasonally adjusted

\*\* Not seasonally adjusted; excludes fruit, vegetables, automotive fuel, child care, preschool & primary education and items that were imputed using headline CPI for all capital cities in the June or September quarter 2020

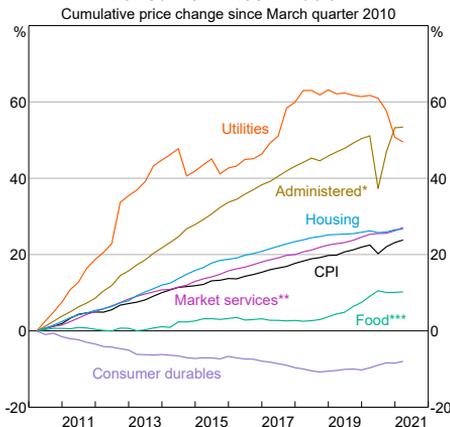
Sources: ABS; RBA

components together account for around one-sixth of the CPI basket.

Ongoing strength in demand for new detached housing construction has been in part supported by the Australian Government’s HomeBuilder program and similar state government grants. Information from liaison suggests that this strong demand, as well as some supply chain disruptions, has contributed to higher material prices and subcontractor rates over the past few quarters (Graph 4.4). Higher input costs have been passed on to consumers through higher base prices. However, these were completely offset by the direct impact of government grants, which are treated by the ABS as price reductions. As a result, CPI prices for newly constructed dwellings fell by 0.1 per cent in the quarter (Graph 4.5). Because HomeBuilder grants are only paid after dwelling construction has commenced, the recent 12-month extension to the HomeBuilder construction commencement deadline will prolong the program’s impact on CPI prices. As a result, the HomeBuilder grants are likely to continue to subtract from new dwelling inflation until late 2022.

**Graph 4.3**

**Consumer Price Inflation**



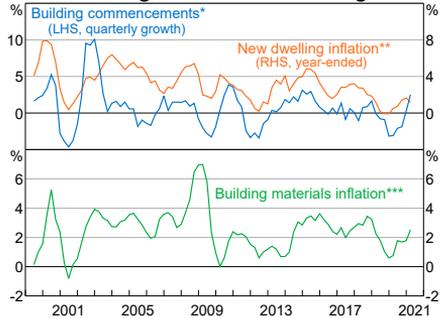
\* Excludes utilities  
 \*\* Includes household services, meals out & takeaway and insurance & financial services  
 \*\*\* Excludes fruit, vegetables and meals out & takeaway  
 Sources: ABS; RBA

Rents were unchanged in the March quarter and 1.4 per cent lower over the year (Graph 4.6).

Advertised rents and available listings suggest rental market conditions have tightened a little over recent months, but this is yet to flow through to the stock of existing rents captured in the CPI. Rents fell further in Sydney in the quarter and were around 3 per cent lower over the year. In Melbourne, declines in the March quarter in rents for some tenants were offset by the unwinding of temporary rent reductions for others. Rents increased in most other cities in the quarter but were particularly strong in Brisbane and Perth. The recent recovery in Perth rents partly reflects a rental stock shortage following years of subdued dwelling investment.

**Graph 4.4**

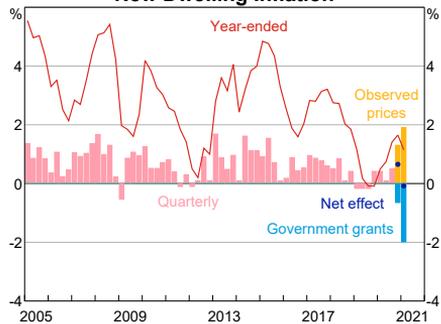
**New Dwelling Inflation and Building Costs**



\* Volumes; 6-quarter average lagged by one quarter; detached only prior to 2017; thereafter attached included with a 20 per cent weight  
 \*\* Adjusted for the tax changes of 1999-2000  
 \*\*\* Year-ended change in producer prices for inputs to house construction  
 Sources: ABS; RBA

**Graph 4.5**

**New Dwelling Inflation**



Sources: ABS; RBA

## Administered price inflation has returned to its pre-pandemic trends

Administered price inflation moderated in the March quarter, returning to the pre-pandemic pattern of subdued price increases.

Administered price inflation has trended lower over the past 6 years and this trend is expected to persist for some time, in part due to ongoing administered price freezes in a number of states and territories.

Price rises for preschool & primary education were smaller than is typical in the March quarter, largely because of ongoing preschool fee waivers in New South Wales and Victoria (Graph 4.7). Tertiary education prices declined, driven by university fee changes as part of the government’s Job-ready Graduates Package. Price increases for other items that typically have their prices reset in the March quarter, such as secondary education fees and state government charges, were a little below average this year. In contrast, pharmaceutical product price inflation rose a little due to the annual reset of safety net thresholds for the Pharmaceutical Benefits Scheme.

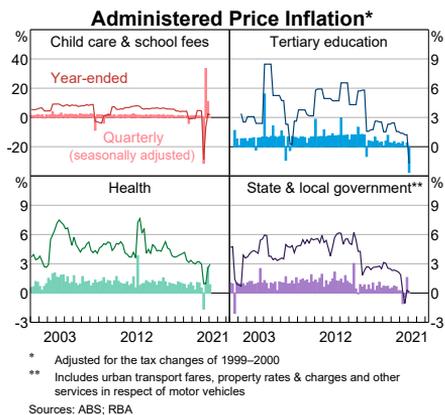
## Utilities prices decreased in the quarter

Prices for utilities, which account for around 5 per cent of the consumption basket, fell in the March quarter owing to declines in regulated

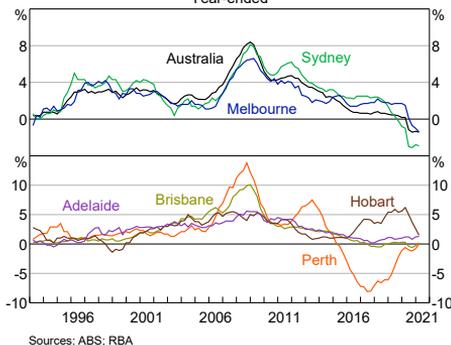
electricity prices and the provision of government rebates in some states (Graph 4.8).

Melbourne electricity prices fell noticeably in the quarter. Market and standing offers declined, consistent with the scheduled reduction in the Victorian Default Offer; a one-off rebate was also provided to concession customers. Partly offsetting this, electricity prices in Western Australia rose as government rebates unwound for some customers. Gas prices increased a little in the quarter, largely driven by scheduled increases in market offer gas prices in Melbourne.

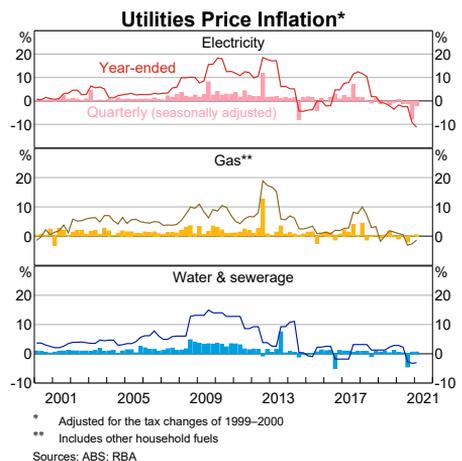
**Graph 4.7**



**Graph 4.6**  
**Rent Inflation**  
Year-ended



**Graph 4.8**



Utilities inflation has been subdued for the past 2 years and is likely to remain low for some time. Lower wholesale gas prices and increased electricity supply from renewables continue to put downward pressure on utilities prices. State government price freezes mean that residential utilities prices are expected to remain broadly unchanged until the second half of 2021 in Canberra, Darwin, Hobart and Perth. Electricity prices in Adelaide, Brisbane and Sydney are likely to decline in the September quarter 2021 owing to a scheduled reduction in the Default Market Offer.

### Automotive fuel prices have rebounded

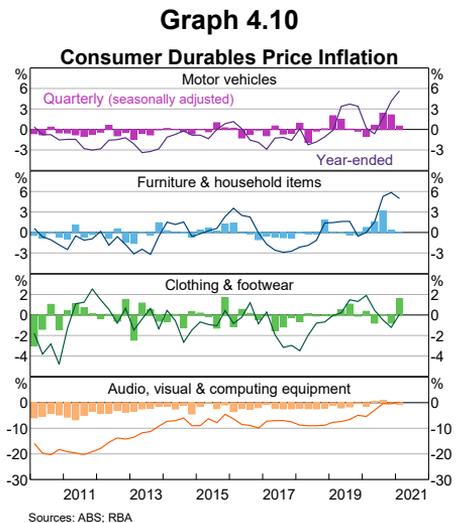
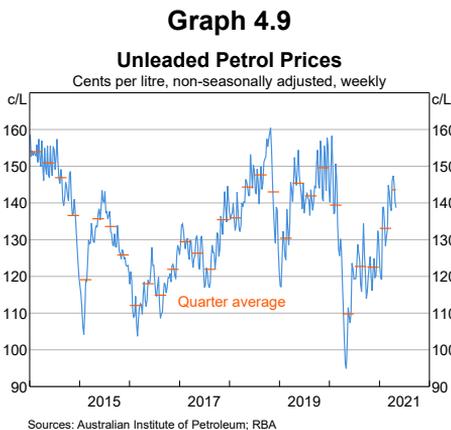
Fuel prices rose strongly in the March quarter, after remaining fairly steady over the second half of 2020 (Graph 4.9). The 8.7 per cent increase in the quarter contributed ¼ percentage point to quarterly headline CPI (half the total increase in the CPI). Fuel prices continued to rise in the month of April – at current levels automotive fuel is expected to again contribute to headline CPI in the June quarter, although less so than in the March quarter.

### Retail inflation outcomes were mixed

Retail prices, which comprise over a quarter of the CPI, rose a little in the March quarter to be 1.7 per cent higher over the year. During 2020,

sustained demand for many consumer durable items – particularly household items and motor vehicles – had driven retail prices higher as a large share of people spent more time at home during the initial COVID-19 outbreak. These pressures had been exacerbated by the difficulties faced by retailers in managing inventories during the pandemic. Some retailers opted to cancel orders early in the pandemic in response to uncertainty over the outlook for demand. Retail inventories then continued to decline over 2020 as strong demand outpaced retailers’ ability to restock, in part due to global supply chain pressures. However, these supply pressures have now eased a little and the appreciation of the exchange rate has provided some offset by reducing prices for imported inputs. Prices for motor vehicles continued to rise in the March quarter, but at a slower pace, while prices for furniture & household items declined (Graph 4.10). In contrast, prices for clothing & footwear rose in the quarter, driven by higher prices for accessories, particularly jewellery.

Grocery prices (excluding fruit & vegetables) were little changed in the March quarter. Price declines for dairy and some packaged foods were offset by price rises for meat products;



better seasonal conditions have led some farmers to rebuild stock numbers, reducing the supply of meat (Graph 4.11). Prices for most other grocery items are now around their levels of a year ago, consistent with business liaison reports that supermarkets have returned to normal discounting strategies following some changes in discounting behaviour during periods of strong demand early in the pandemic.

Prices for fruit & vegetables, which can be volatile, decreased in the March quarter as favourable weather conditions and a fall in fruit exports led to strong supply in supermarkets. Despite recent reports of labour shortages for some produce harvesting, these do not appear to have led to widespread price pressures to date.

### Market services inflation remains subdued

Inflation remains low for market services, which include household services, financial services, meals out & takeaway and domestic travel, and comprise a little under one-quarter of the consumption basket (Graph 4.12). Within domestic travel, price increases stemming from strong demand for holiday accommodation in the March quarter were partly offset by lower airfares. Domestic travel prices are likely to fall in

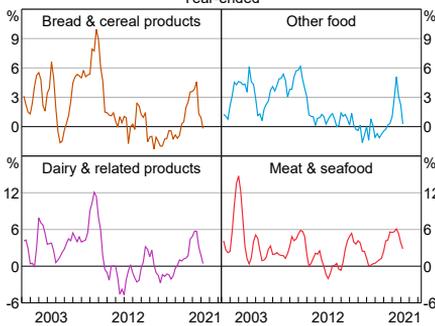
the coming quarters due to the Australian Government’s half-price airfare scheme.

### Inflation expectations have increased a little

Price- and wage-setting behaviour can be affected by expectations about the future rate of inflation. Survey-based measures of short-term inflation expectations have picked up a little and become less volatile over recent months (Graph 4.13). In part this is because large changes in some price components (such as the effects of oil price changes and child care subsidies that occurred during 2020) are no longer influencing year-ahead expectations. Despite the pickup, short-term inflation expectations remain relatively subdued. Survey measures of long-term inflation expectations have increased a little of late and are around 2–2½ per cent (Graph 4.14). Long-term market-based measures of inflation expectations have also picked up from the very low levels seen in early 2020. The pandemic-related market dysfunction observed at times over the past year is no longer affecting market measures of inflation expectations.

**Graph 4.11**

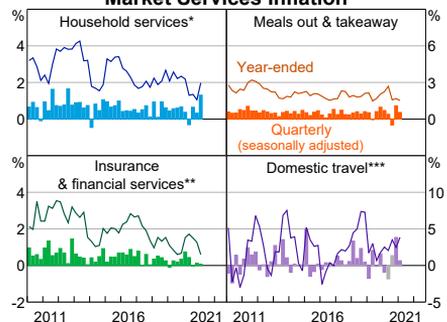
**Food Price Inflation\***  
Year-ended



\* Adjusted for the tax changes of 1999–2000  
Sources: ABS; RBA

**Graph 4.12**

**Market Services Inflation**



\* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services  
\*\* Excludes deposit & loans to June quarter 2011  
\*\*\* Imputed using headline CPI in the June and September quarters 2020  
Sources: ABS; RBA

## Wages growth increased in the December quarter as earlier wage cuts were unwound ...

Growth in the Wage Price Index increased to 0.6 per cent in the December quarter, but year-ended growth remained subdued at 1.4 per cent. Private sector wages increased by 0.7 per cent, primarily reflecting the reversal of a number of large temporary wage cuts implemented in the June and September quarters across mostly senior executive and higher paid jobs in response to the pandemic (Graph 4.15). There was also a small contribution to growth from award wage increases in

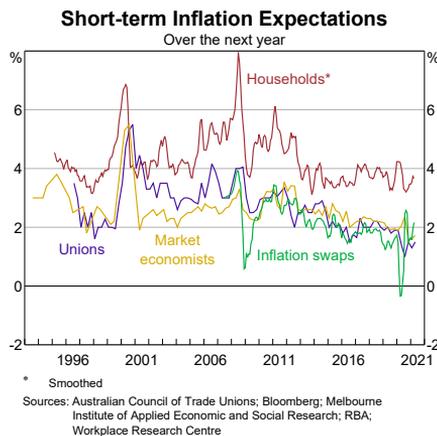
construction, manufacturing and a range of other industries that had previously been delayed from July to November by the Fair Work Commission. Public sector wages rose by 0.3 per cent in the quarter, as wage freezes across the sector continued to weigh on outcomes.

The reversals of the large private sector wage cuts in December were broad-based across industries, but had the biggest impact on wages growth in business services. Looking through the impacts of wage cuts imposed and then reversed over 2020, underlying wage pressures remained weak across all industries.

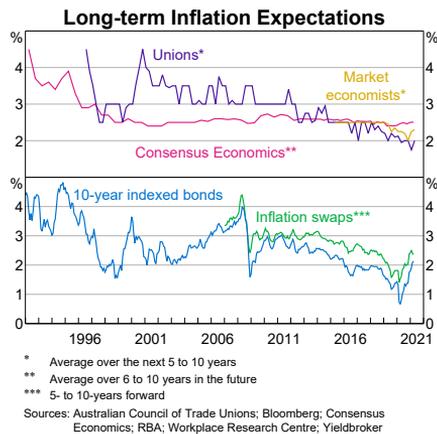
## ... but subdued wages growth is likely to persist for some time

Information from the Bank's business liaison program indicates that more temporary wage cuts have been unwound since December. However, wage freezes remain fairly widespread across industries, with over a quarter of firms in the Bank's business liaison program reporting that a freeze was in place in April (Graph 4.16). The near-term outlook has strengthened a little, though, with fewer firms expecting to have wage freezes in place in coming months. Consistent with this, more firms also report expecting stronger wages growth in the year ahead (Graph 4.17).

**Graph 4.13**



**Graph 4.14**

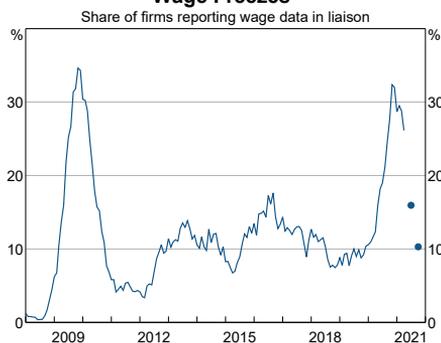


**Graph 4.15**



**Graph 4.16**

**Wage Freezes\***



\* Smoothed; dots represent expected freezes 3 and 6 months ahead  
Source: RBA

Despite the likelihood that wages growth may be past its recent trough, overall wages growth is still expected to remain subdued. Information from the Bank's business liaison program indicates that average wages growth has been below 3 per cent for the majority of firms in recent years (Graph 4.18). This pattern appears to have remained in place in 2021 to date, and stands in contrast to outcomes over much of the previous 2 decades, when a large share of firms reported average wage increases of more than 3 per cent. ↘

**Graph 4.17**

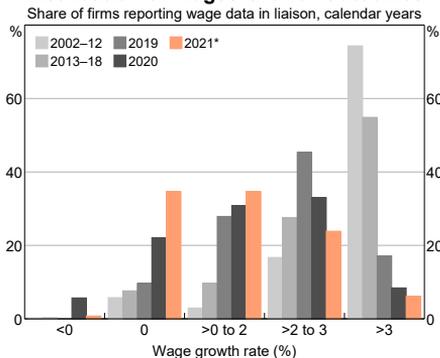
**Expectations for Wages Growth\***



\* 7-month centred moving average  
Source: RBA

**Graph 4.18**

**Distribution of Wages Growth Outcomes**



\* Year to date  
Source: RBA

**Endnotes**

[1] The only item that was still imputed (using headline CPI) in the quarter was international holiday travel & accommodation, which now accounts for less than

1 per cent of the CPI basket following the 2020 update to the CPI weights.

## 5. Economic Outlook

The global economic outlook has firmed this year because of progress in vaccinations and additional fiscal support in some economies. Overall growth in the global economy and in Australia's major trading partners is expected to rebound solidly this year and next (see 'The International Environment' chapter).

Even so, the recovery is expected to be incomplete over the forecast period in many economies, with China and the United States notable exceptions. The near-term outlook has also become more varied across economies recently as vaccination rates and policy support remain uneven and, in some cases, countries are facing another wave of infections. Underlying inflationary pressures are likely to remain contained in most economies for some time given spare capacity in labour markets, though the rebound in commodity and input prices will support inflation at least in the near term.

The Australian economy is transitioning from recovery to expansion phase earlier and with more momentum than anticipated. The unique features of the pandemic and policy response have seen the economy rebound much faster than in previous downturns. Along with favourable health outcomes and the removal of restrictions on activity, this snap-back in activity has been supported by extraordinary fiscal and monetary support. GDP growth in the December quarter 2020 was stronger than expected and the recovery in activity and the labour market again exceeded expectations in the March quarter. GDP is now expected to have reached its pre-pandemic level in the March quarter 2021 and there were more people

employed in March than before the pandemic. The unemployment rate has declined quickly, to 5.6 per cent in March, a little above the rate before the pandemic.

In response to this stronger starting point for the forecasts and improved outlook further out, the baseline scenario for GDP and employment has been upgraded relative to the February *Statement on Monetary Policy*. Under the baseline scenario, GDP is expected to grow by around 4¾ per cent over 2021 and 3½ per cent over 2022. The level of GDP is still expected to remain a little below that forecast before the pandemic, mostly due to lower population growth; in per capita terms, GDP is expected to be on a higher trajectory, supported by higher per capita household income and a strong contribution from public demand. The unemployment rate is expected to continue declining, to around 5 per cent by the end of 2021 and 4½ per cent by the end of the forecast period in mid 2023. The lower forecast unemployment rate results in wages growth and underlying inflation picking up a bit faster than previously anticipated. Inflation is expected to be close to 2 per cent by mid 2023 in the baseline scenario.

The baseline scenario is based on the assumption that the domestic vaccine rollout accelerates in the second half of the year, allowing the international border to be reopened gradually from early 2022. This scenario assumes that no further large outbreaks and accompanying extended hard lockdowns occur within Australia, and that restrictions, when imposed, are brief.

Overall, Australian households and businesses appear to be adjusting well to the tapering of fiscal and other temporary support measures. But the nature and speed of the next phase of growth is still characterised by uncertainty, particularly around household consumption and the extent of spare capacity given the disruptions to the supply side of the economy induced by the pandemic. The outlook is also likely to be uneven across industries for some time yet, reflecting the closed international border, restrictions in parts of the services sector, large shifts in consumer preferences, ongoing supply disruptions and slower population growth.

Given this uncertainty, 2 alternative domestic scenarios (an upside and downside) are considered, based largely on different assumptions for household consumption:

- A stronger economic trajectory than the one envisaged in the baseline scenario is possible if households increase spending by more than expected. This could be in response to stronger wealth effects and a decline in uncertainty that boosts households' willingness to draw down on savings, which reinforces already improving conditions in the labour market and feeds back into faster income growth. Conditions supporting a faster pick-up in consumption would also support stronger private investment. In this scenario, the unemployment rate declines at a faster pace and to a lower level (around 3¾ per cent) than in the baseline scenario. This contributes to inflation picking up to around 2¼ per cent by the middle of 2023.
- A weaker trajectory could instead eventuate if households choose to consume their income and/or their prior savings at a slower pace than assumed in the baseline scenario. In this downside scenario, wealth effects on consumption are smaller, as households divert more of their financial resources to

strengthening their balance sheets. Subdued consumption and private investment results in weaker labour income and the unemployment rate remaining above pre-pandemic levels in this scenario; this in turn sees underlying inflation remaining around 1½ per cent over the forecast period.

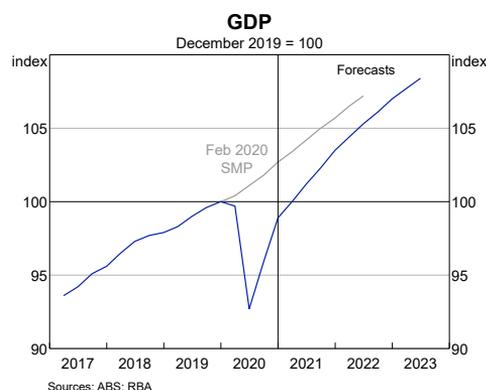
### The domestic economy is expected to absorb spare capacity gradually

The level of GDP is expected to be around 2 per cent higher by mid 2023 than expected at the time of the February 2021 *Statement* (Graph 5.1; Table 5.1). The starting point for the forecasts is stronger than previously expected, following recent outcomes both for output and the labour market, and growth momentum in coming quarters is also a little stronger.

Growth in activity is expected to be broad-based in the period ahead, led by the household sector and public demand. A pick-up in business investment is also now underway and expected to continue, supported by strong balance sheets, rising business confidence, and a steady decline in both spare capacity and general uncertainty.

The outlook for the labour market has improved further. The starting point for the forecasts is noticeably better than anticipated at the time of the February *Statement*. Forward-looking

**Graph 5.1**



**Table 5.1: Output Growth and Inflation Forecasts** <sup>(a)</sup>

Per cent

	Year-ended					
	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
GDP growth	-1.1	9¼	4¾	4	3½	3
(previous)	(-2)	(7¾)	(3½)	(3¼)	(3½)	(3)
Unemployment rate <sup>(b)</sup>	6.8	5¼	5	4¾	4½	4½
(previous)	(6.8)	(6½)	(6)	(5½)	(5½)	(5¼)
CPI inflation	0.9	3¼	1¾	1¼	1½	2
(previous)	(0.9)	(3)	(1½)	(1½)	(1½)	(1¾)
Trimmed mean inflation	1.2	1½	1½	1½	1¾	2
(previous)	(1.2)	(1¼)	(1¼)	(1½)	(1½)	(1¾)
	Year-average					
	2020	2020/21	2021	2021/22	2022	2022/23
GDP growth	-2.4	1	5¼	5	4	3¼
(previous)	(-2¾)	(¼)	(4)	(3¾)	(3¼)	(3¼)

(a) Forecasts finalised on 5 May. Forecast assumptions (February Statement in parenthesis): TWI at 64 (63), A\$ at US\$0.77 (US\$0.76), Brent crude oil price at US\$68bbl (US\$56bbl), population growth of 0.2 per cent over 2021 (0.2 per cent) and 0.4 per cent over 2022 (0.4 per cent); cash rate in line with market pricing out to 2022 (and held constant thereafter); and other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2021 Board meeting. 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

indicators of labour demand have strengthened further, suggesting momentum in employment growth is likely to be sustained in the near term. It is also likely that there will be fewer job losses arising from the end of the JobKeeper program than previously expected. Beyond the near term, the stronger profile for activity underpins the upward revision to employment. The unemployment rate is expected to continue to decline over the forecast period, to around 4½ per cent by mid 2023. Consistent with this, wages growth and inflation are expected to pick up a little faster compared with the previous *Statement*. By the end of the forecast period in mid 2023, wages growth is expected to be around 2¼ per cent, with inflation just below 2 per cent.

### Labour market

Conditions in the labour market have continued to improve more quickly than anticipated; employment and total hours worked in March were higher than before the pandemic, and the decline in the unemployment rate to 5.6 per cent in March (averaging 5.9 per cent in the quarter) has occurred considerably faster than was anticipated at the time of the February *Statement*.

Employment growth is expected to remain strong over the next few months given solid momentum in activity, buoyant forward indicators of labour demand and other available information suggesting a muted effect from the end of the JobKeeper program in March (Graph 5.2). From late 2021, employment growth is expected to moderate in line with activity.

Continued employment growth should drive further declines in the unemployment rate, which is now expected to move down to around 5 per cent by the end of 2021 (Graph 5.3). Additional but more moderate declines are expected over the rest of the forecast period, with the unemployment rate falling to around 4½ per cent by mid 2023. Other measures of labour market spare capacity, such as underemployment, have returned to around pre-pandemic levels, though before the pandemic underemployment was at quite high levels.

The forecasts imply labour force participation will increase a little further over the year ahead and remain elevated for the rest of the forecast

period. Strong labour demand should encourage workers to join and/or remain in the labour force, and structural drivers (such as increases in the pension eligibility age and more flexible working arrangements) should also continue to support an increase in participation.

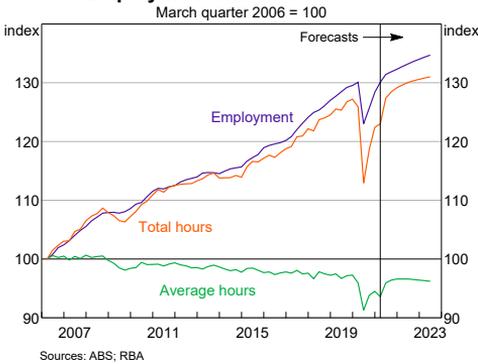
### Household consumption, income and saving

Strong household spending is expected to underpin GDP growth across the forecast period, supported by the further lifting of activity restrictions, a stronger outlook for household disposable income, wealth effects from higher housing prices, and reduced uncertainty (Graph 5.4). Timely indicators suggest that consumption growth moderated in the March quarter from 4¼ per cent in the December quarter, partly as a result of the short sharp lockdowns in a number of states. Consumption is expected to have been around 1½ per cent below its pre-pandemic level at the end of March. As economic outcomes continue to improve and more consumption possibilities become available, households are likely to rebalance more of their spending back towards services.

The outlook for household disposable income growth is supported by stronger employment translating into higher labour income. It is also assumed that tax policy is unchanged, so that growth in household tax paid remains at or

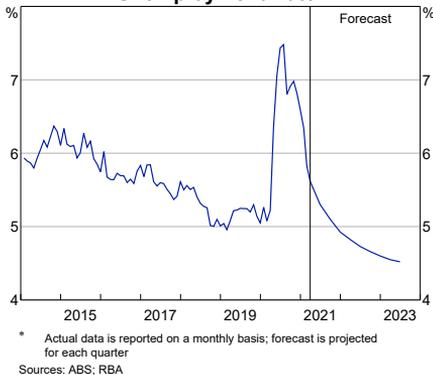
**Graph 5.2**

**Employment and Hours Worked**



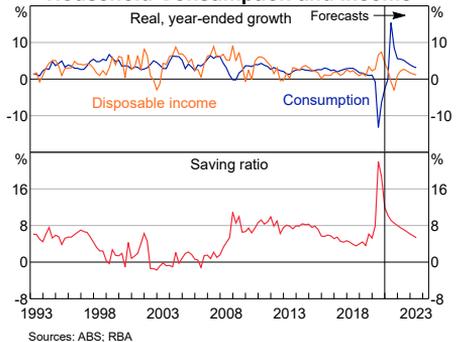
**Graph 5.3**

**Unemployment Rate\***



**Graph 5.4**

**Household Consumption and Income**



below the pace recorded in the years leading up to the pandemic. Higher housing prices lead to higher household wealth, which is expected to flow through to stronger consumption over several years. Both income and wealth effects boost consumption per capita, and together their effects largely offset the effect of slower population growth on aggregate consumption.

The household saving ratio is expected to decline from around 12 per cent in the December quarter 2020 to 8 per cent by end 2021. Further out, the saving ratio is expected to return to around its average level over the 5 years prior to the pandemic. As uncertainty associated with the pandemic fades and restrictions ease, households are expected to avail of opportunities to spend. Households are assumed to treat the additional savings they accumulated through the pandemic (much of which was the result of limited spending opportunities) as an increase in wealth and as such consume only a small share of these savings over the forecast period. A more aggressive drawdown of accumulated savings is possible, and is considered in the upside scenario discussed below.

### Dwelling investment

Over 2020, containment measures did not have a material impact on residential construction activity; instead, government grants, lower interest rates and JobKeeper payments supported both activity and profitability in the sector. Dwelling investment returned to its pre-pandemic level in the December quarter, around 2 quarters earlier than previously expected, proving to be one of the more resilient parts of the economy through the pandemic. Residential construction activity is expected to grow steadily over 2021, as the large volume of development applications approved under the Australian Government's HomeBuilder scheme and similar state-based grants are worked through. The recent announcement of

the extended deadline for the commencement of HomeBuilder projects means that some of this activity will be spread out over a longer period than previously assumed.

While a large share of construction related to the HomeBuilder scheme is expected to represent a pull-forward in activity, low interest rates and the strong rebound in housing prices are expected to sustain growth in dwelling investment across most of the forecast period. Investment in higher-density residential construction is expected to remain subdued over the next year or so; this is due to low levels of building approvals over most of the past 3 years and lower investor appetite for these types of properties than seen over recent housing cycles. A gradual recovery in population growth should support a decline in rental vacancy rates in larger capital cities and a pick-up in higher-density investment towards the end of the forecast period.

### Business investment

Non-mining business investment is expected to increase steadily over the forecast period. Following a 10 per cent decline after the onset of the pandemic, it is expected to return to its pre-pandemic level by early 2022 and expand thereafter. Investment began recovering in the December quarter, which was sooner than expected, and stronger reported business confidence and investment intentions support the more favourable outlook being sustained. This follows a period where the ratio of non-mining investment to output has been low relative to history.

In the near term, the upward revision to non-mining investment is mainly accounted for by higher machinery & equipment investment, which continues to respond to tax incentives, as well as improved business conditions and declining spare capacity, particularly in goods-related industries. With a stronger domestic recovery and firms' improved balance sheet

position, machinery & equipment investment is expected to be higher throughout the forecast period than in the February *Statement*. The profile for non-residential construction investment is also higher throughout, though it recovers at a more gradual pace than machinery & equipment investment due to the lags in the approval and planning of construction projects. For this higher profile to be realised, a sustained pickup in building approvals will be needed over this year.

The forecast profile for mining investment has been revised up a little. Profitability in the sector is picking up strongly in response to the recovery in commodity prices, and higher oil prices have improved the viability of some LNG projects. But despite buoyant commodity prices there have been few indications to date that major miners plan to expand iron ore-related investment in response to higher prices.

### Public demand

Public demand is expected to contribute to GDP growth across the forecast period. The large public investment programs announced over 2020 are expected to remain an important contributor to growth. National accounts data for the December quarter showed a modest increase in public investment, which could suggest that spending is occurring a little more slowly than projected in state and Australian Government budgets. In line with this, the forecast for near-term growth in public investment has been lowered a little; however, it is assumed that public investment will pick up quickly in subsequent quarters. Further delays in obtaining equipment and/or progressing approvals, along with constraints on labour availability, pose downside risks to the public investment forecasts.

The profile for public consumption has been upgraded to incorporate some expected additional spending related to the vaccination program. Other pandemic-related spending is

expected to decline across the forecast period, but is offset by expected public consumption commitments stemming from longer-term factors such as the ageing population. The release of the Australian Government Budget on 11 May will contain further information relevant to the outlook for public demand.

### External sector

The outlook for exports has been upgraded a little, driven by higher rural and resource exports. Rural production benefitted from favourable weather conditions last year and some of this strength is expected to persist as the larger winter crop harvest continues to be exported. Coal exports have been revised higher as firms have been able to find alternative buyers more quickly than anticipated following the significant decline in sales to China. Education exports are forecast to grow a little slower over 2022 than previously expected because of ongoing uncertainty around international travel restrictions. An earlier return of travel to New Zealand has been factored in, reflecting the travel bubble established in April.

The forecasts for import growth have been revised up because of stronger domestic demand, including business investment, and the recent appreciation of the exchange rate. This outweighs the effects of household consumption shifting back towards services, which are less import intensive. There remains a downside risk to trade in services if the wider reopening of international borders is delayed. While the effect of reduced tourism activity on GDP would likely be offset to some extent by Australians spending more at home, lower education exports would also drag on GDP.

The terms of trade have been revised higher throughout, boosted by higher profiles for rural, iron ore, LNG and base metal prices (Graph 5.5). If commodity prices remain around current levels, the terms of trade in the June quarter 2021 will be near their previous peak in 2011,

which was around the height of the mining investment boom. As in the *February Statement*, iron ore prices are expected to decline from near record levels over the forecast period, contributing to a fall back in the terms of trade.

### Wages and inflation

The faster improvement in the labour market is expected to result in labour market spare capacity being absorbed a little more quickly than previously expected. This should put some upward pressure on wages growth over time. After historically low year-ended wages growth of below 1½ per cent in the second half of 2020, growth in the Wage Price Index (WPI) is expected to pick up to a little under 2 per cent over 2021, before gradually increasing to around 2¼ per cent by mid 2023 (Graph 5.6).

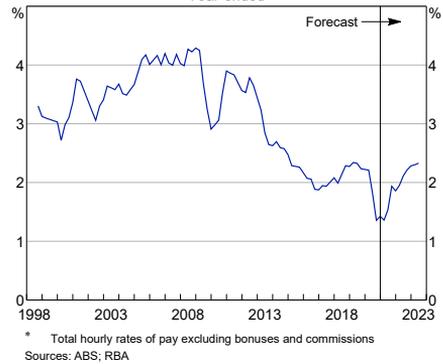
The upward revisions to the outlook for wages are predominantly for private sector wages; the outlook for public sector wages is little changed. Many of the private sector firms that had implemented temporary wage cuts last year reversed them in the December quarter (a little sooner than previously expected). Liaison indicates that many of the firms that currently have wage freezes in place plan to unwind them in coming months, while fewer firms plan to implement new ones. Public sector wages growth is expected to pick up over this year as

some earlier wage freezes unwind, but then settle at a lower rate than in recent years reflecting various governments' wage cap policies.

The GDP and labour market forecasts represent a stronger outlook than presented in the *February Statement*, and this is reflected in the forecasts for inflation. Even so, underlying inflation is still expected to increase only gradually over the next few years, to be close to 2 per cent in mid 2023 (Graph 5.7). However, the extent of estimated spare capacity in the economy is uncertain, which means it is plausible that wages growth and inflation could be slower or faster than currently envisaged in the baseline.

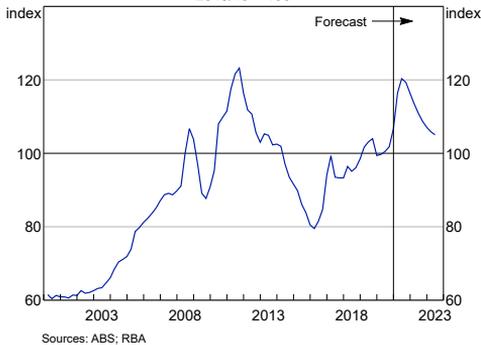
**Graph 5.6**

**Wage Price Index Growth\***  
Year-ended



**Graph 5.5**

**Terms of Trade**  
2018/19 = 100



**Graph 5.7**

**Trimmed Mean Inflation**  
Year-ended



Headline inflation is expected to spike to above 3 per cent over the year to the June quarter 2021, largely because the initial declines in prices from pandemic-related policies (such as free child care and preschool) drop out of the year-ended calculation. This temporary spike has been revised up a little, given automotive fuel prices have risen further recently. Headline inflation is expected to be slightly below trimmed mean inflation over most of the latter half of the forecast period; the recent extension to commencement deadlines for the HomeBuilder program will result in government grants being paid out more gradually than previously expected, subtracting a little from headline CPI each quarter until late 2022.

Inflation outcomes are expected to vary considerably across components. Prices for some consumer durables, for example motor vehicles, are expected to increase further in the near term due to ongoing supply disruptions and strong demand, though business liaison information suggests that these effects are less acute than they were over 2020. Prices for newly built dwellings are likely to be a little stronger than previously expected, driven by strong demand for detached housing; however, the treatment of HomeBuilder and similar state-based grants will provide some offset in terms of measured new dwelling price inflation in the CPI. The forecasts reflect the disinflationary effects of weaker demand for some services, government subsidies and rebates, administered price freezes and the end of the annual 12.5 per cent tobacco excise increase. Utilities prices are expected to continue to fall for some time, because of recently announced reductions in regulated prices, low wholesale prices and increased electricity supply from renewables.

### Upside scenario: stronger consumption

A plausible upside scenario centres on stronger household consumption, where increases in housing and equity prices raise households'

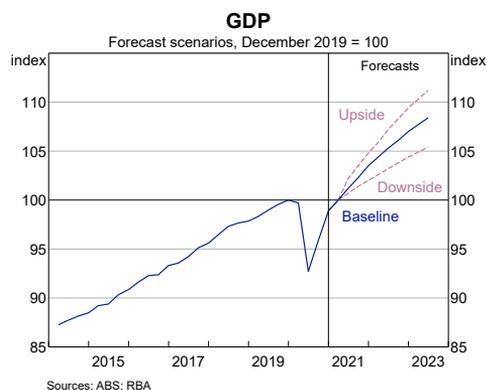
desire to consume by more than assumed in the baseline scenario. At the same time, the ongoing improvement in labour market conditions boosts labour income, out of which households consume, and increases households' willingness to draw down on savings that were accumulated during 2020.

Stronger household consumption in the upside scenario leads the saving ratio to fall more sharply than in the baseline to around 2¾ per cent by mid 2023. Higher consumption and reduced uncertainty about the outlook also underpin faster growth in business investment and employment. This puts additional downward pressure on the unemployment rate. In this scenario, the stronger labour market leads to a faster pick-up in wages growth and inflation over the next couple of years. With the unemployment rate falling below 4 per cent, inflation rises to be back within the target range by mid 2023 (Table 5.2; Graph 5.8; Graph 5.9; Graph 5.10, Graph 5.11).

### Downside scenario: weaker consumption

A weaker trajectory than envisaged in the baseline scenario is possible if households increase their spending more gradually because they choose to save more of their income and/or use more of their accumulated savings for

**Graph 5.8**



**Table 5.2: Scenarios – Comparisons of Key Economic Variables** <sup>(a)</sup>

Percentage change over year to quarter shown

	Scenario	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
Gross domestic product	Baseline	-1	9¼	4¾	4	3½	3
	Upside	-1	10¼	6	5	4½	3¾
	Downside	-1	8½	3¼	2½	2¼	2
Unemployment rate (quarterly)	Baseline	6.8	5¼	5	4¾	4½	4½
	Upside	6.8	5¼	4½	4¼	4	3¾
	Downside	6.8	5¼	5¼	5¼	5½	5½
Trimmed mean inflation	Baseline	1.2	1½	1½	1½	1¾	2
	Upside	1.2	1½	1½	1¾	2	2¼
	Downside	1.2	1½	1½	1½	1½	1½

(a) Forecast assumptions (February Statement in parenthesis): TWI at 64 (63), A\$ at US\$0.77 (US\$0.76), Brent crude oil price at US\$68bbl (US\$56bbl), population growth of 0.2 per cent over 2021 (0.2 per cent) and 0.4 per cent over 2022 (0.4 per cent); cash rate in line with market pricing out to 2022 (and held constant thereafter); and other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2021 Board meeting. Shading indicates historical data, shown to the first decimal point. Forecasts are rounded to the nearest quarter point.

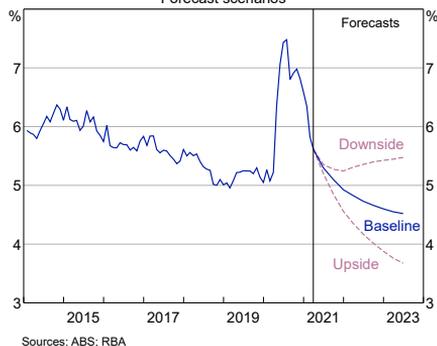
Sources: ABS; RBA

purposes other than consumption. The downside scenario assumes that some households respond to increases in their wealth due to higher asset prices by less than implied in the baseline, in part because they prefer to continue strengthening their balance sheets. High debt levels among some households might be one catalyst for this; a different trigger for prospective home owners could be rising housing prices and the related need to accumulate larger down payments.

This scenario involves a more sluggish increase in activity than assumed in the baseline scenario. A slower pick-up in consumer spending sees the saving ratio remain high throughout the forecast period, edging down to around 8½ per cent by mid 2023. Lower consumption growth weighs on business income, prompting some firms to delay investment plans. Employment growth slows as these firms put off hiring decisions or lay off additional workers. In this scenario, the unemployment rate remains around

**Graph 5.9**

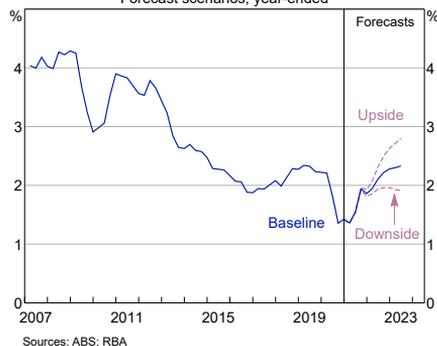
**Unemployment Rate**  
Forecast scenarios



Sources: ABS; RBA

**Graph 5.10**

**Wage Price Index Growth**  
Forecast scenarios, year-ended



Sources: ABS; RBA

5¼–5½ per cent. The slower reduction in spare capacity in the labour market drags on wages growth, resulting in underlying inflation remaining below 2 per cent.

### Other domestic risks and uncertainties

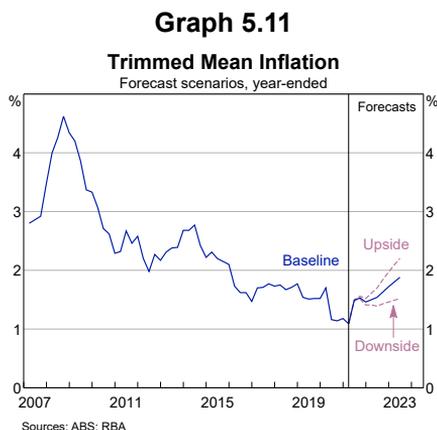
The upside and downside scenarios considered above illustrate 2 plausible alternative paths for the economy based on different underlying assumptions around the ability and willingness of households to consume. Beyond this, other sources of uncertainty remain, although, as set out below, risks to the economic outlook have become more balanced.

Global health outcomes are still highly uncertain. The uneven pace of vaccine rollout globally could stifle the global recovery, as could the emergence of virus strains that vaccines are less effective against. This would also affect when international travel restrictions can be lifted, and therefore the pace of recovery in domestic services trade and consumption. Scarring effects in certain industries and parts of the country could be more pronounced in such an environment. An extended closure of the international border would also depress domestic population growth and thus reduce demand and trend growth in the economy's productive capacity.

The size, composition, timing and effectiveness of additional global and domestic fiscal measures is also a source of uncertainty, including for the investment outlook. One related domestic uncertainty is whether fiscal initiatives designed to spur the recovery in dwelling and business investment have mainly pulled forward demand or instead helped to set it on a new higher trajectory. It is possible that dwelling and business investment is stronger than currently anticipated even after targeted fiscal support measures expire, particularly if overall demand conditions remain strong and commodity prices remain at elevated levels. Furthermore, high commodity prices provide an additional source of government revenue and could support more fiscal stimulus than is currently assumed. Alternatively, public investment could be slower to roll-out than foreshadowed in the Australian Government and state budgets if capacity constraints start to bind.

The outlook for housing and financial asset prices always entails a degree of uncertainty, and households' propensity to spend out of wealth becomes more salient in such an environment. If the expected growth in household wealth fails to materialise, consumption growth over the forecast period could follow a lower path; the reverse is true should household wealth increase by more than anticipated in the baseline scenario. Developments in the labour market and the general level of uncertainty experienced by households at that time would be additional contributors to weaker or stronger household consumption.

The baseline scenario implies further reductions in spare capacity in the labour market (and the economy more generally) over the forecast period. However, it is uncertain how much spare capacity might remain, and how quickly its absorption might feed into upward pressure on wages and prices. Experience in the years prior to the pandemic suggests that the unemploy-



ment rate would need to be well below 5 per cent before wages growth and inflation might be expected to pick up quickly. Currently, both wage and price inflation are at a much lower level than over the past decade and, because of inertia in wage setting norms and inflation expectations, it may take some time for prices pressures to build even if spare capacity is absorbed more quickly than expected.

Alternatively, unusual aspects of the current environment, including constraints in the supply side of the domestic and global economies, could mean that domestic wages growth and inflation pick up earlier and faster than expected. This could occur due to an extended period of supply-chain bottlenecks and firms' reduced ability to address labour shortages through interstate or international migration (see 'Box C: International Border Closures, Slower Population Growth and the Australian Economy'). More generally, the uneven nature of the recovery in supply and demand, along with the effects of various stimulatory policy measures, could see some unusually large movements in a subset of wages or prices in the period ahead. Depending on where these pockets of price pressure emerge and how long they last, it is possible that some households and businesses revise up their expectations for inflation. ✎



