5. Economic Outlook

The ongoing rollout of vaccinations and significant policy stimulus has laid the groundwork for a sustained economic recovery. GDP is forecast to return to its pre-pandemic trend in many advanced economies over the next year. China's economy has already returned to its pre-pandemic path, though the outlook has become more uncertain. In several countries, consumer price inflation has increased to its highest rate in years and inflation expectations have picked up. The increase in global inflation has continued for longer than initially anticipated, and it is possible that inflationary pressures persist for some time yet due to strong global demand and ongoing capacity constraints. Nonetheless, central banks in advanced economies generally expect inflation to return to levels consistent with their targets next year, as bottlenecks in global goods markets ease and labour force participation picks up (see chapter on 'The International Environment').

Economic activity in Australia contracted sharply in the September quarter due to the lockdowns associated with outbreaks of the Delta variant of COVID-19. This setback has delayed but not derailed the economic recovery that was underway in the first half of the year. A rapid bounce back in domestic demand is forecast in the December and March quarters as restrictions are further eased. By mid 2022, the outlook is broadly in line with the pre-Delta recovery path. Under the central scenario, GDP is forecast to grow by around 3 per cent over 2021, 5½ per cent over 2022 and 2½ per cent over 2023 (Table 5.1).

The unemployment rate is expected to be a little below 5 per cent at the end of 2021, before declining to around 4 per cent by the end of 2023. Inflation was higher than anticipated in the September quarter, led by growth in new housing construction costs, as well as higher fuel prices. Underlying inflation is now forecast to be around 2¼ per cent for much of the forecast period, increasing to around 2½ per cent by the end of 2023. This inflation profile reflects a stronger outlook for housing cost inflation in coming quarters and a steady pick-up in wages growth further out.

In light of the considerable ongoing uncertainty around health outcomes and household consumption, two alternative scenarios are considered: an upside and a downside (as in recent *Statements*). Other sources of uncertainty, including the extent of labour market spare capacity and how wages and prices respond to this in the period ahead, are addressed separately from the scenarios.

A stronger economic trajectory than the one envisaged in the central scenario is possible if households increase spending by more than expected. This could be the result of positive news on the health front and high rates of vaccination leading to reduced uncertainty about the outlook and a boost in households' desire to consume out of their rising wealth. These conditions would also support stronger private investment. In this upside scenario, the unemployment rate declines more rapidly than in the central scenario, to be around 3¼ per cent, and the stronger labour market

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

Per cent

	Year-ended					
	June 2021	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023
GDP growth	9.6	3	4	5½	3¼	2½
(previous)	(9½)	(4)	(4½)	(4¼)	(2¾)	(2½)
Unemployment rate[(b)]	5.1	4¾	4½	4¼	4	4
(previous)		(5)	(4½)	(4¼)	(4¼)	(4)
CPI inflation	3.8	3¼	2¾	2¼	2¼	2½
(previous)		(2½)	(1½)	(1¾)	(2)	(2¼)
Trimmed mean inflation	1.6	2¼	2¼	2¼	2¼	2½
(previous)		(1¾)	(1½)	(1¾)	(2)	(2¼)
	Year-average					
	2020/21	**2021**	**2021/22**	**2022**	**2022/23**	**2023**
GDP growth	1.4	4¼	3¼	5	5	3
(previous)	(1¼)	(4¾)	(4½)	(5)	(4)	(2¾)

(a) Forecasts finalised on 3 November. The forecasts are conditioned on a path for the cash rate broadly in line with recent market pricing and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the November 2021 Board meeting. Other forecast assumptions (August *Statement* in parenthesis): TWI at 62 (62), A$ at US$0.74 (US$0.74), and Brent crude oil price at US$80bbl (US$70bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Budget. 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

sees underlying inflation increase to a little above 3 per cent by the end of 2023.

A weaker trajectory could eventuate due to lingering uncertainty about the outlook, which results in near-term precautionary saving, alongside a bad health outcome, such as the emergence of a new variant of the virus or waning efficacy of vaccines in the first half of 2022. The weaker economic environment would depress confidence, resulting in lower consumption and higher saving by households, and a slower recovery in private investment. International travel would also resume more slowly, delaying the recovery in services trade. In this downside scenario, subdued activity pushes the unemployment rate to above pre-pandemic levels and drags on wages growth. This keeps underlying inflation below 2 per cent over most of the forecast period.

Domestic activity is forecast to recover strongly

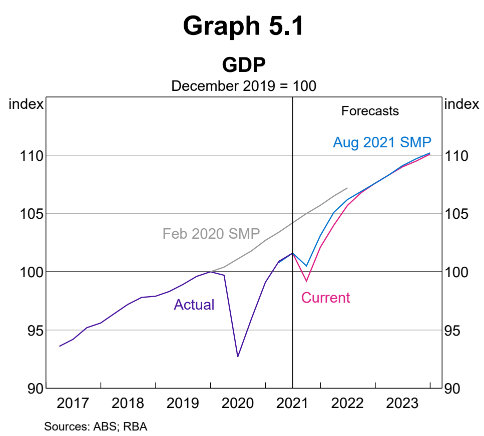
The recovery in the Australian economy from the Delta outbreak is underway. A rapid recovery in household spending is expected in the near term, driven by the broadening of consumption opportunities and supported further out by growth in household income and wealth. Dwelling investment has started to bounce back from the health-related restrictions on construction activity and the recovery in business investment that was underway before the Delta outbreak is expected to resume. By mid 2022, the economy is forecast to be back on its pre-Delta path (Graph 5.1).

Consistent with the outlook for activity, employment is forecast to grow strongly over coming quarters, before moderating after mid 2022.

Participation in the labour force is also forecast to rebound, supported by the strength in labour market conditions. The unemployment rate is expected to decline to around 4 per cent by the end of 2023 (Graph 5.2).

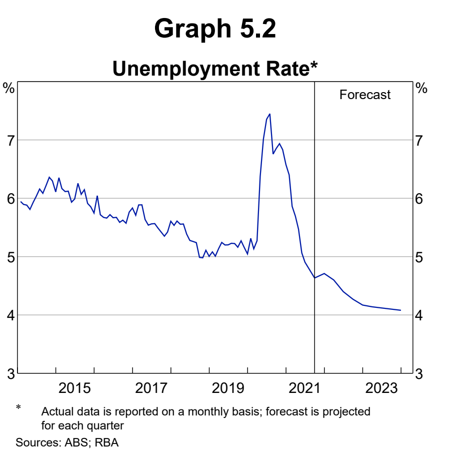
The forecast profile for underlying inflation is higher in the near term, primarily because of larger-than-expected price increases for newly constructed housing. A steady pick-up in wages growth contributes to underlying inflation further out. Underlying inflation is forecast to be around 2¼ per cent for much of the forecast period, before picking up to around 2½ per cent by the end of 2023 (Graph 5.3).

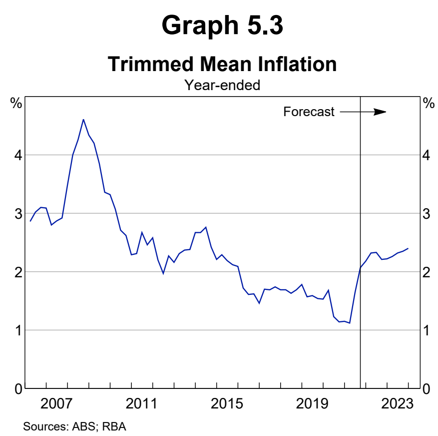
The forecasts are based on some technical assumptions. The cash rate is assumed to move broadly in line with recent market pricing. The exchange rate and oil prices are assumed to remain around recent levels. The forecasts are based on state roadmaps for the relaxation of restrictions on activity, including domestic travel. The international border is assumed to gradually reopen to non-residents over the first half of 2022. The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Budget.



Household consumption, income and saving

Household consumption fell sharply in the September quarter in response to tighter activity restrictions in some states. However, consumption is forecast to rebound strongly across the December 2021 and March 2022 quarters as restrictions are eased and spending opportunities broaden (Graph 5.4). Consumption is projected to be back around its pre-Delta trajectory by mid 2022 and to grow steadily thereafter, supported by strong labour market outcomes, higher net household wealth and a decline in uncertainty related to health and economic outcomes. The strong labour market supports the outlook for household income via labour income, and offsets a decline in non-labour income as disaster payments and other income support measures conclude.





The household saving ratio increased sharply in the September quarter, reflecting reduced consumption opportunities and the delivery of social assistance payments to those who experienced job losses or worked reduced hours during the recent lockdowns. Further out, the saving ratio is forecast to decline to around its average level over the five years prior to the pandemic.

Investment

The outlook for investment remains positive with a large pipeline of public and private projects forecast to boost activity over coming years. While construction declined sharply in the September quarter due to restrictions on activity in some states, both residential and non-residential investment are expected to recover strongly over coming quarters before growth moderates later in the forecast period.

Residential construction increased to be well above its pre-pandemic level in the first half of the year, supported by fiscal stimulus and monetary easing over 2020 and 2021. There were a record number of commencements in the June quarter and work on these dwellings will sustain a high level of construction activity moving forward. Construction firms in the Bank's liaison program report that constraints on labour and the availability of materials are putting pressure on input prices, and have created uncertainty around the pace at which this activity will be completed. While a large share of housing construction activity has been supported by fiscal subsidies such as HomeBuilder, there has also been strong underlying momentum from the effects of low interest rates and increases in housing prices and household income; the desire for more living space since the outbreak of the pandemic is also encouraging renovation activity. The elevated level of residential construction is anticipated to be maintained over coming years.

Following recent disruptions, a robust recovery in non-mining business investment is forecast over coming quarters. Machinery & equipment investment is forecast to contribute to growth over 2022, supported by tax incentives and as firms undertake some catch-up spending following the easing of restrictions. Information from the Bank's liaison program and recent business surveys indicate that firms remain optimistic about the outlook and have not scaled back capital expenditure plans. Private non-residential building approvals have trended higher over recent months, albeit from a low level. However, there is uncertainty over how binding capacity constraints may become and whether this will restrain growth in construction activity.

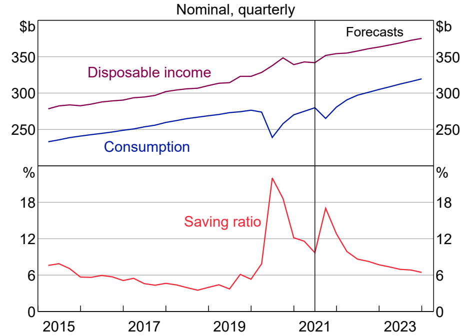
Mining investment is forecast to increase slightly over coming years, though this mainly reflects firms undertaking investment to sustain their level of production rather than to expand capacity. There have been few indications to date that recent large moves in commodity prices have affected the investment plans of the major miners.

Growth in public investment has strengthened over recent quarters and is expected to remain strong over the coming year. Some planned capital expenditure will have been further delayed by health-related restrictions on construction activity in the September quarter,

Graph 5.4

Household Consumption and Income

Nominal, quarterly



Sources: ABS; RBA

but these effects should be mostly temporary. The pipeline of public engineering work yet to be completed is very large and will support a high level of public capital expenditure for several years.

Public consumption

Public consumption is forecast to have increased sharply in the September quarter as governments across Australia responded to the Delta outbreak through additional spending on patient care, containment of the virus and accelerated vaccination programs. Public consumption is anticipated to remain elevated in the near term as spending programs announced in this year's federal and state government budgets are implemented. Further ahead, public consumption will be supported by the large government programs that led to a strong increase in public consumption as a share of GDP prior to the pandemic. This includes the National Disability Insurance Scheme and spending related to the aging of the Australian population.

External sector

Exports are expected to grow strongly over the forecast period. In the near term, this reflects a rebound in resource export volumes following recent weak outturns. Travel and education exports are forecast to grow at a faster pace over 2022 (compared to the previous *Statement*) as a result of the earlier-than-expected reopening of international borders. The recent strength in rural exports is expected to be sustained in the near term because of strong global demand, and as ongoing favourable weather conditions support a faster-than-expected herd rebuild and a lift in wool and crop production. Meanwhile, import volumes have been upgraded over the forecast period due to the earlier reopening of borders, though higher world export prices are likely to drag on import growth in the near term.

The terms of trade have been revised lower across the forecast period (Graph 5.5). While the sharp decline in the iron ore price in recent months has been broadly offset by the impact of higher coal and LNG prices, a projected decline in the terms of trade reflects expectations for lower iron ore and coal prices further out.

Labour market

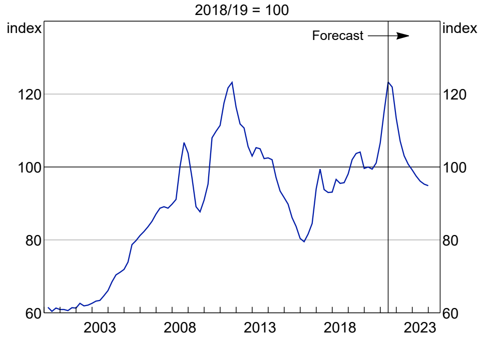
The temporary effects of recent lockdowns on the labour market are already receding, and employment and participation are forecast to have fully recovered to their pre-Delta levels by the end of 2021 (Graph 5.6). The measured unemployment rate has been held down by the fall in labour market participation during the lockdowns more than offsetting declines in employment. At year-end the unemployment rate is expected to be a little below 5 per cent, but month-to-month outcomes for key labour market variables could remain volatile.

In line with the recovery in activity, the labour market is expected to strengthen further over the forecast period, albeit at a more moderate pace from mid 2022. Recent lockdowns do not appear to have had a lasting effect on underlying labour demand. The unemployment rate is expected to reach around 4¼ per cent by the end of 2022 and then decline a little further to be just above 4 per cent by the end of 2023.

Graph 5.5

Terms of Trade

2018/19 = 100



Sources: ABS; RBA

Employment growth is forecast to moderate as activity growth settles around its longer-run trend. A further lift in the participation rate is anticipated, supported by continued employment growth and longer-run structural drivers of higher labour force participation.

Wages and inflation

Wages growth should continue to pick up in the near term, as the remaining wage freezes and cuts implemented in 2020 are unwound and labour market conditions tighten. The medium-term outlook for private sector wages growth is stronger than at the time of the August *Statement*, reflecting the upgrade to labour market forecasts and the further absorption of spare capacity. Aggregate outcomes continue to be weighed down by more muted public sector wages growth, consistent with announced government wages policies.

Growth in the Wage Price Index (WPI) is anticipated to pick up to above 2 per cent by the end of 2021, to be back in line with pre-pandemic wage growth norms of around 2–2½ per cent per annum (Graph 5.7). WPI growth is then forecast to strengthen further as the unemployment rate approaches 4 per cent, to be around 3 per cent by the end of 2023 – the fastest pace since 2013. Increases in the superannuation guarantee rate over coming years are estimated to reduce WPI growth relative to average earnings by around a ¼ percentage point by the end of the forecast period; average earnings per hour is forecast to be growing above 3 per cent by 2023.

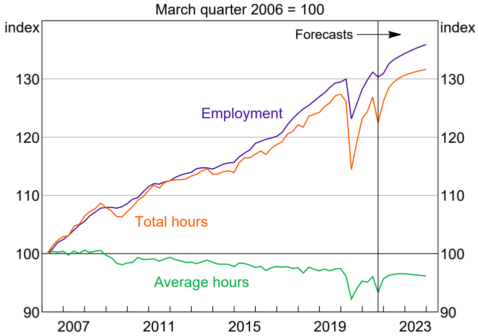
Near-term inflation outcomes are expected to be boosted by the effects of stronger new dwelling construction prices. Headline inflation is also being lifted by high fuel prices; however, it should converge back to underlying inflation as the effect of the recent run up in fuel prices wanes over the next year (Graph 5.8). Although some upstream price increases are expected to fade further out the forecast period, broader inflationary pressures are expected to continue building as spare capacity in the economy continues to be absorbed. Underlying inflation is forecast to be around 2¼ per cent for much of the forecast period, and then increase to be around 2½ per cent by the end of 2023. Similar to wages growth, this would represent a meaningful pick-up in underlying inflation relative to the experience of recent years.

Price pressures are expected to remain strong for new dwelling construction. Materials and labour costs have increased as demand has surged and supply chain constraints have become more binding. HomeBuilder and similar government grants will continue to have an important effect

Graph 5.6

Employment and Hours Worked

March quarter 2006 = 100

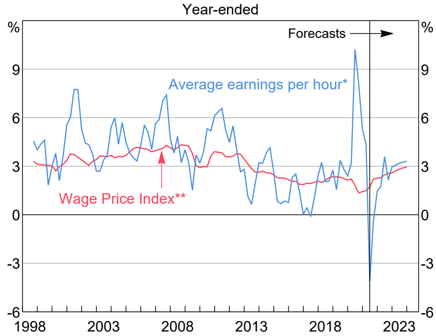


Sources: ABS; RBA

Graph 5.7

Wages and Earnings Growth

Year-ended



* Non-farm; includes social contributions

** Excluding bonuses and commissions

Sources: ABS; RBA

on measured inflation over the year ahead. As these subsidies conclude and fewer grants are paid, more buyers will pay the full price for dwellings, which will contribute to aggregate inflation. The forecasts also allow for some risk of persistent price pressures for imported consumer durables goods. Liaison information suggests that, to date, cost increases have largely been absorbed into margins (including for firms where sales volumes have been strong) or mitigated by earlier forward orders of goods or hedging of the exchange rate. However, if cost pressures persist, further pass-through to consumer prices would be expected. Administered prices are anticipated to grow relatively slowly, and some ongoing government subsidy and rebate schemes will weigh on the inflation outlook. Utilities prices are also expected to remain subdued, reflecting reductions in regulated prices, low wholesale prices and increased electricity supply from renewables.

Scenarios

Upside scenario

A plausible upside scenario hinges on stronger consumption than in the central scenario, driven by stronger wealth effects and reduced uncertainty related to positive health outcomes and high vaccination rates. These developments result in a greater desire on the part of households to consume out of the wealth that they have accumulated through saving as well as rising housing and equity prices. In this scenario, faster household spending has positive flow-on effects to private investment and activity more broadly, which reinforces the improvement in labour market conditions and boosts labour income (Graph 5.9).

Consumption is around 4 per cent higher than in the central scenario by the end of 2023, and the saving ratio falls more sharply. A stronger pick-up in household consumption and business investment supports faster growth in employment. The resulting decline in the unemployment rate, to around 3¼ per cent, induces a strong recovery in wages growth and inflation over the next couple of years, with inflation rising to be above 3 per cent by the end of 2023 (Graph 5.10; Graph 5.11).

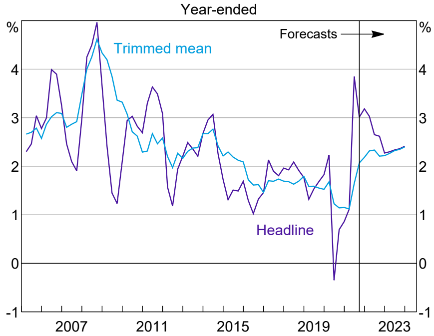
Downside scenario

A slower trajectory for the economy could materialise because of some combination of lingering uncertainty about the outlook alongside adverse health outcomes, such as the emergence of a new variant of the virus or declining efficacy of vaccines in the first half of 2022. In this scenario, the setback to the health

Graph 5.8

Inflation Forecasts

Year-ended

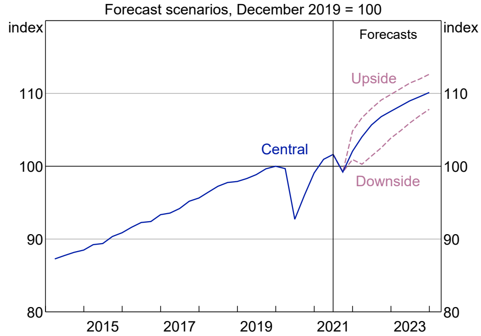


Sources: ABS; RBA

Graph 5.9

GDP

Forecast scenarios, December 2019 = 100



Sources: ABS; RBA

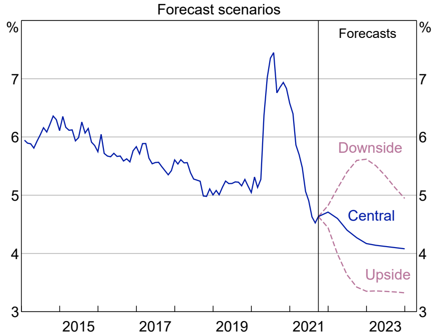
outlook leads to a temporary resumption of lockdowns and activity restrictions so that consumption slows sharply in early 2022 and international borders are unable to open fully until later in that year.

Weaker consumer and business confidence results in weaker household spending, higher saving and a delayed recovery in private investment. The slower return to international travel reduces opportunities for discretionary spending on services. Faced with a weaker outlook for activity, some firms reduce headcount while others forego or delay hiring decisions, which means the unemployment rate remains in the 4¾–5½ range for the entire forecast horizon. In this downside scenario, the lack of reduction in labour market spare capacity weighs heavily on wages growth, with underlying inflation below 2 per cent for most of the forecast period.

Graph 5.10

Unemployment Rate

Forecast scenarios

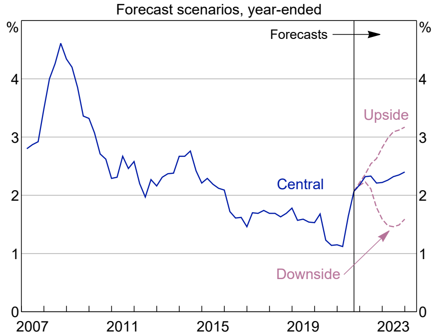


Sources: ABS; RBA

Graph 5.11

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

Other domestic risks and uncertainties

The upside and downside scenarios considered above illustrate two plausible alternative paths for the economy based on different underlying assumptions about health outcomes and household consumption. These include the extent of domestic lockdowns and activity restrictions, the consumption response out of wealth, and the speed with which international travel recovers. All of these factors have implications for the pace of improvement in the labour market. Beyond this, there are other sources of uncertainty.

An unexpected slowing in China's economy – arising, for example, from a deeper-than-expected decline in construction activity or from increased uncertainty about economic policy more generally – would reduce demand for iron ore and other commodities. This would result in lower Australian resource export volumes and a decline in commodity prices, impacting Australia's terms of trade, corporate profits and reducing government revenues from taxation and royalties. A slowdown in China or further restrictions on Australian exports would also delay the recovery in other parts of the Australian economy, possibly including the education and tourism sectors.

A key domestic uncertainty relates to the extent of labour market spare capacity and how wages and prices respond as this is absorbed over coming years. The central scenario assumes that acute labour shortages are limited to pockets of the economy, but these could become more widespread. Labour supply could also be constrained as activity picks up, especially if there is a lack of fully vaccinated staff in some sectors or because of isolation requirements due to outbreaks of the virus. On the other hand, the expected decline in the unemployment rate could occur more slowly than forecast if firms rely more on increases in employees' hours worked rather than headcount, or if labour market participation increases by more than forecast. Another consideration for the labour market outlook is the timing of the reopening of the domestic and international borders, and the resultant effects on labour supply across regions, industries and occupations.

In the central scenario, the unemployment rate is forecast to decline to around 4 per cent by the end of 2023, resulting in a steady pick-up in wages growth and inflation. In the past half century or so, this rate of unemployment has been experienced in Australia only briefly. As there is little recent historical experience to draw on, and the longer-term effects of the pandemic on potential growth and full employment are uncertain, it is possible that price pressures build more quickly or slowly than envisaged in the central scenario.

The outlook for inflation could also be influenced by a period of unexpectedly high inflation outcomes in the near term, including internationally, which results in workers demanding higher wages as compensation; if employers pass these increased wage costs on to consumers, this would feed back into higher inflation outcomes. Relatedly, if global price pressures from supply shortages persist for longer than expected, the extent of pass-through to domestic prices could be stronger than envisaged and lead to higher inflation outcomes in Australia. However, it is also possible that global goods demand eases over the next year or so, around the same time that more goods supply comes online; this could see price pressures in global goods markets dissipate and feed through to lower imported price pressures in Australia.

There have been growing reports of labour and material shortages in construction. There is a risk that these capacity pressures could persist or worsen given the forecast increase in activity over coming years. In addition to resulting in more persistent price pressures, capacity constraints could lead to projects being rationed or delayed, resulting in lower output growth than otherwise.

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