Overview

Inflation remains high in all major advanced economies except Japan. While pressures from supply chain disruptions and elevated commodity prices have eased, core inflation has not yet shown clear signs of moderating. Services inflation – which tends to be quite persistent – has risen in many economies. Labour markets remain tight, although employment growth has slowed and leading indicators of labour demand have come off a little.

Growth in the global economy is expected to slow significantly in the year ahead, to rates well below those seen prior to the pandemic. The post-pandemic recovery in services consumption has largely run its course in most advanced economies, and central banks are increasing policy interest rates rapidly in order to combat high inflation. High energy prices are also likely to continue to weigh on growth, especially in Europe. Growth in China is expected to remain modest, given a range of significant headwinds including a weak property sector and the authorities' approach to managing COVID-19 outbreaks.

In Australia, inflation is likewise very high and broadly based, and the labour market is tight. Growth in activity appears to have remained solid in the September quarter. Inflation is expected to peak around the end of the year and then decline over the forecast period towards the 2 to 3 per cent target range as upstream cost pressures ease and higher interest rates slow demand in the economy. Similarly, over the forecast period, GDP growth is expected to slow and the unemployment rate to increase a little.

Headline CPI inflation was 7.3 per cent over the year to the September quarter, the highest rate in over three decades. It is expected to reach around 8 per cent by the end of 2022. Measures of underlying inflation are also high, with trimmed mean inflation at 6.1 per cent over the year to the September quarter; it, too, is forecast to peak around year-end, at about 6½ per cent. From there, headline and underlying inflation are both expected to decline to about 3¼ per cent by the end of 2024, and continue declining in the following year. Higher electricity and gas prices are likely to slow the return of inflation to the target range.

Strong demand and ongoing pass-through of upstream cost pressures continue to boost inflation in groceries, consumer durables and market services. Housing costs are also adding to inflationary pressures. Prices for newly built dwellings continue to rise rapidly, with the annual rate above 20 per cent. Upstream materials cost pressures have been a factor; more broadly, however, the construction industry has faced shortages of materials and labour, as well as disruptions associated with bad weather. This has limited the pace at which the large pipeline of existing projects can be worked down. Rent inflation nationally has been subdued, but it is clearly picking up and is expected to increase further given low vacancy rates and the strong increases in advertised rents.

The labour market is very tight. At 3½ per cent, the unemployment rate remains around the lowest rate in nearly 50 years. Broader measures of labour underutilisation are also at very low rates compared with historical experience. The employment-to-population ratio and the participation rate are both near historical highs. Firms are finding it difficult to fill jobs. While job vacancies and advertisements remain at very high levels, in recent months this strong demand for labour has translated into relatively little additional employment as spare capacity in the labour market has largely been absorbed. The unemployment rate is expected to remain around 3½ per cent until mid-2023, before increasing to around 4¼ per cent by the end of 2024, as economic growth slows.

Wages growth has picked up in recent months, reflecting the tight labour market as well as high inflation and the flow-through of the Fair Work Commission decision in June on minimum and award wage rates. Growth in the Wage Price Index (WPI) is forecast to pick up further, from 2.6 per cent over the year to the June quarter, to around 3¾ per cent by mid-2023 and 4 per cent by mid-2024. Broader measures of wages growth are expected to increase at a faster pace, as firms use bonus payments and other non-base remuneration to attract and retain staff.

The Australian economy is growing solidly. The earlier rapid bounce-back in spending from pandemic-related restrictions is largely complete, and growth in consumer spending remained solid into the September quarter. Most retailers report that demand remains strong. Incomes are being supported by the tight labour market and, at a national level, the record level of the terms of trade.

GDP growth is expected to be 3 per cent over 2022, before slowing to 1½ per cent over 2023 and 2024. The forecast slowdown reflects the combined effects of higher interest rates and lower real wages and wealth on private domestic demand, as well as the slowing global economy.

There are many uncertainties surrounding these forecasts that make the path to achieving the Board's objective of returning inflation to target while keeping the domestic economy on an even keel a narrow one. The main uncertainties around domestic demand centre on the outlook for consumption. Consumption is being influenced by a range of competing drivers that could result in a materially different outcome from the central forecast. So far, consumer spending has been supported by past gains in incomes, asset prices and accumulated saving during the pandemic. Labour income growth is likely to remain solid given the tight labour market and rising wages growth. However, these sources of support are being counteracted by high inflation, rising interest rates and falling housing prices. Demand for housing finance has eased as the housing market has cooled, and housing credit growth is slowing.

The trajectory of inflation is also uncertain due to the ongoing evolution of supply shocks. Some factors that have boosted inflation over the past year are reversing, though it will take some time before the effects flow through to prices paid by consumers. Spot shipping costs and other upstream price pressures stemming from pandemic-related disruptions to supply chains are unwinding quickly. Much of the initial surge in commodity prices in response to Russia's invasion of Ukraine has also reversed. However, energy prices remain much higher than they were at the beginning of the year. The effect of this on domestic electricity and gas prices is expected to be much greater than had been envisaged earlier in the year, and a further significant lift in utilities prices is now expected in 2023. How far and how quickly this flows through to retail bills, and how large the second-round effects on businesses' costs and prices will be, is hard to predict. On top of these largely global factors, inflation in Australia has also been boosted by flooding and other bad weather, which has damaged crops and so increased food prices. The most recent round of flooding looks set to prolong the effect on food prices to at least the end of the year.

A more medium-term risk to the inflation outlook relates to the persistence of domestic inflationary pressures and the possibility that price- and wage-setting behaviour could shift. After initially being predominantly driven by supply shocks, inflation is now spreading to more persistent non-discretionary items. This follows an apparent increase in firms' willingness to pass on upstream cost pressures to consumers. The longer these domestic pressures persist and inflation stays high, the more this could lead workers to make larger wage claims, especially in a tight labour market. This could in turn be reinforced by firms' pricing decisions to pass on higher costs. If this were to occur, domestic demand would likely need to slow by more than currently forecast for inflation to return to target, with implications for the path of monetary policy.

These domestic risks will play out in a context of slowing global growth. Just how far global growth slows depends in part on how much major central banks need to tighten monetary policy. In the current environment of persistently high inflation, major central banks are raising policy rates quickly and some have indicated that policy will need to be restrictive for some time. Such a simultaneous tightening in policy could slow activity by more than expected. In addition, tight financial conditions could expose previously unrecognised vulnerabilities in the global economy.

Global financial conditions have already tightened noticeably and volatility has increased in a range of markets. Longer term government bond yields have increased further in recent months, taking real yields to their highest levels in roughly a decade. Conditions in corporate bond markets have also tightened significantly and equity prices have declined since the start of the year. The US dollar has appreciated considerably over 2022, including against the Australian dollar. On a trade-weighted basis, though, the Australian dollar is at roughly the same level as at the beginning of the year.

The Chinese economy is facing its own particular headwinds and growth is expected to remain modest there, with risks skewed to the downside. Domestic spending is likely to be constrained by the ongoing disruptions from the authorities' COVID-19 control measures; following the National Congress of the Chinese Communist Party held last month, indications are that this policy approach will continue for the foreseeable future. The weak property sector is also dragging on growth, despite still-accommodative monetary policy and other policy measures intended to support activity directly. Financial distress among property developers has continued, and equity prices more broadly have declined sharply in both mainland China and Hong Kong.

Over the past three months, the Reserve Bank Board has continued the process of lifting interest rates from the very low levels reached during the pandemic. It has lifted interest rates materially since this process began in May. This has been necessary to achieve a better balance of supply and demand in the Australian economy, which is needed to return inflation to target.

Inflation in Australia is currently too high. Price stability is a prerequisite for a strong economy and a sustained period of full employment. The Board's priority is therefore to return inflation to target. While some of the current high inflation can be expected to reverse as supply chain pressures and input costs ease, this alone would not be sufficient to return inflation to target. Domestic demand pressures are also playing a role in the current high inflation. The task of bringing inflation down has been made more difficult by the escalating price pressures in the domestic electricity and gas markets and another round of floods that has damaged the domestic food supply.

So far, medium-term inflation expectations and wages growth have remained consistent with the inflation target and it is important that this remains the case. Given the importance of avoiding a price–wage spiral, the Board will continue to pay close attention to both the price-setting behaviour of firms and the evolution of labour costs in the period ahead.

The Board has been mindful that policy operates with a lag and that the full effect of higher rates is yet to be felt in mortgage payments and household budgets, at the same time that higher inflation is eroding real incomes. It is also mindful that global growth is slowing and that other central banks are raising interest rates quickly and simultaneously, which could weigh on global growth – and so reduce inflation – by more than their individual effects would normally imply. The Board is closely monitoring household spending and the global economy to assess their implications for domestic demand pressures.

Following a sequence of increases of 50 basis points, in October and November the Board increased the cash rate target in increments of 25 basis points. In doing so, the Board recognised that interest rates had already been increased significantly in a short period of time and that the full effect of those increases lies ahead. In an uncertain environment, slowing the adjustment of policy allows time to assess the effects of the increases to date and the evolving economic outlook. Drawing out policy adjustments also helps to keep public attention focused for a longer period on the Board's resolve to return inflation to target. While some other central banks have been increasing policy by larger increments, the Reserve Bank Board meets more frequently than policymaking bodies in these central banks. This gives the Board more opportunities to adjust its policy stance.

The Board is focused on returning inflation to target and establishing a more sustainable balance of demand and supply in the Australian economy. To achieve this, the Board expects that interest rates will need to increase further. But monetary policy is not on a pre-set path. The size and timing of future interest rate increases will continue to be determined by the incoming data and the Board's assessment of the outlook for inflation and the labour market. If in future the Board judges that it needs to increase the cash rate in larger steps to secure the return of inflation to target, it will do so. Similarly, if the situation requires the Board to hold the cash rate steady for a period, it will do so. The Board is resolute in its determination to return inflation to target and will do what is needed to achieve this.