

# Overview

Inflation in Australia has passed its peak but is still too high and is proving more persistent than expected a few months ago. CPI inflation remains above 5 per cent in year-ended terms – well above the Bank’s inflation target of 2–3 per cent. Underlying inflation is higher than was expected at the time of the August *Statement on Monetary Policy*. While goods price inflation has continued to moderate largely as expected, the prices of many services are rising briskly. Services price inflation reflects primarily domestically sourced costs for labour and non-labour inputs and demand pressures; services price inflation in many other advanced economies has been slow to decline. Consistent with the signal from inflation, recent indicators of activity also point to growth in the economy having been a bit stronger this year than had been expected.

The economy has been growing below trend this year, as it has slowed in response to high inflation and the cumulative increase in interest rates. In particular, cost-of-living pressures have weighed on people’s real incomes and, consequently, growth in household consumption has been weak. Even so, output growth this year has had a bit more momentum than was expected three months ago, which is partly the result of stronger-than-expected growth in population, as well as more strength in the growth of private and public investment. Business investment and public demand are expected to continue to contribute to output growth in coming quarters, supported by strong population growth, an easing in supply

constraints and a large pipeline of projects, including for public infrastructure.

A period of below-trend growth in the economy is helping to achieve a better balance between the level of demand and supply, which will help to reduce inflation further over time. Output growth is expected to remain below trend over 2023 and 2024, but the outlook over the next year has been revised higher compared with three months ago, consistent with lingering demand pressures in the economy. Inflation is expected to decline more gradually than previously forecast. Inflation is forecast to decline to around 3½ per cent by the end of 2024 and to reach a little below 3 per cent at the end of 2025.

Conditions in the labour market have gradually eased across a range of measures, but they remain tight. Employment growth has slowed from its strong pace late last year and it is now roughly keeping pace with growth in working-age population. Firms have been adjusting hours worked by staff in response to easing demand growth in the economy. This has seen the underemployment rate pick up a little more than the unemployment rate recently, but both remain low by historical standards. Recent strong population growth has added to the supply of labour while also adding to aggregate demand.

The number of employed persons is expected to continue increasing over the period ahead but to grow more slowly than the working-age population for a period, reflecting the expectation that the economy will continue to grow

below trend. The unemployment rate is expected to rise gradually over the next year, to 4¼ per cent from late 2024, which is a more moderate increase than previously forecast.

Wages growth picked up a little further in the September quarter, according to a range of timely indicators. Some further increase was expected because of the previously announced increase in award wages, as well as the ongoing tightness in the labour market and recent changes to public sector wage policies. However, the labour market is not as tight as it was and liaison with firms suggests there has been a moderation in wages growth in some jobs and industries. Even so, the cost of labour for firms also depends on growth in labour productivity, which has been very weak. As a result, growth in the cost of labour is very high and is adding to firms' overall cost pressures; the forecasts assume that productivity growth will pick up, which will be needed for labour cost growth to be consistent with the inflation target.

Some of the earlier tightening in monetary policy is still working its way through the economy. Scheduled mortgage payments have increased in recent months and will rise somewhat further as borrowers with very low fixed-rate loans roll off onto higher mortgage rates. Housing credit growth has remained steady at much lower levels than a year ago, although there has been a modest increase in new housing loans since earlier in the year alongside rising housing prices. The Australian dollar has been little changed over recent months, remaining close to the lower end of its range of the past year.

Consumption growth has been particularly weak this year, as high inflation as well as higher interest rates and tax payable have resulted in declines in real household disposable income. These factors are expected to continue to weigh on growth of real incomes and consumption for a time. As inflation continues to moderate over the coming year or so, real household incomes

are expected to grow again and support consumption growth. Higher housing wealth is also expected to provide some support, as housing prices have risen noticeably to be back around their 2022 peaks. However, the support they provide to consumption growth may be less than usual given low housing turnover and modest credit growth. Overall spending in the economy has been supported this year by a rebound in international students and tourists, which in turn has supported consumer-facing firms in the economy.

Growth in household consumption remains a key source of uncertainty for the economic outlook. Many households are experiencing a painful squeeze on their finances, through higher inflation and interest rates. At the same time, many are benefiting from rising housing prices, substantial savings buffers and higher interest income. Consumer spending could be stronger than anticipated if employment growth does not slow as much as expected, if spending responds more strongly to higher housing prices than assumed or households draw more heavily on their savings buffers. On the other hand, the current weakness in household consumption growth could persist for longer than expected. This could arise if weak real household disposable income has a larger-than-anticipated effect on spending, particularly for households on lower incomes, which typically have lower savings buffers.

There are both upside and downside risks to the outlook for inflation. Domestic demand pressures on inflation could be more persistent than anticipated – for example, if growth in consumer spending or investment were stronger than forecast – and cost pressures on inflation could be accentuated by supply-side shocks from the conflicts abroad or the El Niño weather pattern. With inflation remaining high and forecast to decline more gradually than anticipated three months ago, inflation expectations might drift higher, which could further

delay the return of inflation to the target range. Conversely, domestic demand pressures on inflation could ease faster than expected, particularly if some of the downside risks to consumption growth were to be realised, and global disinflationary pressures could be greater than assumed, particularly if downside risks to the outlook for global economic activity were to materialise.

Persistently high inflation remains the major concern for central banks in advanced economies. Headline inflation has edged higher over recent months because of increases in fuel prices. Core inflation has continued to decline in year-ended terms, but progress has been gradual because core services inflation has been declining only slowly as demand for services has been relatively strong and labour markets have remained tight. The risk that inflation takes even longer to return to target has increased.

Government bond yields at longer maturities have increased over recent months. Policy-makers at several advanced economy central banks have suggested that the tightening in financial conditions associated with higher longer term yields could reduce the need for further increases in policy rates in their economies. Market participants expect policy rates in most advanced economies will be held at or near current levels until at least mid-2024.

The near-term outlook is for relatively weak output growth in Australia's major trading partners, with risks tilted to the downside. Growth is expected to slow from 3½ per cent in 2023 to 3 per cent in 2024, well below average growth in the decade prior to the pandemic. In China, the potential for larger negative spillover effects from the weak property sector to the broader economy and financial system remains a significant downside risk to the outlook there. In advanced economies, a key downside risk to near-term output growth is whether financial conditions tighten further, which could be because central banks decide they need to raise

rates further to bring about a faster decline in inflation. The Hamas–Israel conflict is adding uncertainty to the global economic outlook and poses an upside risk to inflation if it disrupts regional energy markets or trade.

At the November meeting, the Reserve Bank Board decided to raise policy rates by a further 25 basis points, bringing the cumulative increase over this tightening cycle to 425 basis points. The Board had held rates steady at the previous four meetings. It had judged that higher interest rates were working to establish a more sustainable balance between supply and demand in the economy. This had allowed the Board to wait for additional evidence about the evolving state of the economy and to consider an updated set of forecasts. It also allowed the Board to further assess how the increase in interest rates to date was affecting the economy and the outlook, recognising that monetary policy works with a lag. At these previous meetings, the Board had noted the upside risks to growth and inflation, but it was also mindful that there were scenarios where growth in the economy could slow more sharply than anticipated, which could result in an earlier return of inflation to target. The Board had therefore signalled that further rate rises may be required to bring inflation back to target within a reasonable timeframe.

Taken together, the data received over recent months indicate that the domestic economy has been a bit stronger than previously thought and capacity utilisation remains high. The labour market remains tight and, while wages growth looks to have stabilised overall, unit labour costs are still growing very strongly. New loan approvals have been increasing and housing prices have been rising across the country. Consumer prices are rising briskly, particularly in market services and rents, and the inflationary pressures in these components are expected to take some time to dissipate. The latest readings for underlying inflation mean that there is now

likely to be less progress in bringing inflation down over the next few quarters than had been thought a few months ago. In many respects, conditions in Australia continue to echo developments in other advanced economies, where progress in bringing inflation down has slowed, services price inflation remains high and labour markets remain relatively tight.

The weight of recent information suggests that the risk of inflation remaining higher for longer has increased. The updated forecasts have inflation in Australia higher in the near term and taking a bit longer to return to the top of the Bank's target range. The forecasts assume a path for the cash rate that is in line with financial market pricing and market economist expectations, and therefore incorporate some increase in the cash rate. In addition, there is potential for further upside surprises to inflation, both because domestic inflationary pressures are persisting and because of external factors, such as potential global energy market disruptions and the prospect of higher food price inflation related to El Niño.

While it has been reassuring that medium-term inflation expectations have remained anchored to date, some measures have recently been edging up. These could rise further if upside risks to the forecasts were to materialise. Rising inflation expectations would add to inflationary pressures, especially if productivity growth remains subdued. This would require a prolonged period of below-trend growth, and lower employment, to reverse. It is important to avoid this given the significant costs involved, namely even higher interest rates and a larger rise in unemployment.

At its November meeting, the Board also considered the option to continue to hold policy rates steady. The arguments in support of this are that inflation expectations remain consistent with the inflation target despite the recent up-tick in some measures and wages growth looks to have stabilised. The economy is

growing below trend and labour market conditions are gradually easing. It is possible that productivity growth picks up as pandemic disruptions fade, which would help to reduce the growth of unit labour costs. As such, it is still possible that inflation will return to target in a reasonable timeframe. A further pause could also allow further time to consider how the evolving situation in the Middle East will affect the outlook for global activity and energy prices.

The Board judged, however, that an increase in interest rates in November was warranted to be more assured that inflation would return to target in a reasonable timeframe. High inflation makes life difficult for everyone and damages the functioning of the economy. It erodes the value of savings, hurts household budgets, makes it harder for businesses to plan and invest, and worsens income inequality. The Board is also mindful that many households are facing a painful squeeze on their budgets, both from high inflation and the increase in mortgage rates to date. There are also economic and social benefits in preserving as much of the gains in the labour market as possible. Weighing all these considerations, the Board judged that, after holding policy rates steady for the past few months, it was appropriate to raise rates at the November meeting.

The Board's priority is to return inflation to target. Whether further tightening of monetary policy is required to ensure that inflation returns to target in a reasonable timeframe will depend upon the data and the evolving assessment of risks. In making its decisions, the Board will continue to pay close attention to developments in the global economy, trends in domestic demand, and the outlook for inflation and the labour market. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that outcome. ✎