5. Economic Outlook

A solid global economic recovery is underway, but the near-term outlook for many economies remains uncertain and uneven. China's economy is forecast to continue expanding along its pre-pandemic path, underpinning the outlook for growth among Australia's major trading partners. Significant policy support and progress with vaccinations is supporting the recovery in many advanced economies, particularly in the United States. However, COVID-19 outbreaks in largely unvaccinated populations and more limited scope for policy support is clouding the outlook in many other economies, particularly in emerging markets (see 'The International Environment' chapter).

Recent outbreaks of the Delta variant across Australia, and the resulting lockdowns, have introduced a high degree of uncertainty to the outlook for the second half of this year. Activity will contract in the September quarter and some job losses are expected. Towards the end of this year, the economy is forecast to rebound from this setback as restrictions ease, as it has from previous lockdowns. While the Delta strain is likely to require a more measured reopening of the economy in affected areas than in the past, the Australian economy entered this challenging period in a strong position and fiscal policy is directly supporting households and businesses in the affected areas.

Beyond the near term, the level of output is forecast to be a little higher than expected at the time of the previous *Statement*, underpinned by stronger private investment and public demand. Under the baseline scenario, GDP is forecast to grow by a little above 4 per cent over 2022, and 2½ per cent over 2023 (Table 5.1). The unemployment rate is expected to increase in the near term, before resuming its decline to be around 4 per cent by the end of 2023, which would be the lowest rate in many years. With the unemployment rate forecast to decline to a lower level than previously anticipated, wages growth and underlying inflation are also forecast to pick up a little more relative to the previous *Statement*. Inflation is forecast to rise a little above 2 per cent by the end of 2023 in the baseline scenario.

The baseline scenario assumes that the domestic vaccine rollout accelerates in the second half of the year, reducing the frequency and severity of lockdowns and allowing the international border to be reopened gradually from mid 2022. This scenario assumes that the Sydney lockdown extends through the September quarter and the lockdown in south-east Queensland ends as planned, with some further brief (and less severe) restrictions assumed to occur in the December quarter. Health outcomes are the main uncertainty for the outlook and will determine when and how quickly the economy bounces back. As in recent *Statements*, uncertainty around health outcomes is considered through 2 alternative scenarios:

- A weaker path than the one envisaged in the baseline scenario would occur if the spread of the Delta variant results in more extended and widespread lockdowns and the international border reopens more slowly than assumed in the baseline. In this downside scenario, restrictions on the consumption of discretionary services,

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	9½	4	4½	4¼	2¾	2½
(previous)	(9¼)	(4¾)	(4)	(3½)	(3)	(n/a)
Unemployment rate[b]	5.2	5	4½	4¼	4¼	4
(previous)		(5)	(4¾)	(4½)	(4½)	(n/a)
CPI inflation	3.8	2½	1½	1¾	2	2¼
(previous)		(1¾)	(1¼)	(1½)	(2)	(n/a)
Trimmed mean inflation	1.6	1¾	1½	1¾	2	2¼
(previous)		(1½)	(1½)	(1¾)	(2)	(n/a)
	Year-average					
	2020/21	**2021**	**2021/22**	**2022**	**2022/23**	**2023**
GDP growth	1¼	4¾	4½	5	4	2¾
(previous)	(1)	(5¼)	(5)	(4)	(3¼)	(n/a)

(a) Forecasts finalised on 4 August. Forecast assumptions (May *Statement* in parenthesis): TWI at 62 (64), A$ at US$0.74 (US$0.77), Brent crude oil price at US$70bbl (US$68bbl), population growth of 0.1 per cent over 2021, 0.4 per cent over 2022 and 1.2 per cent over 2023; cash rate in line with market pricing; and other elements of the Bank's monetary stimulus are in line with the announcement made following the August 2021 Board meeting. 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

coupled with precautionary behaviour, result in higher saving and a weaker profile for household consumption. Private investment and services exports would also be lower. In this scenario, the unemployment rate rises in coming months, and remains above 5 per cent to the end of the forecast period; as a result, underlying inflation remains in the range of 1¼–1½ per cent through to 2023.

- A stronger economic path could eventuate if the virus is contained more quickly than envisaged in the baseline scenario, with household consumption and private investment increasing faster once containment measures are lifted. In this upside scenario, households are more willing and able to consume out of their savings and wealth than in the baseline scenario, supported by higher labour income and fewer restrictions on discretionary services. International travel recovers more quickly in the event that the international border is opened faster, boosting services exports. In this scenario, the unemployment rate declines faster and to a lower level compared to the baseline. The stronger labour market sees inflation rise to the upper half of the target range by the end of 2023.

The domestic recovery had been stronger than anticipated prior to the recent outbreak and the economy is expected to bounce back when restrictions ease

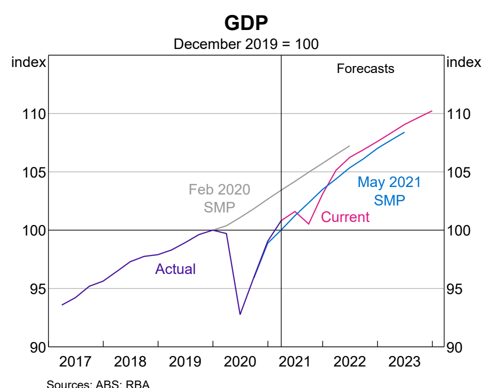
The recovery in the Australian economy had established strong underlying momentum just prior to the recent Delta outbreak and

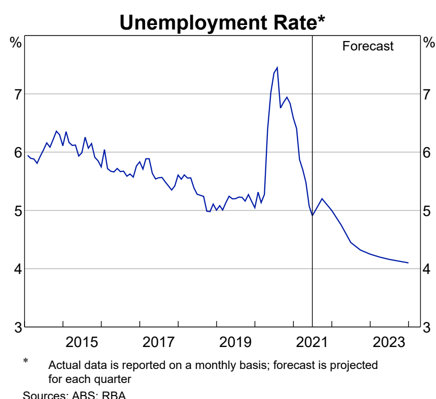
associated lockdowns. Domestic demand is expected to have increased at a solid pace in the June quarter. The unemployment rate declined by a further 0.8 percentage points in the quarter to 4.9 per cent in June; this is a much lower level of unemployment than had been expected at the start of the year.

The recent outbreaks of the Delta variant and accompanying lockdowns will depress economic activity, especially in the September quarter, and temporarily reverse the improvement in the labour market. Output in the September quarter is forecast to contract by at least 1 per cent – instead of increasing by a similar amount, as forecast prior to the lockdowns – with some but not all of the decline recovered in the December quarter. The restrictions on activity are expected to result in a substantial decline in average hours worked by employees (including an increase in the number of people on zero hours due to workers being stood down). A decline in employment is also likely and some workers are anticipated to leave the labour force until the lockdowns end, reducing labour force participation in the September quarter. The unemployment rate is forecast to increase in the quarter.

The experience of the past year domestically and abroad is that private demand and the labour market quickly recover when containment measures are relaxed and cases of the virus remain low. Assuming recent outbreaks can be brought under control soon and further outbreaks are limited, the transition from recovery to expansion should be back on track by early 2022. Monetary and fiscal policy settings will support this, alongside significantly higher vaccination rates. However, worse health outcomes and longer lockdowns would deepen the contraction and result in worse labour market outcomes.

Beyond the near-term impact on activity from the lockdowns, the level of GDP is forecast to be a little higher in 2023 than was forecast at the time of the previous *Statement* (Graph 5.1). This reflects a higher starting point following the March quarter national accounts and the assumption that the economy will bounce back strongly from recent lockdowns. Private investment and public demand are projected to be slightly stronger over the latter part of the forecast period than previously anticipated. Beyond the near-term, the unemployment rate is forecast to decline steadily to around 4 per cent by the end of 2023 (Graph 5.2). With considerable spare capacity likely to be absorbed by this time, wages growth and inflation is forecast to gradually pick up, with inflation forecast to be a little above 2 per cent by the end of 2023.





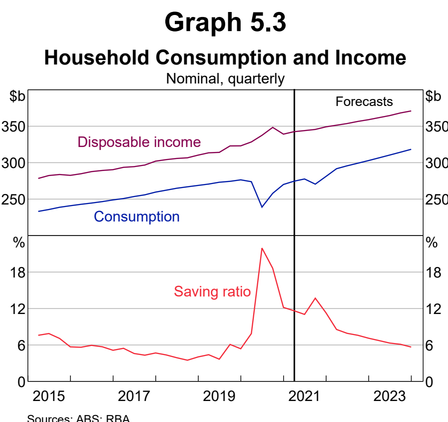
Household consumption, income and saving

Household spending was tracking strongly in the months prior to the recent lockdowns. However, household consumption is forecast to contract in the September quarter, accounting for most of the quarterly decline in GDP. Consumption is forecast to recover in affected areas across the December 2021 and March 2022 quarters, assuming no further extended lockdowns are required (Graph 5.3). A somewhat stronger profile for employment and wages has supported an upgrade to the outlook for household income and, coupled with the recent increase in household wealth, should support household spending across the forecast period.

The household saving ratio is expected to increase in the September quarter, mainly reflecting reduced consumption opportunities, before declining steadily further out. It is projected to remain above its average level over the 5 years prior to the pandemic.

Private investment

Dwelling and business investment are forecast to boost activity over coming years. Recent lockdowns and temporary restrictions on construction activity in some states will weigh on both residential and non-residential investment in the September quarter, but a rebound is anticipated in the December 2021 and March 2022 quarters after restrictions ease.



Graph 5.3
Household Consumption and Income
Nominal, quarterly

Fiscal support and monetary easing over 2021 have underpinned a strong upswing in housing activity. Housing price growth and low interest rates are forecast to sustain a high level of construction of new houses and renovation activity over coming years. Investment in higher-density residential construction is forecast to remain weak in the near term, reflecting the low level of building approvals over the past 3 years. However, as population growth gradually recovers, further declines in rental vacancy rates in larger cities are anticipated and this should support a pick-up in higher-density investment towards the end of the forecast period.

The robust recovery in non-mining business investment is forecast to have continued in the June quarter, and the level of investment over coming years is forecast to be higher than in the previous *Statement*. Machinery & equipment investment is anticipated to have increased strongly in the June quarter, supported by tax incentives, high levels of business confidence, a decline in spare capacity and strong business balance sheets. The forecast recovery in non-residential construction investment has been further delayed by recent restrictions, to the end of the year. The level of non-residential building approvals has edged higher over recent months, from a subdued level, providing some support for an eventual pick-up in construction activity.

Mining investment is forecast to increase over coming years, continuing the steady growth seen since 2019. This partly reflects firms undertaking investment to sustain their level of production, rather than to expand capacity in response to higher commodity prices. Mining machinery & equipment investment is forecast to increase as firms commence programs to replace vehicle fleets.

Public demand

Public demand is expected to have increased in the June quarter and should continue to contribute to GDP growth across the forecast period. The higher level of public consumption expected is based on additional spending announced in this year's federal and state government budgets. Public investment growth is forecast to strengthen over 2021, albeit a little more slowly than projected in the previous *Statement*; recent government budgets have suggested that public investment would be rolled out more slowly.

External sector

The outlook for exports has been downgraded, reflecting lower resource exports in the near term and lower services exports further out. Protracted maintenance and weather-related disruptions are forecast to have weighed on iron ore and coal export volumes in the June quarter. Export volumes are forecast to return to around productive capacity over the second half of the year as these issues are resolved. Services exports are forecast to remain at subdued levels for longer than previously anticipated, and are expected to begin increasing from mid 2022 when international borders are assumed to reopen. By contrast, the recent increase in rural exports is forecast to be sustained as global demand conditions strengthen and ongoing favourable weather conditions support a faster-than-expected herd rebuild and strong cereals exports.

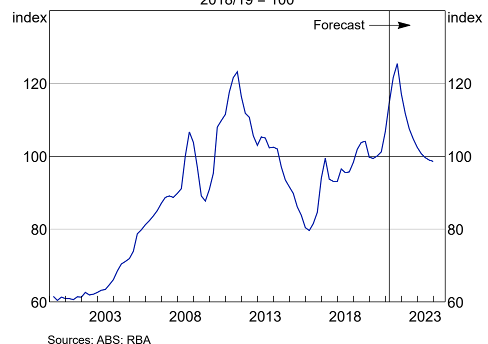
Import volumes are forecast to continue to recover over the forecast period, but the later recovery in travel services imports due to the delayed border reopening, and higher world export prices, are likely to drag on import growth. These factors are expected to outweigh the uplift in imports from stronger domestic demand.

The near-term outlook for the terms of trade has been further boosted by higher iron ore, coal and LNG prices (Graph 5.4). If commodity prices remain around current levels, the terms of trade in the September quarter will exceed its previous peak in 2011. But these levels are not expected to persist. As in the previous *Statement*, iron ore prices are forecast to decline from near-record levels, and higher import prices are also forecast to weigh on the terms of trade over the forecast period.

Labour market

Labour market conditions have improved more quickly than expected in recent months. The unemployment rate was 4.9 per cent in June; at the time of the May *Statement*, it had not been forecast to reach this level until late this year. This gives a stronger starting point for the outlook. The current activity restrictions will see some reversal in the near term. Beyond that, the unemployment rate is forecast to decline steadily to around 4¼ per cent by the end of 2022 and 4 per cent by the end of 2023.

The labour market will be negatively affected by the lockdowns in the September quarter. Some employment losses are anticipated; however, a large part of the adjustment to reduced economic activity is expected to occur through a decline in average hours worked by



employees. Labour force participation is anticipated to decline for a period as people hold off on searching for work while mobility restrictions are in place (Graph 5.5). This is consistent with patterns seen in previous lockdowns over the past year. The temporary fall in labour force participation is expected to limit the increase in the unemployment rate while the lockdowns in Greater Sydney are in place.

Once restrictions are lifted, the underlying strength in economic conditions (including high levels of job vacancies) should see the recovery in the labour market regain momentum towards the end of the year and into the first half of 2022. Beyond this, further improvements in the labour market are forecast to occur but at a more moderate pace, in line with the expected profile for activity. Labour force participation is projected to reach historically high levels as strong labour demand encourages more workers to join the labour force.

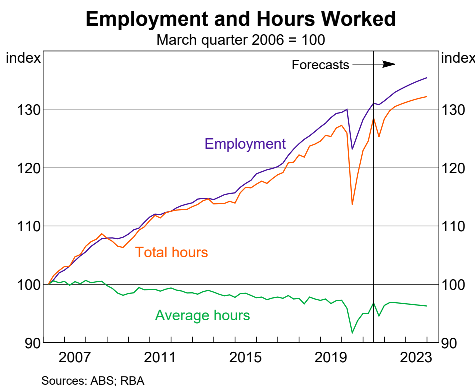
Wages and inflation

The sustained improvement in economic activity and labour market conditions over the forecast period is expected to gradually lift wages growth from its current low levels. The Wage Price Index (WPI) is anticipated to pick up to above 2 per cent by the end of 2021 and gradually increase to around 2¾ per cent by 2023 (Graph 5.6).

The Superannuation Guarantee increased by 0.5 percentage points on 1 July, and is legislated to increase by an additional 0.5 percentage points on each 1 July over the forecast period. Some but not all of these increases are expected to be passed on as lower growth in base wages paid to employees. Some employees already receive superannuation payments greater than the legislated minimum; for those who do not, employers might absorb some of the increase in labour costs or offer smaller wage rises than otherwise. The cumulative effect of this is expected to see year-ended WPI growth by the end of 2023 at around 0.3 percentage points slower than a broader measure of average earnings, which is expected to be growing at around 3 per cent at this time.

The revised outlook for wages growth since the previous *Statement* reflects a faster expected improvement in the labour market. Liaison information suggests that wages growth in many firms is returning to around the pre-pandemic norm of 2–2½ per cent this year, but not stronger than this. Recent announcements for public sector wage policies are also consistent with slightly faster wages growth, although there are differences across states.

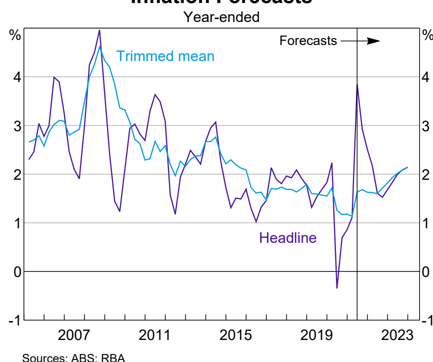
Graph 5.5



Graph 5.6

Underlying inflation has stabilised recently but will likely remain subdued over the next few quarters, given the decline in activity in the September quarter and the absence of broad-based inflationary pressures (Graph 5.7). From mid 2022, underlying inflation is forecast to pick up a little more quickly than previously anticipated to be a little above 2 per cent by the end of 2023; this reflects the faster reduction in spare capacity in the economy. There will continue to be some divergence between headline and underlying inflation, as some of the recent one-off boosts to inflation unwind. However, absent further significant government policies affecting measured inflation, headline inflation should converge back toward underlying inflation by mid 2022.

At the component level, services inflation is forecast to pick up gradually from its current low rates, consistent with increasing labour costs. Tradables inflation has increased due to strong global demand for goods and associated issues with some supply chains, but these pressures are forecast to subside over time. Some boost from new dwelling prices is anticipated, reflecting the waning effect of HomeBuilder subsidies on measured inflation. Partly offsetting upward pressure on inflation in the near term are several government subsidies and rebates, coupled with slow growth in administered prices. Annual 12.5 per cent tobacco excise increases have also ended, after contributing around ½ percentage point to inflation each year since 2014. The outlook for utilities prices is also subdued, reflecting reductions in regulated prices, low wholesale prices and increased electricity supply from renewables.



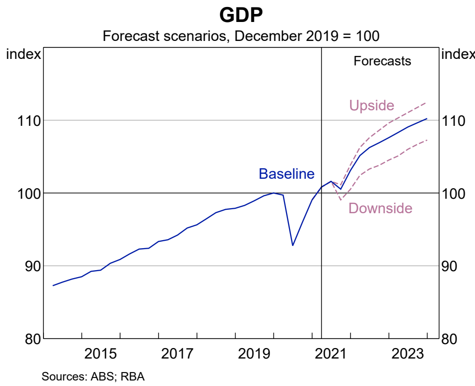
Scenarios

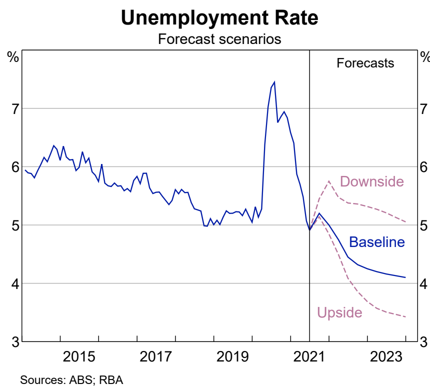
A slower economic path than the one envisaged in the baseline scenario is possible if the spread of the Delta variant (or other new variants of the virus) in Australia results in more extended lockdowns than assumed. The downside scenario assumes that around half of the Australian population experiences rolling lockdowns during both the September and December quarters of 2021, and that a full opening of the international borders is delayed until later in 2022.

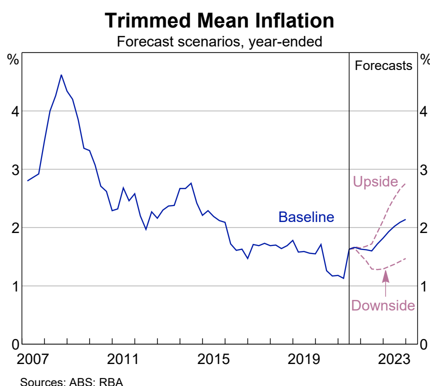
These assumptions result in a larger initial decline in activity and, subsequently, a slower pick-up in growth than assumed in the baseline scenario (Graph 5.8). The extended period of lockdown dampens consumer and business confidence, while the slower resumption of international travel delays the recovery in services trade. Households are assumed to increase saving, both for precautionary reasons and because there are fewer opportunities for discretionary spending, especially on services. In this downside scenario, consumption is around 4 per cent lower at the end of the forecast period than in the baseline scenario. Combined with the direct effect of more prolonged restrictions, lower consumption growth weighs on business income, prompting firms to delay investment plans and lay off additional workers.

In this downside scenario, the unemployment rate increases over coming months and remains above 5 per cent for the forecast period (Graph 5.9). The slower reduction in spare capacity in the labour market weighs on wages growth and in turn underlying inflation remains

in the range of 1¼–1½ per cent out to the end of 2023 (Graph 5.10).







A faster economic path could instead eventuate if the spread of the virus is brought under control and activity restrictions ease more quickly than envisaged in the baseline scenario, supported by a sharp acceleration in the vaccination program. In this scenario, households are more willing and able to spend out of their savings and wealth. International travel is also able to recover more quickly.

The stronger pick-up in household consumption in the upside scenario results in consumption being 3 per cent higher than in the baseline scenario by the end of the forecast period, while the saving ratio falls more sharply, to around 4 per cent by the end of 2023. The faster return to international travel lifts services exports and provides a modest boost to GDP growth. In this upside scenario, higher consumption and reduced uncertainty about the outlook drive a faster pick-up in business investment and employment, and result in a larger decline in the unemployment rate. This in turn leads to a brisk rebound in wages growth and inflation over the next couple of years. In this scenario, the unemployment rate declines below 3½ per cent and inflation picks up to around 2¾ per cent by the end of 2023.

Other risks and uncertainties

The upside and downside scenarios considered above illustrate 2 plausible alternative paths for the economy based on different underlying assumptions about health outcomes. These assumptions affect the extent of domestic lockdowns and activity restrictions, the consumption response out of savings and wealth, and the speed with which international travel recovers. Internationally, rapid spread of more transmissible strains of the virus and delayed vaccine progress could slow the global recovery. Beyond this, other sources of uncertainty remain.

A key domestic uncertainty is how wages and prices respond to declining spare capacity. In

the baseline scenario, the unemployment rate is forecast to decline to around 4 per cent by the end of 2023, resulting in a steady increase in wages growth and inflation. However, since the mid 1970s this rate of unemployment has only been experienced in Australia briefly, in 2007/08 during the height of the mining investment boom. As there is little direct 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 baseline scenario.

One particular element of uncertainty surrounding the outlook for domestic wages and prices relates to the effect of closed international borders. This has reduced the number of temporary migrants in the country, reducing labour supply in some areas and weighing on demand in the economy, mainly via a reduction in education exports and lower population growth. Although prices and wages would typically be expected to adjust fairly smoothly over time to longer-lived changes in the demand for and supply of goods, services and labour, the pandemic has been an abrupt shock. The sudden nature of the resulting changes in demand and supply in the economy, and the possibility of sharp reversals as borders reopen (exacerbated by uncertainty about when this will occur), means there is considerable uncertainty around the future behaviour of wages and prices.

Capacity constraints could also become more prominent in parts of the economy, particularly in residential and non-residential private and public investment where a large amount of activity is forecast over coming years. This volume of investment activity could result in price and wage pressures emerging more quickly than anticipated; restricted interstate labour mobility would exacerbate this. Alternatively, capacity constraints could result in projects being rationed or delayed, resulting in lower output growth than otherwise.

The outlook for housing and financial asset prices, and the willingness of households to consume out of their wealth and savings, is another source of uncertainty for the outlook. National housing and equity prices have increased very strongly since late last year, boosting household wealth and consumption. But asset price growth could slow or even reverse in some circumstances. For example, in the case of housing, the supply of new dwellings is likely to outpace population growth over the next few years. If this weighs on housing prices, household wealth and consumption growth could be lower than otherwise. However, it is also possible that a prolonged period of low interest rates contributes to further strong growth in asset prices and therefore a higher level of household wealth and consumption than envisaged in the baseline scenario. How willing households are to consume out of a given increase in wealth remains a related source of uncertainty for the outlook.