Overview

The Australian economy has bounced back strongly from the lockdowns associated with the outbreak of the Delta variant of COVID-19 in the second half of 2021. GDP is expected to have grown by 5 per cent over the year despite these lockdowns. In light of this strong recovery and signs that the effect of the Omicron outbreak on spending has been relatively small, the outlook for the Australian economy has been upgraded relative to the forecasts presented in the November *Statement on Monetary Policy*. GDP is expected to grow by around 4¼ per cent over 2022 and 2 per cent over 2023.

The labour market has likewise recovered quickly. The unemployment rate declined to 4.2 per cent in December and there has been a welcome reduction in underemployment to its lowest rate in 13 years. Labour force participation also recovered to high levels. While the Omicron outbreak is expected to have reduced hours worked significantly in January and into February as workers recover from illness or are required to self-isolate, employment is likely to have been little affected. With job vacancies and other indicators of labour demand remaining strong, further improvement in the labour market is anticipated over the course of this year and into 2023. The central forecast is for the unemployment rate to fall below 4 per cent later this year and to remain so over the rest of the forecast period.

Many countries, including Australia, are contending with large outbreaks of the Omicron variant of the COVID-19 virus, but these outbreaks are expected to have much smaller effects on activity than those experienced previously. Although this variant is much more transmissible, rates of severe disease are significantly lower than for earlier strains, assisted by high vaccination rates in many countries. As a result, restrictions on activity have been much less than in earlier outbreaks. Mobility and other indicators of economic activity have declined in response to the limited restrictions that have been put in place, as well as because people have been reducing their movements either to avoid infection or to isolate because they are infected or are close contacts.

Inflation pressures have been elevated in many advanced and emerging economies, though less so in parts of Asia. Recent inflation outcomes in many advanced economies have been higher and more persistent than expected, and indications are that inflationary pressures are becoming more broadly based. Supply disruptions have added significantly to a wide range of goods and commodity prices. Strong global demand for goods, driven by changing consumption patterns related to the pandemic and underpinned by policy support, is also contributing to price pressures. The current Omicron outbreak has added to the existing supply disruptions that have contributed to rising price pressures globally. Central banks in advanced economies have revised up their near-term forecasts for inflation, but generally still expect inflation to decline towards their targets over the coming year or so as the supply disruptions are resolved.

Australia has been affected by these global inflationary pressures, but to a lesser extent than some other advanced economies. Headline and

underlying inflation were both higher in the December quarter than the Bank had expected. The Consumer Price Index increased by 1.3 per cent in the quarter; fuel, new dwelling construction costs and consumer durable prices accounted for about two-thirds of that increase. The increases in the prices of consumer durables are consistent with global supply-chain pressures persisting for longer than expected. There is also some evidence of inflation pressures recently broadening beyond goods prices into services prices. Trimmed mean inflation was 1 per cent in the quarter and 2.6 per cent over the year, and a higher share of items recorded inflation above 2½ per cent than has been the case in recent years.

The outlook for inflation has been revised higher. Upstream cost pressures in housing construction and durable goods are expected to push underlying inflation higher in the near term, but moderate over time. Underlying inflation is forecast to peak around 3¼ per cent in the next few quarters, before returning to around 2¾ per cent as some of the shorter-term cost pressures abate. Given the tighter labour market and strong demand conditions anticipated over coming years, inflation is expected to remain in the upper half of the Bank's inflation target range of 2 to 3 per cent. There are, however, considerable uncertainties surrounding this outlook, not least because the effect of very low unemployment rates on wages and other prices is uncertain, given there is little recent historical experience to draw upon.

Growth in wages has increased a little, but so far only to the slow rates seen prior to the pandemic. Most employers in the Bank's liaison program are not anticipating wages growth to move beyond the 2 to 3 per cent range this year. Given the strong current and expected labour market outcomes, the medium-term outlook for private sector wages growth is stronger than at the time of the November *Statement*. Some industries are already reporting strong wages growth for jobs requiring skills that are in high demand. However, the pick-up in aggregate wages growth is likely to be only gradual, reflecting slow growth in public sector wages and the inertia resulting from multi-year enterprise agreements. Broader measures of earnings growth that include bonuses and other non-base wage payments are likely to increase at a faster pace than base wages.

Consumer spending recovered quickly following the end of last year's lockdowns and the fundamental drivers for consumption remain positive. Spending is being supported by a robust labour market and household finances. Household wealth has increased strongly during the pandemic, with substantial growth in housing wealth and some contribution from the savings accumulated while spending opportunities were constrained by lockdowns. As the labour market continues to improve, household incomes will expand solidly. The growth in incomes and wealth will support both consumption and dwelling investment over the period ahead.

Dwelling investment is expected to remain at a high level. This outlook is underpinned by the substantial pipeline of work prompted by the HomeBuilder program and other fiscal incentives, as well as the strength in household incomes and wealth. In addition, household preferences have shifted towards demanding more space in homes following the experience of lockdowns and other consequences of the pandemic. This preference shift has contributed to the strong conditions in established housing markets. Nationwide, housing prices increased by 22 per cent over 2021. In recent months, however, the pace of housing price growth has eased in the largest cities. Growth in advertised rents has also eased in some capital cities, but remains strong elsewhere.

Similar to the housing construction sector, a significant pipeline of construction work

underpins the outlook for business and public investment. However, supply shortages are evident in the construction sector, suggesting that capacity constraints could slow actual investment relative to stated plans. Capacity constraints are also being reported in some exporting sectors and other parts of the labour market. Firms in the construction, professional services, agriculture and hospitality sectors are reporting difficulties in finding labour, especially for selected skills in high demand. Some of these difficulties could ease now that the international border is reopening to some skilled migrants. In the meantime, though, firms are reporting higher rates of staff leaving for higher pay than in recent years.

Strong construction activity and demand for housing more generally in the low interest rate environment are reflected in the strong demand for finance. Accordingly, credit growth picked up strongly over 2021. Growth in housing credit moved higher over recent months and new financing commitments rebounded from the effects of lockdowns in some states. Business credit growth has increased noticeably, driven by lending to large firms. With interest rates at historically low levels, it is important that lending standards are maintained and that borrowers have adequate buffers.

Financial conditions domestically and overseas generally remain accommodative and, in Australia, banks' funding costs are at historic lows. Government bond yields in most advanced economies have risen noticeably over the past couple of months, as market participants increasingly expect central banks to begin withdrawing monetary policy stimulus in the near future. Many central banks in advanced economies are expected to raise policy rates in 2022; a few have already done so. Likewise, most central banks have ceased their pandemic-related asset purchases or will do so soon.

Output and labour markets in advanced economies have recovered from pandemic-related contractions much more quickly than in a typical downturn. Unemployment rates are now close to or a little below pre-pandemic levels, which in many cases were already low relative to the experience of previous decades. GDP in advanced economies is expected to regain its pre-pandemic path during 2022; in China, this has already occurred. By contrast, in some other emerging economies, a persistent shortfall in output is likely to remain.

The most significant downside risks to the global and domestic economies continue to be health-related. In the downside scenario contemplated in the 'Economic Outlook' chapter, the Australian unemployment rate would increase back to around pre-pandemic levels. Supply disruptions would partially offset the ensuing downward pressures on prices, with underlying inflation remaining in the lower part of the target range. On the other hand, if health outcomes turn out to be better than expected, households' confidence and willingness to spend out of accumulated savings could be higher. In that scenario, the unemployment rate could fall to around 3 per cent by the end of the forecast period and inflation would be noticeably higher.

The global outlook is subject to a range of risks outside the health sphere. If the upswing in global inflation turns out to be larger or more persistent than currently expected, it could trigger an earlier and larger tightening in global monetary policy. This could in turn prompt a further sharp rise in global bond yields and financial market risk premiums, which could be disruptive, particularly for some emerging market economies. The Chinese economy is subject to some specific risks related to the various policy trade-offs that the authorities face. There are also risks to the Chinese economy should a widespread outbreak of COVID-19 occur and require large-scale suppression measures there. Geopolitical risks have also come to the fore in recent weeks.

At its recent meetings, the Reserve Bank Board considered the Australian economy's faster-than-expected recovery from the 2021 lockdowns, particularly in the labour market. It also observed that inflation has picked up faster than anticipated and is now expected to remain above the middle of the 2 to 3 per cent target range for the next few years. If realised, the staff forecasts imply that the Bank's policy goals would be achieved sooner than previously envisaged.

The bond purchase program, together with the low level of interest rates and the Term Funding Facility, have provided important support in moving the economy closer to reaching the Bank's policy goals. At its February meeting, the Board decided to cease further purchases under the bond purchase program after 10 February on the basis of the three criteria that had guided it from the outset: the actions of other central banks; the functioning of Australia's bond market; and actual and expected progress towards the Bank's policy goals of full employment and inflation consistent with the target. By the time of the February meeting, most other central banks had concluded their programs, or were expected to do so shortly. While the Australian bond market has been functioning reasonably well, with support from the Bank's stock-lending activities, some pressure points have emerged. Most importantly, there has been significant progress towards the Bank's goals, with the unemployment rate at 4.2 per cent and underlying inflation at 2.6 per cent.

Given the next maturity date for an Australian Government bond the Bank holds is not until July, the Board plans to consider the issue of whether or not to reinvest the proceeds of maturing bonds at the May meeting, with the benefit of further information on actual and expected progress towards its goals.

Ceasing purchases under the bond purchase program does not imply a near-term increase in interest rates, nor does it represent a tightening of monetary policy. The international evidence is that it is the stock of bonds purchased, not the flow of purchases, that provides the economic support. As the Board has stated previously, it will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. Progress towards the Bank's goals has been material, but significant uncertainties surround the inflation outlook. There have been large shifts in both supply and demand in response to the pandemic, and it is unclear how these patterns will evolve, or how quickly. As some of the supply-side issues are resolved, it is possible that some of the recent increases in prices will be reversed, or that the rate of increase will moderate. It is also possible that consumption patterns rebalance over time and demand for goods slows, both in Australia and globally. There are also uncertainties about how labour supply might evolve, related to the reopening of the borders and people's availability to work given ongoing pandemic-related illness and isolation requirements. This will have a bearing on wages growth, which in aggregate has only just returned to the low rates prevailing before the pandemic.

The Board judged that it is too early to conclude that inflation is sustainably in the target range. Underlying inflation has just reached the midpoint of the target range for the first time in over seven years. Consequently, the Board is prepared to be patient as it monitors how the various factors affecting inflation in Australia evolve. It is committed to achieving the inflation target, which remains at the centre of the monetary policy framework. It will do what is necessary to maintain low and stable inflation, which is important not only in its own right but also as a precondition for a sustained period of full employment.