Overview

Global inflation is still very high but looks to have peaked. Global goods inflation is starting to decline, as supply chains improve and other upstream cost pressures ease; global energy prices have also stopped rising. However, services inflation remains high in many advanced economies, driven by resilient demand and rising labour costs. Most central banks have continued raising policy interest rates in order to return inflation to target. As tighter policy takes hold on demand, services inflation should also begin to ease.

China's approach to containing COVID-19 was reversed abruptly in mid-December. The disruptions from the last phase of restrictions in November and the wave of illness in the following month led to weak activity in the December quarter. Since then, though, the Chinese economy has recovered quickly. Together with the Chinese authorities' shift to a more growth-focused policy stance, the earlier opening of the Chinese economy has brought forward its recovery from what had previously been expected. This has added to growth in global demand in the near term, especially for some industrial commodities, and so is supporting Australia's terms of trade and national income.

As is the case elsewhere, inflation in Australia is too high and is broadly based. CPI inflation reached 7.8 per cent over the year to the December quarter. Trimmed mean inflation was 6.9 per cent over the same period, which was higher than had been expected. The easing in global goods price pressures is not yet evident in retail prices here; consumer durables price inflation picked up in the December quarter, especially for clothing and vehicles. Services inflation also reached very high rates, with the prices of market services 7 per cent higher over the year. Rental markets are tight and growth in rents has been picking up.

Inflation is likely to have peaked around the end of 2022 and is forecast to return to the target range over coming years. The central forecast is for CPI inflation to decline to 4¾ per cent over 2023 and to around 3 per cent by mid-2025. The easing in global price pressures already underway is expected to flow through to domestic prices over time. In addition, slower growth in domestic demand and a moderation in labour market conditions are expected to reduce domestic inflationary pressures. The inflation forecasts have been revised up a little in the short term in light of recent stronger outcomes, but further out inflation is expected to be a touch lower than previously forecast. This reflects recent policy changes that have reduced the size of the expected increases in domestic electricity prices over 2023.

Growth in activity has moderated since the first half of 2022 and the outlook continues to be for slower GDP growth this year and next, at around 1½ per cent. Some of this moderation occurred as the strong recovery from the pandemic mostly ran its course. The effects of higher interest rates, the rapidly increasing cost of living and declining real wealth are all expected to weigh on demand in the period ahead. Offsetting this to some extent, the elevated terms of trade will boost national income. The large pipeline of investment projects is also supportive of growth. However, despite some easing in supply chain issues, ongoing capacity constraints – especially those arising from the lack of availability of skilled labour – are expected to limit the pace at which some of these projects can be delivered.

The labour market remains tight. The unemployment rate has remained around 3½ per cent in recent months – around the lowest rate in nearly 50 years. Broader measures of labour underutilisation are also around multi-decade lows. Job ads and vacancy rates remain very high, though they have turned down a little in recent months; still, many firms report difficulty finding suitable labour. Demand for labour remains strong, supporting growth in employment in recent months. Labour supply has expanded to meet some of this strength in demand, with the participation rate around its historical high. Increased net arrivals from overseas over the second half of last year, following the reopening of the international border, has also boosted growth in the working-age population.

Wages growth has picked up, particularly in the private sector, consistent with the tight labour market. Aggregate wages growth is expected to pick up further over the course of 2023, with growth in the Wage Price Index forecast to peak at around 4¼ per cent late in the year. As growth in the economy slows, labour market conditions are expected to ease, and wages growth to slow a little. The unemployment rate is expected to start picking up from around the middle of 2023, reaching 4½ per cent by mid-2025.

Growth in household spending moderated over the second half of 2022. Spending related to overseas travel rose sharply, but other categories (such as discretionary goods) were softer as the recovery from the pandemic mostly ran its course. The tight labour market and resulting strong growth in labour incomes has to date supported solid growth in nominal household spending. However, real growth in consumption has been much slower, reflecting strong growth in prices; the volume of retail sales declined in the December quarter.

Over the period ahead, high inflation is expected to continue to weigh on growth in real household incomes and consumption. Rising interest rates are expected to add to this effect by reducing real disposable incomes for some households. Declines in net wealth, driven by lower housing prices, are also expected to dampen household spending. Housing prices have continued to decline across most of the country over recent months.

These competing forces influencing household spending represent a considerable uncertainty surrounding the outlook. Consumption growth could turn out to be either stronger or weaker than expected, depending on how these factors net out. It is not clear how far households will be willing to reduce current saving rates or draw down on extra savings accumulated during the pandemic to cushion consumption from the effects of declining real incomes; these accumulated buffers represent a larger share of household income in Australia than in some other economies, but some households have little to no buffer and will instead need to cut back on spending.

The forecast decline in inflation is subject to a number of uncertainties. Although goods inflation is expected to ease in line with the easing of global cost pressures, the timing and pace of this could differ from the expected trajectory. If global goods prices reverse some of their recent increases, goods inflation in Australia could decline further and faster than currently envisaged. Working in the other direction, given the current tightness in the labour market, there are upside risks to wages growth, which would boost domestically sourced inflation. Price- and wage-setting behaviour could become more sensitive to strong demand and high inflation, given that households and firms may be more attentive to rising costs when inflation is high for a time. Longer term inflation expectations remain anchored, but it is possible they could move higher. If that were to occur, it would make the task of bringing inflation down harder.

Global growth slowed during 2022. Some of this reflected the end of the bounce-back from the pandemic. However, as in Australia, high inflation and energy prices have weighed on demand more recently. Growth in Australia's major trading partners is expected to remain well below the historical average over 2023 and 2024. Some downside risks to growth in the major global economies have abated of late, including those stemming from China's previous approach to containing COVID-19. Overall, though, the global outlook remains uncertain, with there being plausible scenarios for both stronger and weaker growth and inflation.

The cumulative effect of the highly synchronised tightening in monetary policy has caused global financial conditions to tighten over the past year, reducing demand in the global economy; this is expected to be the main drag on global growth in the period ahead. Many central banks have begun to slow the pace of interest rate increases as signs of moderation in growth and inflation emerge, and a few have paused rate rises or signalled they will soon do so. In Australia, tighter financial conditions have seen banks' funding costs increase and growth in credit ease. The Australian dollar has appreciated slightly on a trade-weighted basis over recent months.

Over recent meetings, the Reserve Bank Board has continued to take action to ensure inflation returns to the target range over time, and raised interest rates by 25 basis points at each of its meetings in December and February. This has been necessary to achieve a better balance of supply and demand in the Australian economy, and prevent high inflation from becoming entrenched. The Board is seeking to return inflation to the 2–3 per cent target range while keeping the economy on an even keel. However, the path to achieving a soft landing remains narrow. There are considerable uncertainties surrounding the outlook, and so around the level of interest rates needed to achieve the Board's objectives. Maintaining a steady pace of increases over several months has given the Board the time to assess the flow of incoming data and any shifts to the outlook that it may imply.

Longer term inflation expectations and wages growth in Australia have so far remained consistent with the inflation target. It is important this remains the case. That said, domestically sourced inflation and wages growth are both picking up. Given the importance of avoiding a price-wage spiral, the Board will continue to pay close attention to both the price-setting behaviour of firms and the evolution of labour costs in the period ahead. It will be closely monitoring how quickly declines in global costs are passed through to prices by businesses in Australia.

The Board is mindful that a considerable adjustment to interest rates has already been made and that monetary policy affects activity and inflation with a lag and through different channels. The effects on the cash flows of the roughly one-third of households with mortgages generally comes through faster than the effect on the broader economy and inflation. The effects on households are also uneven. Some households have substantial savings buffers or are benefiting from the tight labour market and faster wages growth. Others, though, are experiencing a painful squeeze on their budgets due to higher interest rates and the rising cost of living. In addition, some households may moderate their spending in response to the decline in housing prices. In light of these competing forces, the Board is closely monitoring household spending and saving behaviour, and their contribution to domestic demand pressures.

The Board's priority is to return inflation to target. High inflation makes life difficult for people and damages the functioning of the economy. And if high inflation were to become entrenched in people's expectations, it would be very costly to reduce later. The Board expects that further increases in interest rates will be needed to ensure that the current period of high inflation is only temporary. In assessing how much further interest rates need to increase, the Board will be paying close attention to developments in the global economy, trends in household spending and the outlook for inflation and the labour market. It remains resolute in its determination to return inflation to target and will do what is necessary to achieve this.