Statement on Monetary Policy

MAY 2022

RESERVE BANK OF AUSTRALIA

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Statement on Monetary Policy enquiries:

Secretary's Department
Tel: +61 2 9551 8111
Email: rbainfo@rba.gov.au

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Overview

Global inflation is high and is likely to remain so for a while, given recent supply-side shocks. Energy and food prices have increased sharply following Russia's invasion of Ukraine. The spread of COVID-19 in China is disrupting production there, which will add to existing challenges in global supply chains. Core inflation is also high in a number of economies where strong demand has outpaced growth in supply capacity, although it is not quite as high as headline inflation. Many central banks have responded to inflation developments by withdrawing some of the extraordinary policy support that was put in place during the height of the pandemic.

Despite low unemployment rates, wages growth has not kept pace with inflation, so real wages have declined – in some cases noticeably. Consumer sentiment has fallen significantly in many advanced economies, with concerns about declining real incomes and the cost of living frequently cited as the reason for this. The dampening effect on consumer spending can be expected to be cushioned to some extent by the strength of household balance sheets and, in some economies, continuing fiscal support and scope for current high rates of household saving to return to more normal levels.

Inflation in Australia remains lower than in many other advanced economies, but it has picked up faster and to a higher level than previously expected. Headline inflation was 2 per cent (seasonally adjusted) in the March quarter and 5.1 per cent over the year. While petrol prices and other global factors contributed significantly to the quarterly outcome, the sources of inflation are broadening. Firms are increasingly passing on cost increases as supply chain pressures have persisted and demand has remained strong. Trimmed mean inflation was 1.4 per cent in the quarter and 3.7 per cent over the year.

The outlook for inflation is also materially higher than envisaged three months ago. Headline inflation is now expected to peak at around 6 per cent in the second half of this year, partly driven by higher petrol prices and sharp increases in the cost of new dwellings. Trimmed mean inflation is expected to peak at around 4¾ per cent. As the supply-side disruptions start to ease, inflation is expected to decline from these peaks. However, with labour market conditions being the tightest they have been for a long time, growth in labour costs is expected to pick up further in the period ahead. Inflation is expected to return to the top of the 2 to 3 per cent target range in 2024.

The labour market has improved further and demand for labour is strong. The unemployment rate reached 4 per cent in recent months and measures of underemployment have also declined. The level of job vacancies is very high, at a time when the participation rate and the ratio of employment to working-age population are already at historical highs. The unemployment rate is therefore forecast to decline further, to around 3½ per cent in early 2023. This would be its lowest level in almost 50 years.

Wages growth was subdued through 2021, recovering to the low rates seen before the pandemic. Labour cost pressures are building,

however, with an increasing share of liaison contacts now reporting that they are paying larger wage increases or that they expect materially higher wages growth over the coming year. Business surveys are also consistent with a pick-up in labour costs, as is the rise in job turnover. Many employers are reporting difficulties finding workers with the appropriate skills and that they are having to offer higher wages and other non-wage remuneration to attract and retain staff.

More broadly, the Australian economy remains resilient and is expected to grow strongly this year. GDP is forecast to expand by 4¼ per cent over 2022. Growth is expected to moderate thereafter, to 2 per cent over 2023, as the recovery matures and as extraordinary policy support is withdrawn. The expansion is likely to be driven by robust consumption growth as spending on discretionary goods and services continues to recover, underpinned by strong household balance sheets and high real household disposable income, despite rising prices.

Housing construction has been supported by specific policy measures and the low level of interest rates, as well as an apparent increased preference for more space in homes. The resulting large pipeline of work yet to be done will underpin a high level of dwelling investment over the period ahead. However, shortages of labour and materials are limiting the pace of work and contributing to delays in completions. Demand for housing finance has been robust and housing credit growth remains strong, but broader housing market conditions vary across the country. In Sydney and Melbourne, established housing prices are declining and rental inflation has been subdued. Elsewhere, housing markets are tight, with prices and rents both increasing strongly and the available stock for sale or rent at low levels.

The outlook for business and public investment spending is also positive; although, in both cases, capacity constraints and disruptions to supply chains are posing an increasing challenge. An upswing in non-mining business investment is expected to resume in the period ahead, after pausing in the second half of 2021. Growth in business debt remains strong. Public investment is expected to be strong for several years as the current pipeline of large infrastructure projects is worked through and new projects commence.

Both the global and domestic outlooks for growth and inflation involve considerable uncertainties stemming from various supply-side factors. The challenges arising from the pandemic are being exacerbated by renewed disruptions in China, and developments associated with Russia's invasion of Ukraine are unpredictable. It is uncertain how consumer demand will react to rising prices and to the withdrawal of policy stimulus that can be anticipated in many economies in response to heightened inflationary pressures. Relatedly, in tight labour markets and given high and rising inflation, workers might seek larger wage increases to compensate for the loss of purchasing power; however, it is difficult to predict how successful these efforts will be and, if they are, how quickly that could occur. These uncertainties are salient in Australia, where there is little recent experience of how the labour market and inflation might behave when unemployment is as low as it is currently.

Even as many central banks begin to withdraw some of the substantial stimulus implemented during the pandemic, macroeconomic policy settings remain supportive of growth across advanced economies. Globally, financial conditions have become slightly less accommodative but have generally remained supportive, including in Australia. Bond yields have increased and equity prices have declined as market participants have revised their expectations about global inflation and growth and, relatedly, the paths for policy interest rates. The

Australian equity market has outperformed other markets, as resources companies have benefited from high commodity prices. Fixed borrowing rates have increased broadly in line with bond yields and other market interest rates; however, overall, interest rates remain low for most borrowers in Australia and in other advanced economies. China has been an exception to the shift towards withdrawing policy stimulus; monetary and fiscal policy are being eased there to support growth in the context of the current disruptions. The US dollar has appreciated significantly this year, particularly against the yen, reflecting that there has been very little change to the expected path of policy rates in Japan. The Australian dollar is higher than at the start of this year, despite depreciating recently.

The economic impact of Russia's invasion of Ukraine outside those two economies has been manifested in higher commodity prices. High commodity prices are adding to upstream price pressures but, in commodity-exporting economies such as Australia, they are also boosting national income. As a result, Australia's terms of trade are likely to reach a new peak in the first half of 2022 and thereafter remain generally higher than previously envisaged.

At its recent meetings, the Reserve Bank Board considered the rapidly evolving outlook. Inflation has increased faster than expected as global supply-side disruptions persist and multiply in the face of strong demand. Indeed, there are signs that domestic price and labour cost pressures are broadening and building. The economy has been more resilient than expected in recent months, and is much stronger now than when the current very supportive policy settings were put in place. Australia is also closer to full employment.

The tight labour market and environment of higher inflation mean that an increasing number of firms are paying higher wages and other benefits to attract and retain staff. While aggregate wage growth picked up during 2021, it was no higher than prior to the pandemic. However, the more recent evidence from liaison and business surveys is that larger wage increases have been occurring, or are planned, in many private-sector firms.

At its May meeting, the Board judged that some withdrawal of the monetary support provided through the pandemic and a start to the process of normalising interest rates is appropriate, given both the progress towards full employment and the evidence on prices and wages so far. It therefore increased the cash rate target by 25 basis points to 35 basis points. It also increased the interest rate on Exchange Settlement balances from zero per cent to 25 basis points.

Consistent with this assessment, the Board will not reinvest the proceeds of maturing government bonds and expects the Bank's balance sheet to decline significantly over the next couple of years as the Term Funding Facility comes to an end. The Board is not currently planning on selling the government bonds that the Bank has purchased during the pandemic.

The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time. This will require a further lift in interest rates over the period ahead. The Board will continue to closely monitor the incoming information and evolving balance of risks as it assesses the timing and extent of future interest rate increases.

1. The International Environment

The upward pressure on inflation evident over the second half of 2021 has persisted and the global economic outlook remains uncertain. Inflation in many advanced economies increased in March and is now expected to reach 6–9 per cent during 2022, 1–2 percentage points higher than forecast earlier in the year and well above central banks' inflation targets. The recent increase in inflation largely reflects the increase in energy, food and other commodity prices associated with the Russian invasion of Ukraine, but inflation pressures are broad based. At the same time, goods production in China is being disrupted by the widening spread of COVID-19 and associated restrictions. These supply shocks are affecting the global economy at a time of limited spare capacity – unemployment rates are at generational lows and job vacancy rates at historical highs in a number of economies.

The rise in inflation has exceeded the increase in wages growth, eroding households' purchasing power across a wide range of economies. Lower-income households are particularly affected by higher fuel and food prices. The impact of higher commodity prices will boost national incomes for some economies but be negative for overall global growth. European economies are especially affected, due to their reliance on Russian gas. More generally, higher commodity prices transfer income from commodity importers to commodity exporters, who will tend to save much of the additional income.

Central banks in many advanced economies have begun to withdraw the extraordinary monetary stimulus introduced during the pandemic by increasing policy rates and announcing plans to reduce their asset holdings. This reflects the increase in inflationary pressures, including from tight labour markets in many economies, and a desire to avoid the risk that high inflation causes a noticeable increase in longer-term inflation expectations. Many central banks have signalled that further policy rate increases are likely in the near term. Government bond yields have risen considerably, and financial conditions for households and businesses have become less accommodative in many economies. Central banks in emerging markets – including in Asia – have already increased policy rates or are expected to start raising rates in the next few months, in response to rising inflation.

In China, conditions have become significantly more challenging as a result of the recent outbreaks of COVID-19 and stringent restrictions on mobility in some cities. Restrictions have reduced consumer spending and the production of manufactured goods, adding to the challenge facing the government in meeting its recently announced growth target. Fiscal policy settings had already turned expansionary earlier this year, as the authorities' priorities shifted towards stabilising economic growth; however, they have announced additional targeted measures in recent weeks as risks to growth have increased. Chinese authorities have also eased monetary policy since the previous *Statement*, but by less than markets had expected.

Table 1.1: Commodity Price Growth[(a)]

SDR terms; percentage change

	Since previous *Statement*	Over the past year
Bulk commodities	11	72
– Iron ore	–1	–13
– Coking coal	6	368
– Thermal coal	45	364
LNG – Asia spot price	–6	165
Rural	12	42
Base metals	4	43
Gold	9	6
Brent crude oil[(b)]	16	105
RBA ICP	11	51
– Using spot prices for bulk commodities	7	61

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

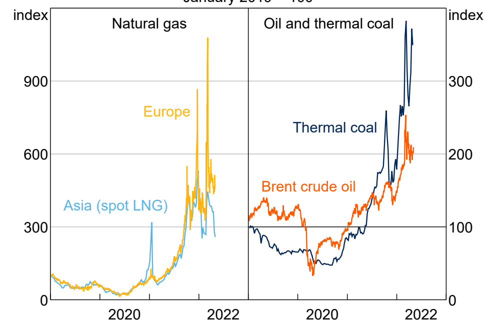
(b) In US dollars.

Sources: Bloomberg; McCloskey by OPIS; RBA

Commodity prices have risen since early February

The prices of thermal coal and European gas have risen by 30–40 per cent since the start of February, while the price for oil is around 20 per cent higher (Graph 1.1; Table 1). These increases follow the invasion of Ukraine, as official sanctions and other private sector decisions have led to significant disruptions to global trade and financial flows with Russia – the world's largest exporter of natural gas and the second-largest exporter of crude oil. However, the price of Asian gas – which is most relevant to Australia – diverged from that in Europe during April to be lower than at the start of February (but still well above its 2021 average). The disruption to the global supply of energy has added pressure to what was an already tight market, in large part due to strong underlying demand conditions ahead of the conflict. While market participants generally expect commodity prices to ease from current high levels, analyst forecasts and market pricing imply that prices for energy commodities are still expected to be at least 70 per cent higher by the end of the year than at the start of 2021.

The United States, the United Kingdom, the European Union and Japan have all announced or are considering bans on crude oil or coal imports from Russia; collectively, this amounts to about 5 per cent of world crude oil and thermal coal trade. A number of global energy firms have also decided to cease buying Russian oil. In addition, many countries have prohibited new investment in Russian energy projects and



several private firms have sold or written down their investments in Russia. To offset this reduction in crude oil supply, members of the International Energy Agency (and particularly the United States) have released oil from their strategic reserves. This is equivalent to slightly less than half the reduction in their imports from Russia over the next six months. At the same time, it is possible that some non-sanctioning countries purchase more oil from Russia and less from elsewhere.

Russian gas supplies to Europe have mostly continued. However, Russia suspended deliveries to Poland and Bulgaria in late April and the risks that trade between Europe and Russia might cease more broadly, or that critical infrastructure will be damaged by the war, have contributed to a high and volatile risk premium on gas prices. The European Commission has proposed to reduce dependency on Russian gas by two-thirds by the end of 2022. This is possible if Europe increases other LNG imports and reduces gas consumption. Some ways of reducing consumption are relatively costless (e.g. by modestly reducing demand for heating), but a large reduction would be costly for economic activity.

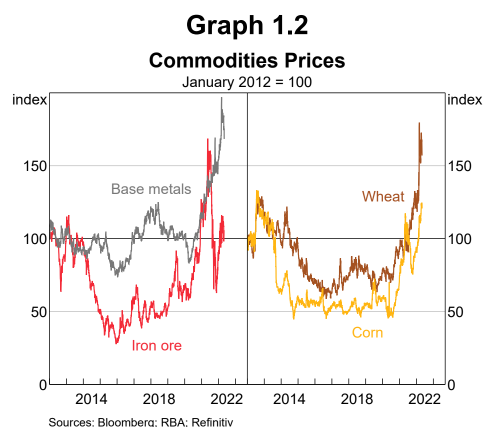
The war has also caused significant disruption to agricultural supply chains, particularly for wheat (Graph 1.2). Global wheat prices have increased by around 30 per cent since February, reflecting the fact that Ukraine and Russia collectively account for nearly 30 per cent of global exports. In addition, disruptions to the supply of nitrogen have caused fertiliser prices to rise sharply, which may reduce global crop yields in the year ahead if farmers respond by restricting their use of fertilisers.

Supply concerns and higher energy prices have also supported the prices of base metals and some other minerals. This includes aluminium, nickel, palladium and various noble gases – commodities that are either energy-intensive to produce, or notably supplied by Russia or Ukraine. Prices for iron ore have also increased by 20 per cent since the start of the year, as strength in Chinese infrastructure investment has outweighed concerns about the impact of the Omicron outbreak and the recent tightening of the annual limit on steel production (see below). Trade routes for Ukrainian iron ore (which accounts for around 3 per cent of global iron ore exports) have also been blocked.

COVID-19 restrictions in China are amplifying supply chain challenges

The outbreak of COVID-19 in China continues to place additional pressure on the supply chains for manufactured goods. While case numbers have been low in an international context, the authorities have continued their strategy of seeking to suppress the virus, including through very strict restrictions on movement in a number of cities. With the south-east of the country serving as the gateway for more than half of China's trade, outbreaks and restrictions there could materially disrupt the export of manufactured goods.

Exports from China declined in March, but remained above the levels of mid-2021 (Graph 1.3). The fall reflects reduced traffic through the port of Shenzhen in mid-March associated with restrictions to stop the virus spreading (with other ports only partly able to



offset this). Restrictions in Shenzhen were eased in late March and throughput quickly recovered, but the lockdown in Shanghai since that time saw throughput at that port fall in April. Various adjustments, including some factories establishing worker 'bubbles' that allow production to continue, have mitigated the fall in exports to date; however, disruptions to goods distribution domestically mean these responses will be less effective the longer restrictions are in place (see below).

Various measures of supply chain pressures remain elevated, although they have generally eased from their recent peaks. Global shipping costs are the main exception and have risen further, with the increase in oil prices in recent months adding to the cost of transport (Graph 1.4). The price of semiconductors has also risen modestly due to concerns that supply could be disrupted by the reduced supply of neon – a key input for which Ukraine makes up around half of global supply. However, these factors are yet to be reflected in survey measures of supply constraints; while supplier delivery times are still significantly elevated, they have eased from their 2021 peaks in countries other than China. One reason for recent easing could be that labour supply has improved in advanced economies since early in the year, as the number of workers who are sick or isolating due to COVID-19 has declined.

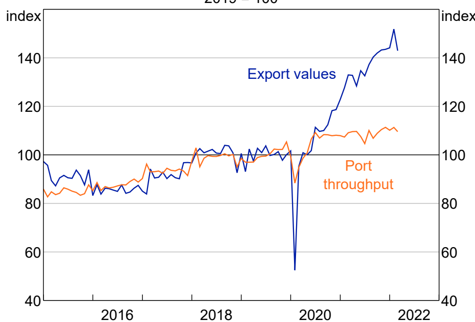
These disruptions are adding further impetus to inflation

Year-ended inflation in major advanced economies picked up in March. For most, headline inflation is in the 5–8 per cent range. The increase in inflation in the early part of this year reflects the surge in wholesale oil prices flowing through to consumer petrol prices (Graph 1.5). Higher prices for energy and food are expected to continue to be passed through into higher consumer prices over the rest of the year. Professional forecasters expect headline inflation to peak at around 6–9 per cent in many advanced economies, 1–2 percentage points higher than had been expected late last year.

Core inflation is also well above its pre-pandemic average across a wide range of economies, with the notable exceptions of China, Japan and some parts of Asia where activity remains depressed (Graph 1.6). Recent monthly growth rates show little sign of an easing in core inflation. High rates of underlying inflation are consistent with broad-based inflationary pressures associated with the lack of spare capacity in many economies, including in labour markets. Inflation continues to be more

Graph 1.3

Chinese Export Indicators*

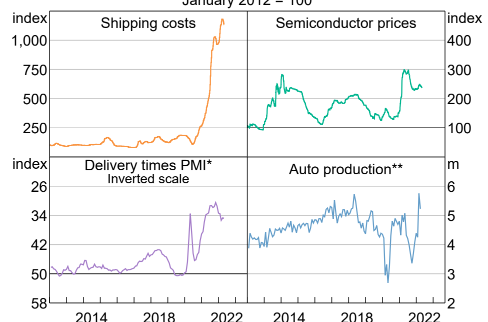


* Seasonally adjusted by the RBA.

Sources: CEIC Data; RBA

Graph 1.4

Supply Indicators



* Purchasing Managers' Index; excluding China.

** Top five producing countries.

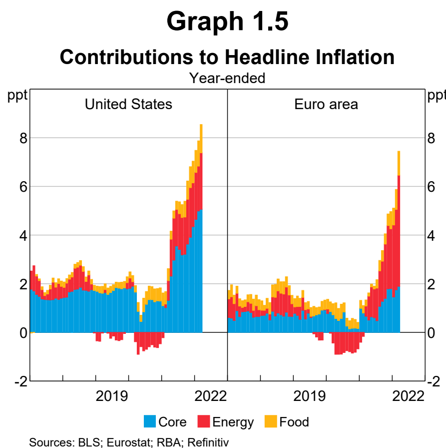
Sources: IHS Markit; RBA; Refinitiv

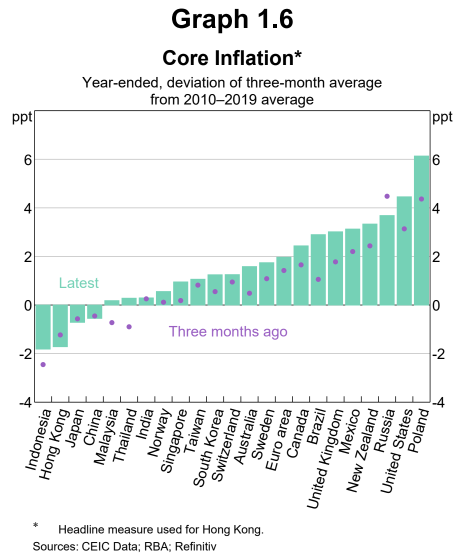
rapid for goods than services, and further disruptions to global supply chains could exacerbate this. Inflation in the price of consumer services – which comprises a much larger share of the basket and tends to be more persistent – has, however, increased to be above historical norms in many economies. Inflation could increase further in the year ahead if rising inflation expectations feature in wage- and price-setting behaviour. Measures of near-term consumer and business inflation expectations are substantially elevated relative to recent decades, and measures of longer-term expectations derived from financial markets have also lifted moderately (see below).

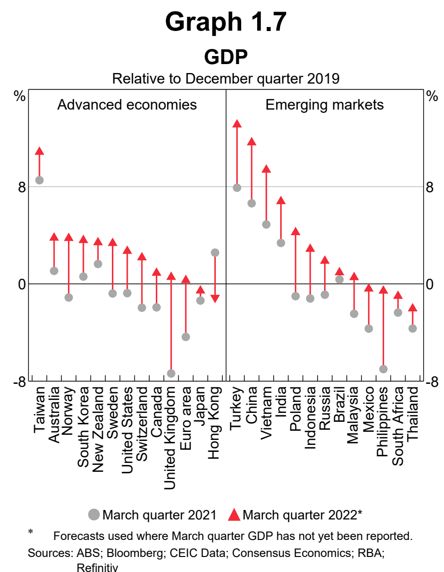
These supply disruptions occurred amid strong demand and tight capacity

GDP increased strongly in most economies over the year to the March quarter (Graph 1.7). In advanced economies, this strength was underpinned by the relaxation of mobility restrictions, expansionary monetary policy and the ongoing boost from generous fiscal support during the pandemic. Goods consumption has remained robust even as services consumption has picked up, supported by strong household incomes and accumulated savings. Household saving rates generally remain above pre-pandemic levels (the United States is a notable exception), suggesting the recovery in consumption has further potential. In many emerging market economies, the recovery has been sizeable but less complete than in advanced economies, largely due to their more limited capacity to provide fiscal support and ongoing weakness in international tourism.

The strong recovery in many advanced economies has seen unemployment rates fall to

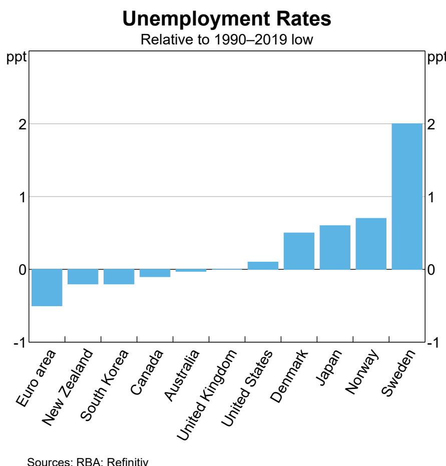






around generational lows (Graph 1.8). Broader measures of labour market conditions also show considerable strength. Employment has risen strongly and job vacancies are around record highs, particularly in the leisure and hospitality industry that is now recovering strongly. In many economies, measures of underutilisation have decreased by more than unemployment rates.

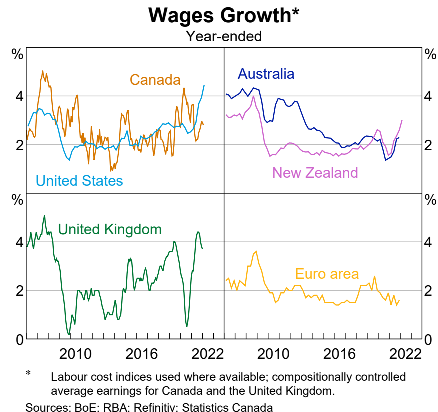
Despite very low unemployment, wages growth has been slow to pick up in most advanced economies (Graph 1.9). The notable exceptions are the United States and the United Kingdom, where wages are growing at their fastest pace in many years. In the United States, a reduced supply of labour (in part due to lingering health concerns) has contributed to this, especially in the leisure and hospitality industry. However, labour supply is starting to recover; the participation rate has lifted significantly since October and employment in leisure and hospitality has grown strongly (partly in response to higher wages). Labour supply also contracted in the United Kingdom during the pandemic but, unlike in the United States, is yet to recover.



High inflation is eroding household purchasing power …

Real wages have fallen significantly in advanced economies over the past year, as the increase in inflation has outpaced growth in nominal wages (Graph 1.10). This has reduced household purchasing power and contributed to sizeable declines in consumer confidence over recent months (Graph 1.11). These effects are likely to have been larger for lower-income households because they typically spend a greater share of income on energy and food. They also tend to have less savings (both from current income and past accumulation) with which to buffer consumption in the face of negative income shocks.

Governments in many countries have recently announced additional fiscal support to mitigate the effects of high inflation on household income. In Europe, national governments have announced energy rebates, income support or reductions in value-added taxes that equate to around 0.5 per cent of household income in the euro area and around 1 per cent in the United Kingdom. In some cases, these fiscal measures have been uniformly distributed to all households; in others, they are targeted towards households with lower incomes. Many Asian governments have also provided tax cuts or



increased fuel subsidies (in some cases by maintaining fuel price caps).

… weighing on the outlook for global growth

The reduction in real purchasing power is forecast to be most significant for European economies, given electricity prices are expected to rise most there. Consensus forecasts for GDP growth in the euro area in 2022 have been revised down by around 1½ percentage points since earlier in the year (Graph 1.12); forecast growth in most other trading partner economies has also been revised down, but generally by around ½ percentage point. In these economies, higher inflation and commodity prices are reducing real wages – and the national incomes of commodity-importing economies – while also lifting the expected path of policy rates in some cases. For many energy exporters, forecasts have been little changed given increases in their terms of trade and national incomes; Russia is a notable exception. Asian growth is expected to slow but only modestly, despite most economies in the region being energy importers. This is largely because the impact of higher commodity prices on consumer prices is expected to be diluted by existing price-setting mechanisms and contractual arrangements in the energy sector, as well as food consumption patterns that are less exposed to the commodities with the fastest rising prices.

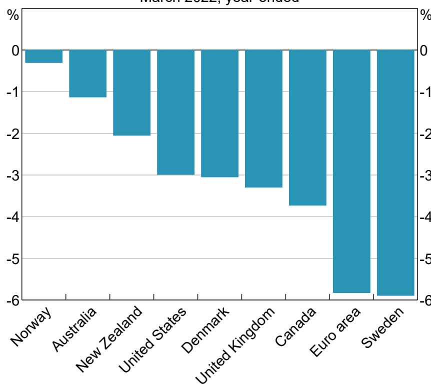
Forecasts for growth in China have been revised down largely because of the disruptions stemming from COVID-19 restrictions there. Year-average GDP growth is forecast to be about ½ percentage point short of the 'around 5.5 per cent' GDP growth target announced by policymakers in March.

Overall, growth in Australia's major trading partners in 2022 and 2023 is forecast to be around 4 per cent, which is below its pre-pandemic decade average. The forecast for

Graph 1.10

Real Wages Growth*

March 2022, year-ended



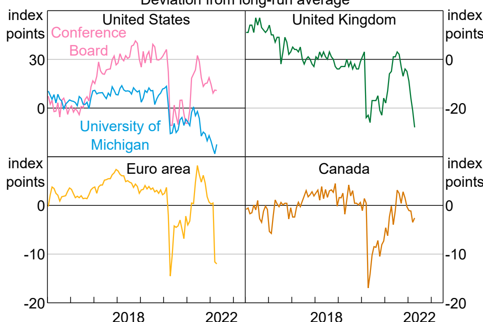
* Using earnings measures; forecast used for Australia; nominal wages growth for March 2022 assumed to equal December 2021 where March 2022 data are unavailable.

Sources: RBA; Refinitiv; Statistics Canada

Graph 1.11

Consumer Confidence Indicators

Deviation from long-run average

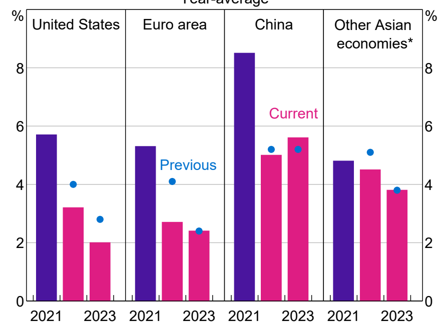


Sources: RBA; Refinitiv

Graph 1.12

GDP Growth Forecasts

Year-average



* Exports-weighted average of major Asian economies excluding China.

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

2022 has been revised down by ½ percentage point since the February *Statement*.

There are some scenarios where global growth could be stronger than currently forecast. For instance, European economies could substitute away from Russian energy faster and in a less disruptive way than currently anticipated. It is also possible that the transition to living with COVID-19 as an endemic disease is smoother than assumed, with strong household and business balance sheets underpinning more spending than currently envisaged. However, the balance of risks to the global economic outlook appear to be skewed to the downside, and reflect the following:

- *Financial conditions could tighten more quickly than implied by current market pricing.* The persistent rise in commodity prices and ongoing supply disruptions are complicating the policy trade-offs facing central banks. If central banks remove monetary stimulus relatively quickly in response to further rises in inflation, they could slow economic activity and increase unemployment by more than expected, particularly in highly indebted economies. Alternatively, if policy-makers choose to 'look through' the rise in commodity prices and other supply disruptions, there is a risk that higher inflation expectations feed into a further pick-up in wage and price inflation; this could be more costly for growth in the future if it necessitates a much larger eventual policy tightening. More generally, there is evidence that growth in some economies, including the United States, is increasingly constrained by capacity. Unless these economies can lift productivity or increase labour force participation, additional growth in demand could manifest in persistently higher inflation that would require much tighter monetary policy and could unsettle financial conditions.
- *The global economy could be more sensitive to falling real incomes (and consumption) than currently envisaged.* Consumer sentiment has recently declined sharply in a number of advanced economies as inflation and interest rates have increased and real wages have fallen. Uncertainties relate to how much households will reduce their savings to sustain spending in the face of lower purchasing power, and the willingness of governments to continue providing fiscal support in response to cost-of-living pressures when inflation is already high. Although labour markets are tight, it is also uncertain how much workers can offset recent falls in real wages by demanding larger nominal wage rises.
- *The Chinese economy could slow more sharply than forecast if outbreaks of COVID-19 are not contained quickly and long-running macro-financial vulnerabilities worsen.* Further mobility restrictions in response to COVID-19 outbreaks would compound supply disruptions and add to upward pressure on inflation globally. Slower growth would also amplify the risks already present in China's residential property sector, adding to the stress already faced by property developers. However, it is also possible that China manages to contain the impact of COVID-19 outbreaks on the economy, or that the authorities are able to largely offset the impact with more policy stimulus.

Central banks in many advanced economies have raised policy rates and indicated that further rate increases are likely

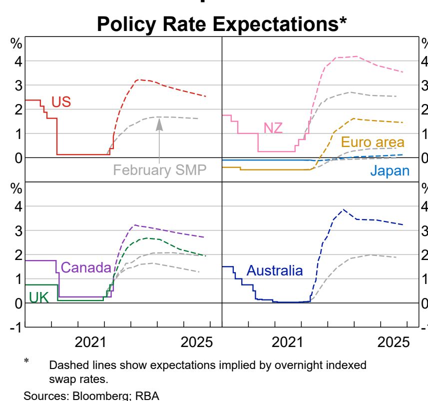
Many central banks in advanced economies have begun to withdraw some of their substantial monetary stimulus in response to improved economic conditions and higher-than-expected inflation. Several central banks have increased their policy rate in recent

months, some for the first time this cycle, and have indicated that further increases are likely in the near term (Graph 1.13). A number have noted that higher policy rates are needed to avoid the risk that longer-term inflation expectations increase to a degree that threatens the return of inflation to target. Some have signalled that policy rates may need to reach a restrictive level – that is, above estimates of the longer-run neutral rate – within the next year or so. In particular:

- At its meetings in March and May, the US Federal Reserve (Fed) increased the target range for its policy rate by a cumulative 75 basis points to 0.75 to 1 per cent. The Fed indicated that further increases are likely to be appropriate because of broad price and labour market pressures, with the potential for rate rises in 50 basis point increments at its next few meetings. Fed policymakers project that the policy rate will reach around 2.8 per cent by the end of 2024.
- In March, the Bank of England (BoE) increased its policy rate by another 25 basis points to 0.75 per cent. The BoE expects that the rise in commodity prices will increase inflation and, in turn, lower real household incomes and economic activity. Nonetheless, it judged that less accommodative monetary policy settings were appropriate because of a tight labour market, strong domestic cost and price pressures, and the risk that those pressures would persist.
- In March, Norges Bank increased its policy rate by 25 basis points to 0.75 per cent and revised up its projected path for the policy rate. It projects that the rate will reach around 2.5 per cent by the end of 2023.
- At its meetings in March and April, the Bank of Canada (BoC) increased its policy rate by a cumulative 75 basis points to 1 per cent. It noted that economic slack had been absorbed, and indicated that it will need to raise rates further to return inflation to its 2 per cent target and keep inflation expectations well anchored.
- At its meetings in February and April, the Reserve Bank of New Zealand (RBNZ) increased its policy rate by a cumulative 75 basis points to 1.5 per cent. In April, the RBNZ said it was increasing the policy rate to a more neutral stance sooner than it had projected in February in order to reduce the risk of rising inflation expectations. It projects that its policy rate will peak at around 3.25 per cent by the end of 2023.
- At its meeting in April, Sveriges Riksbank increased its policy rate by 25 basis points to 0.25 per cent. It also revised up its forecast path for the policy rate; at its previous meeting in February, the Riksbank had indicated that the first increase in the policy rate would occur in 2024. The Riksbank noted that it was increasing the policy rate to prevent high inflation from becoming entrenched in wage and price setting.

Many central banks have outlined plans to reduce their asset holdings

Central banks in advanced economies have ended the purchasing phases of their pandemic-related quantitative easing (QE) programs (Graph 1.14). Only the European



Central Bank (ECB) and the Bank of Japan (BoJ) continue to make net asset purchases – both under asset purchase programs introduced prior to the pandemic. Many central banks have ceased reinvesting proceeds from maturing bonds, which will lead to a gradual decline in their bond holdings. While these central banks note that this process will contribute to the removal of some monetary stimulus, they continue to emphasise that the policy rate will be the main tool for removing stimulus.

The BoC, the BoE, the Fed, the Riksbank and the RBNZ are reducing their holdings of government bonds by allowing bonds to mature or have announced that they will begin doing so in coming months. The RBNZ has also announced that it will sell NZ$5 billion per annum of its portfolio to New Zealand Debt Management, the issuer of New Zealand Government bonds. The BoE has said it will consider bond sales once its policy rate reaches 1 per cent. The Riksbank and the Fed will continue to reinvest a portion of the proceeds from maturing bonds such that their holdings decline in a gradual manner. In the case of the Fed, from June it will only reinvest proceeds from maturing Treasury securities that exceed a cap of US$30 billion per month; it will increase that cap to US$60 billion per month from September.

Meanwhile, the ECB has said it will reinvest maturing assets purchased under pandemic-related programs for some time. At its March meeting, the ECB announced a faster tapering of purchases under its asset purchase program – a distinct QE program that preceded the pandemic. It now expects to end net purchases early in the September quarter.

In contrast, the BoJ has reaffirmed that it will continue to implement its accommodative monetary policy stance until inflation has reached the 2 per cent target in a stable and sustainable manner, and has increased asset purchases across the yield curve. This includes further fixed-rate operations to maintain its yield curve control, whereby it seeks to maintain the yield on 10-year Japanese Government bonds within a range of zero per cent plus or minus 25 basis points.

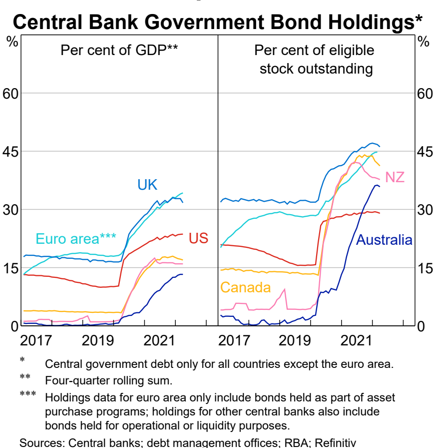
Government bond yields have risen further …

Government bond yields have risen significantly over recent months, reflecting an increase in compensation for inflation and expectations that central banks will tighten policy faster and to a greater extent in response (Graph 1.15; Graph 1.16). The increase in bond yields has been more pronounced for shorter-term maturities in several advanced economies; in other words, yield curves have 'flattened'.

Market-implied inflation expectations have increased notably for the year ahead, a direct impact of the increase in energy and food prices. Long-term market-implied inflation expectations have risen moderately but remain around levels consistent with central bank inflation targets. Real yields remain well below their pre-pandemic levels in Germany but have increased significantly in the United States, Canada and Australia, consistent with market expectations that policy will be tightened more quickly in these economies than in the euro area (Graph 1.17).

Graph 1.14

Central Bank Government Bond Holdings*



* Central government debt only for all countries except the euro area.
** Four-quarter rolling sum.
*** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.

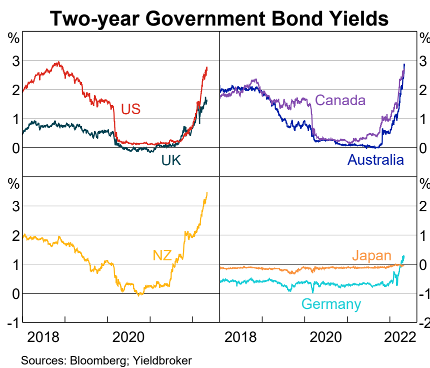
Sources: Central banks; debt management offices; RBA; Refinitiv

… contributing to less-accommodative financial conditions for the private sector

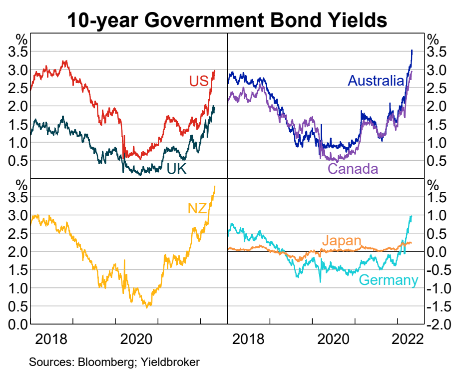
Conditions in corporate bond markets have become less accommodative. Corporate bond yields have risen alongside an increase in government bond yields and there has been some widening of credit spreads in Europe due to concerns about the economic implications of tighter monetary policy and Russia's invasion of Ukraine (Graph 1.18). As yields have increased in recent months, issuance of sub-investment grade bonds has declined, while issuance of investment grade bonds has remained robust.

Equity prices in most major markets declined sharply following Russia's invasion of Ukraine and are below their levels at the start of the year (Graph 1.19). This reflects some ongoing concern about the economic impact of the war, as well as the effect of tighter monetary policy and the COVID-19 situation in China. The additional compensation that investors require to invest in equities versus government bonds (the equity risk premium) has risen somewhat, to be around its pandemic peaks for European equities. Equity issuance has been subdued since the start of the year in both the United States and Europe.

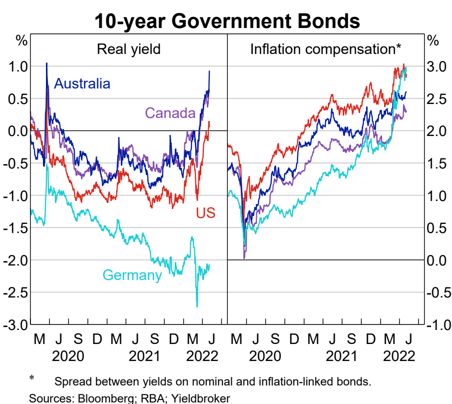
Graph 1.15



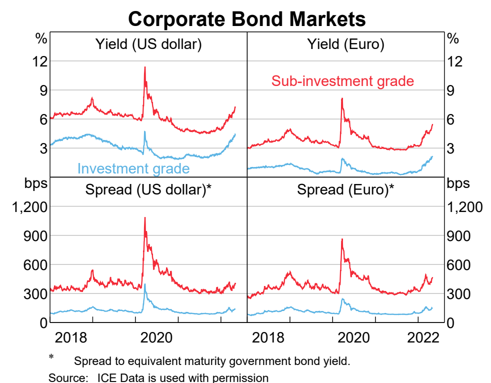
Graph 1.16



Graph 1.17



Graph 1.18



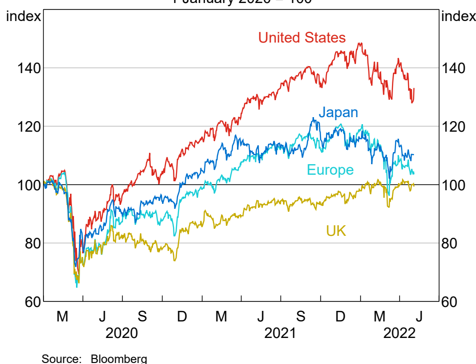
The US dollar has appreciated

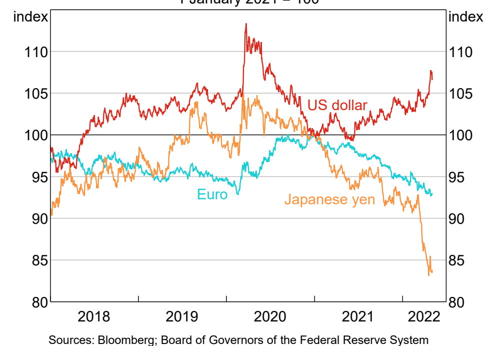
The US dollar has appreciated against most currencies since the start of the year alongside the increase in US Government bond yields relative to many other advanced economies (Graph 1.20). Conversely, the Japanese yen has depreciated noticeably over the same period, reaching its lowest level since 2015 on a trade weighted (TWI) basis, as yields of Japanese Government bonds have remained at low levels. The euro and British pound have depreciated since the invasion of Ukraine, largely as a result of increased uncertainty about the outlook for growth in Europe. The currencies of commodity-exporting economies, including the Australian dollar, have depreciated on a TWI basis over the past month but are higher than levels seen prior to the invasion of Ukraine, supported by the rise in commodity prices (see chapter on 'Domestic Financial Conditions' for recent developments in the Australian dollar).

Spillovers from the invasion of Ukraine have so far been limited for most emerging market economies

Russia's financial markets have experienced significant disruptions since February, following its invasion of Ukraine and international sanctions imposed on its economy. The rouble depreciated sharply in the first two weeks of the war, notwithstanding the Central Bank of Russia (CBR) more than doubling its policy rate to 20 per cent and the Russian authorities introducing extensive capital controls (Graph 1.21). These measures include banning foreign investors from selling Russian assets, and requiring exporters to buy roubles with their foreign-currency receipts. There is currently very little rouble trade in foreign exchange markets, making the exchange rate indicative at best. The CBR subsequently lowered its policy rate twice by a cumulative 600 basis points to 14 per cent, citing constraints to economic activity. Premiums on Russian credit default swaps and spreads on US-dollar-denominated government bonds widened substantially as market participants became increasingly concerned about Russia's ability and willingness to repay its sovereign debts. Spreads narrowed considerably in early May after Russia reportedly made two overdue bond payments in US dollars before the end of a grace period.

The effects of the war have not yet spilled over to most other emerging market economies other than via the adverse impact of higher commodity prices. Emerging European economies that are proximate to Ukraine and some economies in North Africa and the Middle East that import large amounts of food have been most affected by higher commodity prices.



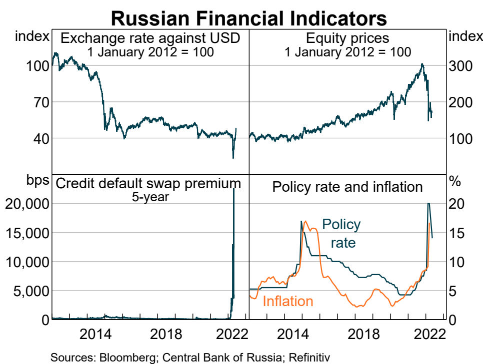


Local currency government bond yields in emerging markets have risen in line with broader inflation pressures and increases in policy rates, particularly in Europe and Latin America (Graph 1.22). The currencies of emerging European economies also depreciated against the US dollar since the start of the war amid large outflows by foreign investors in their bond and equity markets.

Emerging market central banks are increasingly concerned about inflation

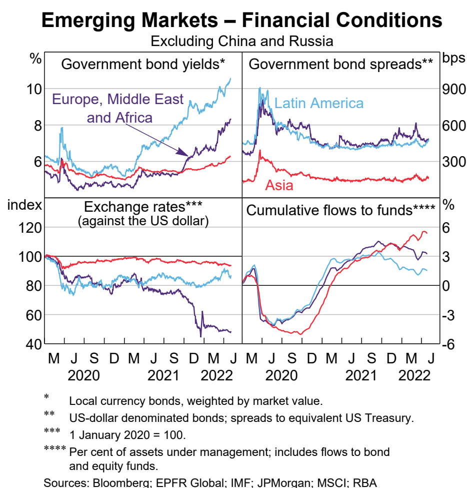
Most central banks in middle-income Asian economies have left policy rates unchanged amid subdued inflation there, with many noting that higher global commodity prices will contribute to higher domestic inflation (Graph 1.23). The Reserve Bank of India raised its policy rate by 40 basis points at an unscheduled meeting in early May, citing elevated inflationary pressures. Market-implied paths of policy rates continue to suggest that most other Asian central banks are expected to gradually start raising rates this year. By contrast, central banks in much of Latin America have tightened policy further since the February *Statement* due to continued concerns about high inflation, and are expected to raise policy rates further.

Graph 1.21



Sources: Bloomberg; Central Bank of Russia; Refinitiv

Graph 1.22



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

Many emerging market central banks have continued to express concerns around the potential for disruptions from a faster-than-expected tightening in monetary policy in advanced economies. However, emerging markets had received only modest banking and portfolio inflows as a share of GDP in the years leading up to the pandemic compared with earlier episodes of capital inflows.

The International Monetary Fund (IMF) approved a new lending program for Argentina in late March. The US$44 billion program will help Argentina cover the sizeable repayments it is due to make to the IMF over the next few years from an earlier program, as well as provide a boost to its international reserves. As part of the

Graph 1.23

* Solid lines show actual policy rate; coloured dashed lines show current implied rates. Asia comprises India, Malaysia, Philippines and Thailand; Latin America comprises Brazil, Chile and Mexico.
Sources: Bloomberg; Refinitiv

new program, Argentine authorities have agreed to take steps to improve public finances and start to reduce the persistently high rates of inflation. More recently, the IMF has been in discussions with a number of countries affected by Russia's invasion of Ukraine to arrange support. Most notably, the Fund has already provided US$1.4 billion in emergency assistance to Ukraine.

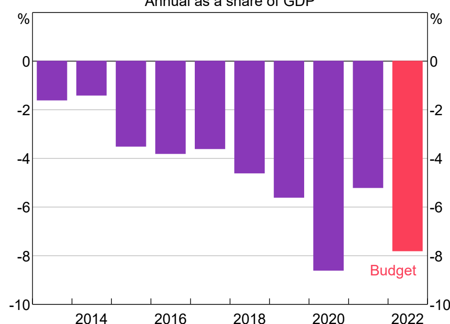
China has increased policy stimulus, as strict mobility restrictions disrupt activity

Chinese authorities shifted towards prioritising economic growth and stability earlier this year. While tackling climate change and reducing risk in the financial system will remain important objectives, the focus of new policies will be on sustaining growth. Consistent with this, China announced a GDP growth target of 'around 5.5 per cent' in 2022, which was significantly stronger than most forecasts at the time.

In support of this target, policymakers unveiled plans for a fiscal expansion of around 2½ per cent of GDP in 2022, after a fiscal drag of around 3 per cent of GDP in 2021 (Graph 1.24). A sizeable portion of this expansion is expected to come from increased infrastructure spending. While authorities set the annual quota for issuance of special local government bonds (which are normally tied to infrastructure projects) at the same high level as last year, it asked local governments to fill these quotas by September. Moreover, a large share of special bonds raised last year were issued in the final months of 2021, with funds being carried over into 2022. Together, this would suggest significantly higher infrastructure investment (and, in turn, steel demand).

The shift in policy focus contributed to solid growth in late 2021 and early 2022. However, the Chinese economy slowed notably in March because of COVID-19 restrictions. During March and April, strict lockdowns were imposed in cities that account for around 6 per cent of national GDP, with an additional 25 per cent of the economy experiencing tighter restrictions than seen in 2021 (Graph 1.25). Accordingly, household consumption fell a little in the March quarter (Graph 1.26). Industrial production also retraced the growth it recorded in the first two months of the year, led by falling automotive production, and the manufacturing PMI signalled further contraction in April, recording its lowest level since February 2020. By contrast, business investment remained strong, led by infrastructure and manufacturing. The weakening in economic growth prompted the Chinese Government to announce a variety of measures to support incomes of affected businesses, beyond the fiscal expansion already announced as part of the budget.

Conditions in China's real estate markets remain subdued, and stress continues to build for many developers. However, a range of indicators – such as property sales, new housing prices and construction sector PMIs – had improved slightly prior to the spread of COVID-19. This was partly in response to authorities' attempts to stimulate demand for housing (Graph 1.27). These signs of housing market stabilisation, together with expectations of stronger infrastructure investment, have supported the outlook for Chinese steel. Reflecting this, the price of iron



* Consolidated measure that includes central government, local government and government funds.
Sources: CEIC Data; RBA

ore has increased by 60 per cent since late 2021, despite the Omicron outbreak and an announcement that steel production quotas will be tighter this year. Notwithstanding these signs of stabilisation, any recovery in residential construction is likely to be modest, since authorities continue to emphasise that they will not turn to the real estate sector as a short-term means of stimulating the economy.

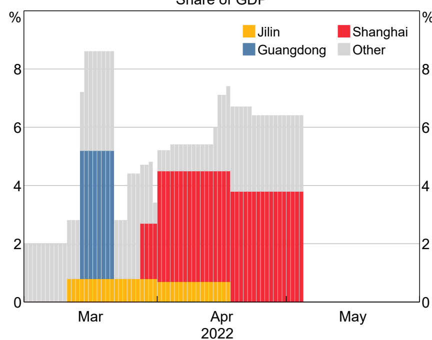
Private Chinese property developers remain under acute stress

Private Chinese real estate developers remain under acute financial stress, with some of the largest developers delaying the publication of their audit results (Graph 1.28). The Chinese authorities have not announced any significant new policies to alleviate developers' funding pressures, despite stating that they will put forward a 'strong and effective response plan to prevent and defuse risks' for developers. However, more local governments have announced measures to support the housing market, including removing bans on purchasing second homes and abolishing the minimum period before resales.

Graph 1.25

China – Regions in Full Lockdown

Share of GDP

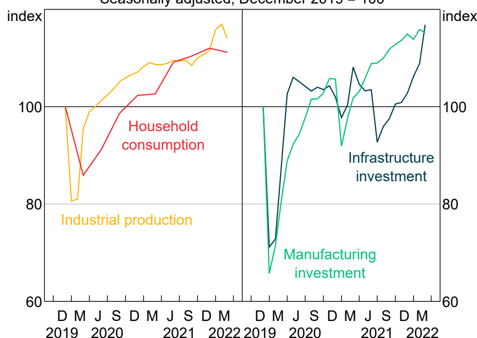


Sources: CEIC Data; Gavekal Dragonomics; Plenum China; RBA

Graph 1.26

China – Activity Indicators

Seasonally adjusted, December 2019 = 100

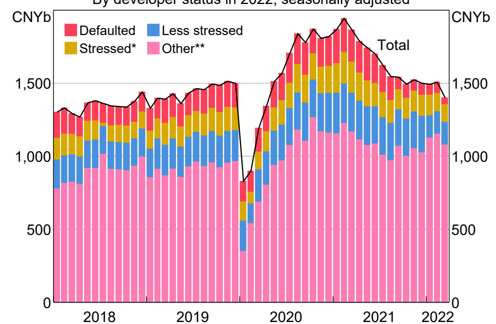


Sources: CEIC Data; RBA

Graph 1.27

China – Property Sales

By developer status in 2022, seasonally adjusted



* Developers with bonds trading at above 50 per cent yield to maturity in 2022.

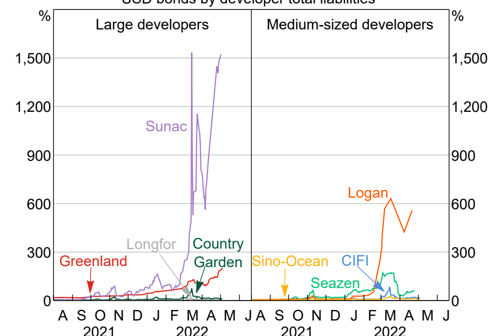
** Calculated as the difference between national sales and sales published by 31 large Chinese developers.

Sources: CEIC Data; RBA; WIND Information

Graph 1.28

Chinese Developer Bond Yields

USD bonds by developer total liabilities*



* Next maturing bond; large developers are those with liabilities of more than CNY500 billion in 2020; medium-sized developers are those with liabilities of CNY100 billion–CNY500 billion in 2020.

Sources: Bloomberg; RBA

Chinese financial markets have been volatile

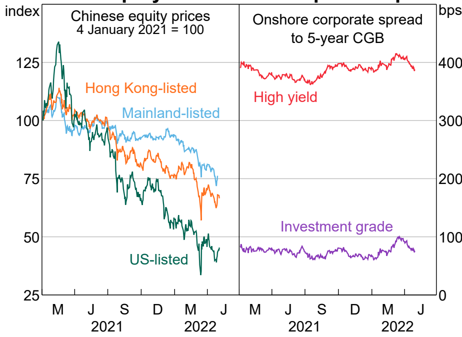
Chinese equity prices have fallen considerably since the previous *Statement*, reflecting both international and domestic developments (Graph 1.29). International factors include rising commodity prices and faster-than-expected tightening in the monetary policy of advanced economies. Domestic factors include growing COVID-19 disruptions, weaker-than-expected household lending data and less policy easing than the market had been expecting. Onshore corporate bond spreads are around levels seen near the start of the year.

The People's Bank of China (PBC) eased monetary policy modestly in April by lowering its reserve requirement ratio by 25 basis points for most banks (Graph 1.30). It kept policy interest rates unchanged, however, despite market expectations of a cut. The authorities also announced targeted relending arrangements for specific sectors, particularly those affected by COVID-19 restrictions; these arrangements provide funding from the PBC on favourable terms to banks that lend into specified sectors. Chinese Government bond (CGB) yields have been little changed.

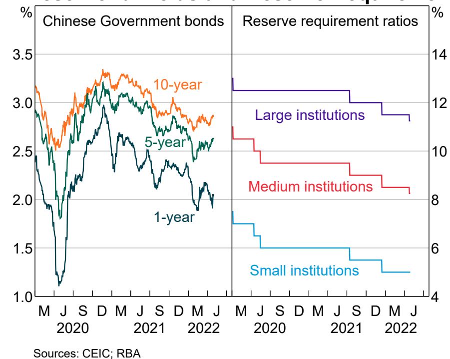
Growth in Chinese total social financing (TSF) has been steady over recent months. The easing in credit conditions pursued by authorities continues to be targeted mostly at businesses – especially small and micro-enterprises and those in the agriculture sector – and growth in business financing has risen moderately. Strong government bond issuance has contributed significantly to TSF growth, but this has been offset by a sharp deceleration in household credit growth (Graph 1.31).

The Chinese renminbi has depreciated against the US dollar since the previous *Statement* as the COVID-19 situation deteriorated in China (Graph 1.32). In late April, the PBC reduced its reserve requirement ratio for foreign-currency deposits, which should increase the amount of foreign currency available onshore and reduce

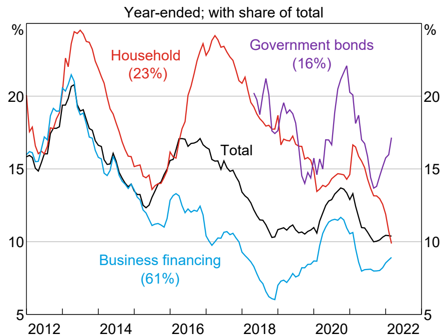
Graph 1.29



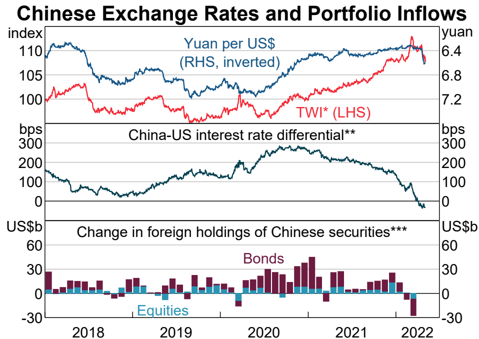
Graph 1.30



Graph 1.31



depreciation pressure on the renminbi. The interest rate differential between Chinese and US government bonds has continued to decline to become negative. In line with this, there has been a net outflow of foreign investments in Chinese bonds and equities since the start of 2022. ✈



2. Domestic Economic Conditions

The Australian economy staged a strong recovery in late 2021 and timely indicators suggest economic activity has remained resilient to the Omicron outbreak and the east coast floods in early 2022. The underlying strength in the economy has been particularly evident in the labour market, where conditions are the most robust in many years. Strong labour demand and fiscal measures are supporting growth in household income, although recent large increases in food and energy prices are having a significant negative impact on household budgets. More broadly, the increase in commodity prices following Russia's invasion of Ukraine has boosted national income, mainly in the form of elevated profits for companies in the resources sector and higher government tax revenue.

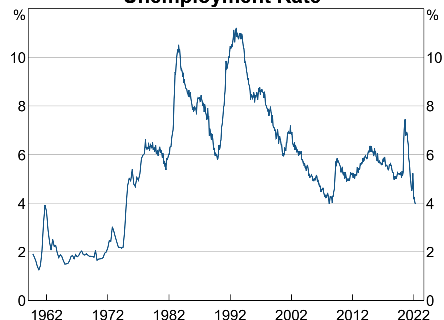
Labour market conditions are the tightest they have been in a long time …

The unemployment rate declined to 4 per cent in March – as low as in 2008 and, prior to that, the mid-1970s – amid strong labour demand (Graph 2.1). This demand has been met by firms increasing both headcount and hours of existing staff, which has seen other measures of spare capacity (such as heads- and hours-based underutilisation rates) also decline to levels not seen for many years (Graph 2.2). Labour underutilisation has declined across most industries and has been particularly notable in industries where employment has grown strongly (such as professional services) and those reporting labour supply shortages (such as hospitality). There are also signs that wages growth is picking up in response to this tightening in labour market conditions (see chapter on 'Inflation').

Overall, the supply of labour has been responsive to the strong demand for labour; the

Graph 2.1

Unemployment Rate*



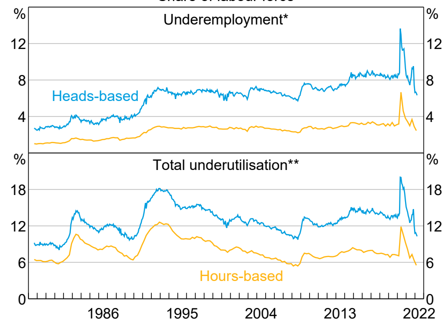
* Data are quarterly to February 1978 and monthly thereafter.

Source: ABS

Graph 2.2

Labour Underutilisation Rates

Share of labour force



* Full-time workers on part-time hours for economic reasons and part-time workers who would like, and are available, to work more hours.

** The underutilisation rate adds together the unemployment and underemployment rates.

Sources: ABS; RBA

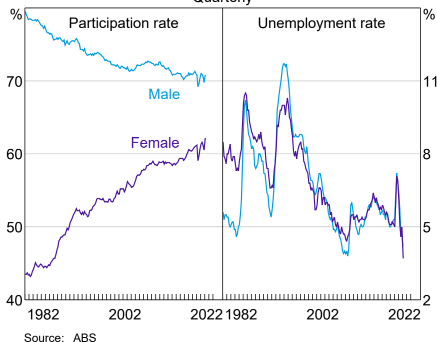
participation rate increased to a record high of 66.4 per cent in March, and the employment to working age population ratio also increased to a historically high level. This is in contrast to the experience of some other advanced economies, such as the United States and the United Kingdom, where the participation rate remains materially below pre-pandemic levels.

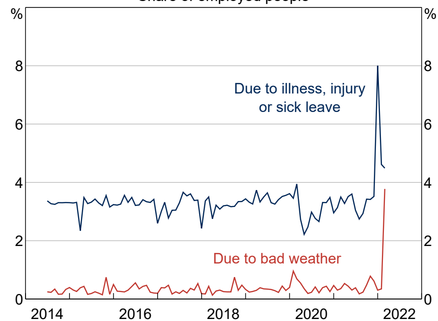
The increase in the participation rate in Australia has been largely driven by strong female participation, which has risen by 1 percentage point since February 2020 to a record high (Graph 2.3). Female employment has grown by 4 per cent over this period, which has seen the female unemployment rate decline to its lowest level since the mid-1970s. By contrast, the male participation rate is near its pre-pandemic level and, while still strong, male employment growth has been around half that for females. The relative strength in female labour market outcomes is partly due to robust growth in employment in a number of industries that employ a larger share of female workers, including the healthcare & social assistance industry.

The Omicron outbreak and the east coast floods have temporarily affected labour supply. Similar to previous outbreaks of COVID-19, reduced hours rather than headcount has been the primary way the labour market has adjusted to disruptions from Omicron. However, in contrast to previous outbreaks, people have mostly still been paid for these unworked hours. The number of employed people working fewer or zero hours due to 'illness, injury or sick leave' remained elevated in March but was well below its January peak (Graph 2.4). Information from the Bank's liaison program suggests that most firms were able to manage staff absenteeism in the past few months without material disruptions to operations. The heavy rain and floods in New South Wales and Queensland from late February onwards also saw a much higher-than-usual number of people working reduced hours due to bad weather in March.

… and forward-looking indicators of labour demand remain strong

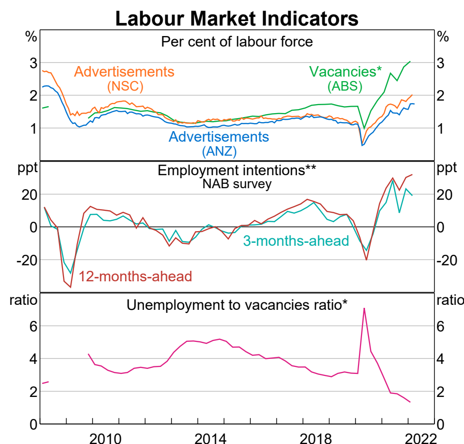
Leading indicators of labour demand point to a further tightening in the labour market in the period ahead (Graph 2.5). The ratio of the number of unemployed people to the stock of vacancies fell further in February to a record low of around 1½ unemployed persons per vacancy. Job advertisements also remained elevated in recent months and point to continuing strong growth in employment. Around three-fifths of firms in the Bank's liaison program intend to increase headcount over coming months (and most firms intend to increase wages, see





discussion below), while very few intend to reduce headcount. Most firms continue to report issues with labour availability in parts of their operations, although only a few have reported such issues across their entire workforce. Liaison information suggests that the reopening of international borders has not yet materially improved labour availability in sectors that tend to hire workers on temporary visas. While net overseas arrivals are picking up slowly, the numbers remain well below pre-pandemic levels, particularly for international students and working holiday makers who are often employed in the hospitality, administration & support and agriculture industries.

Job mobility remains high relative to the decade leading up to the COVID-19 pandemic, and has returned to levels that were common prior to the global financial crisis. The increase in the number of people switching jobs over the past year reflects some catch-up in planned job changes that were put on hold during the pandemic; however, it is also partly due to increased competition for workers. In response to elevated turnover, some firms in the Bank's liaison program reported having raised the wages of existing employees to meet increases in corresponding market salaries. Workers remain upbeat about the employment outlook, with the share of employees expecting to change jobs over the next year rising in recent months (Graph 2.6). The increase in expected job mobility has been primarily driven by full-time workers, particularly in higher-skilled occupations.



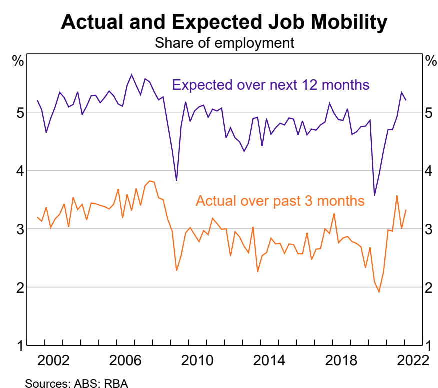
* ABS Vacancies Survey was suspended between May 2008 and November 2009.
** Net balance for the following period; deviation from average; 12-months-ahead measure seasonally adjusted by the RBA.
Sources: ABS; ANZ; NAB; National Skills Commission (NSC); RBA

Household income continues to be supported by the strong labour market

Household income has grown strongly during the pandemic but declined slightly in the December quarter as the tapering of fiscal measures, such as COVID-19 support payments, offset growth in labour income (Graph 2.7). Household income is expected to increase in the March quarter supported by strength in the labour market, with tax receipts indicating continued strong growth in labour income. Government disaster payments and resource company dividends from high commodity prices are also expected to contribute to higher household income.

Activity rebounded in the December quarter as consumption opportunities broadened …

The Australian economy grew by 3.4 per cent in the December quarter as household consump-



Sources: ABS; RBA

tion rebounded sharply following the easing of Delta-related restrictions (Graph 2.8). The increase in household consumption was broad based, but was particularly pronounced for discretionary goods and services. With higher consumption and lower income, the household saving ratio declined to 13½ per cent in the December quarter; this ratio is below the peak seen earlier in the pandemic but is still more than twice that typically observed in the years prior to 2020.

Public consumption was little changed after a large increase in the September quarter of 2021, while business, dwelling and public investment declined. Ongoing capacity pressures in the construction sector and supply chain issues contributed to the weak outturns for investment. In addition, the effect of tax incentives on growth in business investment may have waned over time. Net trade subtracted a little from growth in the December quarter; exports declined due to maintenance and weather disruptions in the resources sector, while a smaller decline in imports was driven by lower capital and consumption goods.

… but supply shocks temporarily slowed domestic activity growth in the March quarter

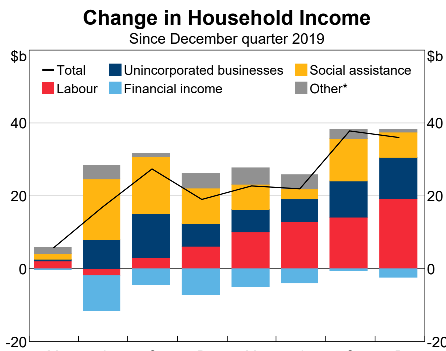
The Omicron outbreak experienced throughout the country and flooding in New South Wales and Queensland weighed on economic activity in the March quarter. However, the effect of these supply shocks should be limited and temporary. While labour shortages related to employee illness and isolation requirements have caused disruptions in some industries, timely indicators suggest that the impact of Omicron on domestic activity has been much less than that seen during earlier outbreaks. And, while the economic effect of the floods is substantial in the geographic areas directly affected by the devastation, it will be less evident in economy-wide data. Over time, government support and reconstruction efforts will also add to spending.

Domestic demand has been underpinned by household spending, which has remained resilient despite recent increases in the cost of living. Households increased their expenditure on discretionary goods and services as restrictions on activity were lifted in late 2021, particularly in hospitality and tourism (Graph 2.9). Retail sales values grew strongly in the March quarter. However, information from

Graph 2.7

Change in Household Income

Since December quarter 2019



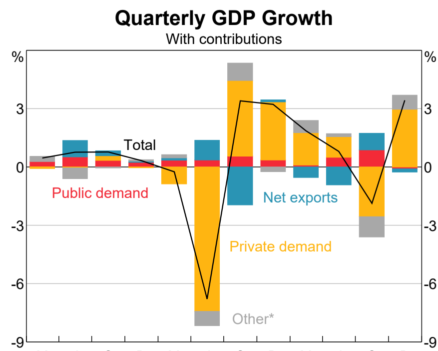
* Includes rent, tax payable, interest payable and other.

Sources: ABS; RBA

Graph 2.8

Quarterly GDP Growth

With contributions



* Includes change in inventories and statistical discrepancy.

Sources: ABS; RBA

retailers in the Bank's liaison program suggests that price increases contributed significantly to the increase in sales values as firms responded to the persistence and magnitude of cost increases (see chapter on 'Inflation'). Rising prices were also likely to have contributed to the decline in consumer confidence to below its long-run average, and are expected to weigh on consumption in the period ahead.

Supply chain disruptions and rising costs have weighed on business investment …

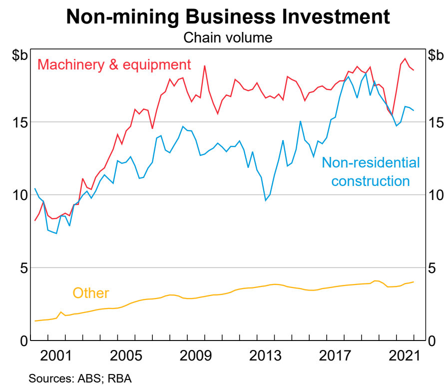
The strong upswing in non-mining business investment that had been underway in the first half of 2021 paused over the second half of the year. After a lockdown-affected September quarter, non-mining business investment declined a little further in the December quarter (Graph 2.10). Machinery & equipment investment declined, after earlier strong growth in response to tax incentives from the Australian Government that brought forward some investment. Imports of capital goods also slowed alongside ongoing supply chain disruptions. The earlier rebound in non-residential construction paused as some large projects finished, and costs increased amid broader capacity pressures in the construction industry. Nevertheless, surveyed measures of investment intentions have continued to highlight a positive backdrop for business investment. The ABS Capital Expenditure survey, conducted in January and February this year, indicated that both mining and non-mining business investment are expected to increase in the 2021/22 financial year (Graph 2.11).

The Omicron outbreak affected many businesses over recent months (Graph 2.12). Around 20 per cent of firms surveyed in each of the first few months of 2022 reported being affected by COVID-19-related employee absences, while around 40 per cent experienced supply chain disruptions. Despite this, and in contrast to declining consumer sentiment, surveyed

Graph 2.10

Non-mining Business Investment

Chain volume

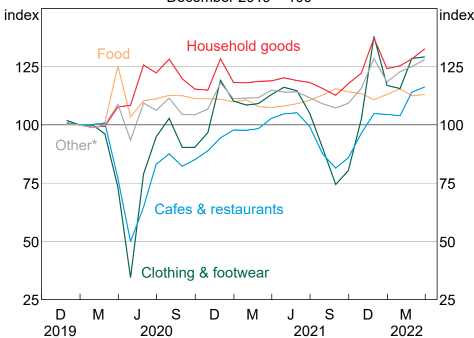


Sources: ABS; RBA

Graph 2.9

Retail Sales Values

December 2019 = 100



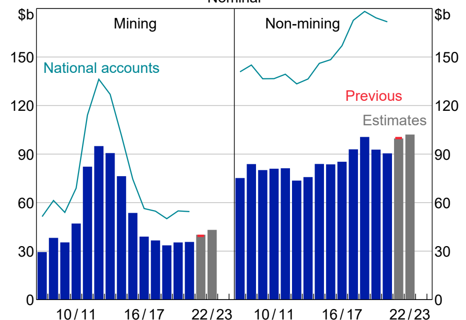
* Includes department stores and other retailing.

Sources: ABS; RBA

Graph 2.11

Capital Expenditure Intentions*

Nominal



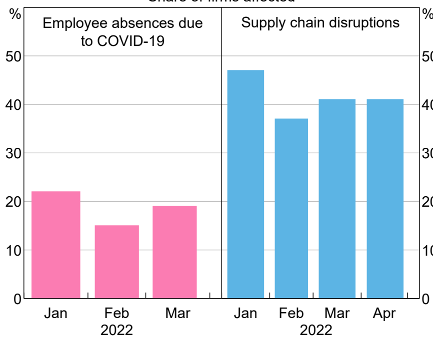
* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending.

Sources: ABS; RBA

measures of business conditions and confidence increased in recent months and remained above their long-run averages. The increase reflected a rebound in activity in services-related industries and continued strong demand in goods-related industries.

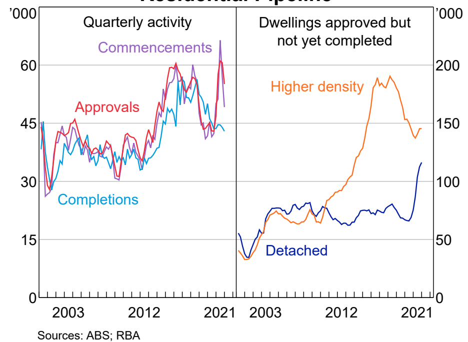
… and the pace of new housing construction has slowed

Demand for new housing and renovations has been strong over the past two years, reflecting government policy measures, low interest rates, and an apparent shift in preferences towards more space as people spent more time at home during the pandemic. There remains a large pipeline of residential construction work, but the pace of delivery has slowed recently due to supply bottlenecks (Graph 2.13). Construction activity declined in the December quarter, with builders in the Bank's liaison program reporting that construction times in most states are around three months longer than average due to shortages of materials and labour. Capacity utilisation in the construction sector is well above average, consistent with the sector operating at close-to-peak capacity. Widespread rainfall along the east coast and absenteeism due to the Omicron outbreak will have further weighed on construction activity in the March quarter. New home sales and greenfield land sales indicate demand for new housing has eased but remains above pre-pandemic levels.



Housing price growth has slowed, but conditions vary across the country

Housing price growth has eased at the national level over recent months following strong gains throughout 2021 (Graph 2.14). Prices have been declining a little in Sydney and Melbourne alongside falling auction volumes and clearance rates in these cities (Table 2.1). Survey measures of housing price growth expectations have also begun to ease from high levels. In most other capital cities and regional areas, price growth has moderated but remains strong, supported by a very low number of properties available for sale (Graph 2.15).



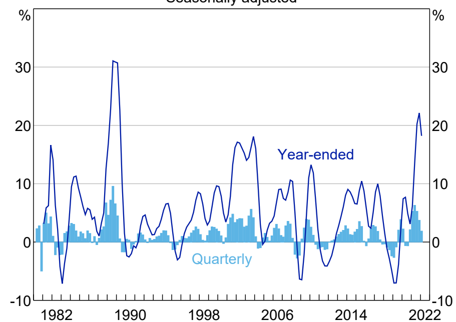


Table 2.1: Housing Price Growth

Percentage change, seasonally adjusted

	April	March	February	January	Year-ended	Five-year growth
Sydney	−0.4	−0.5	−0.3	0.7	15	22
Melbourne	0.0	−0.4	−0.2	0.0	8	17
Brisbane	1.7	1.7	1.7	2.4	29	45
Adelaide	1.7	1.9	1.8	2.2	26	44
Perth	1.0	0.4	−0.1	0.3	7	15
Darwin	0.5	0.4	0.7	0.4	9	4
Canberra	1.3	1.0	0.4	1.9	21	56
Hobart	0.1	0.4	0.9	1.1	21	69
Capital cities	0.2	0.1	0.1	1.0	15	22
Regional	1.3	1.4	1.4	1.6	24	46
National	0.5	0.4	0.4	1.1	17	27

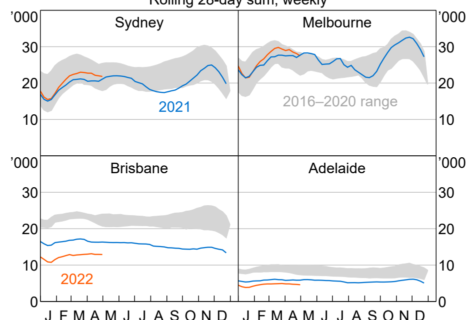
Sources: CoreLogic; RBA

Growth in advertised rents has been strong in most states, reflecting low vacancy rates and strong income growth (Graph 2.16). Advertised rents in capital cities declined in the initial stages of the pandemic but are now significantly above pre-COVID-19 levels. Vacancy rates in Sydney and Melbourne declined recently, particularly in inner city suburbs, suggesting that strong advertised rent growth will persist in these cities. Over time, this will flow through to overall rents paid in those cities, which have been subdued for several years. In other capital cities, vacancy rates remain around historical lows despite reduced levels of overseas migration through the pandemic period. Recent flooding is expected to have placed additional short-term pressure on rental markets in affected regions in Queensland and New South Wales.

Graph 2.15

Total Residential Property Listings*

Rolling 28-day sum, weekly



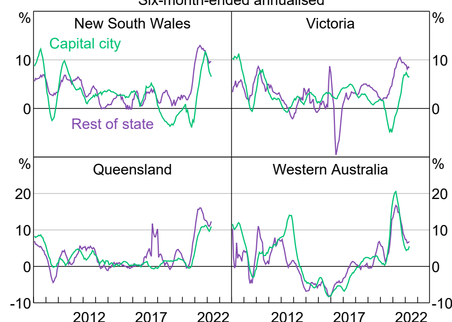
* Properties advertised for sale across multiple sources or multiple times in the same 28-day period are only counted once.

Sources: CoreLogic; RBA

Graph 2.16

Advertised Rents Growth*

Six-month-ended annualised



* Hedonic; seasonally adjusted.

Sources: CoreLogic; RBA

Public spending continues to provide strong support for the economy

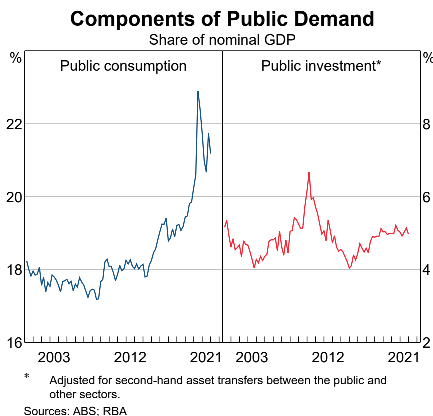
Public demand declined in the December quarter as an increase in state public consumption and investment was offset by a decline in federal consumption and investment expenditure. The increase in state public demand was driven by health measures and a pick-up in activity on key infrastructure projects. Public demand as a share of GDP remained at a very high level compared with the pre-pandemic period (Graph 2.17). The Australian Government Budget 2022–23 affirmed that federal government consumption and investment spending would remain at high levels in coming quarters. The Budget included a very large upgrade to realised tax revenue, as well as expected receipts over the forward estimates, supported by stronger economic and employment outcomes, and higher commodity prices. Only part of the upgrade in receipts was earmarked to support household incomes, with the remainder reducing the deficit over the forecast period (Graph 2.18).

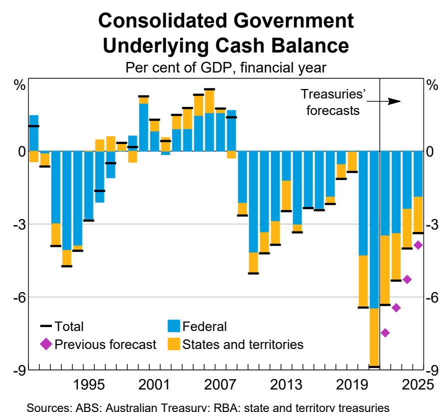
Production issues have weighed on resource exports …

Partial data and information from the Bank's liaison program indicate that resource export volumes have declined over recent months. Coal production in the March quarter was impacted by flooding in eastern Australia, while LNG production was affected by maintenance-related disruptions. Labour shortages due to Omicron-related staff absenteeism also affected production volumes, resulting in longer shipping queues at ports, particularly in the coal sector. Rural exports have continued to increase over recent months as ongoing favourable weather conditions have supported record grain harvests. Higher commodity prices have sharply increased the value of exports in recent months, boosting national income via higher profits in the resources sector. However, the trade surplus has trended downward since mid-2021, largely due to strong growth in import values (Graph 2.19).

… while services trade has begun to recover

Trade in services has begun to recover following the full reopening of the international border for vaccinated travellers in February, which in turn followed the partial reopening to select eligible visa-holders in December (Graph 2.20). Education exports have increased as international students arrived for the first semester of 2022, though student visa numbers remain well below their pre-pandemic level.



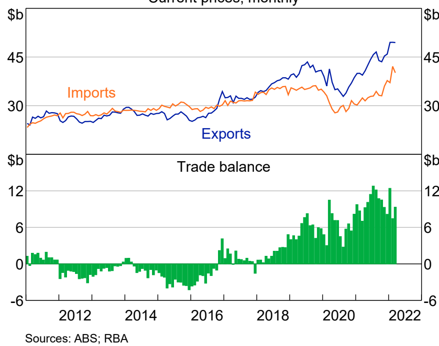


Liaison contacts in the sector anticipate that student enrolments will continue to pick up in the second half of this year and in early 2023 but that it will take several years for enrolments to return to their pre-pandemic level. Travel imports have continued to recover following the commencement of unrestricted outbound travel for Australian citizens and permanent residents in November 2021.

Graph 2.19

Trade in Goods and Services

Current prices, monthly

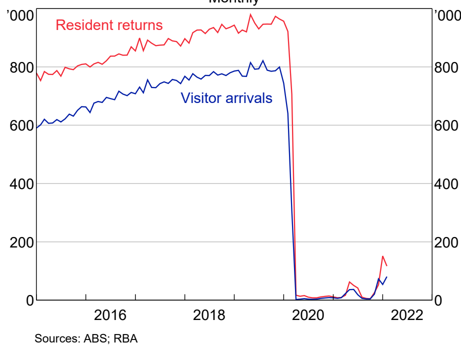


Sources: ABS; RBA

Graph 2.20

Short-term Visitor Arrivals and Resident Returns

Monthly



Sources: ABS; RBA

3. Domestic Financial Conditions

The Reserve Bank's policy measures continue to support highly accommodative financial conditions, even though yields have risen in a number of financial markets and the Bank has begun to withdraw some of the extraordinary monetary support provided through the pandemic. The policy measures implemented by the Bank to support the economy since 2020 have included the low level of the cash rate, the Term Funding Facility (TFF) and the bond purchase program. In May, the Board increased the cash rate target by 25 basis points to 35 basis points, and the interest rate on Exchange Settlement balances from zero per cent to 25 basis points. New purchases under the bond purchase program ceased in February, and in May the Board decided not to reinvest maturing bond holdings. Accordingly, the stimulus from the bond purchase program will gradually lessen over time as the bonds mature.

Australian Government bond yields have risen noticeably over recent months. This has occurred alongside an increase in bond yields globally, largely reflecting expectations of higher inflation and monetary policy tightening. Money market rates have also risen, as have market participants' expectations of further policy tightening; current market pricing implies expectations of an increase of the cash rate to around 2¾ per cent by the end of 2022. Bond markets continue to function reasonably well. Australian equity prices have largely recovered from their decline earlier in the year, as resources companies have benefited from elevated commodity prices.

Banks' funding costs remained low in recent months, although elements of costs have increased with the rise in market yields. Interest rates on outstanding housing and business loans remained low, despite increases in interest rates on some new fixed-rate loans. The increase in the cash rate in May will add to banks' funding costs and many banks have announced they will pass through the increase to variable housing rates. Growth in credit remained high and demand for housing finance continues to be robust. Business debt has been growing strongly.

The Australian dollar is higher than at the start of the year, having been supported by high commodity prices, which are expected to remain at elevated levels compared with recent years. This is despite the exchange rate depreciating in April alongside concerns about the outlook for Chinese activity and the appreciation of the US dollar.

AGS yields have risen considerably

Yields on Australian Government Securities (AGS) have risen considerably since late 2021, to be at their highest level since 2014 (Graph 3.1).

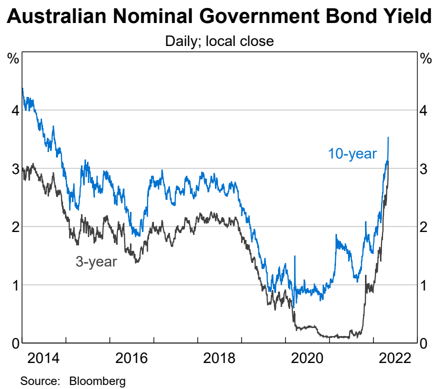
These increases have occurred alongside similar movements in international markets (Graph 3.2). The rise in government bond yields largely reflects expectations for further monetary policy tightening as well as higher inflation over the next few years. Further, in addition to putting upward pressure on energy prices, Russia's invasion of Ukraine has contributed by raising global risk premia. The increase in shorter-term

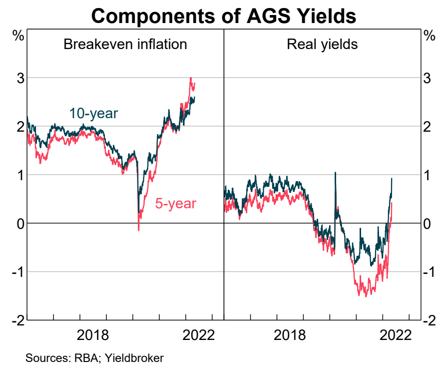
AGS yields has been driven by both higher real yields and higher inflation compensation (which captures both inflation expectations and risk premia) (Graph 3.3). By contrast, the increase in longer-term AGS yields has been largely driven by higher real yields. Yields on semi-government securities (semis) have increased in line with those on AGS.

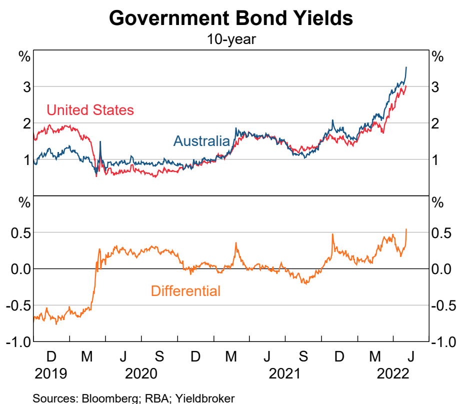
Having ceased new purchases under the bond purchase program in February, the Board announced in May that it will not reinvest the proceeds of the Bank's maturing government bond holdings. The Board also stated that it was not currently planning to sell the government bonds the Bank purchased during the pandemic. As the Bank's bond holdings mature, the stimulatory effect of the stock of bonds purchased by the Bank will gradually decline.

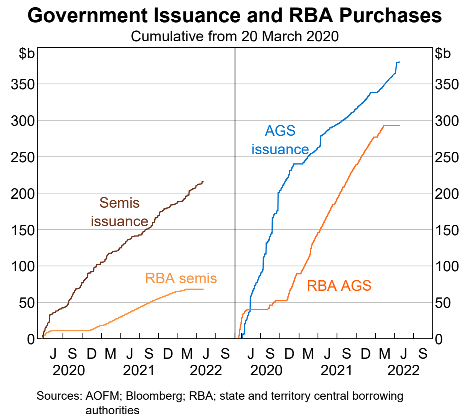
Government bond issuance has been steady

Following the release of the Australian Government Budget 2022–23, the Australian Office of Financial Management (AOFM) lowered its annual funding guidance for the 2021/22 fiscal year slightly to $100 billion from $105 billion, and plans to issue $125 billion of nominal AGS in the next financial year. Bond issuance by the AOFM has been steady in recent months, with auctions continuing to be well subscribed (Graph 3.4). In April, the AOFM issued $15 billion of the new November 2033 AGS via syndication.





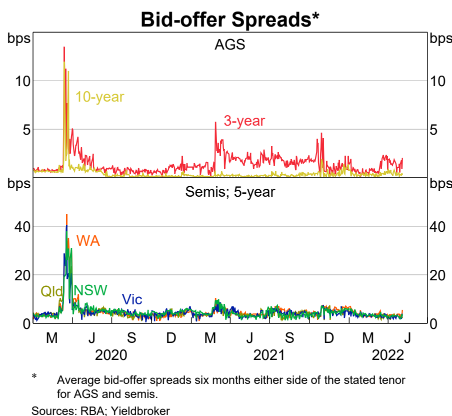




Most measures suggest bond markets are functioning reasonably well

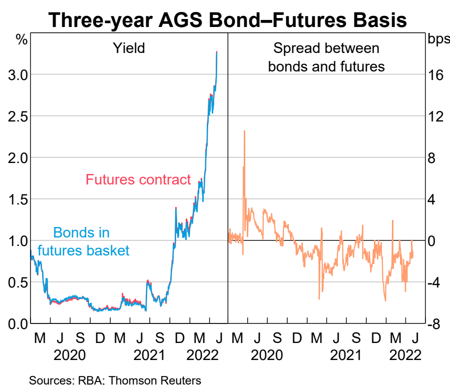
Bid-offer spreads for longer-term AGS and semis remain around their lowest levels in recent years. Bid-offer spreads for short-term AGS increased in March, alongside the sharp increase in yields globally, but remain around the levels seen over the past year (Graph 3.5). The implied yield on three-year bond futures contracts continued to diverge from the yield on three-year bonds over much of the quarter, although this difference has narrowed of late; arbitrage should keep this difference close to zero in an efficient market (Graph 3.6).

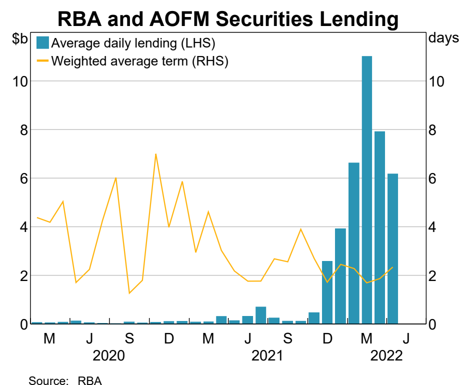
Demand to borrow AGS from the Bank rose strongly in late 2021 and early 2022, reaching an average of around $11 billion per day in February (Graph 3.7). Demand has declined since then, although it remains elevated with an average of around $6 billion of bonds per day lent out to the market in April. Demand remains focused on bonds with residual maturities of two to three years. The end of the Bank's bond purchase program in February and steady issuance by the AOFM (particularly of the November 2024 bond) have contributed to the decline in demand to borrow AGS from the Bank. However, market liaison suggests that bond dealers have continued to hold low AGS inventories because AGS have remained relatively more expensive than futures. By lending bonds back into the market for short periods, the Bank is supporting the functioning of government bond markets.



Cash rate expectations have increased significantly

Market expectations for the cash rate have increased in recent months, alongside expectations for higher inflation in Australia and globally and policy rate rises in advanced economies, including Australia. Following the increase in the cash rate target to 35 basis points in early May, prices for overnight indexed swap (OIS) contracts imply that market participants expect the cash rate to be increased over the





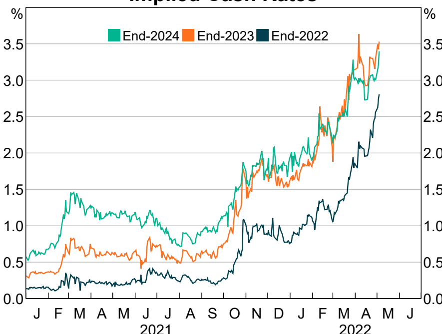
remainder of the year to be around 2¾ per cent by the end of 2022, and around 3½ per cent by the end of 2023 (Graph 3.8). In April, transaction volumes in the cash market picked up a little, and as a result the proportion of days when the cash rate was determined by market transactions, rather than expert judgement, has increased. The cash rate increased slightly to 6 basis points in April, and to 31 basis points in early May, following the increase in the cash rate target.

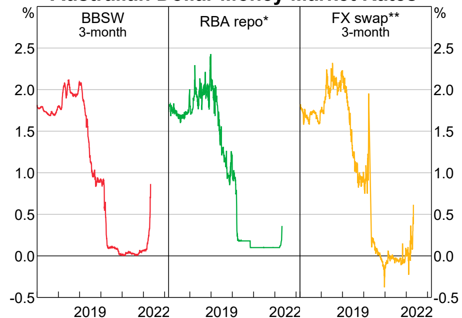
Money market rates have increased from historically low levels

Short-term money market rates have increased but remain at relatively low levels, reflecting the high level of liquidity in the banking system and the low level of the cash rate (Graph 3.9). Bank bill swap rates (BBSW) increased alongside the rise in policy rate expectations and as investor demand for longer-tenor bills declined somewhat amid heightened geopolitical uncertainty. The cost of Australian dollar funding from offshore short-term issuance (via the foreign exchange swap market) also moved higher over the past three months but remains low. Repurchase agreement (repo) rates at the Bank's regular open market liquidity operations (OMO) increased from 10 basis points, where they had been since late 2020, to be 36 basis points at the OMO the day after the Board meeting in early May. Part of this increase occurred following the Bank changing the OMO hurdle rate at the end of March from the cash rate target to the rate on term-matched OIS plus a modest spread. This operational change was announced in February to ensure that the Bank's OMO continues to support liquidity as intended as conditions in money markets evolve over time.[1] Demand for short-term liquidity obtained at OMO has been little changed and remains at historically low levels.

The Bank's balance sheet remains large but will decline significantly over the next few years

The Bank's balance sheet has declined since the previous *Statement*, but remains large by historical standards, reflecting the policy measures introduced by the Bank in response to the COVID-19 pandemic (Graph 3.10; Graph 3.11). The recent decline in the balance sheet reflects a decrease in the market value of the Bank's bond holdings due to an increase in yields. On the liabilities side, there has been a corresponding decline in the valuation reserves component of 'other liabilities', which has resulted in a negative balance for this item in the past month or so.[2] The Bank's balance sheet will decline significantly over the next few years





as TFF funding begins maturing in 2023, with the TFF coming to an end in mid-2024. Also, the maturing of the Bank's government bond holdings will contribute to a decline in the Bank's balance sheet over a number of years.

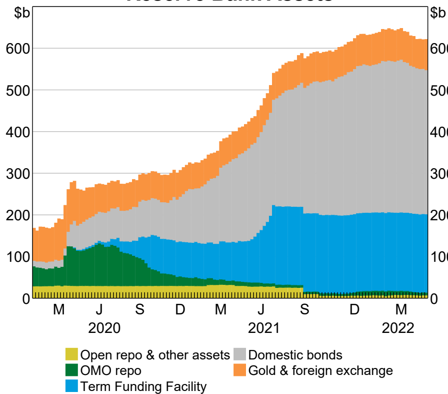
Bank bond issuance increased in recent months, alongside rising yields

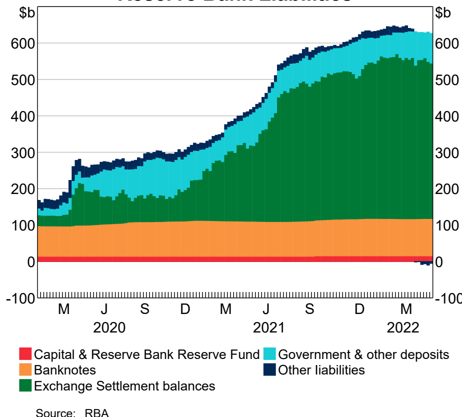
Australian bank bond issuance increased in early 2022. Banks raised $56 billion in bond markets during the March quarter, with an average tenor of four and a half years (Graph 3.12). This was the largest quarterly bank bond issuance in about a decade and followed low issuance in 2020 and 2021 (which reflected the availability of low-cost funding from the TFF and strong deposit growth during that time). Of late, banks may also be seeking to fund purchases of AGS to satisfy High Quality Liquid Asset requirements given APRA is phasing out use of the Committed Liquidity Facility (CLF) by the end of 2022.[3] In the March quarter, about 60 per cent of funds were raised in offshore markets, which are typically deeper and more liquid for bond issuance. Net issuance – the difference between bonds issued and those maturing – was positive for the first time since early 2019.

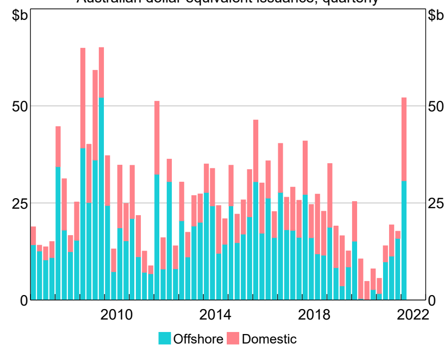
Bank bond yields increased sharply in recent months, with yields on three-year bonds now at around 4 per cent for the first time since 2013 (Graph 3.13). The increase in yields was somewhat larger than the increase in the swap rate, a reference rate for the pricing of fixed-income securities, reflecting stronger demand for funding and a broader increase in risk premiums.

RMBS issuance remained robust, driven by non-banks

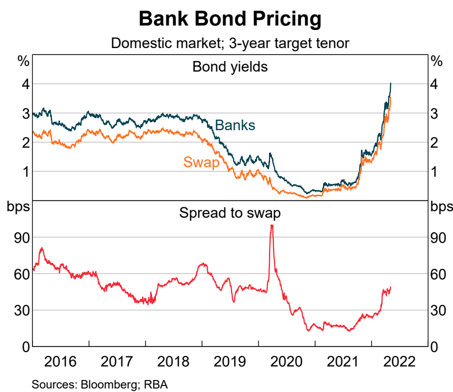
Issuance of asset-backed securities remained strong in the March quarter and continued to be driven primarily by non-banks. Of the $10 billion



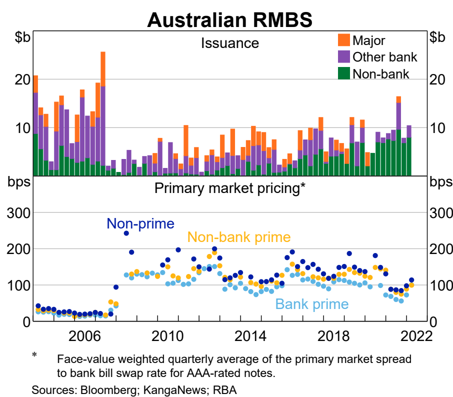




residential mortgage backed securities (RMBS) issued in the quarter, non-banks issued $8 billion (Graph 3.14). Market liaison suggests that conditions since late February were a little more challenging than over the past year or so – for example, some issuers had to increase efforts to contact potential investors to preplace notes. Spreads on RMBS have risen for both banks and non-banks since the start of the year, likely reflecting increased issuance of bank bonds weighing on demand for RMBS, with investors treating bonds and RMBS as close substitutes. Nevertheless, spreads remain around the bottom of the range seen in the decade preceding the pandemic.



Sources: Bloomberg; RBA



* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA-rated notes.

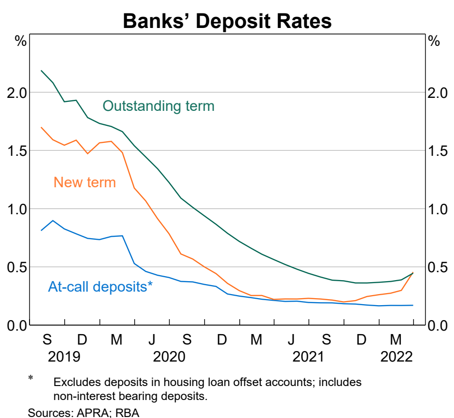
Sources: Bloomberg; KangaNews; RBA

Some deposit rates have increased

Interest rates on at-call deposits – which make up the bulk of banks' deposits – were little changed over the March quarter, after declining during the pandemic (Graph 3.15). The share of non-interest bearing deposits across the banking sector has increased a little over the same period. By contrast, interest rates on new term deposits edged higher again, driven by wholesale term deposit rates that tend to be linked to BBSW rates. Interest rates paid on outstanding term deposits have also increased slightly since the end of 2021, as maturing deposits have been replaced with new higher-rate term deposits. As the spread between rates on new term and at-call deposits widened, funding sourced from term deposits stabilised, after falling steadily since early 2019. Following the increase in the cash rate, some banks have announced increases to rates paid on a broader range of deposit products.

Banks' funding costs are lifting from historical lows

While banks' overall funding costs remain close to historical lows, they have risen with the increase in market yields over recent months and the increase in the cash rate in early May. Much of banks' wholesale debt funding is linked



* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits.

Sources: APRA; RBA

to BBSW rates (either directly or via hedging), which have increased in recent months (Graph 3.16). As noted above, banks' cost of issuing new debt also rose in early 2022. This has begun to put upward pressure on banks' overall funding costs as banks have also increased the pace of bond issuance over this period. Bond issuance is likely to remain higher than in recent years as banks respond to the wind-down of the CLF over 2022 and expected TFF maturities from next year. In addition, the cessation of government bond purchases under the Bank's bond purchase program is, all else equal, likely to see some easing in deposit growth compared with 2021. The Bank's bond purchases added to deposit growth because payments for bonds purchased from the private (non-bank) sector were credited to deposit accounts of the sellers of these bonds. Growth in low-rate deposits had also put downward pressure on funding costs over the past two years.

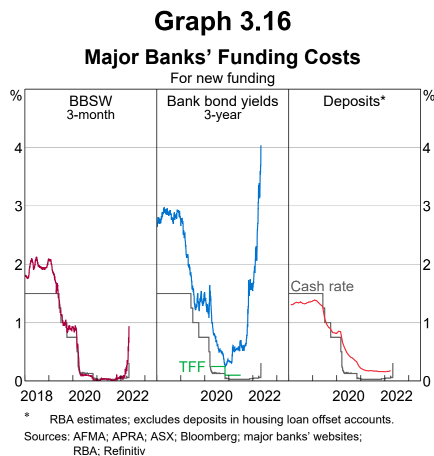
Interest rates have increased on new fixed-rate housing loans

Average interest rates on new fixed- and variable-rate loans continued to diverge over the March quarter (Graph 3.17). The average rate on new fixed-rate housing loans rose by almost 85 basis points from its historical low in mid-2021, following significant increases in swap rates, which are the pricing benchmark for these loans. By contrast, the average rate on new variable-rate housing loans declined further over this period, which preceded the May policy rate increase. As a result, at the end of the March quarter the average rate on new fixed-rate housing loans was higher than that on new variable-rate housing loans, and the proportion of borrowers taking out new fixed-rate mortgages has declined substantially since the end of last year (Graph 3.18). The recent movements in pricing and in lending volumes indicate that competition among mortgage lenders is shifting back towards variable-rate loans after a period of competitive pricing pressures on fixed-rate loans.

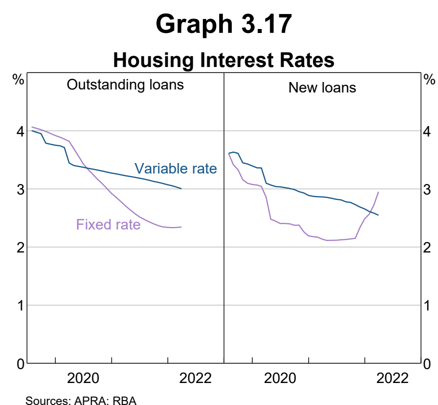
While increases in interest rates on fixed-rate loans have been broadly based, the largest increases have been on loans with fixed-rate terms of more than two years (Graph 3.18). Despite easing in recent months, the value of new borrowing for shorter-term fixed-rate mortgages was still more than double its pre-pandemic level in March.

Interest rates on outstanding housing loans remain low

The average rate on outstanding variable-rate mortgages continued to drift downwards over the March quarter, as low variable rates encouraged new borrowing and refinancing



* RBA estimates; excludes deposits in housing loan offset accounts.
Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv



Sources: APRA; RBA

Table 3.1: Average Outstanding Housing Rates

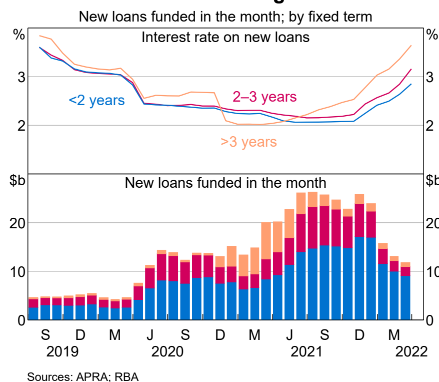
March 2022

	Interest rate (per cent)	Change since Feb 2021 (basis points)	Change since Feb 2020 (basis points)
Variable-rate loans			
– Owner-occupier	2.89	–23	–69
– Investor	3.24	–24	–73
All variable-rate loans	3.00	–24	–71
Fixed-rate loans			
– Owner-occupier	2.22	–41	–151
– Investor	2.58	–45	–143
All fixed-rate loans	2.34	–44	–151
Loans by repayment type[(a)]			
– Principal-and-interest	2.68	–34	–94
– Interest-only	3.25	–39	–97

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

Sources: APRA; RBA

activity (Graph 3.17). Following the increase in the cash rate in early May, several banks have announced that they will increase variable rates for existing loans by 25 basis points. As these changes come into effect, this will cause the average rate paid on outstanding loans to increase. Meanwhile, the average rate on outstanding fixed-rate housing loans was little changed over the March quarter. The average outstanding fixed rate on housing loans was around 65 basis points lower than the average outstanding variable rate, reflecting the high volume of fixed-rate mortgages that were taken out when new fixed rates were lower than new variable rates (Table 3.1). The average rate on outstanding fixed-rate housing loans is expected to increase gradually in the period ahead, since the average rate on new fixed-rate loans is now well above the average rate on outstanding fixed-rate loans and given the relatively short terms of fixed-rate loans.



Interest rates on outstanding business loans remained around historical lows

Interest rates on outstanding business loans have drifted down slightly or been little changed across most types of loans over recent months (Graph 3.19). However, interest rates on new business loans have increased or been little changed for most types of loans over the same period. Average interest rates on new fixed-rate loans for small and medium businesses – which account for just under 12 per cent of business loans by value – have picked up recently,

Table 3.2: Growth in Financial Aggregates

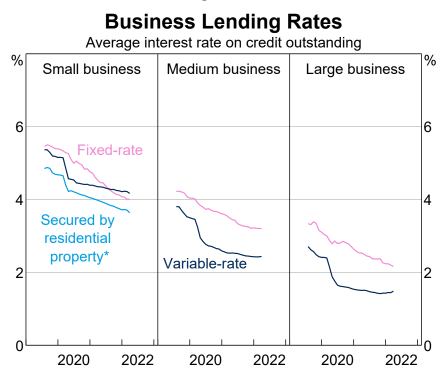
Percentage change[(a)]

	Three-month annualised		Six-month annualised	
	Dec 21	Mar 22	Sep 21	Mar 22
Total credit	9.4	6.9	7.5	8.1
– Household	7.5	7.1	6.8	7.3
– Housing	8.2	7.8	7.7	8.0
– Owner-occupier	9.1	8.2	9.7	8.6
– Investor	6.4	6.8	4.0	6.6
– Personal	–0.2	–2.7	–5.2	–1.5
– Business	13.2	6.8	8.8	10.0
Broad money	13.7	4.8	9.9	9.2

(a) Figures are break-adjusted and seasonally adjusted.

Sources: ABS; APRA; RBA

following the rise in longer-term swap rates (a key pricing benchmark for fixed-rate loans). Interest rates on variable-rate loans may increase in the period ahead, following the increase in the cash rate in early May. The recent increase in three-month BBSW rates may also see a rise in large business lending rates in the period ahead, given interest rates on a range of variable-rate loans for larger businesses are typically linked to three-month BBSW rates.



* 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 credit remains high

Growth in total credit remained high in recent months, at around its fastest pace in more than a decade on a six-month-ended annualised basis (Graph 3.20; Table 3.2). Total housing credit growth was little changed over recent months on a six-month-ended annualised basis, remaining around its highest pace of the past decade. Demand for housing credit continued to be supported by the low level of interest rates and strong activity in housing markets in the first few months of this year.

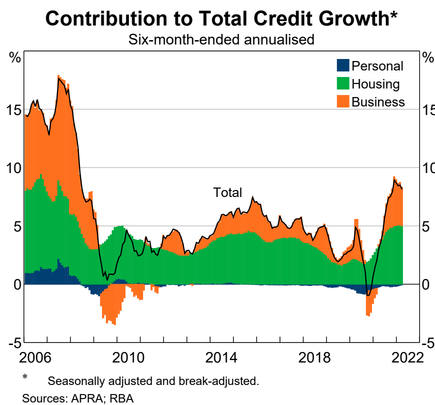
Growth in business credit remains strong relative to the past decade. Demand for business credit has been driven by large- and medium-sized businesses. Growth in credit to large businesses has been supported by elevated merger and acquisitions (M&A) activity as well as strong economic growth.

Personal credit continued to decline over the past six months, but at a slower pace than in late 2021. This is consistent with the easing of lockdowns over this period and the associated increase in spending opportunities for consumers.

Demand for housing loans has been strong

Housing credit growth remains high at 8 per cent on a six-month-ended annualised basis. Owner-occupier credit growth has moderated a little over the past few months, while investor credit growth has picked up (Graph 3.21).

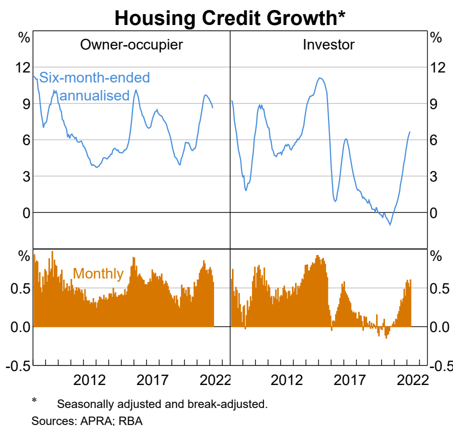
Commitments to owner-occupiers and investors remain close to their highest levels on record (Graph 3.22). Commitments to first home buyers have declined in recent months, in part owing to the end of the HomeBuilder subsidy. Nevertheless, they remain elevated relative to pre-pandemic levels, supported by a number of other government support schemes for first home buyers.

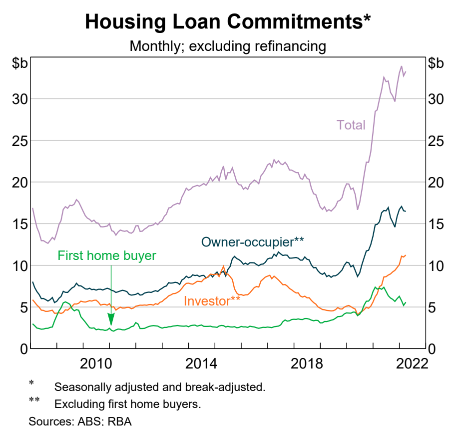


Payments into housing loan offset and redraw accounts have declined

Net payments into offset and redraw accounts declined a little further in the March quarter from the high level reached in the September quarter. This decline is consistent with the end of lockdowns during late 2021, and the associated increased consumption opportunities and tapering of income support payments. Since the onset of the pandemic in early 2020, mortgage borrowers' payments into offset and redraw accounts have been substantial, totalling about 3½ per cent of disposable income (around $106 billion).

Interest payments on housing loans have declined by around 1¼ percentage points as a share of disposable income since March 2020, despite both housing credit and household income increasing at roughly the same pace over that period. This reflects the pass-through of the low cost of overall bank funding and borrowers refinancing to lower interest rates.





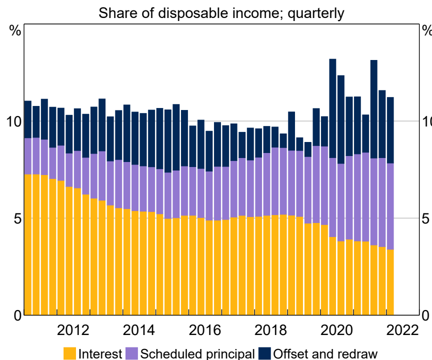
Lending to businesses has continued to grow strongly in recent months

Growth of business lending remained strong over recent months. Growth has been driven by lending to medium- and large-sized businesses, while lending to small businesses has been little changed for some time (Graph 3.24). Over the past year, growth in business lending has been most pronounced for business services and finance firms (Graph 3.25). Within the business services sector, lending to firms in the rental, hiring and real estate industry has been particularly strong.

Graph 3.23

Flows into Housing Loan and Offset Accounts*

Share of disposable income; quarterly



* Seasonally adjusted and break-adjusted.

Sources: ABS; APRA; RBA

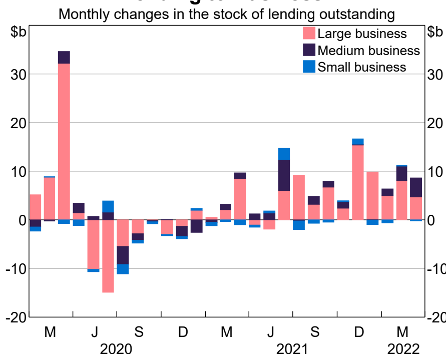
Liaison with banks suggests that outbreaks of the Omicron variant of COVID-19 have not weighed noticeably on business lending, and there have been very few requests for support by businesses. Views on the outlook for business lending are mixed. Some banks expect lending growth to remain strong over the coming year, owing to generally positive economic conditions and high levels of M&A activity over the past 12 months; others have noted that economic uncertainty, rising input costs and expectations for rising interest rates may contribute to some slowing.

Small- and medium-sized enterprise (SME) lending continues to receive some support from government loan guarantee schemes. As at March, around $5.8 billion of loan commitments had been made under the government's SME Recovery Loan Scheme since April 2021; this compares with total SME business loan commitments over the same period of around $110 billion. Loans are available under the SME Recovery Loan scheme until June 2022 (previously December 2021), with a guarantee of 50 per cent (previously 80 per cent).

Graph 3.24

Lending to Business*

Monthly changes in the stock of lending outstanding

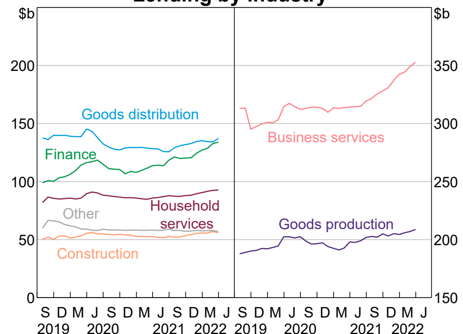


* Data cover financial institutions with $2 billion or more of business credit; not seasonally adjusted.

Sources: APRA; RBA

Graph 3.25

Lending by Industry*



* Excludes lending to ADIs, registered financial corporations and central borrowing authorities.

Sources: APRA; RBA

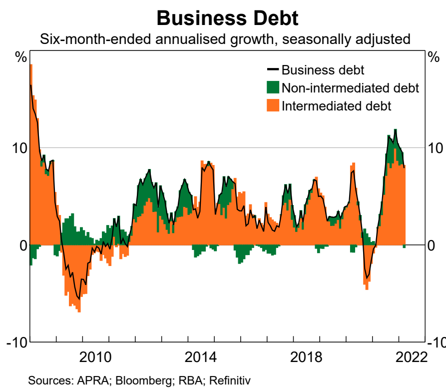
Growth of broader business debt remains strong

Growth in a broader measure of business debt remains well above the average of recent years, supported by an increase in business credit (Graph 3.26). Notwithstanding this, weaker growth in non-intermediated debt has contributed to a slight easing in overall growth of business debt in recent months.

Australian equity prices have increased in recent months

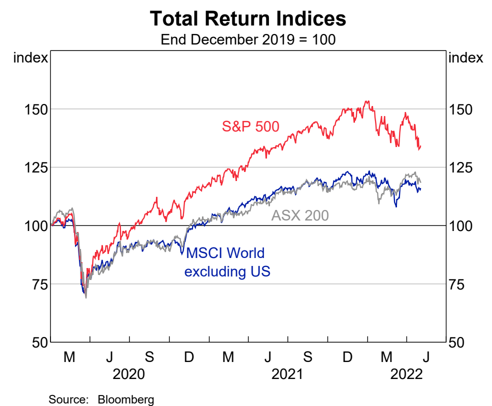
The ASX 200 index has increased by around 5 per cent, on a total return basis, since early February, largely unwinding the decline from January and outperforming equity markets in the United States and the rest of the world (Graph 3.27). The recovery in equity prices in part reflects the composition of the Australian market, which has a larger resources sector and a smaller IT sector compared with many other markets. Energy stocks have increased as Russia's invasion of Ukraine has pushed energy prices higher, while IT stocks have declined alongside the rise in long-term bond yields. Technology companies are often expected to experience strong growth in profits over the longer term, making their valuations more sensitive to changes in interest rates.

Graph 3.26

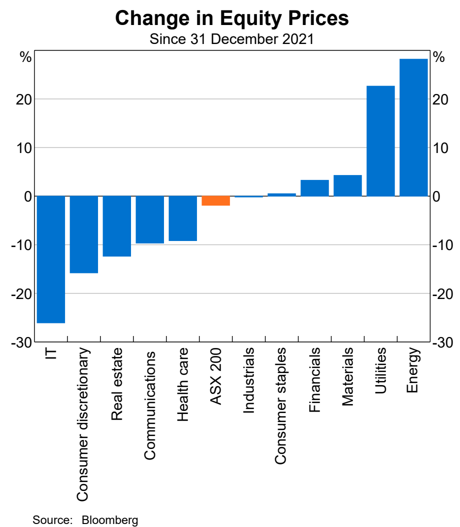


Energy stocks have increased by almost 30 per cent since the beginning of the year (Graph 3.28). Utilities stocks have also increased significantly as investors look for companies that tend to have steady earnings given the current environment of geopolitical and economic uncertainty. By contrast, prices of stocks in the interest-rate-sensitive IT and consumer discretionary sectors have declined noticeably as expectations of interest rate increases have risen.

Graph 3.27



Graph 3.28



Buybacks remain elevated, while equity raisings have been subdued

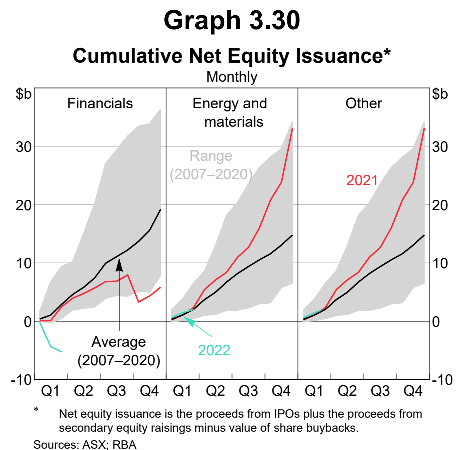
Australian listed companies have continued to return cash to shareholders through share buybacks in 2022. About $8 billion of buybacks were completed during the first quarter of the year, driven by the major banks returning surplus capital accumulated during the pandemic (Graph 3.29). By contrast, after a high level of initial public offerings (IPOs) activity in 2021, only around $180 million were raised by 28 companies that listed on the ASX in the first quarter of 2022.

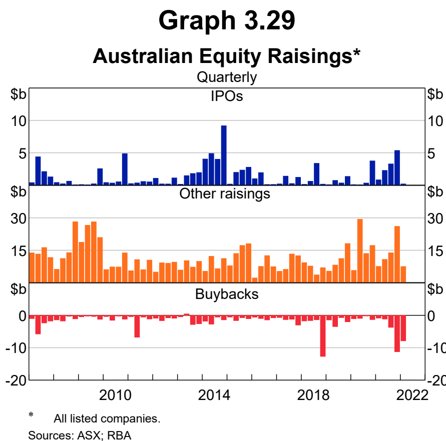
The elevated level of buybacks by financial companies has resulted in an aggregate decline in equity on issue in early 2022 (Graph 3.30). By contrast, equity on issue in the resources and other sectors has increased at around trend rates of growth.

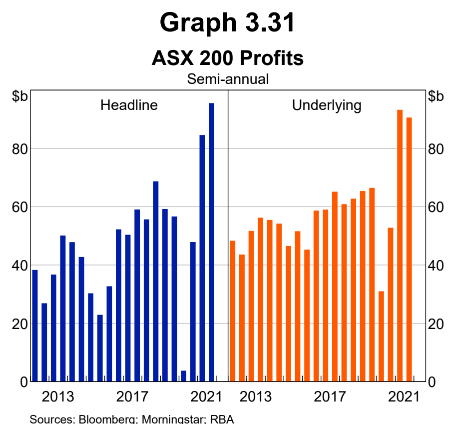
Profits and dividends of Australian companies remain high

Aggregate underlying profits of ASX 200 companies in the second half of 2021 were substantially higher than the same period a year earlier, and only slightly below the record level of underlying profits in the first half of 2021 (Graph 3.31). The high level of profits continues to reflect elevated earnings for energy and materials companies, driven by high commodity prices. Even so, the increase in profits was broadly based. Over 70 per cent of all ASX 200 companies reported increased earnings relative to the second half of 2020 (during the earlier phase of the pandemic), with over 50 per cent of these companies exceeding analysts' expectations.

Dividends announced in the first half of 2022 fell in comparison to those paid in the second half of 2021, but remained substantially higher than the same period a year earlier (Graph 3.32). The elevated level of dividends continued to be driven by the major miners, with these companies making up over 40 per cent of all dividends announced.







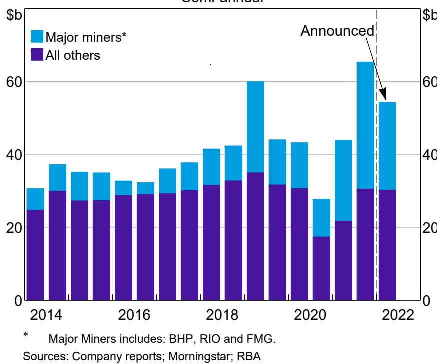
The Australian dollar is higher than at the start of the year, despite depreciating of late

The Australian dollar is around 4 per cent higher than at the start of the year on a trade-weighted (TWI) basis. While the appreciation has been noticeable against the Japanese yen and the euro, the Australian dollar depreciated markedly against the US dollar in April alongside the appreciation of the US dollar and concerns about the outlook for Chinese activity (Graph 3.33). The Australian dollar exchange rate is currently below US$0.73, having appreciated to US$0.76 after the April Board meeting.

Graph 3.32

ASX 200 Dividends Paid

Semi-annual

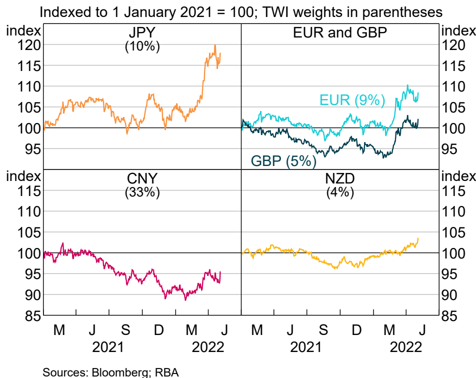


* Major Miners includes: BHP, RIO and FMG.

Sources: Company reports; Morningstar; RBA

Graph 3.33

Australian Dollar Against Selected Currencies



Sources: Bloomberg; RBA

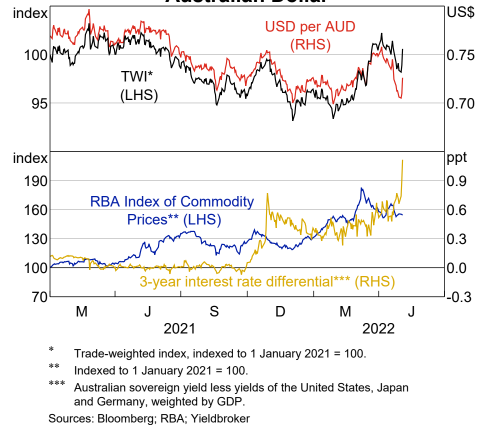
The Australian dollar has been supported this year by the elevated level of commodity prices, which has boosted Australia's terms of trade and national income. The RBA Index of Commodity Prices remains at high levels despite a recent decline from its peak. Market participants generally expect commodity prices to remain above the levels of the last few years (see chapter on 'The International Environment'). While import prices have also risen, Australia's terms of trade are forecast to be quite a bit higher across the forecast period than at the time of the February *Statement* (Graph 3.34). The exchange rate has also been supported by yields on Australian Government bonds increasing noticeably against yields on the government bonds of Japan and Germany.

Australia continued to be a net exporter of capital in 2021

Capital outflows from Australia continued to exceed capital inflows in 2021. In other words, Australia was a net exporter of capital, which is consistent with running current account surpluses whereby domestic savings exceed investment (see chapter on 'Domestic Economic Conditions').[4] Net outflows of capital were largely accounted for by Australian investment funds – including superannuation funds –

Graph 3.34

Australian Dollar



* Trade-weighted index, indexed to 1 January 2021 = 100.

** Indexed to 1 January 2021 = 100.

*** Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.

Sources: Bloomberg; RBA; Yieldbroker

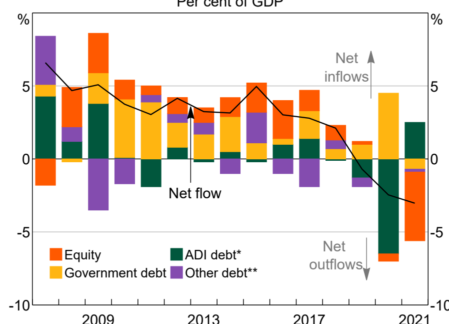
increasing their holdings of foreign equities (Graph 3.35). These outflows were partly offset by capital inflows associated with Australian banks returning to offshore markets to issue debt, particularly in the second half of the year.

Australia's net foreign liability position decreased over 2021 to be slightly below 40 per cent of GDP – its lowest level since the 1980s. This reflected a further increase in Australia's net foreign equity assets and a decline in long-term debt liabilities (Graph 3.36). The net income deficit – the net payments made to service the net foreign liability position – widened considerably over the year, mainly because higher commodity prices flowed through to an increase in dividend payments as well as direct investment income payments to non-residents.

Graph 3.35

Net Capital Flows

Per cent of GDP



* Adjusted for the US dollar swap facility in 2008–2009 and 2020.

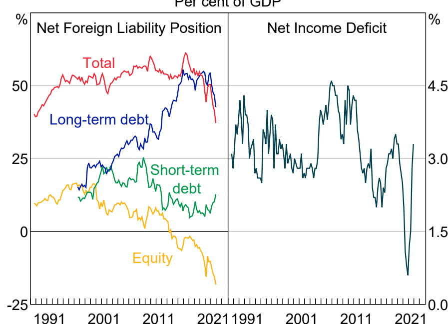
** Includes public corporations and private sector.

Sources: ABS; RBA

Graph 3.36

Net Foreign Position and Payments

Per cent of GDP



Sources: ABS; RBA

Endnotes

[1] See Kent C (2022), 'Changes to the Reserve Bank's Open Market Operations', Remarks to the Australian Financial Markets Association, Sydney, 22 February. Available at <https://www.rba.gov.au/speeches/2022/sp-ag-2022-02-22.html>

[2] Valuation reserves reflect accumulated gains or losses on the Bank's assets from movements in yields and exchange rates.

[3] APRA introduced the CLF in 2015 to enable banks to meet their liquidity requirements given the low level of government debt in Australia at the time. Under the CLF, the Reserve Bank provides a commitment (in exchange for a fee) to provide funds (against collateral) to banks in a period of liquidity stress. See RBA, 'Committed Liquidity Facility'. Available at <https://www.rba.gov.au/mkt-operations/committed-liquidity-facility.html>. See also APRA (2021), 'APRA Phases Out Reliance on Committed Liquidity Facility', Media Release, 10 September.

[4] For more information on the significant shift in Australia's balance of payments over recent years, see Adams N and T Atkin (2022), 'The Significant Shift in Australia's Balance of Payments', RBA *Bulletin*, March. Available at <https://www.rba.gov.au/publications/bulletin/2022/mar/the-significant-shift-in-australias-balance-of-payments.html>

4. Inflation

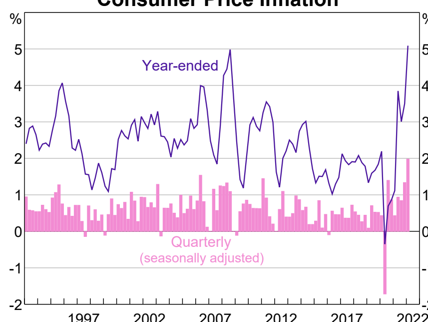
Inflation is high and picked up more than expected in the March quarter of 2022. Underlying inflation is also high and stronger than anticipated. Strong demand is enabling firms to pass through increases in input costs, which continued to drive strong inflation outcomes for durable goods and new dwellings in the March quarter. These pressures have now broadened to affect the prices of other items, including groceries. Inflation in the components that are most sensitive to domestic labour market conditions, including some market services, has picked up in recent quarters.

Wages growth picked up slightly in the December quarter but remained in line with the low rates observed in the years leading up to the COVID-19 pandemic. While wages growth was low for most industries, there were signs of the impact of the recent tightening in labour market conditions – for example, broader measures of wages growth that include bonuses and commissions were slightly stronger than base wages. More timely information from the Bank's business liaison program and business surveys suggests that growth in labour costs has picked up further over the course of this year, and that many firms now anticipate wages growth will increase more quickly in the period ahead. This is in line with the outlook for further labour market tightening, an upswing in job mobility and a strong focus by firms on retaining and attracting workers.

Inflation in the March quarter was very strong

The headline Consumer Price Index (CPI) increased by 2.1 per cent (2 per cent seasonally adjusted) in the March quarter and 5.1 per cent over the year (Graph 4.1; Table 4.1). This outcome was higher than anticipated a few months ago, in part reflecting much higher fuel prices due to Russia's invasion of Ukraine. Price increases for newly constructed dwellings and automotive fuel, which together comprise a little under 15 per cent of the CPI basket, accounted for close to half of the increase in the headline CPI in the quarter (Graph 4.2).

Although a few items continued making outsized contributions to growth in the CPI, inflationary pressures broadened further in the March quarter, with price increases picking up for many grocery items and a number of market services. Around 70 per cent of the CPI basket had an annualised inflation rate above 2.5 per cent in the quarter, which is comparable



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

Sources: ABS; RBA

Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly[(a)]		Year-ended[(b)]	
	March quarter 2022	December quarter 2021	March quarter 2022	December quarter 2021
Consumer Price Index	2.1	1.3	5.1	3.5
Seasonally adjusted CPI	2.0	1.3	–	–
– Tradables	2.7	1.8	6.8	4.9
– Tradables (excl volatile items)[(c)]	1.7	1.4	3.6	2.2
– Non-tradables	1.6	1.2	4.2	2.8
Selected underlying measures				
Trimmed mean	1.4	1.0	3.7	2.6
Weighted median	1.0	0.9	3.2	2.5
CPI excl volatile items[(c)]	1.6	1.2	4.0	2.6

(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

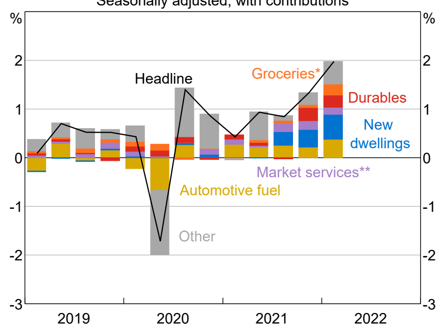
to the levels seen during the period of elevated inflation in Australia prior to the global financial crisis (Graph 4.3).

Measures of underlying inflation were also very strong in the March quarter. Trimmed mean inflation was 3.7 per cent over the year and 1.4 per cent in the quarter – the strongest quarterly outcome since the inflation targeting era began in 1993 (Graph 4.4; Table 4.1).

Graph 4.2

Quarterly CPI Inflation

Seasonally adjusted, with contributions

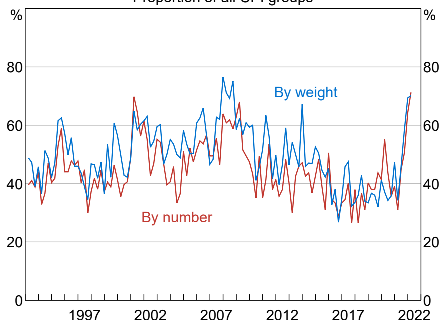


* Excludes fruit and vegetables.
** Excludes domestic travel and telecommunications.
Sources: ABS; RBA

Graph 4.3

CPI Items Rising More than 2.5 Per Cent*

Proportion of all CPI groups



* Based on seasonally adjusted data; adjusted for the tax changes of 1999–2000; CPI items with annualised quarterly growth more than 2.5 per cent.
Sources: ABS; RBA

Fuel prices increased sharply in the quarter, making a large contribution to headline inflation

Fuel prices increased by 11 per cent in the March quarter to a record high level, contributing close to 0.4 percentage points to headline inflation in the quarter (Graph 4.5). This was primarily due to the increase in global oil prices following Russia's invasion of Ukraine, alongside strengthening global demand after the easing of COVID-19 restrictions. Fuel prices increased by 35 per cent over the year to the March quarter – the largest annual increase since 1990. However, fuel prices have since decreased due to the reduction in fuel excise and declines in oil prices; if sustained around current levels, fuel will subtract from quarterly headline inflation in the June quarter.

Pass-through of upstream cost pressures continued to drive strong inflation outcomes for new dwellings and durable goods …

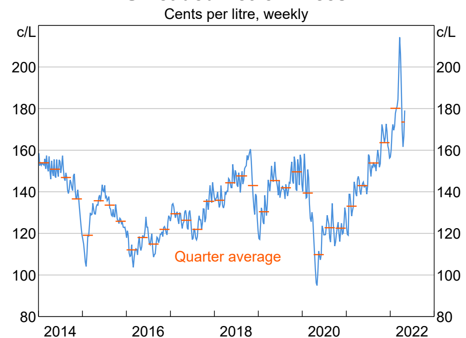
The upstream cost pressures that have boosted the prices of new dwellings and durable goods since the latter part of 2021 continued in the March quarter. Prices for new dwelling construction, which make up just under one-tenth of the CPI basket, continued to increase significantly – prices were up by 5.7 per cent in the March quarter to be 13.7 per cent higher over the year. This was driven primarily by further substantial increases in the prices charged by builders in all capital cities, particularly in Perth (which saw a 15.8 per cent increase). Sustained strong demand for housing construction has enabled builders to pass through increased costs for labour and building materials; prices for building materials increased by 4.2 per cent in the March quarter and 15.4 per cent over the year (Graph 4.6).

Prices for new dwellings also increased because fewer government grants were paid out in the March quarter than in the December quarter – this accounted for close to one-quarter of the

Graph 4.5

Unleaded Petrol Prices

Cents per litre, weekly

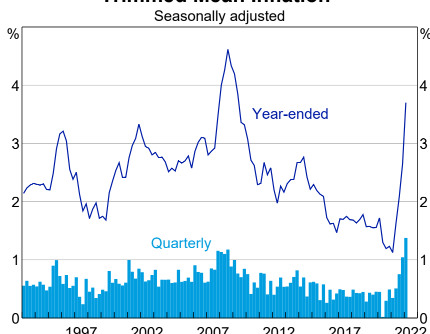


Sources: Australian Institute of Petroleum; RBA

Graph 4.4

Trimmed Mean Inflation*

Seasonally adjusted

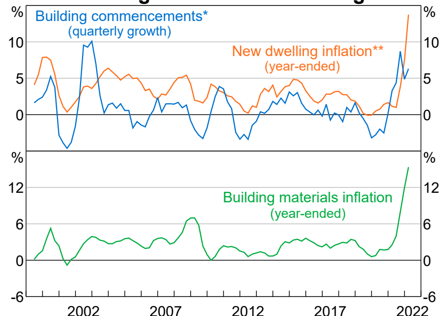


* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.6

New Dwelling Inflation and Building Costs



* Six-quarter average lagged by one quarter.

** Adjusted for the tax changes of 1999–2000.

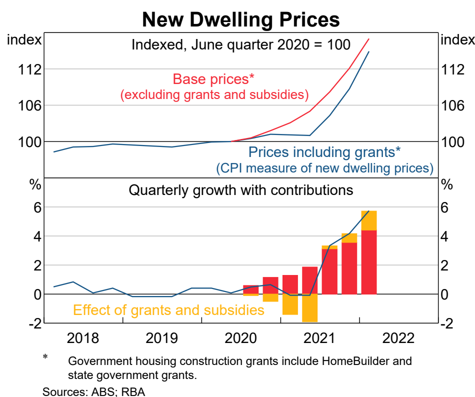
Sources: ABS; RBA

total increase in new dwelling prices (Graph 4.7). The number of grants paid out is expected to decline further over time, which will boost measured inflation as prices measured in the CPI converge to the prices charged by builders. However, the effect on inflation in a given quarter will vary depending on how many grants are paid out during that period.

Consumer durables inflation increased at its fastest pace in more than three decades, at a little over 3 per cent in year-ended terms (Graph 4.8). This reflected ongoing global supply chain disruptions, sustained global and domestic demand, and high shipping costs. Price increases were broadly based across most items within the durables category (Graph 4.9). The exception was clothing and footwear, where firms increased discounting activity by a larger-than-usual amount to reduce excess summer stock. Nonetheless, liaison suggests that some firms have increased base prices for their new winter stock.

Reports of non-labour input cost pressures remain widespread across goods-related firms. These pressures are likely to persist for longer than previously expected, because of the Russian invasion of Ukraine and renewed lockdowns in China. Additional demand for household goods and building materials induced by the flooding along the east coast is also expected to contribute to inflationary pressures in the near term. Most retailers in the Bank's liaison program have increased prices over recent months, or expect to do so over the months ahead, due to the persistence and magnitude of cost increases. To date, many retailers have limited price increases to items where cost pressures have been most pronounced or where demand is relatively inelastic; only a small share of firms have undertaken across-the-board price increases.

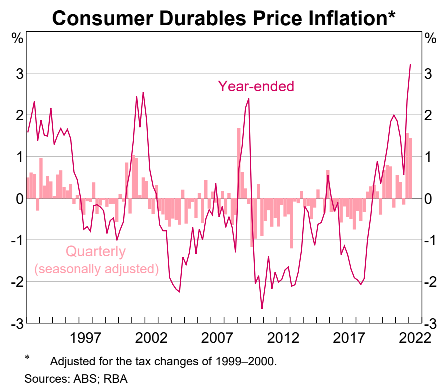
Graph 4.7



* Government housing construction grants include HomeBuilder and state government grants.

Sources: ABS; RBA

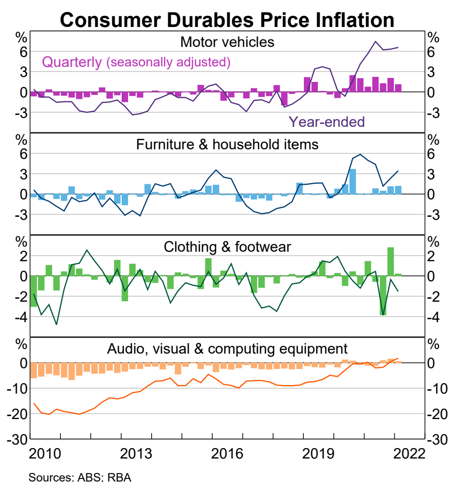
Graph 4.8



* Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.9

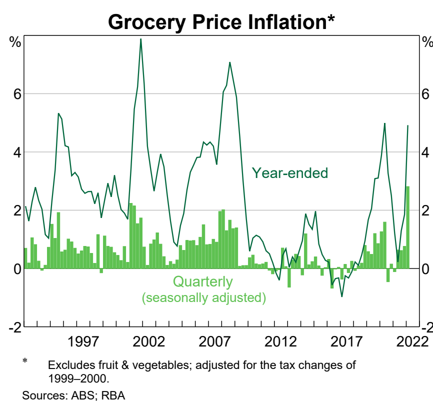


Sources: ABS; RBA

… and broadened to affect the prices of many grocery items

Grocery prices have also picked up strongly over recent months as supermarkets passed through supplier cost increases and reduced discounting activity in response to supply disruptions (Graph 4.10). Grocery prices (excluding fruit & vegetables) increased by 2.8 per cent in the quarter – the strongest quarterly outcome since 1983 – with prices 4.9 per cent higher than a year ago. Retailers in the Bank's liaison program have become more willing to accept price increases from their suppliers due to the broad-based cost increases their suppliers have faced, including for inputs such as fertilisers, chemicals, shipping and packaging. Price increases for most fresh food categories were strong in the quarter, including for meat, which continued to be affected by limited supply as farmers restock herds.

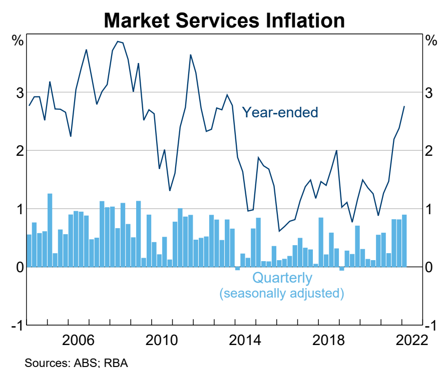
Prices of fruit & vegetables increased by 2.3 per cent in the quarter to be 6¾ per cent higher over the year. This primarily reflected supply chain disruptions and higher input costs, such as for transport and fertiliser. Flooding in production areas of New South Wales and Queensland also disrupted supply in early March, placing additional pressure on vegetable prices late in the quarter.



Domestic inflationary pressures have started to pick up

Inflation in the prices of market services, which account for a little over one-fifth of the CPI basket, picked up further in the March quarter to be 2.8 per cent higher over the year – the fastest annual increase since 2013 (Graph 4.11). The prices of these services are generally among the most sensitive to domestic labour costs, although increases in non-labour costs have driven the price increases for some of these services in recent quarters. Price increases were particularly strong for household services that have been experiencing acute labour shortages such as hairdressing and vehicle repair, and for domestic travel and accommodation.

Prices of meals out & takeaway increased by 0.7 per cent in the quarter as firms passed through increases in both labour and non-labour costs (Graph 4.12). Underlying price increases were partly offset by greater use of state government vouchers such as the NSW 'Dine & Discover' and Melbourne's 'Melbourne Money' vouchers. Many of these vouchers are yet to be redeemed and will continue to weigh on measured market services inflation in the June quarter. Prices for domestic travel and accommodation services increased by 2.5 per cent in the quarter in seasonally adjusted terms, reflecting strength in demand for domestic holidays.



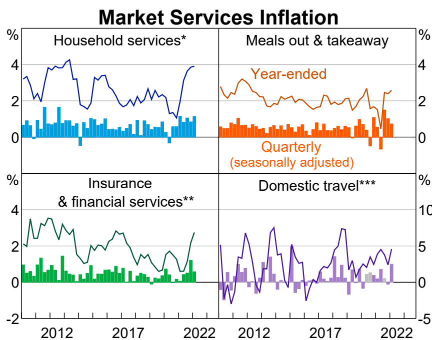
Rents – accounting for around 6 per cent of the CPI basket – increased by 0.6 per cent in the March quarter, after increasing by 0.1 per cent in the previous quarter. This is the strongest quarterly outcome since the September quarter of 2014. Rents in Sydney and Melbourne increased modestly, driven by increases for detached houses; in Sydney, this is the first quarterly increase in CPI rents since 2018 (Graph 4.13). Rents across other capital cities continue to record relatively strong rises, reflecting historically low vacancy rates. The gap between CPI rents (covering the entire rental stock) and advertised rents for new tenants remains large by historical standards (see chapter on 'Domestic Economic Conditions'). Stronger advertised rents are expected to contribute to a further pick-up in CPI rent growth in the year ahead, although the timing and extent of this pass-through remains uncertain.

Growth in administered prices remains around pre-pandemic rates

Administered prices (excluding utilities) rose by around 1.3 per cent in the March quarter and 3.7 per cent over the year, broadly in line with pre-pandemic trends. The effects of freezes and rebates implemented early in the pandemic have mostly faded but changes to other government policies continue to affect prices. Tertiary education prices increased by more than 5 per cent in the quarter in seasonally adjusted terms, driven by the changes in the federal government's contribution scheme for university courses (Graph 4.14). Prices for preschool and primary education also increased strongly in the quarter following the commencement of the new school year and the end of a two-year free preschool period in Victoria. Child care prices increased only slightly, with underlying price increases partially offset by the increase in the child care subsidy rate for families with more than one child and the NSW Before and After School Care voucher; these changes will continue to weigh on child care prices in the June quarter. Price increases for medical and hospital services were broadly in line with pre-pandemic rates.

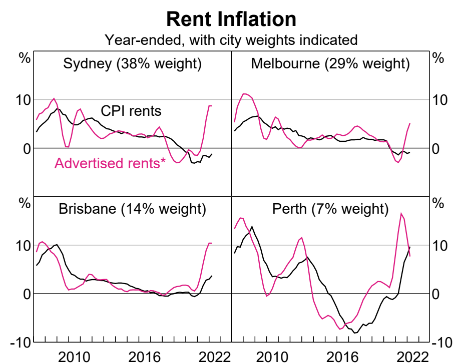
Retail electricity prices declined by 1.6 per cent in the March quarter, continuing the downward trend of recent years; prices are now over 11 per cent lower than their peak at the end of 2018, in part reflecting increased supply of renewable energy (Graph 4.15). While wholesale electricity prices have picked up strongly in recent months, information from liaison suggests that wholesale prices typically comprise only around one-third of retail

Graph 4.12



* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services.
** Excludes deposit & loans to June quarter of 2011.
*** Imputed using headline CPI in the June and September quarters of 2020 and September quarter of 2021.
Sources: ABS; RBA

Graph 4.13



* Hedonic three-month average.
Sources: ABS; CoreLogic; RBA

electricity bills and that pass-through is gradual. Retail gas prices increased by 4.4 per cent in the quarter, driven by a 10.9 per cent rise in Melbourne (largely due to the annual price reviews that factored in rising wholesale and network costs). The sharp increase in wholesale energy prices observed in recent quarters suggests that retail energy prices could increase in the period ahead.

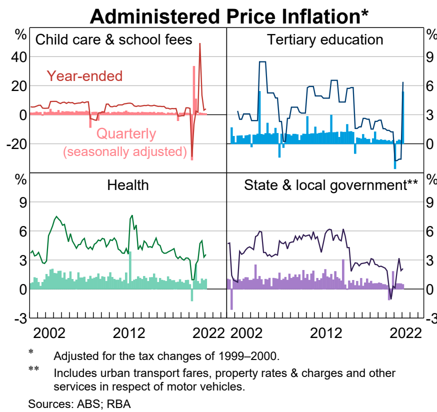
Short-term inflation expectations have increased further in recent months, but long-term expectations remain consistent with the inflation target

Survey-based measures of short-term inflation expectations have increased further over recent months to be around their highest levels in many years (Graph 4.16). Most measures of long term inflation expectations remain around 2½ per cent, although expectations of union officials have picked up to around 3 per cent, the highest level since 2012 (Graph 4.17).

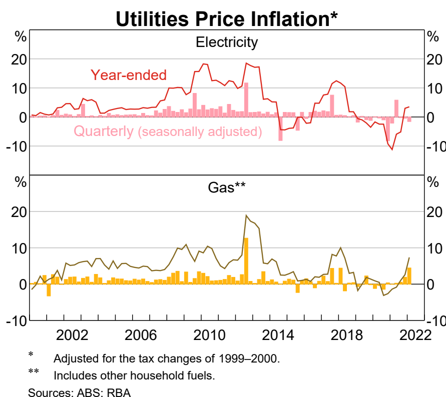
Wages growth remained around its pre-pandemic pace in the December quarter …

The Wage Price Index (WPI) grew by 0.7 per cent in the December quarter, and 2.3 per cent in year-ended terms. Private sector wages growth remained at 2.4 per cent over the year, with

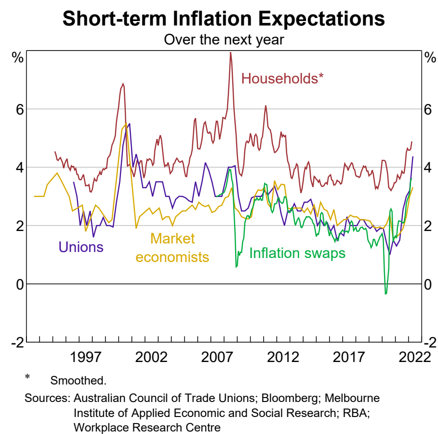
Graph 4.14



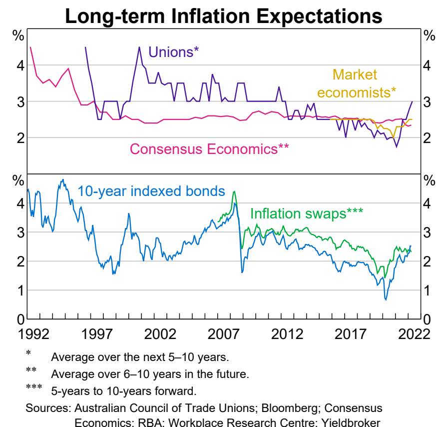
Graph 4.15



Graph 4.16



Graph 4.17



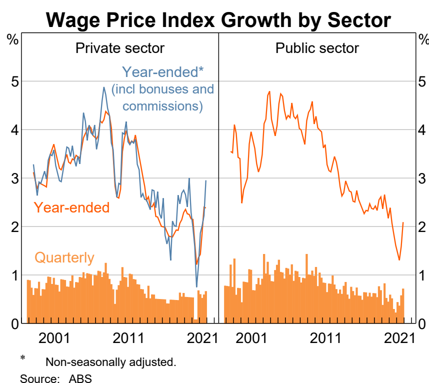
wages growth for jobs covered by enterprise agreements showing little sign of picking up above recent low rates (Graph 4.18). Wages growth in most industries was around pre-pandemic norms of 2–2.5 per cent (Graph 4.19). Exceptions to this included accommodation & food and retail trade, where stronger growth was largely due to some workers on modern awards receiving two wage increases in 2021 following the delay to some modern award implementations in 2020. Consistent with a tightening in labour market conditions, measures of private sector wages growth that include bonuses and commissions have grown faster than base wages in recent quarters, with growth averaging around 3 per cent in the December quarter in year-ended terms.

Public sector wages grew by 0.7 per cent in the quarter and 2.1 per cent in year-ended terms, as public sector wages policies continued to weigh on outcomes. The pick-up in quarterly growth was driven by scheduled increases in enterprise agreements for several large state employers, following a period of wage freezes.

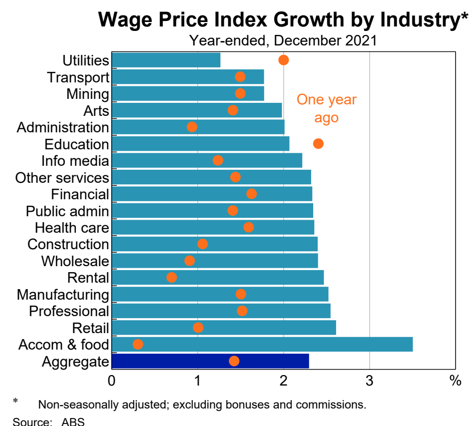
Real (inflation-adjusted) wages have declined since mid-2021 because consumer price inflation has picked up faster than wages growth; however, this decline has been less pronounced than in many other advanced economies. Households whose spending is concentrated in the categories where prices have risen the fastest – such as fuel, food, some durables and dwelling construction – have experienced a larger decline in real purchasing power; that said, the range of items in the CPI basket subject to larger-than-average price rises has broadened in recent quarters, implying that the share of households exposed to reductions in purchasing power has increased. Cost-of-living pressures from rising food and fuel costs are likely to fall unevenly across households, as lower-income households spend a greater proportion of their income on food and fuel and have relatively limited buffers of savings to draw upon. That said, growth in households' real incomes has recently been supported by increases in non-labour sources of income. Broad measures of growth in average earnings have remained highly volatile in recent quarters, due to large compositional changes in the workforce caused by the pandemic.

… though more timely indicators suggest that wages growth has increased recently and will pick up further in the period ahead

Information from the Bank's liaison program and other business surveys suggests that private sector wages growth has picked up in the past



* Non-seasonally adjusted.
Source: ABS



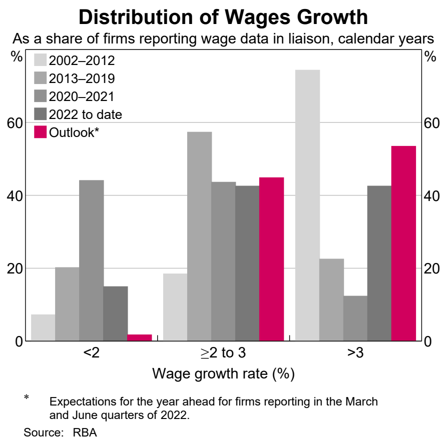
* Non-seasonally adjusted; excluding bonuses and commissions.
Source: ABS

couple of months. While the majority of liaison contacts continue to report annual wages growth of 3 per cent or less, there has recently been a marked increase in the share of firms reporting average wage increases already above 3 per cent (Graph 4.20). Higher average wages growth at many firms is being driven by larger increases for specific occupations and skill sets in high demand, with these firms otherwise looking to non-base-wage measures to retain and attract staff. However, there have been a growing number of firms reporting more broad-based salary increases for all staff.

Liaison reports suggest that wages growth will pick up further over coming quarters. More than half of firms expect to pay wage increases above 3 per cent over the year ahead, consistent with further tightening in the labour market and a greater focus on attracting and retaining workers. By contrast, only a small share of firms expect to pay wage increases below 2 per cent; the share expecting to keep wages frozen has fallen to a very low level. In line with messages from liaison, surveys of wages growth expectations have also risen recently (Graph 4.21).

Graph 4.20

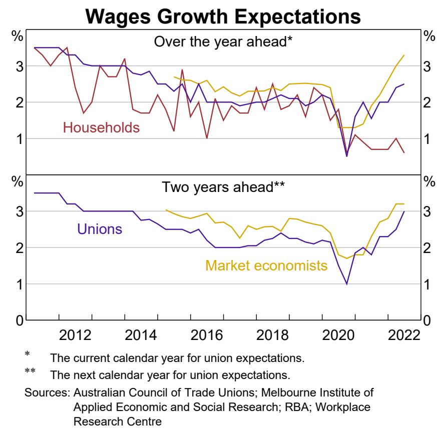
Distribution of Wages Growth



* Expectations for the year ahead for firms reporting in the March and June quarters of 2022.

Source: RBA

Graph 4.21



* The current calendar year for union expectations.

** The next calendar year for union expectations.

Sources: Australian Council of Trade Unions; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

5. Economic Outlook

Global economic growth is forecast to be slower and inflation higher than forecast a few months ago. Inflation has been persistently high because many advanced economies are at or close to full employment, commodity prices have risen sharply and there are ongoing supply disruptions. High inflation has prompted a faster withdrawal of monetary policy accommodation and is also clouding the growth outlook. Despite low unemployment, wages growth has been much slower than consumer price inflation across a range of economies, resulting in significant declines in real wages and consumer sentiment. Following a strong recovery from the depths of the pandemic, growth in the global economy is forecast to slow in the year ahead, to a little below the average rate of growth in the decade prior to the pandemic (see chapter on 'The International Environment').

A strong expansion in the Australian economy is underway. This is expected to continue over the forecast period, despite the slowdown in global growth. The domestic outlook is supported by the substantial boost to national income from high commodity prices and growth in private consumption and investment. After slowing in the March quarter in response to the Omicron outbreak, activity is forecast to regain momentum over 2022 as saving and spending patterns continue to normalise and a further tightening in the labour market supports real household income. Growth is then forecast to moderate in 2023 as extraordinary policy support is withdrawn, rising prices weigh on real income and consumption growth slows to more typical rates. GDP is forecast to grow by 4¼ per cent over 2022, and by 2 per cent over 2023; these forecasts are little changed from three months ago (Table 5.1). Strong ongoing demand for labour is expected to see the unemployment rate decline to around 3½ per cent in early 2023, a little below the previous forecast, and remain around this level for the rest of the forecast period. This is anticipated to result in labour costs picking up faster than previously expected.

As observed in other advanced economies, consumer price inflation in Australia has picked up markedly since the middle of 2021 and the outlook for inflation has again been revised higher. Headline inflation is forecast to peak around 6 per cent in the second half of this year. Underlying inflation has also risen strongly and is forecast to increase further to 4¾ per cent in the second half of 2022, largely reflecting further pass-through of upstream cost pressures. As some of the current cost pressures reflect supply bottlenecks domestically and abroad and are likely to moderate over time, headline and underlying inflation are forecast to return to the top of the 2 to 3 per cent target range by the end of the forecast period. Higher labour costs in response to a tight labour market are expected to become the primary driver of inflation outcomes later in the forecast period.

Key sources of uncertainty for the domestic outlook include the future evolution of COVID-19, changes in price- and wage-setting behaviour at historically low levels of unemployment, and the response of households, firms and asset prices to higher inflation and interest rates.

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	4.2	3½	4¼	3	2	2
(previous)		(5)	(4¼)	(2½)	(2)	(2)
Unemployment rate[b]	4.7	3¾	3¾	3½	3½	3½
(previous)		(4)	(3¾)	(3¾)	(3¾)	(3¾)
CPI inflation	3.5	5½	6	4¼	3¼	3
(previous)		(3¾)	(3¼)	(2¾)	(2¾)	(2¾)
Trimmed mean inflation	2.6	4½	4¾	3½	3¼	3
(previous)		(3¼)	(2¾)	(2¾)	(2¾)	(2¾)
	Year-average					
	2021	**2021/22**	**2022**	**2022/23**	**2023**	**2023/24**
GDP growth	4.7	3¾	4½	4½	2¾	2
(previous)		(4½)	(5½)	(4¾)	(2½)	(2)

(a) Forecasts finalised on 4 May. 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 May 2022 Board meeting. Other forecast assumptions (February *Statement* forecasts in parenthesis): TWI at 63 (60); A$ at US$0.71 (US$0.71); Brent crude oil price at US$101bbl (US$85bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government Budget 2022–23. 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

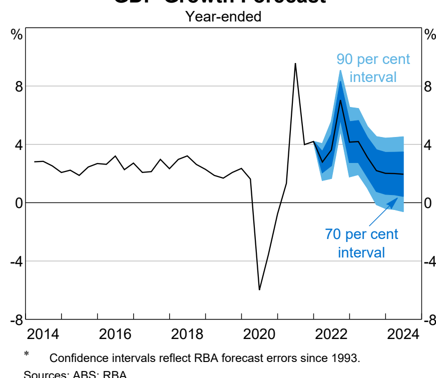
A strong expansion in the Australian economy is under way and inflation will increase further

The outlook for economic activity in Australia is underpinned by growth in private consumption and investment (Graph 5.1). Household consumption is forecast to grow strongly over 2022 as spending on services picks up; this outlook is supported by rising labour income, fiscal measures and the large increase in wealth over recent years. Increases in interest rates and consumer prices are anticipated to weigh on households' budgets over the forecast period, but the effect on consumption is expected to be cushioned by a decline in the household saving ratio. An upswing in business investment continues to be in prospect, supported by strong corporate balance sheets and the broader recovery in demand. Commodity price developments are forecast to result in the terms of trade reaching a record high in the June quarter, boosting national income.

Graph 5.1

GDP Growth Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

Employment is forecast to grow strongly during 2022, consistent with the ongoing strength in leading indicators of labour demand, before moderating thereafter in line with activity. Participation in the labour force is expected to be sustained at historically high levels over the forecast period, supported by the cyclical strength in labour market conditions and the longer-term trend toward increased participation among females and older Australians. The unemployment rate is forecast to decline to around 3½ per cent in early 2023 – the lowest level since 1974 – and remain around this level 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 staff hours to meet demand. The reopening of the border could, over time, help to alleviate labour shortages in some industries, while also adding to demand in the economy.

The forecast profile for underlying inflation has been revised up substantially compared with a few months ago. A shift in the sources of inflation over the forecast period is still expected. The upstream cost pressures that have boosted the prices of consumer durables and new dwellings since the latter part of 2021 are now expected to persist for longer than previously anticipated, reflecting the impact of the war in Ukraine (including the effect of higher oil prices on costs faced by firms) and renewed lockdowns in parts of China. The effects of these cost increases on consumer prices have also broadened over recent months. A significant share of firms in the Bank's liaison program have increased prices or expect to increase their prices over coming months as a result of the sustained rise in input costs.

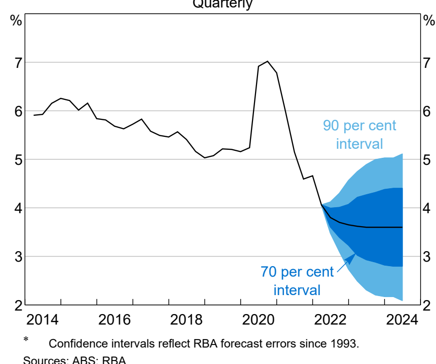
Reflecting these developments, underlying inflation is forecast to increase to around 4¾ per cent in the second half of 2022 before easing back towards the top of the inflation target range as international and domestic supply chain pressures subside (Graph 5.3). Later in the forecast period, the main contributor to inflation is expected to be the increase in labour costs resulting from a tight labour market. Headline inflation is forecast to be well above trimmed mean inflation in the near term (mainly due to the prices of fuel and new dwellings) but to be broadly in line with underlying inflation thereafter.

The forecasts are based on some technical assumptions. The assumed path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing, with a cash rate of 1¾ per cent in the December quarter of 2022 and 2½ per cent in

Graph 5.2

Unemployment Rate Forecast*

Quarterly



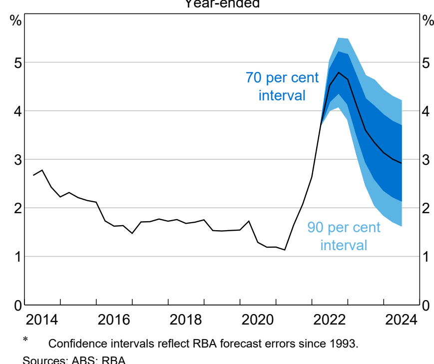
* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

Graph 5.3

Trimmed Mean Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

the December quarter of 2023. The exchange rate and oil price are assumed to remain unchanged at current levels. Population growth projections have been revised up, reflecting the assumptions used in the Australian Government Budget 2022–23. The forecasts are also based on the assumption that future waves of COVID-19 variants will mostly have a temporary impact on the economy, with limited restrictions on economic activity required and the labour market adjusting mainly through a reduction in hours worked. The risk of a more harmful variant of the virus with more serious economic consequences is one of several uncertainties for the outlook (see 'Key domestic uncertainties', below).

Household consumption, income and saving

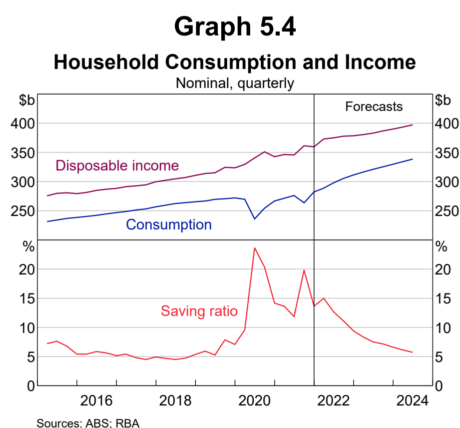
Household consumption remained resilient in the March quarter despite the Omicron outbreak and floods in New South Wales and Queensland, and is forecast to grow strongly over the rest of the year as spending on discretionary goods and services, including travel, continues to recover (Graph 5.4). The consumption forecast is underpinned by strong household balance sheets and higher household disposable income; this partly reflects strong growth in labour income, supported by the tight labour market. Non-labour income is also forecast to be significantly higher this year, reflecting pandemic-related social assistance payments, flood disaster payments, and other policy measures announced in the Australian Government Budget 2022–23, including cost-of-living support payments for low-income households. High commodity prices are forecast to boost financial income via dividend payments from the resources sector, as well as returns on superannuation.

Further ahead, consumption growth is forecast to ease as rising prices and higher net interest payments weigh on real income growth, and housing prices moderate. After increasing in the March quarter to levels significantly above pre-pandemic norms, the household saving ratio is expected to decline over the remainder of the forecast period.

Investment

The outlook for investment remains positive with a large pipeline of public and private projects expected to sustain activity over coming years (Graph 5.5). However, construction activity declined in the December quarter due to capacity constraints relating to shortages of materials and skilled labour. The recent flow of data and information from the Bank's liaison program indicate that these pressures have intensified and are likely to be a constraint on output for some time, resulting in a lower level of construction activity across the forecast period compared with earlier projections.

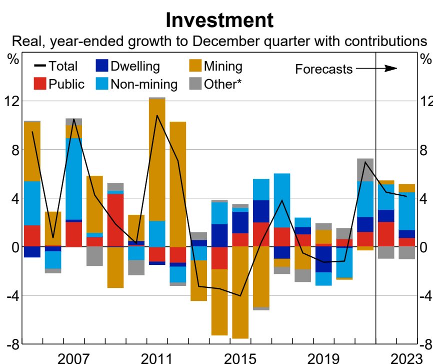
Though demand for new dwellings appears to be easing after strong growth over the past few years, a large pipeline of residential construction work is anticipated to sustain a high level of activity for several years. Capacity constraints and the recent floods in eastern Australia have, however, led to longer construction times, which will limit the pace of work in the near term. Prospects for higher density residential projects are expected to improve following the decline in vacancy rates in Sydney and



Melbourne and the reopening of the international border.

The strong upswing in non-mining business investment that was underway over the first half of 2021 has paused since then but is expected to regain momentum over the next two years. This growth is forecast to exceed that of the overall economy and so lift the non-mining investment share of GDP from historically low levels. Investment in machinery & equipment declined late last year, after earlier strong growth as some firms brought forward investment in response to tax incentives. Supply chain disruptions also persisted into the March quarter and, alongside shortages of skilled labour, are expected to restrain growth in the near term. However, over coming years, a tight labour market and higher labour costs are likely to encourage some firms to lift their investment in machinery & equipment and software. A rebound in non-residential construction investment is expected, but the timing has been pushed out in response to delays as higher costs and capacity constraints restrain growth across the construction industry. Private non-residential building approvals have also trended lower over recent months.

Mining investment is forecast to increase a little over coming years, though shortages of skilled labour and some materials are anticipated to weigh on growth in the near term. There is little evidence to date that recent large moves in bulk commodity prices have affected the investment plans of the major miners, though higher prices for some other commodities such as gold and battery minerals are stimulating additional investment in exploration and production.



Public demand

Public consumption is forecast to have increased further in the March quarter from an already high level, after a pause in growth in the December quarter. Governments' health spending remains elevated due to Omicron, and the response to the floods will add to public consumption. Beyond 2022, consumption is forecast to decline a little as these measures are partly unwound.

Growth in public investment is forecast to be strong over 2022 as more infrastructure projects get underway. The pipeline of public engineering work is anticipated to support a high level of public capital expenditure for several years, but the speed of the rollout will be constrained by labour and materials shortages for some time.

External sector

Growth in exports will be supported by a recovery in travel and education exports now the international border has reopened. Resource export volumes declined over the second half of 2021 as maintenance and weather-related disruptions weighed on production; these disruptions are forecast to persist in coming quarters. The recent strength in rural exports is expected to be sustained in the near term; this reflects favourable growing and pasture conditions, and strong global demand for grains following disruptions to agricultural trade due to Russia's invasion of Ukraine. Manufactured exports are forecast to remain below their pre-

pandemic level over 2022 due to ongoing global supply chain disruptions.

Import volumes are forecast to increase in line with domestic demand and the reopening of the international border. Strong global goods price inflation is expected to lift import prices further over the forecast period.

The outlook for the terms of trade has been boosted by higher commodity prices. Global energy prices have risen sharply in response to Russia's invasion of Ukraine, and there has been considerable volatility in energy markets. It is likely that the terms of trade in the June quarter of 2022 will exceed their previous peak in late 2021 (Graph 5.6). Commodity prices are projected to decline over the forecast period but to remain higher than previously anticipated, contributing to an elevated level in the terms of trade compared with three months ago.

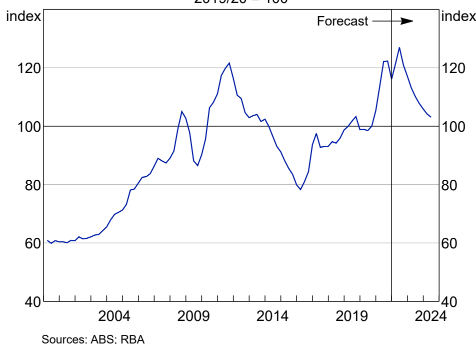
Labour market

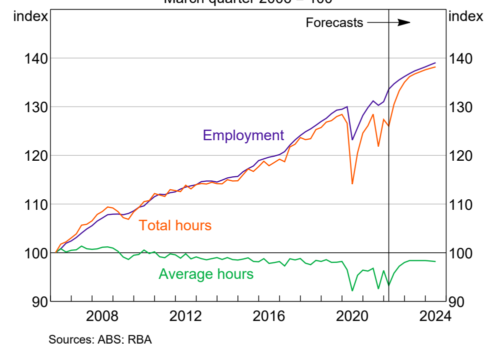
Labour market conditions improved further in early 2022 and leading indicators suggest this will continue for some time. The labour market adjustment to Omicron-related disruptions earlier in the year occurred mostly through hours worked and the effects have been short lived. Employment growth is forecast to remain strong in 2022 before moderating thereafter in line with slowing activity growth (Graph 5.7). The participation rate is forecast to reach a historic high later this year, supported by strong labour demand and longer-run structural drivers, such as higher participation rates among females and older Australians.

A broad range of measures of labour market spare capacity suggest the labour market is the tightest it has been in many years. The unemployment rate is forecast to decline to around 3½ per cent in early 2023 and stay around this level for the remainder of the forecast period; an unemployment rate this low has not been observed in Australia since 1974. An increase in average hours worked is also expected to be a key margin of adjustment in response to strong labour demand. Average hours worked are forecast to rise to around the pre-pandemic level over the course of 2022, leading to further declines in broader measures of labour underutilisation.

Wages

Wages growth is forecast to pick up further as labour market conditions continue to tighten. The outlook for private sector wages growth is stronger than a few months ago, reflecting the upgrades to the labour market and inflation forecasts; firms in the Bank's liaison program expect materially higher wages growth over coming quarters than they were anticipating





just a few months ago. Business surveys also indicate that labour costs are picking up. The outlook for broader measures of employee earnings growth has been upgraded as firms use bonuses, allowances and other non-base wage payments to attract and retain workers in a tightening labour market. As multi-year enterprise agreements expire and private-sector benchmarks flow through to public sector wage policies, some of the increase in aggregate wages growth outcomes will occur with a lag.

Growth in the Wage Price Index (WPI) is forecast to pick up to around 3 per cent by the end of 2022. Wages growth is then forecast to strengthen further as the unemployment rate declines, to be 3¾ per cent by mid-2024; this would be the fastest pace since 2012 (Graph 5.8).

The forecasts for broader measures of earnings imply more upward pressure on firms' labour costs than the narrower measure of base wages captured in the WPI. Average earnings are expected to increase at a faster pace than the WPI over the forecast period due to scheduled increases in the Superannuation Guarantee, along with increases in bonus payments and as more hours are worked at overtime rates. This will also be supported by a pick-up in job turnover as workers are more willing to move jobs for higher pay.

Inflation

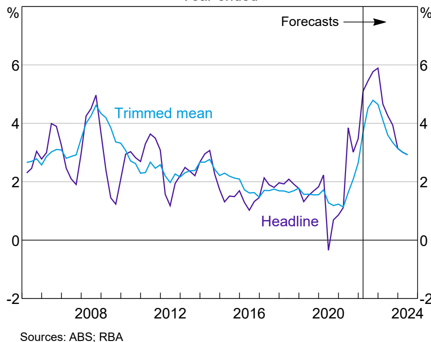
The outlook for inflation is much stronger than anticipated a few months ago. In the near term, underlying inflation is forecast to be significantly boosted by the pass-through of upstream cost pressures to consumers, continuing the pattern observed in recent quarters. The war in Ukraine (and associated sanctions on Russia and Belarus) and renewed lockdowns in parts of China are expected to delay the easing of these cost pressures until later this year. High energy prices will also put pressure on margins for many firms, although it is uncertain how much or how quickly these cost increases will pass through to consumer prices. Additional demand for household goods and building materials induced by the flooding along the east coast is also forecast to contribute to inflationary pressures in the near term.

Inflationary pressures have broadened in recent months beyond energy, consumer durables and the prices of newly constructed homes. Many firms in the Bank's liaison program and business surveys, across a range of industries, have increased selling prices over recent months or indicated that they expect to increase prices over the months ahead. Price increases for new dwelling construction have been very strong, and are likely to persist in the near term. The treatment of HomeBuilder and similar state government grants will boost measured new dwelling inflation a little further over the year ahead. Momentum in rental prices has picked up and is forecast to continue over 2022 as the uplift in advertised rents observed over the past year or so works its way into the stock of outstanding rental agreements.

The primary driver of inflation outcomes is expected to change during the forecast period, though there is uncertainty about the timing of this transition. The pass-through of upstream

non-labour cost pressures is anticipated to wane alongside an easing in supply bottlenecks, while growth in labour costs is forecast to pick up further out in the forecast period. Relative to the February *Statement*, the easing of non-labour input cost pressures is forecast to occur later, while the pick-up in domestically generated inflationary pressures from a tight labour market is forecast to occur sooner – this is anticipated to keep inflation above the target range for much of the forecast period.

Year-ended headline inflation is forecast to be well above underlying inflation over the coming year, largely reflecting the impact of higher prices for fuel and new dwellings (Graph 5.9). While new dwelling costs are expected to rise further in the June quarter, fuel prices will subtract from June quarter CPI if they remain around recent levels; however, the expiration of the fuel excise cut will boost headline inflation again in the December quarter. Headline inflation is forecast to converge back to underlying inflation later in the forecast period as the effect of recent fuel price movements dissipates. While the outlook for inflation has been revised higher, it remains below the headline inflation rate currently being experienced in many advanced economies.



Key domestic uncertainties

The economic effects of future COVID-19 variants

An ongoing uncertainty for the economy is the way governments, firms and households will respond in the event of a new variant of COVID-19 that has more severe health effects than Omicron. Renewed restrictions and/or precautionary behaviour would pose a downside risk to activity and labour market outcomes, although lockdowns as stringent as those implemented earlier in the pandemic appear much less likely now. The effect on inflation of any future restrictions is more uncertain than for activity; lower household consumption and higher unemployment would weigh on inflation but further disruptions to supply could sustain upstream cost pressures and stronger inflation outcomes for longer than currently expected.

The outlook for household consumption

Many households have benefited from large increases in housing wealth over recent years as prices have risen, which has supported growth in consumption. Many Australians have also built considerable savings buffers during the pandemic. 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 expected.

However, consumption growth could also be weaker than forecast if rising interest rates and inflation were to weigh on asset prices and discretionary spending by more than anticipated. The sensitivity of asset prices to rising interest rates is uncertain, particularly in the case of housing where prices are high relative to incomes; a sharp decline in asset prices is a downside risk for consumption. More broadly, while many households would be well placed to absorb higher interest costs without

sharp adjustments to spending, some households have low savings buffers and high debt relative to incomes, and their spending may fall more sharply than others. The additional pressure on household budgets from rising prices could exacerbate these downside risks to consumption, particularly for lower-income households.

The impact of supply shocks on price pressures

An important source of uncertainty is the speed of resolution of the various supply-side issues facing the economy and how prices respond. While COVID-19 was the initial source of disruption domestically and abroad in early 2022, the war in Ukraine, lockdowns in China and the east coast flood recovery effort are expected to exacerbate these issues in the near term. That said, the available evidence suggests that supply constraints – such as in construction, food and durable goods markets – are partly related to the combination of strong demand and the inability of supply to respond in a timely way. These constraints could intensify or persist for longer than forecast (as they have in some other economies), and firms have indicated in liaison that they are now more willing to pass on input cost pressures to consumer prices. In 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-forecast growth in prices, and less output growth, while capacity constraints bind.

On the other hand, these constraints could ease more quickly than expected if production capacity can respond sufficiently or global demand growth slows more rapidly than forecast; this could result in price declines for some goods, which would weigh on inflation outcomes. Price pressures could also reverse more quickly than expected if oil and other commodity prices were to decline. In addition, businesses may refrain from passing on higher costs (by accepting margin compression) if they observe upstream price pressures resolving more quickly than currently indicated.

The evolution of labour costs and supply

The unemployment rate is forecast to decline to around 3½ per cent – its lowest level since the 1970s – and remain around this level for the rest of the forecast period. The participation rate is also forecast to remain at historically high levels. But with little recent relevant experience to draw on, it is possible that wage and price pressures build more quickly or slowly than expected. The pace and composition of net overseas migration following the reopening of the international border is also a source of uncertainty for the labour market outlook and could have different effects on labour supply across regions, industries and occupations. Depending on the interaction of these factors, it is plausible that unemployment falls even further, or that it begins to drift up towards the end of the forecast period as activity slows and the cost of labour increases.

The longer-term effects of the pandemic and changes in the pattern of globalisation on potential growth and full employment are uncertain but tilted towards capacity being more limiting than in the years prior to 2020. It is possible that some of the recent changes in spending and production patterns are long-lasting and that these constrain the efficient allocation of resources and, in turn, productivity. In this event, any given rate of growth could be more inflationary than before the pandemic.

The effect of high inflation and cost-of-living pressures on price-setting behaviour

Inflation in Australia and internationally is now forecast to be elevated for much of the forecast period. As well as dampening real incomes, a period of higher inflation could change how governments, businesses and households respond to actual and expected movements in

prices. Given the labour market is already quite tight, workers might be more able to demand and achieve higher wages to compensate for the increased cost of living even in the absence of a lift in productivity; if employers pass these increased wage costs on to consumers, this could result in inflation being sustained at a higher rate than currently anticipated. ✠