5. Economic Outlook

Global economic growth picked up in the second half of 2021 following the lifting of mobility restrictions, and is forecast to remain above trend in 2022. The rapid spread of the Omicron variant of COVID-19 has been disruptive but is not anticipated to have a large or sustained impact on growth. Inflation in many countries has persisted at multi-year highs and has broadened in scope. Central banks in advanced economies still expect inflation to moderate, but have raised their inflation forecasts for 2022 and have emphasised the considerable uncertainty surrounding this outlook (see chapter on 'The International Environment').

The Australian economy had established solid momentum prior to the Omicron outbreak at the end of 2021. Domestic economic activity bounced back strongly in the December quarter, driven by a surge in household spending as restrictions relating to the Delta outbreak were eased. The spread of the Omicron variant will slow growth in the March quarter, but is expected to have a much smaller impact on economic activity than previous waves of COVID-19; activity is forecast to regain momentum in coming quarters. In the central scenario, GDP is forecast to have grown by 5 per cent over 2021, and to grow by around 4¼ per cent over 2022 and 2 per cent over 2023. The unemployment rate is forecast to decline gradually over the forecast period, to 3¾ per cent by the end of 2023 (Table 5.1).

Inflation picked up in the second half of 2021, by more than expected at the time of the November *Statement*, and the outlook for inflation has been revised higher. Consumer price inflation in the December quarter was 1.3 per cent and 3½ per cent over the year, led by increases in the prices of new dwellings, durable goods and fuel. Underlying inflation has also picked up in recent quarters and is forecast to increase further to 3¼ per cent in mid-2022, largely reflecting upstream cost pressures amid strong demand in housing construction and the durables goods sector. Further out, the drivers of inflation are anticipated to shift, with a steady pick-up in labour costs in response to strong labour market conditions forecast to sustain inflation in the top half of the 2 to 3 per cent target range.

In light of the ongoing uncertainty around health outcomes, alternative scenarios for the outlook are considered below. The upside and downside scenarios illustrate two plausible alternative paths for the economy based on different underlying assumptions about health outcomes and how household consumption responds to higher wealth. These factors have implications for the pace of improvement in the labour market and the rate of inflation. Other sources of uncertainty, including the extent of labour market spare capacity and how wages and prices respond to this in the period ahead, are addressed separately from the scenarios.

Domestic activity and inflation are forecast to increase in coming quarters

After a rapid recovery in activity in the December quarter, the effect of the Omicron variant is expected to drag on growth in economic activity during early 2022. With large

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

Per cent

	Year-ended					
	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023	June 2024
GDP growth	5	5	4¼	2½	2	2
(previous)	(3)	(4)	(5½)	(3¼)	(2½)	(n/a)
Unemployment rate[(b)]	4.7	4	3¾	3¾	3¾	3¾
(previous)		(4½)	(4¼)	(4)	(4)	(n/a)
CPI inflation	3.5	3¾	3¼	2¾	2¾	2¾
(previous)		(2¾)	(2¼)	(2¼)	(2½)	(n/a)
Trimmed mean inflation	2.6	3¼	2¾	2¾	2¾	2¾
(previous)		(2¼)	(2¼)	(2¼)	(2½)	(n/a)
	Year-average					
	2021	**2021/22**	**2022**	**2022/23**	**2023**	**2023/24**
GDP growth	4¾	4½	5½	4¾	2½	2
(previous)	(4¼)	(3¼)	(5)	(5)	(3)	(n/a)

(a) Forecasts finalised on 2 February. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing, and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2022 Board meeting. Other forecast assumptions (November *Statement* forecasts in parenthesis): TWI at 60 (62), A$ at US$0.71 (US$0.74) and Brent crude oil price at US$85bbl (US$80bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Mid-year Economic and Fiscal Outlook. 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

numbers of people isolating, many businesses' operations have been disrupted by worker shortages, and total hours worked are forecast to decline temporarily as a result. Household spending, particularly on services, is forecast to be lower than otherwise due to reduced spending by those in isolation and reduced discretionary spending more broadly. However, the effect of Omicron is expected to be limited compared with previous COVID-19 waves as high vaccination rates and less severe health outcomes mean that lockdowns are likely to be avoided.

GDP growth is forecast to strengthen through the middle of this year, with broad-based growth in domestic demand sustained across the forecast period. Consumption is forecast to be supported by strong labour income growth and the large increase in household wealth over recent years. Dwelling investment is expected to remain elevated across the forecast period as the large pipeline of work is progressed. The recovery in business investment that was underway before the Delta outbreak in mid-2021 is forecast to continue, supported by tax incentives, strong corporate balance sheets and the broader recovery in demand conditions. Federal and state midyear budgets point to a stronger outlook for public demand than was previously expected, adding to overall domestic demand growth over 2022. The external sector is forecast to drag on growth as the recovery in domestic demand sees imports grow rapidly, while exports recover more gradually.

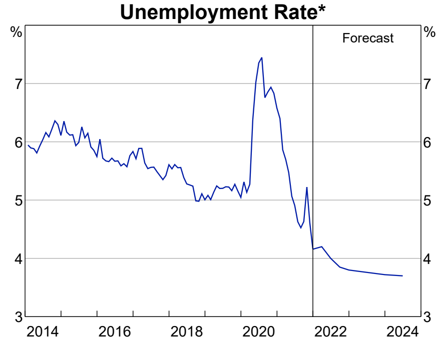
Average hours worked, rather than employment, is expected to bear most of the adjustment to labour supply disruptions in the March quarter. The average number of hours worked per worker is forecast to fall temporarily in early 2022, reflecting a surge in absences in some industries due to Omicron-related illness and isolation requirements. However, the spread of Omicron is expected to have no lasting impact on labour demand. Employment is forecast to grow strongly over the remainder of 2022 before moderating in 2023 in line with growth in activity. Participation in the labour force is forecast to be at a historically high level over the forecast period, supported by the strength in labour market conditions. The unemployment rate is forecast to decline to around 3¾ per cent in the second half of 2022 and edge a little lower thereafter (Graph 5.2). Broader measures of labour underutilisation that include workers who are underemployed are also forecast to decline to their lowest level in many years as firms increase hours of existing staff to meet demand.

The forecast profile for underlying inflation is noticeably higher in the near term, reflecting stronger pass-through of upstream cost pressures to consumer prices than was assumed in the November *Statement* (Graph 5.3). Underlying inflation is forecast to increase to 3¼ per cent by mid-2022 before easing as international and domestic supply chain pressures subside. Further out, the tightening labour market and resulting lift in labour costs is forecast to sustain underlying inflation in the top half of the target range of 2 to 3 per cent. Headline inflation is forecast to be above trimmed mean inflation in the near term (mainly due to fuel prices) but to be broadly in line with underlying inflation thereafter.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing. The forecasts also incorporate other elements of the Bank's monetary stimulus that are currently in place and are reflected in market pricing. The exchange rate and oil price are

Graph 5.2

Unemployment Rate*



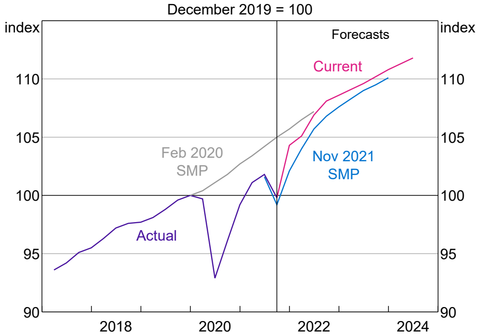
* Actual data is reported on a monthly basis; forecast is projected for each quarter.

Sources: ABS; RBA

Graph 5.1

GDP

December 2019 = 100

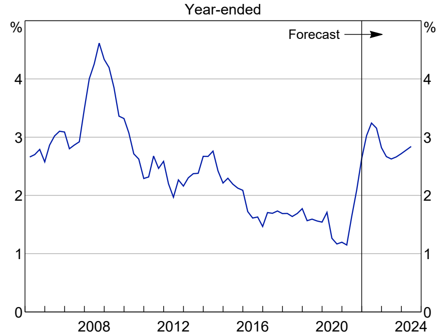


Sources: ABS; RBA

Graph 5.3

Trimmed Mean Inflation

Year-ended



Sources: ABS; RBA

assumed to remain unchanged at current levels. The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's Mid-year Economic and Fiscal Outlook; population growth is expected to recover gradually following the easing of international border restrictions in late 2021. The international border is assumed to reopen to tourists from a wider range of countries over the first half of 2022.

Household consumption, income and saving

Household consumption rebounded strongly in the December quarter as restrictions on activity related to the Delta outbreak were eased and consumption possibilities broadened. Household spending growth is forecast to slow in the March quarter because of precautionary behaviour and lower spending on discretionary goods and services in response to the spread of Omicron, before rebounding across the June and September quarters (Graph 5.4). Further out, the outlook for consumption is supported by strong labour market outcomes, recent increases in household wealth and reduced uncertainty. Strong conditions in the labour market continue to support the outlook for household income via labour income, and are anticipated to offset a decline in non-labour income from disaster payments and other temporary income support measures.

The household saving ratio is forecast to decline in the December quarter, reflecting increased consumption opportunities and lower income support payments. Further out, the saving ratio is expected to continue to decline, while remaining higher than its average level over the five years prior to the pandemic.

Investment

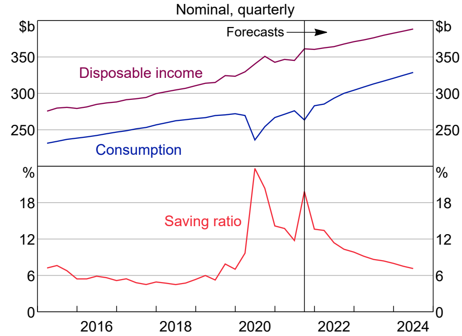
The outlook for investment remains strong with a large pipeline of public and private projects expected to boost activity over coming years (Graph 5.5). Construction activity was resilient in the September quarter as restrictions related to the Delta outbreak were less binding than expected; construction activity is forecast to have increased in the December quarter following the easing of restrictions. The Omicron outbreak is not expected to have a large impact on investment activity in the March quarter. Thereafter, investment is expected to be sustained at a high level across the forecast period.

Fiscal support and monetary easing over recent years have underpinned a strong upswing in housing activity. A large pipeline of residential construction work has commenced and will sustain a high level of construction of new dwellings and renovation activity over coming

Graph 5.4

Household Consumption and Income

Nominal, quarterly

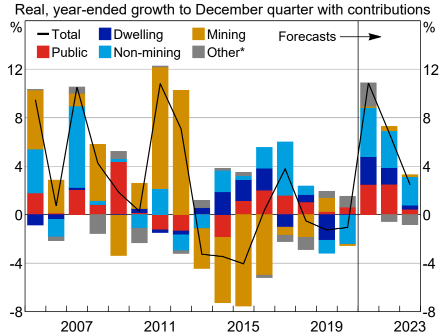


Sources: ABS; RBA

Graph 5.5

Investment

Real, year-ended growth to December quarter with contributions



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

Sources: ABS; RBA

quarters. While a significant share of these projects have been supported by fiscal subsidies such as HomeBuilder, there is also strong underlying demand for new housing and renovation activity. Some part of this is a response to people's experience of spending a greater amount of time at home during the pandemic and a subsequent desire to improve their residences. Recent increases in household income and wealth, alongside the resumption of population growth following the reopening of the international border, are forecast to lead to an elevated level of residential construction for several years.

The momentum established in non-mining business investment in 2021 is expected to be only slightly disrupted by Omicron and, further out, investment should be supported by the broader recovery in domestic demand. This is consistent with large firms' investment intentions having remained steady through the Delta outbreak in the second half of 2021 and firms' ability to adapt to significant restrictions in the September quarter. While the level of non-residential building approvals has picked up (from a low level) over recent months, there is a risk that businesses complete these projects more slowly than usual due to increased workplace absences related to the spread of Omicron. In addition, supply chain bottlenecks and labour shortages are expected to temporarily slow the ongoing expansion in machinery & equipment investment.

Mining investment is forecast to increase a little over coming years. This partly reflects firms undertaking investment to sustain their level of production, rather than to expand capacity. There is little evidence to date that recent large moves in commodity prices have affected the investment plans of the major miners.

Growth in public investment is forecast to remain strong over 2022. The pipeline of public engineering work yet to be completed is significant and will support a high level of public capital expenditure for several years. Infrastructure firms may face difficulty completing the projects as scheduled because of labour shortages in key roles, as well as constraints on the supply of key materials.

Public consumption

Public consumption is forecast to make a larger contribution to domestic final demand growth over the forecast period than was anticipated at the time of the November *Statement*. The upgrade reflects larger programs for public health spending announced in recent federal and state budgets, including additional spending on patient care and accelerated vaccination programs. The response to the Omicron variant, including the booster vaccination program, will further add to public consumption in the near term.

External sector

The volume of exports is forecast to recover gradually towards pre-pandemic levels over the forecast period, driven mainly by a recovery in travel and education exports as the international border reopens. Resource export volumes have been fairly resilient during the pandemic and resource export values were historically high in the second half of 2021, though maintenance and weather-related disruptions weighed on resource production at that time and are expected to persist in the near term. While growth in manufactured exports is forecast to remain subdued over the first half of 2022 due to ongoing global supply chain disruptions, the recent strength in rural exports is expected to be sustained in the near term because of favourable growing and pasture conditions, as well as strong global demand for grains and meat. Import volumes are forecast to increase strongly in line with domestic demand and the reopening of the international border, though this will be partly offset by the dampening impact from higher world prices for traded goods.

The terms of trade is expected to decline over the forecast period after reaching a record high level in the September quarter (Graph 5.6). An increase in energy-related export prices, particularly LNG and thermal coal, is offset by higher import prices in the forecasts. The price of iron ore has been above US$100 per tonne since the end of 2021, but is forecast to gradually decline to around US$80 per tonne by the end of the forecast period.

Labour market

The outlook for the labour market remains strong. By mid-2022, strong demand for labour is expected to translate into a lower unemployment rate, as well as a declining rate of underemployment as firms boost hours of their existing staff to meet demand.

The Omicron wave is expected to temporarily disrupt labour supply. Average hours worked are forecast to decline sharply in early 2022, reflecting a surge in absences due to Omicron-related illness and isolation requirements (Graph 5.7). However, the fall in aggregate hours worked in January 2022 is expected to be smaller than experienced during the formal lockdowns in 2020 and 2021, and hours are forecast to rebound in February and March.

Beyond the near-term, average hours worked are forecast to rise above their pre-pandemic level, consistent with a labour market that is tighter than it has been for more than a decade.

Employment growth is forecast to rise strongly throughout the year after the Omicron-related disruptions subside, before moderating in 2023 in line with slowing activity growth. The unemployment rate is forecast to decline to 3¾ per cent later in 2022; an unemployment rate this low has not been seen in Australia in nearly half a century. The participation rate is forecast to reach a historical high in late 2022, supported by strong labour demand and longer-run structural drivers, such as higher participation rates among females and older Australians.

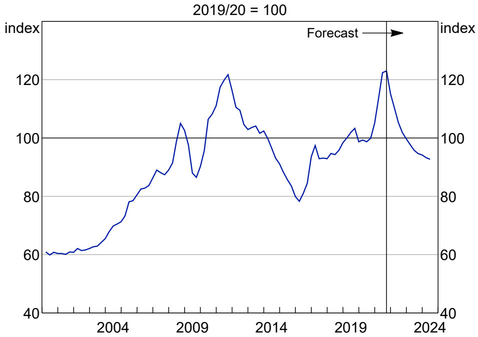
Wages and inflation

Wages growth is forecast to continue to pick up gradually. In the near term, remaining wage freezes are expected to unwind, but most employers in the Bank's liaison program are not expecting wages growth to move beyond the 2–3 per cent range this year. The medium-term outlook for private sector wages growth is stronger than at the November *Statement*, reflecting the upgrade to the labour market forecasts and further absorption of spare capacity. The outlook for broader measures of

Graph 5.6

Terms of Trade

2019/20 = 100

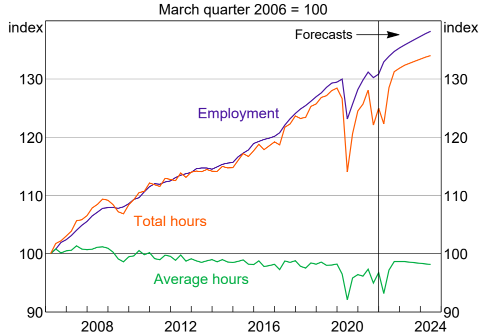


Sources: ABS; RBA

Graph 5.7

Employment and Hours Worked

March quarter 2006 = 100



Sources: ABS; RBA

employee earnings growth has been upgraded more substantially, as bonuses, allowances and other non-base wage payments are expected to respond more quickly to the tightening labour market. Aggregate wages growth outcomes continue to be weighed down by more muted wages growth in public and private enterprise agreements, consistent with announced government wages policies and the multi-year duration of private sector agreements.

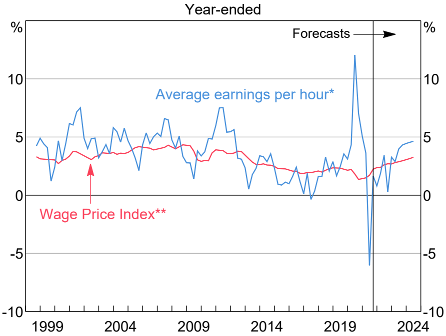
Growth in the Wage Price Index (WPI) is anticipated to pick up to close to 2½ per cent by the end of 2021, which is marginally above its pre-pandemic growth rate (Graph 5.8). WPI growth is then forecast to gradually strengthen further as the unemployment rate declines, to be 3¼ per cent by mid-2024; this would be the fastest pace since 2012.

As the unemployment rate declines, average earnings are forecast to increase at a faster pace than the WPI – the result of an increase in bonus payments, a larger share of hours being worked at overtime rates, and a pick-up in job turnover as workers are more willing to move jobs for higher pay. Increases in the superannuation guarantee rate over coming years are also estimated to increase average earnings growth relative to the WPI. These broader measures of average earnings per hour are forecast to be

Graph 5.8

Wages and Earnings Growth

Year-ended



* Non-farm; includes social contributions; uses hours worked from the Labour Account.

** Excluding bonuses and commissions.

Sources: ABS; RBA

growing strongly later in the forecast period, generating more upward pressure on firms' labour costs than implied by the measure of base wages from the WPI. Growth in firms' unit labour costs (labour costs adjusted for any increases in worker productivity) is expected to pick up in response; this is the measure of labour costs most relevant for inflation.

Near-term inflation outcomes are forecast to be significantly boosted by the pass-through to consumers of upstream cost pressures, including those caused by temporary disruptions to domestic supply chains. As in the latter half of 2021, price increases are forecast to be most evident in durable goods and in the prices of newly constructed homes. For the latter, materials and labour costs have increased as demand has surged and supply chain constraints (including internationally) have become more binding. The treatment of HomeBuilder and similar state government grants by the Australian Bureau of Statistics will continue to have an important effect on measured inflation over the year ahead. As these subsidies conclude and fewer grants are paid, more buyers will pay the full price for dwellings, which will contribute to measured inflation. Year-ended headline inflation in the near term is also supported by high fuel prices; however, headline inflation is expected to move back towards underlying inflation as the effect of the recent run-up in fuel prices wanes over the year ahead (Graph 5.9).

The underlying sources of inflation are expected to shift later in 2022. As the near-term impact from the pass-through of upstream price pressures eases, broader inflationary pressures are forecast to be supported by the gradual absorption of remaining spare capacity in the labour market. In the central scenario, inflation is expected to be around 2¾ per cent by the end of the forecast period.

Domestic risks and uncertainties

Upside scenario: Faster trajectory

A plausible upside scenario hinges on stronger consumption than in the central scenario, driven by a swift resolution of the Omicron outbreak and benign health-related developments further out. This would provide a strong boost to confidence and result in a greater desire on the part of households to spend out of unplanned savings and wealth accumulated during the pandemic. The bulk of this effect is likely to be seen in stronger consumption, although households are also assumed to tap some of the savings accumulated during the pandemic (including, for example, in offset and redraw accounts) to invest in housing renovations, which would further support dwelling investment.

In this upside scenario, stronger activity increases the demand for labour, pushing the unemployment rate down to 3 per cent by the end of the forecast period (Graph 5.10). However, supply constraints in the short term mean that the stronger aggregate demand does not translate one-for-one into output; instead, there is a sharper pick-up in near-term price pressures than typical historical relationships would suggest (Graph 5.11). Further out, the strong underlying demand impulse and tight labour market sees underlying inflation increase steadily to around 3¾ per cent by the end of the forecast period.

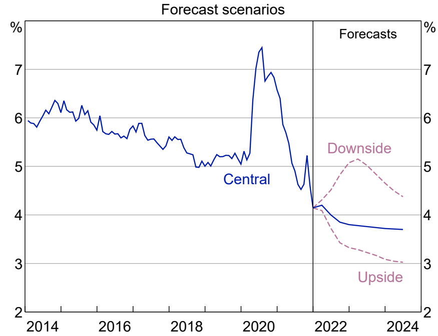
Downside scenario: Slower trajectory

A slower trajectory for the economy could eventuate due to a combination of heightened health-related risk aversion following successive virus outbreaks and a major negative health event, such as a more protracted and damaging Omicron outbreak or the emergence of a new variant. It is plausible that both demand and supply would be negatively affected as a result of a more challenging health situation that leads to a temporary reintroduction of activity restrictions and/or self-imposed restraint by individuals.

Graph 5.10

Unemployment Rate

Forecast scenarios

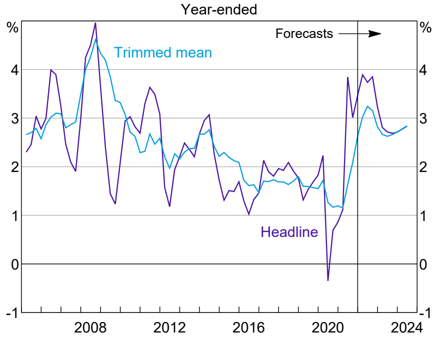


Sources: ABS; RBA

Graph 5.9

Inflation Forecasts

Year-ended

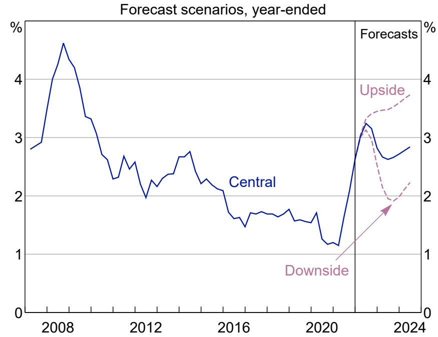


Sources: ABS; RBA

Graph 5.11

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

In this downside scenario, households rein in their discretionary spending on services sharply, which weighs heavily on labour demand. As such, the unemployment rate remains in the 4½–5 per cent range for the remainder of the forecast period, which places downward pressure on wages growth. The adverse health environment would be likely to exacerbate existing supply-side pressures, but persistent weakness in labour market conditions would be sufficient to keep inflation in the bottom half of the target range for most of the forecast period.

Other domestic uncertainties

A larger-than-expected slowing in China's economy would reduce demand for iron ore and other commodities. This would be particularly relevant to Australia if it was driven by a deeper-than-expected decline in construction activity. Alongside lower resource export volumes, this could result in a decline in commodity prices, impacting Australia's terms of trade, corporate profits and tax revenues. Further trade restrictions could also delay the recovery in Australian exports, including the education and tourism sectors.

A key near-term uncertainty for the domestic economy is the way firms and households navigate the challenges from the Omicron wave of infections. Worker absences due to illness and isolation requirements have hampered the ability of the economy to operate at normal capacity. It is possible that supply-side disruptions could be more widespread than assumed, particularly if case numbers increase again. Further disruption to supply chains from COVID-19 variants could have widespread ramifications for the economy, including limited spending due to a narrower range of goods and services available for consumers as well as deferred investment. Limited availability of some products could also lead firms to reduce discounting activity by more than expected, leading to additional inflationary pressure in the near term. While the central scenario assumes these effects are largely confined to the March quarter, the longer the disruption is sustained, the greater the risk of lasting effects on the economy.

An important source of uncertainty for the outlook is the extent of spare capacity in the economy and how prices and wages respond as this is absorbed. The available evidence suggests that supply constraints, such as in construction and durable goods markets, are mostly related to the combination of strong demand and the inability of supply to respond in a timely way, in part because of temporary disruptions caused by the virus. These constraints could intensify or persist for longer than expected, as they have in some other economies. Capacity pressures could lead to some investment projects being rationed or delayed, resulting in lower output growth than otherwise. With time, businesses will be able to invest to expand their capacity to deliver goods and services, but in the interim there could be a period of stronger-than-expected growth in prices due to binding capacity constraints. Price pressures could also be more material than has been assumed in the central scenario, particularly if increases in input costs faced by some firms feed through to larger and ongoing price increases for consumers.

In the labour market, the central scenario assumes that acute labour shortages remain confined to pockets of the economy, but these could become more widespread. Growth in labour supply could also be constrained, even as activity picks up, if there are persistent isolation requirements due to ongoing virus outbreaks. On the other hand, there could be more spare capacity in the labour market than expected if firms are able to rely more heavily on other margins of adjustment (such as increases in hours worked rather than headcount) or if labour market participation increases by more than forecast. Contributing to the uncertain outlook for the labour market is the timing of domestic and international borders reopening, and the resultant effects on labour supply across regions, industries and occupations.

The unemployment rate is forecast to decline below 4 per cent in the second half of 2022, resulting in a steady pick-up in wages growth and inflation. This rate of unemployment has not been seen in Australia since the 1970s. As there is little recent experience to draw on, and the longer-term effects of the pandemic on potential growth and full employment are uncertain, it is possible that wage and price pressures build more quickly or slowly than envisaged in the central scenario. The outlook for inflation could also be influenced by an extended period of high inflation outcomes in the near term, including internationally, resulting in workers demanding higher wages as compensation; if employers pass these increased wage costs on to consumers, this would feed back into higher inflation outcomes.

The outlook for asset prices and households' use of savings accumulated over the pandemic are further sources of uncertainty for the outlook. If the willingness of households to spend from these liquid savings is higher than from other forms of wealth, consumption (or dwelling investment) would be stronger than envisaged in the central scenario. More broadly, these additional savings are small relative to the increases in household wealth from higher housing prices over recent years. But asset prices could be higher or lower over the forecast period as a result of changes to housing demand and supply as well as other factors, with consequent implications for consumption and activity.