Speech

The Outlook for Inflation and Employment

RESERVE BANK OF AUSTRALIA

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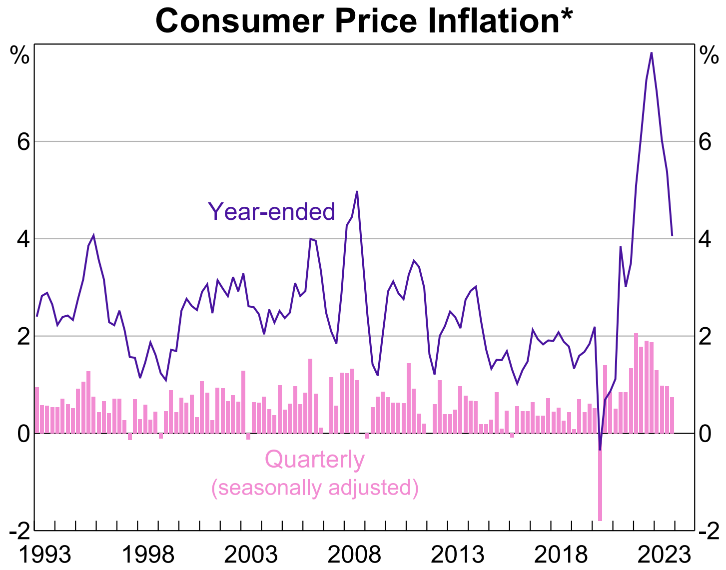
Good morning. It's a pleasure to be back at the ABE's Annual Forecasting Conference. The year just past has certainly been another eventful year for forecasters.

Today I wanted to speak to you about three topics. I'll begin with the RBA's outlook for the Australian economy. We've just updated it in last week's *Statement on Monetary Policy*. I'll then discuss our current assessment of spare capacity in the labour market and in the economy. And I'll round this out by talking about some of the changes we've been making at the RBA to enhance transparency. This includes changes to the *Statement on Monetary Policy*, which we've published last week for the first time immediately after the Board meeting. The *Statement* has also had a makeover, designed to give you new insights into how we are seeing the key economic issues.

The outlook for the Australian economy

I'll start with our views on the outlook. A year ago, when I last spoke to you, we'd just seen the highest rate of inflation in several decades (Graph 1). And monetary policy had been tightened at a brisk pace from the ultra-accommodative level during the pandemic.[1]

Graph 1



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

Sources: ABS; RBA.

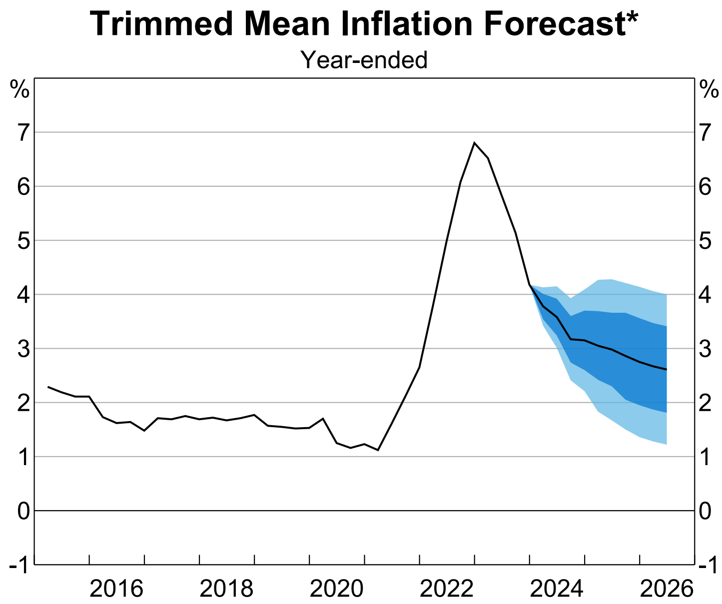
Since then, the economy has evolved broadly in line with our expectations – inflation (measured in underlying terms) and GDP growth are not too far from where we thought they would be a year ago. Similar to the experience of many advanced economies, two key forces driving developments in the economy continue to be high inflation and the restrictive monetary policy needed to address it.

Inflation is still high but is expected to ease gradually

First on inflation. It's still high and above the RBA's target range. But it has been coming down, and at a slightly faster rate than our forecasts three months ago. Headline inflation is 4.1 per cent, around half of its peak a year ago. Underlying inflation – we often use a trimmed mean to measure this – has also decreased over the same period; it is now sitting at 4.2 per cent.

Looking ahead, it will take some time for inflation to get back within the target range. Based on our central forecast, we expect it to return to the target range in 2025, and to the midpoint in 2026 (Graph 2). I'd like to stress that there is substantial uncertainty around forecasts that far out – you can see that in the blue uncertainty 'fans' around the central forecast. Our forecast reflects our expectation that subdued economic growth will balance demand and supply of goods and services in the economy and labour market conditions will ease to be around levels consistent with sustained full employment and inflation at target. I'll return to our assessment of spare capacity later.

Graph 2

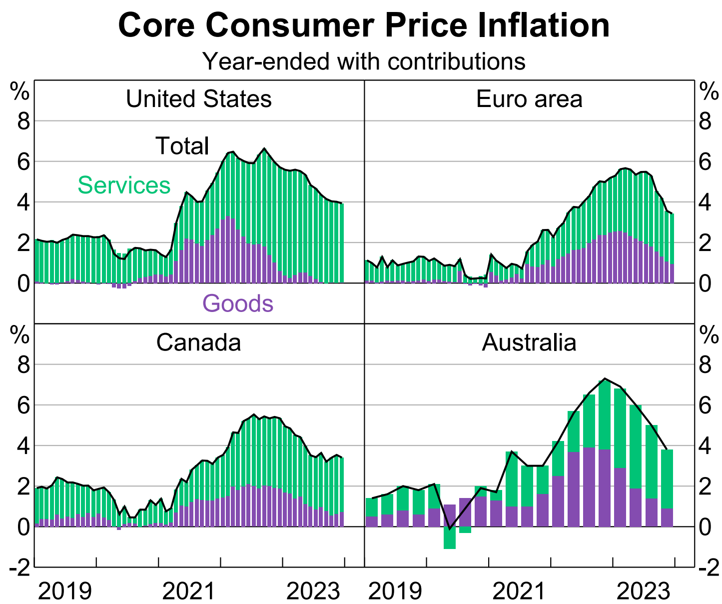


* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

An important trend underneath the aggregate inflation figures is the divergence in the path of core goods and services price inflation (Graph 3). Like in many other advanced economies, most of the decline in inflation so far in Australia has been from lower goods price inflation. In fact, a faster decline in goods inflation was the main driver of the lower-than-expected outcome in the most recent inflation release. We are seeing the earlier easing in global upstream costs being passed through to the prices consumers are facing. We have been hearing for some time now from firms in our liaison program that supply chains have been improving and imported goods inflation easing. Subdued demand growth has also contributed to the decline in goods inflation. Looking ahead, we expect goods inflation for many categories to be low for a time. This reflects the earlier improvements in global supply chains and below-trend global demand. Recent events in the Red Sea highlight that this moderation in global goods inflation might be bumpy, however.

Graph 3



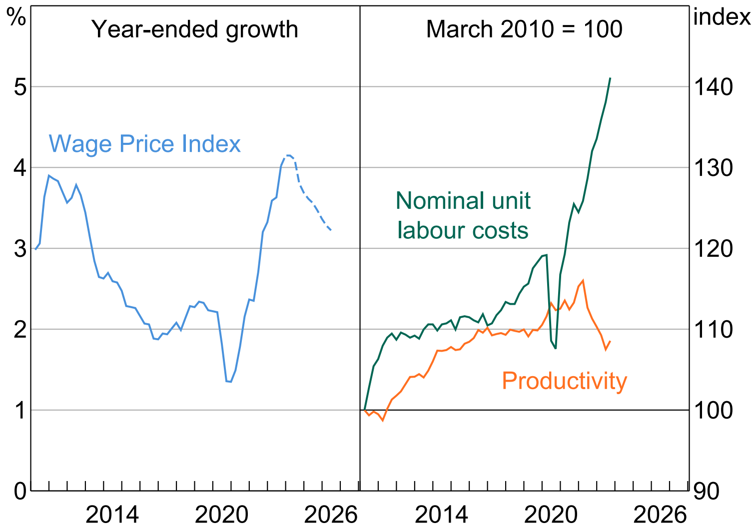
Sources: ABS; BLS; Eurostat; LSEG; RBA; Statistics Canada.

But services price inflation remains high and broadly based. This strength has been because of continued pressure from the level of demand exceeding supply alongside strong growth in domestic costs. Firms in our liaison program continue to say that they face pressure from higher labour and non-labour costs like professional services, logistics and insurance. We are forecasting that services inflation will decline from here, but only gradually as demand moves into better balance with supply and domestic cost pressures moderate. This decline in services price inflation is necessary for the inflation target to be achieved over time.

The overall cost of labour is one cost consideration for firms when setting the prices of the goods and services they provide, particularly in the relatively labour-intensive services sector. We expect wage growth to be around its peak and to decline gradually in line with the easing labour market (Graph 4). We're already seeing signs of easing wage pressures in some industries, particularly in business services.

Graph 4

Labour Costs*



* Dashed line indicates forecast.

Sources: ABS; RBA.

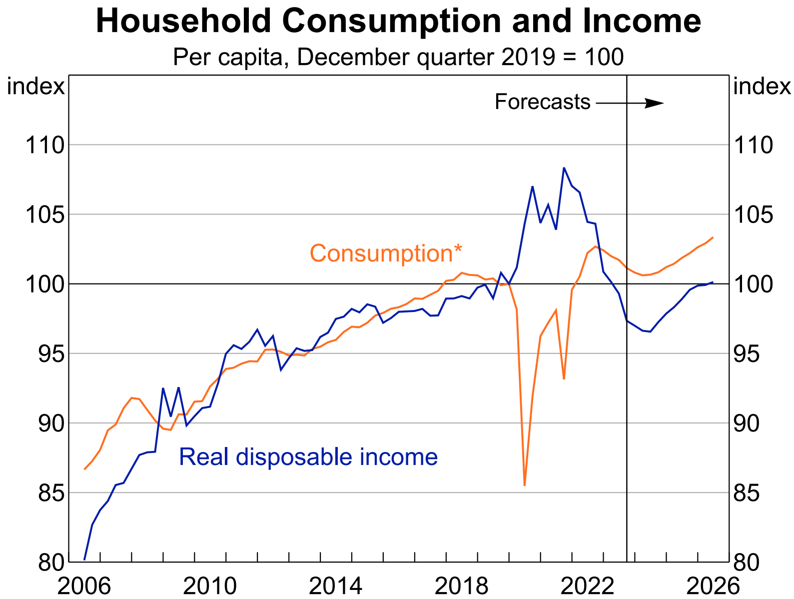
Importantly though, overall labour costs faced by firms are also determined by labour productivity – that is, the output produced by each hour an employee works. Recent weak productivity outcomes have been an important contributor to high labour cost growth. Our forecast for wages growth is consistent with inflation in the target range, assuming that productivity growth returns to around its long-run average over the next few years. I'd like to emphasise that productivity growth is a structural factor that has a lot of measurement noise over a high frequency, so it takes a longer period of observation to get a decent gauge of it. So, quarterly movements of productivity are not a useful guide when it comes to assessing the relationship with inflation and average earnings growth over the next few years.

While it is difficult to forecast productivity growth, much of the recent weakness in productivity has likely been a by-product of the pandemic and the economic cycle and so can be expected to unwind over the next few years. Examples of these temporary factors are the capacity challenges faced by firms related to pandemic or weather disruptions, capital shallowing (as the increase in hours worked outpaced growth in the capital stock) and additional employee training required given the high turnover and jobs growth we've seen in a very tight labour market. As these influences fade or indeed unwind, productivity growth should pick up in the period ahead.

Growth in economic activity will be subdued in the near term

Turning to economic activity, we've seen activity here and in most advanced economies soften over the second half of last year in response to high inflation and tighter monetary policy. A common component of this recent softness is weaker consumption growth. In Australia, high inflation, higher tax payments and higher interest rates have, together, significantly reduced household incomes. And many households have responded to this by cutting back on their spending or making other adjustments to their finances, like saving less or in some cases drawing on their savings buffers (Graph 5).

Graph 5



* Resident population adjusted to exclude student visa holders.
Sources: ABS; Department of Home Affairs; RBA.

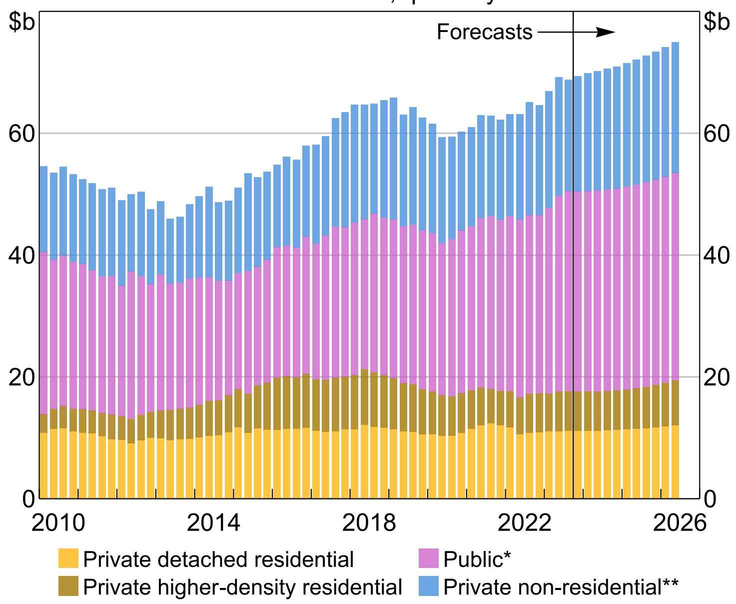
Going forward, we expect economic growth to remain subdued in the near term as inflation and earlier interest rate increases continue to weigh on domestic demand growth, particularly household consumption. For the next few quarters, the pressure on household budgets from declines in real incomes over the past couple of years is expected to continue to drag on consumption. We expect it to affect consumption a bit more than in our forecasts three months ago. This period of below-trend demand growth will bring about a better balance between supply and demand in the economy.

Growth in non-mining business and public investment has been high over the past year. This has been supported by a large pipeline of public and private sector construction projects and an easing of supply constraints. While we don't expect to see a continuation of the high *growth* rates of 2023, activity in the construction sector is forecast to remain at a high *level* (Graph 6). So, there will likely continue to be capacity constraints in the industry, which firms in our liaison program report particularly for the construction of infrastructure projects.

Graph 6

Construction Activity

Chain volume, quarterly



* Includes all public sector investment, not just construction projects.

** Expenditure by non-mining firms only.

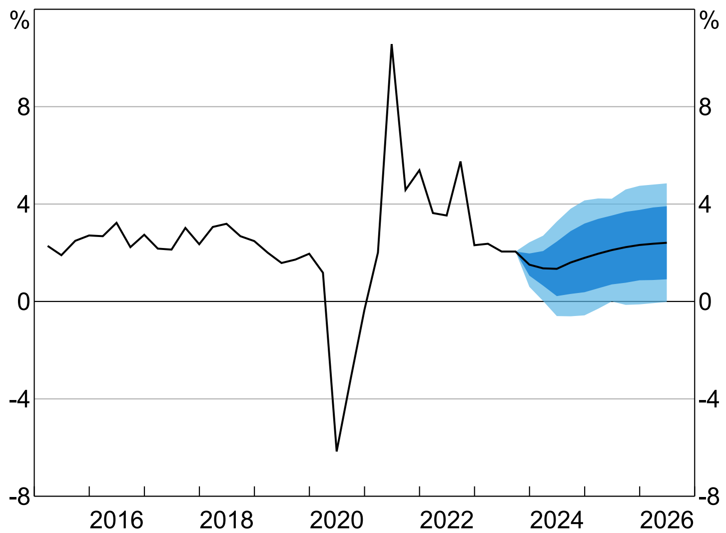
Sources: ABS; RBA.

Later this year, GDP growth is forecast to pick up gradually as the effects of high inflation ease (Graph 7). The impact of earlier increases in the cash rate on GDP growth will also start to fade. This forecast is underpinned by a pick-up in consumption growth as real household income growth turns positive again this year.

Graph 7

GDP Growth Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

There are uncertainties to the outlook

As always, there are a range of uncertainties around these forecasts, and I'll briefly touch on two key ones we have been considering. First, while we have a good idea of how tighter monetary policy has affected household incomes, the full effect on household consumption is still to play out. It is possible that – following a period of large declines in real incomes – households save more of their income than we expect and so consumption remains subdued for longer than anticipated. This would put downward pressure on labour demand and inflation.

But there could also be developments in the economy that would mean it takes longer to get inflation back to target. This could happen if households save less or draw down on their savings to support spending to a greater degree than assumed in our central forecasts. The pressure on labour or non-labour costs could also be more than we expect – for instance, from poor productivity outcomes or unexpected supply shocks. The longer inflation stays away from target, the greater the risk that inflation expectations drift higher. And history shows that, if inflation expectations were to drift higher, it would require more monetary policy tightening and a costly period of higher unemployment to stabilise inflation expectations and return inflation to target.

Full employment and spare capacity

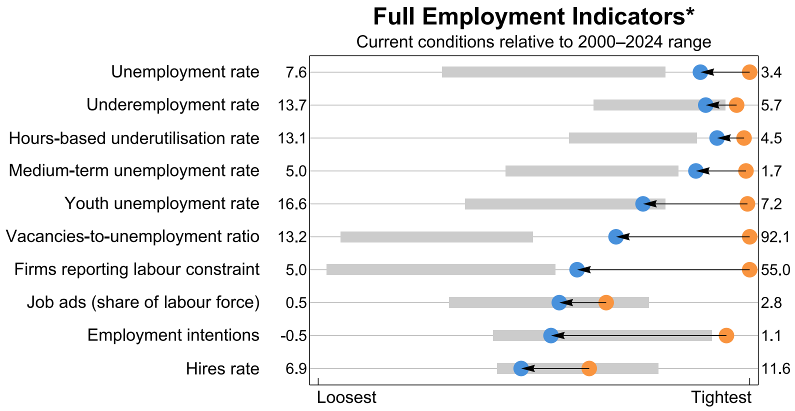
Let me now turn to developments in spare capacity. We have increased our focus on this area in the *Statement*, including by publishing our assessment of spare capacity in the labour market and the economy. We have also published a chapter on full employment in the *Statement*, which explains how we assess full employment, expanding on a speech the Governor made late last year.[2] For monetary policy, full employment is the maximum level of employment that is consistent with low and stable inflation.

I've previously highlighted the challenges around measuring spare capacity in the labour market and the economy.[3] Full employment cannot be observed directly or summarised by a single statistic. Any single labour market indicator provides only a partial view of spare capacity in the labour market. It also changes over time as the structure of the economy evolves.

For this reason, we draw on a broad set of information to form a comprehensive assessment of how close the labour market is to full employment. This information includes labour market data, survey measures, model-based estimates and liaison with businesses. We also seek the views of a wide range of stakeholders. Of course, we also use economic models to infer spare capacity. Each of these models has their own strengths and weaknesses. So, using a number of approaches allows us to capture a better, more diverse range of information and perspectives.

Some of the measures we look at to assess the labour market and full employment are summarised in Graph 8. This graph shows where these measures are currently compared with history. Currently, we assess that most labour market indicators are still looking 'tight' relative to historical norms. Model-based estimates of full employment also suggest that conditions are still tight. But the labour market has eased and is closer to full employment than in late 2022, when we think it was at its tightest in the past two decades. This easing in the labour market reflects the slowdown in economic growth I discussed earlier. Adding to this, labour supply has increased, boosted by elevated population growth and record high participation in the labour force.

Graph 8



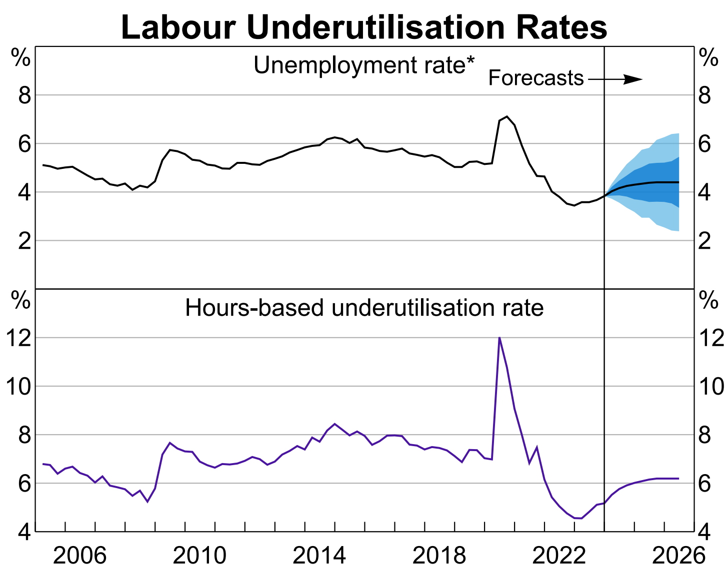
* Blue dots represent current outcomes, orange dots show outcomes at October 2022 and light grey shaded regions cover the middle 80 per cent of observations since 2000.

Sources: ABS; JSA; NAB; RBA.

In addition to spare capacity in the labour market, we also make assessments of demand relative to the economy's capacity to supply goods and services (which is also referred to as potential output). Like full employment, potential output cannot be measured directly, and so we also use a range of indicators. Looking at these measures, we assess that current demand exceeds potential output. Similar to developments in the labour market, though, the recent slowing in economic growth has lessened the gap between demand and supply.

Looking ahead, we expect the labour market to slow in response to the softening in economic growth (Graph 9). We expect much of the adjustment in the labour market to happen through a decline in average hours worked. And, while employment is expected to continue to increase, for a time it is expected to do so at a slower rate than the increase in the working-age population. This means that the unemployment rate is expected to increase, though it is still forecast to remain at low levels relative to the past couple of decades.

Graph 9



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Sources: ABS; RBA.

This easing will contribute to bringing the labour market broadly in line with full employment. Subdued economic growth will also help bring demand and supply in the economy back into balance. We will continue to share our assessment of how conditions in the labour market stand relative to our view of full employment.

Improvements to transparency

I'd like to finish up by highlighting some of the recent changes we have made to improve the transparency of our forecasts and assumptions. These changes will provide greater insights into our economic assessment and a richer view of the inputs to the monetary policy decision-making process. This improved transparency is aligned with the recommendations of the RBA Review, as well as the recently updated *Statement on the Conduct of Monetary Policy*.

Here are three key changes we've made I'd like to highlight:

- First, as I mentioned earlier, we've remodelled the *Statement* by revising its structure, improving its flow and adding an overview that highlights the narrative leading to the policy decision. We've also added a high-level summary to help readers access the key information at a glance.
- Second, we have published our assessments of potential output and full employment in the *Statement*. From here on, these will be a regular feature of the publication.
- Third, we have increased the availability and accessibility of forecast data. This includes increasing the range of forecast variables and assumptions published in the *Statement*. Data files of historical forecasts are also being published in an easily downloadable format. We hope this will help to stimulate external research that could be beneficial to the wider community of economists. I imagine this audience will be keen users of these data!

We have also committed to regularly publish an evaluation of the staff forecasts. Each year, we conduct an internal review of the RBA forecasts and insights from these reviews have been published for the past two years in the November *Statement*. We'll continue to do so going forward. We'll also continue to publish insights from our business and community liaison program as we have been doing since late 2022.

Conclusion

To sum up, inflation is coming down, but it is still high and it will take some time before it is back in the RBA's target range. Inflation is expected to decline to be in the RBA's target range of 2–3 per cent in 2025 and to reach the midpoint of 2.5 per cent in 2026. This decline is based on the central projections that the subdued economic growth that we have forecast will balance demand and supply of goods and services and that in the next couple of years the labour market will be around levels consistent with full employment. Risks remain though and as you'd expect we will continue to monitor incoming data closely.

I also hope you will find the sizeable changes to the *Statement* and the enhanced transparency useful. These changes are a step in a continuous evolution, and like our forecasts, our way of communication will continue to develop.

Thank you for your time.

Endnotes

[*] I would like to thank Ashwin Clarke for invaluable help in preparing these remarks and Susan Black, Fiona Georgiakakis, Callum Hudson, Tom Rosewall and Declan Twohig for their comments and assistance.

[1] Kohler M (2023), '[The Outlook for the Australian Economy](),' Speech at UBS Australasia Conference, 13 November.

[2] Bullock M (2023), 'Monetary Policy in Australia: Complementarities and Trade-offs', Speech at the Commonwealth Bank Global Markets Conference, Sydney, 24 October.

[3] Kohler M (2023b), 'The Outlook for the Australian Economy', Speech at UBS Australasia Conference, 13 November.