

5. Economic Outlook

The prospects of a significant slowing in the global economy have intensified over the past three months, fuelled by persistently high inflation and rising policy rates, the energy crisis in Europe, and the various headwinds affecting China's recovery. Overall growth in Australia's trading partners is expected to be a bit below 3½ per cent in 2022 and then again in 2023 – well below its pre-pandemic decade average of 4½ per cent. The outlook is highly uncertain because of the scale of the challenges to the global economy at present (see chapter on 'The International Environment').

The Australian economy is forecast to grow solidly over the second half of 2022, before slowing next year as higher consumer prices, rising interest rates and declining housing prices weigh on growth. GDP growth is forecast to be 3 per cent over 2022 and then 1½ per cent over 2023 and 2024 (Table 5.1). The labour market is very tight; the unemployment rate is forecast to remain around 3½ per cent until mid-2023, before rising as a result of slower growth in activity.

Headline consumer price inflation is expected to peak around 8 per cent at the end of 2022, before starting to decline in early 2023; this compares with a forecast peak of 7¾ per cent in the August *Statement*. The upward revision to the near-term peak reflects stronger-than-expected pass-through of upstream cost pressures, as well as estimates of the impact on food prices of the recent flooding in the eastern states. The outlook for headline inflation beyond this has also been revised higher, reflecting larger increases in retail prices for electricity and

gas in 2023 than previously assumed. Inflation is still expected to decline towards the top of the target band over coming years. The effect of high inflation and cost-of-living pressures on wage- and price-setting behaviour is a material risk to the inflation outlook.

A key source of uncertainty for the domestic growth outlook relates to the competing forces affecting household spending. Household incomes have been sustained by strong labour demand, which has supported employment and hours worked; this strong labour demand will ultimately lead to stronger wages growth. Household balance sheets are in generally good shape, underpinned by a high level of savings in recent years. However, high inflation and rising interest rates are raising the cost of living and will weigh on households' income and spending in real terms. Household consumption will also be dampened by wealth effects as housing and other asset prices continue to weaken. Other important sources of uncertainty include the outlook for global growth and the possible knock-on effects of a sharper-than-expected downturn in a major economy.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing, with an assumed cash rate that peaks at around 3½ per cent in mid-2023 before easing back to around 3 per cent by the end of 2024. The exchange rate is assumed to be unchanged at its current level, which has depreciated a little from its level in August. Petrol prices are assumed to be broadly unchanged around their

Table 5.1: Output Growth and Inflation Forecasts^(a)

Per cent

	Year-ended					
	June 2022	Dec 2022	June 2023	Dec 2023	June 2024	Dec 2024
GDP growth	3.6	3	2	1½	1½	1½
(previous)		(3¼)	(2¼)	(1¾)	(1¾)	(1¾)
Unemployment rate ^(b)	3.8	3½	3½	3¾	4	4¼
(previous)		(3¼)	(3½)	(3½)	(3¾)	(4)
CPI inflation	6.1	8	6¼	4¾	4¼	3¼
(previous)		(7¾)	(6¼)	(4¼)	(3½)	(3)
Trimmed mean inflation	4.9	6½	5½	3¾	3½	3¼
(previous)		(6)	(5)	(3¾)	(3¼)	(3)
Year-average						
	2021/22	2022	2022/23	2023	2023/24	2024
GDP growth	3.9	4	3½	2	1½	1½
(previous)		(4)	(3½)	(2¼)	(1¾)	(1¾)

(a) Forecasts finalised 2 November. 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. Other forecast assumptions (assumptions as of August *Statement in parenthesis*): TWI at 62 (63); A\$ at US\$0.64 (US\$0.69); Brent crude oil price at US\$89/bbl (US\$94/bbl). 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

recent level. Population growth projections have been revised slightly higher compared with three months ago and largely reflect assumptions used in the Australian Government Budget 2022–23. The forecasts are also based on the assumption that any future waves of COVID-19 variants will have a limited effect on the economy, with few restrictions on economic activity required and the labour market adjustment occurring mainly through a reduction in hours worked.

Inflation is forecast to peak at 8 per cent, a little higher than a few months ago

Inflation is high and broadly based. Global factors – including pandemic-related disruptions to supply chains and Russia's invasion of Ukraine – have accounted for much of the increase in inflation over the past year (see 'Box C: What

Explains Recent Inflation Forecast Errors?').

Strong domestic demand, a tight labour market, flood-related disruptions and capacity constraints in some sectors are also contributing to the upward pressure on prices. While upstream pressures are easing globally, earlier increases in input costs are expected to contribute to inflationary pressures in the near term.

Headline inflation is expected to peak around 8 per cent at the end of 2022, a little higher than expected previously (Graph 5.1). The decline in petrol prices in recent months has been offset by stronger-than-anticipated pass-through of upstream cost pressures, and expectations of increases in food prices over coming months due to recent flooding in the eastern states. Expectations for above-average rainfall, consistent with the ongoing La Niña event, have

also increased the likelihood of further supply disruptions affecting costs and prices for a range of goods in late 2022 and early 2023.

Energy prices are expected to add significantly to inflationary pressures over coming years. Retail prices for electricity and gas have increased by 10–15 per cent in recent months but will mostly affect measured prices in the CPI in the December quarter; this is because state government subsidies effectively delayed the price increase for households. Information from government agencies suggests that price increases in 2023 are likely to be larger than previously assumed; wholesale prices remain around double the levels seen in 2021 and network costs are also expected to rise. As a result, retail gas and electricity prices are projected to rise by 20–30 per cent in 2023. Overall, these changes have resulted in inflation being higher than previously expected in the second half of the forecast period.

Inflationary pressures have broadened significantly since late 2021. Faster rates of price inflation have spread beyond consumer durables and the prices of newly constructed homes to items such as groceries and market services. Grocery inflation has been elevated and this is expected to be sustained in the near term as requests from suppliers to increase prices continue to be implemented in supermarkets.

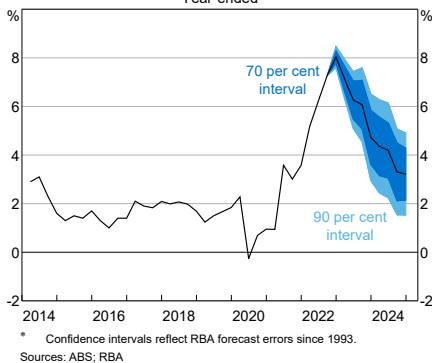
Price increases for new dwelling construction have been very large and building costs continue to grow strongly, albeit at a slower pace than earlier in the year. As a result, price increases are likely to persist in the near term before easing later in the forecast period as cost pressures and demand for new housing moderate. Rental price inflation has picked up and is expected to increase further over coming quarters as the impact of low vacancy rates on higher advertised rents over the past year or so works its way through the stock of outstanding rental agreements.

The outlook for underlying inflation is a little higher than three months ago, and is expected to peak at 6½ per cent in late 2022 before declining gradually towards the top of the inflation target range by the end of 2024 (Graph 5.2). Information from liaison and business surveys indicate that some upstream costs are starting to ease. From early 2023, underlying inflation is forecast to moderate as the global imbalance between supply and demand for goods continues to be resolved and commodity prices either stabilise at a high level or decline. Higher interest rates globally are helping to moderate demand pressures. While underlying inflation is expected to moderate over 2023 and 2024, second-round effects from higher energy prices are forecast to keep underlying inflation a little higher than previously expected toward the end of the forecast period. Domestic labour cost growth is expected to pick up over the coming year and remain high over the forecast period.

GDP is expected to grow solidly over 2022, before slowing next year

The Australian economy is forecast to grow solidly over the second half of 2022, as growth in household spending on services remains firm alongside a further pick-up in education and travel services exports. GDP growth is then forecast to slow in early 2023, as the recovery in

Graph 5.1
Headline Inflation Forecast*
Year-ended



household spending from pandemic-related restrictions is expected to have mostly run its course (Graph 5.3). Recent large declines in household real wealth, largely reflecting declining housing prices, and disposable income are also expected to contribute to a substantial slowing in consumption growth from early next year. The slowing in GDP growth over 2023 also reflects weaker dwelling investment and a stabilisation of public demand at high levels after recent strong growth.

Consumption growth is forecast to slow because of rising prices and higher interest rates

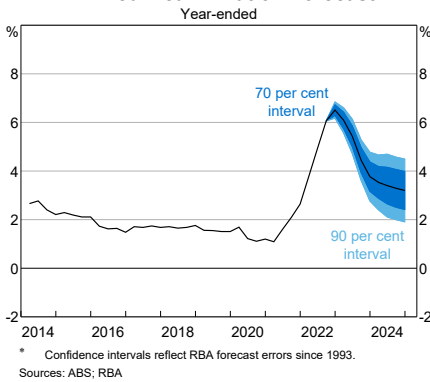
Growth in household spending is expected to remain solid in the second half of 2022 as spending on discretionary services, such as hospitality and travel, continues to rebound. Consumption growth is then expected to ease significantly. While strong labour market conditions are expected to continue to support household income over this period, consumption will be tempered by rising consumer prices and higher net interest expenses on household debt. Lower net household wealth, mainly due to lower housing prices, is also expected to weigh on consumption.

The household saving ratio is projected to continue to decline over the forecast period, to be below its average level prior to the pandemic.

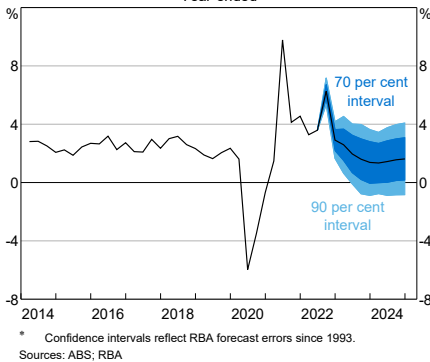
The outlook for business investment remains positive

A large pipeline of residential and non-residential projects is expected to sustain construction activity into 2023. While the recent flow of data and information from the Bank's liaison program indicate that there has been an easing in materials shortages and related supply chain issues, labour shortages remain a

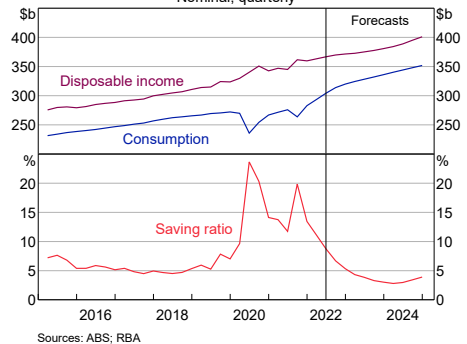
Graph 5.2
Trimmed Mean Inflation Forecast*



Graph 5.3
GDP Growth Forecast*



Graph 5.4
Household Consumption and Income



significant constraint on investment. Construction timelines have been pushed out further; capacity constraints, rising costs and adverse weather (including the recent flooding in the eastern states) are expected to restrain growth across the construction industry in the near term. Rising insolvencies in the residential construction sector could further limit the pace at which this existing pipeline can be worked through.

Further out, a decline in the demand for new dwellings is expected to weigh on dwelling investment, despite an increase in population growth. In particular, expectations for further increases in interest rates, rising construction costs and continued housing price declines reduce the incentive to build new dwellings. Prospects for higher density residential projects are brighter than for detached dwellings – particularly in Sydney and Melbourne, where vacancy rates have declined following the reopening of the international border.

Investment in machinery and equipment is forecast to increase. Information from the ABS Capital Expenditure Survey and the Bank's liaison program suggests that firms' nominal investment intentions remain at or above average levels, though this partly reflects the higher cost of undertaking a given volume of investment. The recent easing of supply chain pressures, which had previously prevented the delivery of some machinery and equipment, is also expected to support investment in the near term.

Mining investment is forecast to increase a little over coming years, supported by investment in new iron ore and LNG capacity. Shortages of skilled labour and some materials, along with adverse weather conditions, are expected to weigh on investment growth in the near term. High commodity prices and recent strong growth in profits for Australia's bulk commodity producers have not resulted in a material change of investment plans to date, in part

because the peak level of prices was not expected to be sustained.

Public demand is forecast to remain at a high level

Public consumption is expected to increase over the second half of 2022, partly reflecting state and federal government responses to the recent flood damage. Further out, public consumption is expected to stabilise at a high level.

Underlying growth due to public spending programs such as the National Disability Insurance Scheme is expected to be broadly offset by the unwinding of temporary spending measures introduced during the pandemic.

Public investment is expected to grow over the forecast period. The existing 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 may be constrained by labour and materials shortages, particularly in the near term.

The ongoing recovery in travel will support services exports and imports

Exports are expected to grow strongly over coming years. Weather and maintenance issues have weighed on resource production in the September quarter, but resource exports are expected to recover by early 2023. Travel and education exports are expected to continue to grow strongly as tourists and students take advantage of the reopened international border. Rural export volumes rose strongly in the September quarter and are expected to remain robust, despite a material impact from recent flooding in some agricultural areas in the December quarter. Optimal growing conditions associated with higher rainfall are expected to continue in Australia as part of the third La Niña event, though there are risks to production in some areas from flooding. Strong demand for grains is also expected to continue, reflecting disruptions to global supply.

Import volumes are expected to increase a little faster than domestic demand over the next year as Australians travel overseas in greater numbers following the reopening of the international border. The recent depreciation of the exchange rate is expected to have a dampening effect on import growth over the forecast period compared with what was expected three months ago, though this should be partly offset by an easing in global goods price inflation.

After reaching a record high level in the June quarter, the terms of trade are expected to have fallen in the September quarter, reflecting both a decline in commodity prices and an increase in import prices (Graph 5.5). The terms of trade are projected to decline further over the forecast period as commodity prices continue to decline from high levels.

The unemployment rate is forecast to increase as economic growth slows ...

A broad range of measures suggest the labour market is the tightest it has been in decades. The unemployment rate is forecast to remain around 3½ per cent until mid-2023; broader measures of labour underutilisation are also anticipated to be around their lowest levels in many years as firms increase the hours of workers in response to strong labour demand. As economic growth slows in 2023, the unemployment rate is

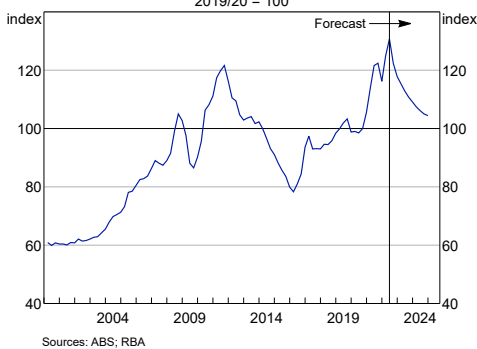
forecast to rise gradually to 4¼ per cent by the end of 2024 (Graph 5.6).

While employment growth has moderated, demand for labour remains strong and firms continue to find it difficult to achieve their desired increases in headcount. Employment growth is forecast to soften throughout the forecast period amid a tight labour market in the near term and slowing growth in activity from 2023 (Graph 5.7). Following the reopening of the border, immigration could help alleviate labour shortages in some industries, while also adding to aggregate demand in the economy. Participation in the labour force is expected to be sustained around historically high levels over the forecast period. The longer term trend towards increased participation among females and older Australians is expected to offset cyclical softness in labour market conditions in the second half of the forecast period.

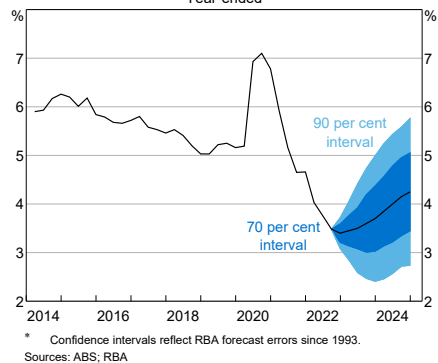
... but the pick-up in wages growth is expected to continue

Aggregate wages growth has picked up further over recent months and this is expected to continue in the period ahead. Firms in the Bank's liaison program report that this has been largely driven by strong labour demand in a tight labour market, elevated staff turnover, higher inflation outcomes and pass-through to award

Graph 5.5
Terms of Trade
2019/20 = 100



Graph 5.6
Unemployment Rate Forecast*
Year-ended



wages from the Fair Work Commission decision in June. Aggregate wages growth outcomes are expected to be restrained by more muted wages growth in public and private enterprise agreements, particularly in the near term, consistent with the multi-year duration of agreements.

Growth in the Wage Price Index (WPI) – a measure of changes in base wage rates for a given quantity and quality of labour – is expected to pick up to around 3¾ per cent by mid-2023 and 4 per cent by mid-2024 (Graph 5.8). WPI growth is expected to stabilise in the second half of the forecast period, as the unemployment rate rises and labour market capacity becomes less binding. However, wages growth is expected to continue increasing modestly over this period, reflecting inertia in the wage-setting process, ongoing cost-of-living pressures and a still relatively tight labour market. The effect of high inflation and cost-of-living pressures on price- and wage-setting behaviour is a material risk to the outlook (see ‘Key domestic uncertainties’ below).

Broader measures of labour income growth are expected to increase at a faster rate than the WPI over the forecast period as employers use bonus payments to retain or attract staff, more hours are worked at overtime rates, job turnover rates remain high and workers are more willing

to move jobs for higher pay. These broader measures imply less of a decline in real incomes than suggested by the WPI measure (Graph 5.9).

Key domestic uncertainties

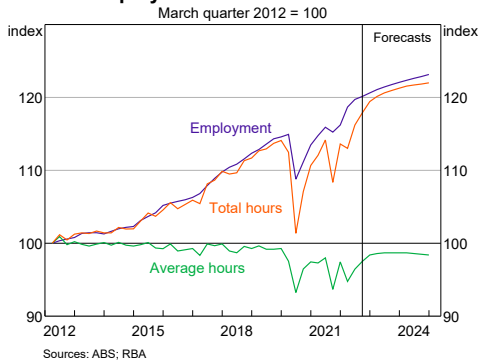
Global factors could weigh on activity in Australia

The outlook for global growth is weak and highly uncertain, with risks skewed to the downside. If these downside risks materialise, it could cause economic activity in Australia to be weaker than projected in the base case.

A prominent example is the challenges facing China. A sharper-than-expected slowing in the

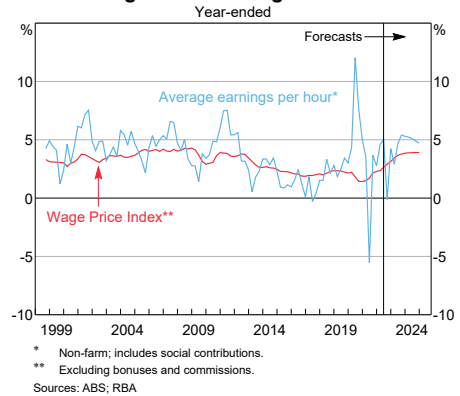
Graph 5.7

Employment and Hours Worked



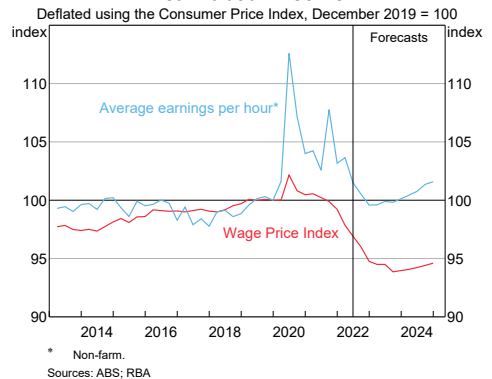
Graph 5.8

Wages and Earnings Growth



Graph 5.9

Real Labour Income



Chinese property market would likely reduce demand for Australia's iron ore and lower the terms of trade, with flow-on impacts to domestic demand. More broadly, if consumption in China is weaker than expected (perhaps because COVID-19 outbreaks are more disruptive than assumed), it would weigh on growth in the Asian region more generally and both directly and indirectly reduce demand for Australia's commodity and non-commodity exports.

A larger-than-expected slowing in growth in advanced economies could also weigh on Australian growth, particularly if coupled with a further increase in energy prices in Europe. The US and European economies are not large trading partners of Australia, but developments there can still have a material influence on our economy through transmission to global financial markets and household and business sentiment.

High inflation and cost-of-living pressures could shift wage- and price-setting behaviour and raise inflation expectations

Inflation in Australia and internationally is high and expected to result in further declines in real incomes. The composition of inflation in Australia is also expected to shift, with higher inflation expected in more persistent and non-discretionary items, such as rents, in coming years. Cost-of-living pressures are changing how governments, businesses and households respond to changes in prices. In a tight labour market, the pass-through of temporarily high inflation to wages may be larger than when there is more labour market slack. The forecast for wages growth seeks to centralise some of this risk to the wages outlook. Higher wage outcomes would alleviate downside risks to consumption at the expense of higher inflation outcomes. Information from the liaison program indicates that higher inflation outcomes are a factor in current wage negotiations; this is likely

to contribute to a pick-up in wages growth in the period ahead. If wage outcomes turn out stronger than expected and employers pass these and other increased costs on to consumers, it could result in inflation remaining elevated for longer than currently anticipated.

Higher expectations of future inflation could lead to a broadening of second-round price increases by firms, leading to higher actual inflation. Moreover, retailers have indicated in liaison that they are now more willing to pass on input cost pressures to prices rather than accepting lower margins. To date, longer term measures of inflation expectations remain well anchored, but it is not assured that this will continue.

The outlook for household consumption is clouded by competing forces

Household incomes have been sustained by robust labour demand, which could in turn result in sustained momentum in household consumption. Further, many households have built up savings buffers during the pandemic; if households are more willing to spend from these liquid savings than from other forms of wealth, spending could also be stronger than anticipated for a time. Stronger-than-expected growth in domestic demand would see domestic inflationary pressures build further.

On the other hand, a significant further decline in real disposable incomes for the average household could weigh on consumption growth by more than forecast. While many households are well placed to absorb higher interest costs without significant spending cuts, some households have low savings buffers and high debt relative to incomes, and so 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. Consumption growth could also be weaker than anticipated in response to

larger-than-expected falls in housing prices or other asset prices, or because of larger-than-expected spending responses to those declines. The magnitude of the decline of housing prices arising from higher interest rates is uncertain, especially given the high level of prices relative to incomes.

Energy and other supply shocks could boost inflation and lower growth

The various energy price shocks and other supply-side issues facing the economy could intensify or persist for longer than expected, leading to higher inflation outcomes and lower output growth. The third La Niña event in as many years has increased the risk of further supply shocks in the near term, particularly for sectors that tend to be most affected by heavy rain such as home building, food and coal

production. The potential for gas prices in Europe to be higher than anticipated – if the European winter is especially cold or Russia's war with Ukraine escalates – could also push global energy prices higher and add to upward pressure on Australian electricity prices.

On the other hand, global supply chain constraints are easing and there is much less upside risk from this source than has been the case for some time. Global prices of some goods could decline significantly in the period ahead, which would moderate inflation outcomes by more than expected, particularly if the simultaneous tightening of monetary policy across many economies affects demand by more than the sum of individual-economy effects would imply. ❖