Statement on Monetary Policy

FEBRUARY 2024

RESERVE BANK OF AUSTRALIA

Statement on Monetary Policy

FEBRUARY 2024

Contents

The cut-off for data used to prepare the *Statement on Monetary Policy* was 31 January 2024. The next *Statement* is due for release on 7 May 2024.

The *Statement* is published quarterly in February, May, August and November each year. All the *Statements* are available at www.rba.gov.au when released. Expected release dates are advised ahead of time on the website. For copyright and disclaimer notices relating to data in the *Statement*, see the Bank's website.

The graphs in this publication were generated using Mathematica.

Statement on Monetary Policy enquiries:

Communications Department
Tel: +61 2 9551 8111
Email: rbainfo@rba.gov.au

ISSN 1448–5133 (Print)
ISSN 1448–5141 (Online)

Overview

Inflation continues to moderate but remains high.

Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and to reach the midpoint in 2026. Goods price inflation has declined but services price inflation remains high, supported by continued excess demand in the economy and strong domestic cost pressures, both for labour and non-labour inputs.

Higher interest rates are working to establish a more sustainable balance between demand in the economy and its overall capacity to supply goods and services. The staff's assessment is that the stance of monetary policy in Australia is currently restrictive, based on financial indicators and the ongoing easing in the growth of aggregate demand. Conditions in the labour market continue to ease gradually, although they remain tighter than is consistent with sustained full employment and inflation at target. A period of subdued demand growth and moderate employment growth over the coming year or two will bring about a better balance between supply and demand.

Cash rate target unchanged to support inflation returning to target.

High inflation hurts all Australians. It erodes purchasing power and the value of savings and makes it harder for businesses to plan and invest. It adversely affects all Australians, but particularly those on low incomes. Low and stable inflation, consistent with the inflation target, facilitates strong and sustainable growth in the economy over the longer term. The best contribution that monetary policy can make to the wellbeing of the Australian people is to ensure that inflation returns to target in a reasonable timeframe.

At its February 2024 meeting, the Reserve Bank Board decided to leave the cash rate target unchanged at 4.35 per cent. This decision supports progress of inflation to the midpoint of the 2–3 per cent target range within a reasonable timeframe and continued moderate growth in employment. The Board expects that it will be some time yet before inflation is sustainably in the target range, and the Board remains resolute to return inflation to target in a reasonable timeframe. The path of interest rates that will best ensure this will depend upon the data and the evolving assessment of risks, and a further increase in interest rates cannot be ruled out.

What is going on in the economy?

Global inflation remains high but there has been encouraging progress towards central banks' targets.

Much of the easing in inflation to date in advanced economies has been due to lower energy and goods price inflation. Services price inflation remains elevated, partly reflecting still tight labour markets. Economic growth has slowed to below trend in many advanced economies in response to restrictive monetary policy settings and is contributing to returning inflation to target. In the United States, economic growth has remained robust while inflation has continued to decline.

Monetary policy settings in advanced economies are restrictive, but broader measures of financial market conditions have eased over recent months. Amid better-than-expected global inflation data, market participants expect central banks to start easing their policy rates over coming quarters.

Government bond yields have fallen and spreads on riskier asset classes have declined. Many central banks expect inflation to gradually return to target on a sustained basis over the next year or two. However, they have indicated that rate cuts may not come as soon as market participants expect as they await more evidence that the moderation in inflation will be sustained. Overall, the Australian dollar has been little changed.

In Australia, growth in demand has slowed noticeably.

A large share of the increase in the cash rate since May 2022 has been passed on to borrowers. The most recent cash rate increase in November 2023 has been passed through to advertised rates, and most remaining low fixed-rate loans will roll off onto higher rates over 2024. The share of household incomes used to meet mortgage payments is high by recent historical standards and still rising. Housing credit growth has stabilised at a lower level than in 2022, although new lending has risen over the past year.

Tighter monetary policy has contributed to a noticeable slowing in the growth of demand over the past year. Household spending growth has been weak, and in per capita terms spending has declined. This has been only partly offset by strong growth in business investment, public sector spending and spending by international students and tourists.

High inflation as well as higher interest rates and tax payments have weighed on household disposable incomes. In aggregate, households have responded to these pressures by curbing their spending, particularly on discretionary items. Households are saving less and, in some cases, drawing down on their accumulated savings buffers. Timely indicators, including from the RBA's liaison program, suggest that growth in consumer spending has remained subdued this year so far.

Labour market conditions remain tight but have continued to ease over recent months.

Employment growth has gradually eased and average hours worked have declined in recent months. At the same time, the supply of labour has increased with strong population growth and record high labour force participation (although population growth also adds to aggregate demand). As a result, the unemployment rate and the underemployment rate have both increased by around ½ percentage point since mid-2023 but from very low levels.

Wages growth remains robust, although there are signs that it is slowing in some segments of the labour market. Firms expect wages growth to ease more broadly over the year ahead. Very weak productivity outcomes have contributed to a sharp increase in labour costs per unit of output over the past year.

Demand in the Australian economy has continued to exceed supply, but subdued demand growth is closing this gap.

The staff's overall assessment is that the aggregate level of demand has remained above the economy's capacity to supply goods and services, thereby putting pressure on inflation. The labour market has also remained tight relative to what would be consistent with sustained full employment and inflation at target. This assessment is discussed in more detail in Chapter 2: Economic Conditions and Chapter 4: In Depth – Full Employment.

Inflation has moderated but services price inflation remains high.

Recent data confirm that inflation in Australia continues to slow. Both headline and underlying inflation declined in the December quarter by slightly more than had been expected at the time of the November *Statement*. Goods price inflation was weaker than expected, a pattern also seen overseas.

Services price inflation, which largely reflects conditions in the domestic economy, remained high and was broadly in line with expectations.

How do we see the economy developing?

Economic growth is expected to slow both at home and abroad.

Economic growth in Australia's major trading partners is expected to slow in 2024 and remain well below its pre-pandemic average for some time. This outlook is largely unchanged from that in the November *Statement*. In China, growth is expected to slow over the next two years as the post-pandemic rebound in services consumption fades and the property sector remains weak.

In Australia, overall demand growth is expected to remain subdued in the near term as high inflation and earlier interest rate increases continue to weigh on consumption. The near-term outlook for GDP growth has been revised down modestly since November, primarily reflecting a weaker outlook for consumer spending. The decline in real incomes over the past couple of years is expected to continue to weigh on consumption, particularly in the first half of 2024. As inflation moderates and real incomes start to rise, consumption growth is expected to recover to its pre-pandemic average over the next couple of years.

Conditions in the labour market are expected to ease further in the next year or so to be broadly consistent with sustained full employment while inflation declines toward the target. Employment is expected to continue to grow moderately, but more slowly than the working-age population, and so the unemployment rate and the broader underutilisation rate are expected to increase further. Nominal wages growth is expected to remain robust in the near term, before moderating in response to easing in the labour market. The outlook for wages growth is consistent with the inflation target, on the assumption that productivity growth increases to around its long-run average.

Inflation is expected to decline to be in the target range of 2–3 per cent in 2025 and to reach the midpoint in 2026.

Services inflation remains high and is expected to decline only gradually as demand for services moderates and growth in labour and non-labour costs eases. Goods price inflation is expected to be subdued over coming years, having already declined substantially over the past year as the resolution of earlier supply disruptions flowed through to prices paid by consumers.

These forecasts are conditioned on a path of the cash rate target based on expectations of market economists and financial market pricing. In this path, the cash rate is around its peak in the current cycle and will remain around this level until the middle of the year, before gradually declining over the remainder of the forecast period.

The outlook is still highly uncertain.

The full effect of policy tightening on household consumption is uncertain. The squeeze on household finances, including from the increases in interest rates to date, could result in household consumption remaining subdued for longer than expected. This would put more downward pressure on labour demand and wages and see an earlier return to the inflation target than forecast. This could also occur if economic growth among our trading partners is slower than forecast.

Developments in the economy could prolong the time it takes to get inflation to target. Household consumption could turn out to be stronger than forecast if households are more willing to maintain a low saving rate or even draw down on their savings to support their spending. Other things equal, poor productivity outcomes would underpin higher-than-expected costs for businesses and put upward pressure on the prices paid by consumers. Adverse shocks caused by weather-related or geopolitical events that disrupt supply could also put upward pressure on prices of energy and consumer goods and prolong the time spent away from target.

The longer it takes to return inflation to target, the greater the erosion of the purchasing power of Australian households, and the greater the risk that inflation and wage expectations drift higher than is consistent with inflation at target. History shows that, should this occur, it would require more monetary policy tightening and a costly period of higher unemployment to stabilise inflation expectations and return inflation to target.

What did the Board decide?

The Board decided to leave the cash rate target unchanged at 4.35 per cent. This decision balances the objectives of monetary policy by supporting the return of inflation to target in a reasonable timeframe with gradual easing in labour market conditions to levels consistent with full employment. The Board expects that it will be some time yet before inflation is sustainably in the target range. The path of interest rates that will best ensure that inflation returns to target in a reasonable timeframe will depend upon the data and the evolving assessment of risks, and a further increase in interest rates cannot be ruled out.

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

Per cent

	Year-ended					
	Dec 2023	June 2024	Dec 2024	June 2025	Dec 2025	June 2026
GDP growth	1.5	1.3	1.8	2.1	2.3	2.4
(previous)	(1.6)	(1.8)	(2.0)	(2.2)	(2.4)	–
Unemployment rate[(b)]	3.8	4.2	4.3	4.4	4.4	4.4
(previous)	(3.8)	(4.0)	(4.2)	(4.3)	(4.3)	–
CPI inflation	4.1	3.3	3.2	3.1	2.8	2.6
(previous)	(4.5)	(3.9)	(3.5)	(3.3)	(2.9)	–
Trimmed mean inflation	4.2	3.6	3.1	3.0	2.8	2.6
(previous)	(4.5)	(3.9)	(3.3)	(3.0)	(2.9)	–
	Year-average					
	2023	2023/24	2024	2024/25	2025	2025/26
GDP growth	2.0	1.6	1.5	1.9	2.2	2.3
(previous)	(2.0)	(1.7)	(1.8)	(2.0)	(2.2)	–

(a) Forecasts finalised 31 January. 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; the cash rate is assumed to remain around its current level of 4.35 per cent until the middle of 2024 before declining to around 3.2 per cent by the middle of 2026. Other forecast assumptions (assumptions as of November Statement in parenthesis): TWI at 62 (61); A$ at US$0.66 (US$0.64); Brent crude oil price at US$80bbl (US$84bbl). The rate of population growth is assumed to have peaked in the September quarter at 2.5 per cent. After which it is expected to decline back to its pre-pandemic average of around 1.4 per cent. Shading indicates historical data.

(b) Average rate in the quarter.

Sources: ABS; RBA.

1. Financial Conditions

Summary

- **Monetary policy settings in advanced economies are restrictive**, but broader measures of financial market conditions have eased over recent months, in response to a number of signs that labour markets are becoming less tight and that inflation continues to moderate.
- **Market participants have brought forward the timing of when they expect central banks to begin cutting policy rates, although fewer rate cuts are anticipated in Australia than in other peer economies.** Government bond yields have declined significantly from their peaks, and risk spreads have narrowed on market expectations that inflation can return to central banks' targets without significant downturns.
- **Advanced economy central banks have generally been more cautious in their own signalling, judging that more evidence is required to justify an easing of policy.** However, most have acknowledged that policy rates have probably peaked.
- **Overall financial conditions in Australia appear to be restrictive.** The tightening of monetary policy has led to a significant rise in household debt payments, households are reducing their rates of savings and household credit growth has moderated from the highs of 2022. At the same time, the value of the Australian dollar remains consistent with its key drivers and the flow of new lending to households has edged higher.

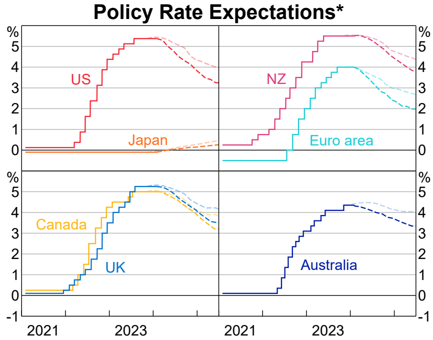
1.1 Interest rate markets

Many advanced economy central banks have signalled that policy rates are likely to have peaked amid a further moderation of inflation.

Most advanced economy central banks assess their policy rates to be restrictive and many, including the US Federal Reserve (Fed) and the European Central Bank (ECB), have also recently become more willing to discuss the possibility of reducing their policy rates in 2024. Indeed, the most recent rate projections from Fed policymakers imply a median projected decline of 75 basis points in the federal funds rate in 2024. The shift in assessment has occurred against a backdrop of continued progress on disinflation, a number of signs pointing to labour markets becoming less tight, and downward revisions to most advanced economy central banks' inflation projections. Market participants continue to expect a more rapid easing of policy than has been indicated by central banks (Graph 1.1).

Graph 1.1

Policy Rate Expectations*



* Darker dashed lines show expectations implied by current overnight indexed swap rates; lighter dashed lines show the same expectations as at the November SMP.

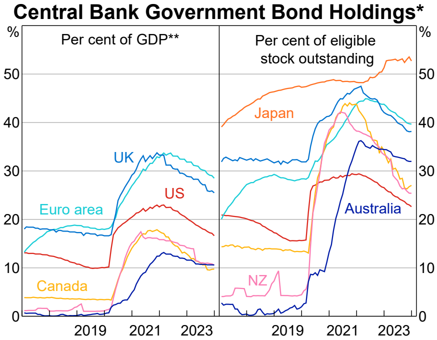
Sources: Bloomberg; RBA.

While advanced central banks are emphasising that policy rates are their active policy instrument, almost all continue to reduce the size of their balance sheets (Graph 1.2). In some cases, they have been signalling adjustments to the pace of decline. Fed officials have noted the option to slow the pace at which its balance sheet is declining to support an orderly transition to the desired steady-state level of reserves. They have pointed to measures indicating that the decline in reserves to date, from the approach of only reinvesting some bonds as they mature, has not caused any shortage of aggregate system-wide liquidity, although there were some small, temporary increases in repo rates in late 2023. By contrast, the ECB has announced that it will speed up the decline in its asset holdings, to bring forward the adjustment of its balance sheet, by reducing reinvestment.

In Australia, there was little reaction to the release of the minutes of the December Reserve Bank Board meeting. These noted the Board's decision to continue reducing the RBA's holdings of government bonds through maturities while keeping the approach under active consideration. Bonds to the value of $38 billion will mature in 2024.

Graph 1.2

Central Bank Government Bond Holdings*



* Central government debt only, except the euro area. Holdings for euro area only include asset purchase programs; holdings for UK do not include financial stability purchases; other central banks include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 98 per cent of GDP.

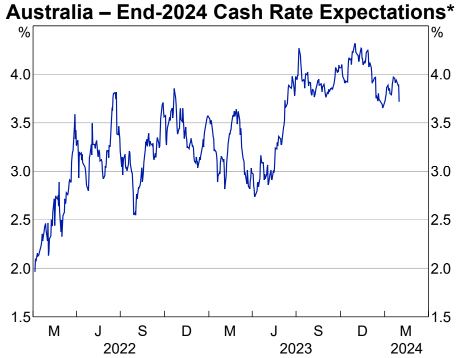
Sources: Central banks; debt management offices; LSEG; RBA.

Fewer cuts to the policy rate are expected in Australia than in many other advanced economies.

In Australia, market participants' expectations for the path of the cash rate as implied by overnight indexed swaps (OIS) have declined a little since late last year (Graph 1.3). Market-implied expectations for the cash rate declined following the December US Federal Open Market Committee meeting, but this was unwound as some advanced economy central bank officials pushed back against market expectations of near-term decreases in policy rates. More recently, OIS rates declined a little in response to lower-than-expected inflation data for Australia. Market pricing suggests that market participants believe the cash rate has reached its peak, with rate cuts of around 60 basis points priced in by the end of 2024. This is a little lower than the median forecast of market economists but broadly in line with market-implied forecasts for inflation to return to the target range during 2025. Compared with many other advanced economy central banks, both market pricing and economist forecasts suggest that the cash rate in Australia will peak at a lower level and begin to decline only later this year.

Graph 1.3

Australia – End-2024 Cash Rate Expectations*



* Daily; expectation implied by OIS.

Sources: Bloomberg; RBA.

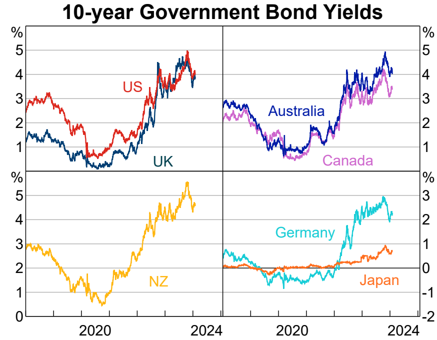
Government bond yields in advanced economies have declined over recent months, along with market expectations for significant reductions in policy rates amid larger-than-expected declines in inflation.

In many cases, the recent decline in yields reversed the increases that occurred between July and October, leaving the current levels of yields generally well above their post-global financial crisis (GFC) averages (Graph 1.4). The decline has been underpinned by falls in both real yields and inflation expectations (Graph 1.5). Longer term market-implied inflation expectations remain broadly consistent with central banks' inflation targets. Real yields have declined, which appears in part to reflect a decline in the real term premium, which is the yield on bonds over and above what is explained by expectations of inflation and future short-term real interest rates. This may reflect greater confidence that policy rates have peaked, speculation that the Fed may soon reduce the pace of quantitative tightening and an expected slowing in the pace of new government bond issuance. As usual, Australian Government Securities (AGS) yields have moved closely with those of major advanced economies.

Even so, the differential between AGS and US Treasury yields increased a little in recent months, particularly at the short end of the yield curve, reflecting a smaller decline in policy rate expectations in Australia compared with the United States (Graph 1.6).

Graph 1.4

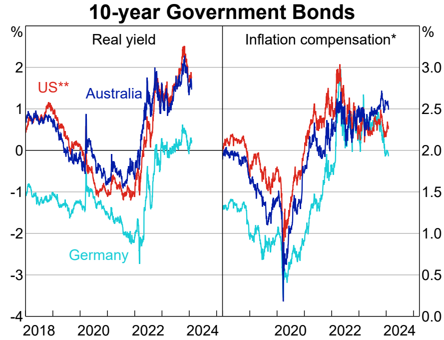
10-year Government Bond Yields



Source: Bloomberg.

Graph 1.5

10-year Government Bonds



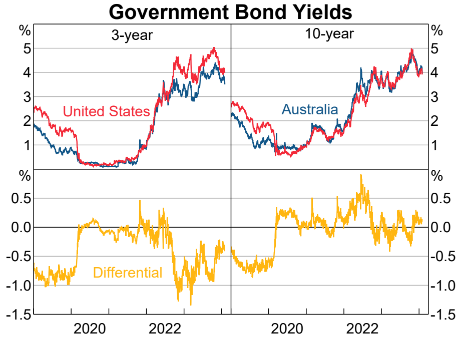
* Spread between yields on nominal and inflation-linked bonds.

** The price index referenced in US inflation-linked bonds has averaged 0.5 percentage points more than the index targeted by the US Federal Reserve over the longer term.

Sources: Bloomberg; RBA.

Graph 1.6

Government Bond Yields

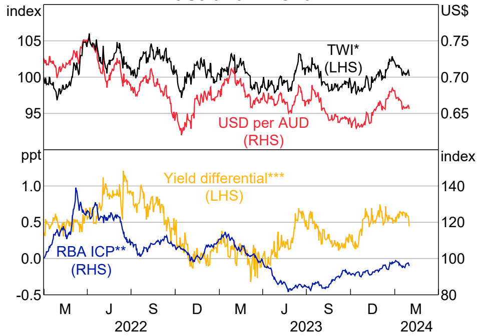


Sources: Bloomberg; RBA.

The Australian dollar is little changed overall.

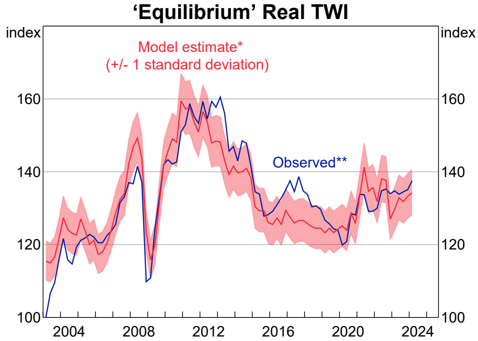
The Australian dollar has appreciated slightly, both on a trade-weighted (TWI) basis and against the US dollar, since the November *Statement* (Graph 1.7). The appreciation has mostly reflected market expectations for a more rapid pace of policy easing in the United States than in Australia, relative to what had previously been anticipated. Indeed, the US dollar TWI has depreciated by around 1 per cent since early November. Riskier assets, which tend to be positively correlated with the Australian dollar, have rallied as markets have priced in additional policy easing in the United States. Meanwhile, there has been a modest increase in the RBA's Index of Commodity Prices (ICP), reflecting demand from China for iron ore and coking coal, and increases in LNG prices (see Chapter 2: Economic Conditions). The real Australian dollar TWI has remained in a relatively narrow range since the start of 2022 and is broadly consistent with model estimates implied by the forecast terms of trade and real yield differentials (Graph 1.8).

Graph 1.7
Australian Dollar



* Trade-weighted index; 31 December 2021 = 100.
** Index of Commodity Prices (USD terms); 31 December 2021 = 100.
*** Three-year Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.
Sources: Bloomberg; RBA.

Graph 1.8
'Equilibrium' Real TWI



* Using terms of trade forecast and real Australian Government bond yield curve factors relative to the G3, see Chapman, Jääskelä and Smith (2018); standard deviation based on model errors.
** Indexed to March 2003 = 100; quarterly average real TWI.
Sources: Bloomberg; RBA.

1.2 Other measures of financial conditions

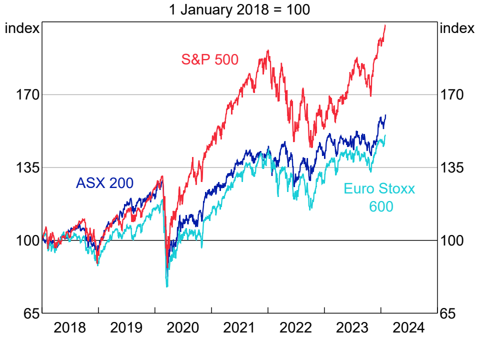
Some measures of private financial conditions have eased as markets appear increasingly confident that central banks can return inflation to target with minimal adverse effects on corporate profitability.

Equity prices in advanced economies have increased over the past two months, reaching record highs in the United States, Japan and Australia, and a little below record highs in Europe (Graph 1.9; Graph 1.10). The rise in equity prices is in part due to declines in bond yields, which increase the present value of future company earnings. Gains in equity prices are also likely to reflect increased market confidence that inflation can return to central bank targets with minimal adverse impact on future earnings. Similarly, spreads on corporate bonds in the United States, Europe and Australia have narrowed and are at their lowest levels since early 2022, consistent with market expectations of a relatively benign credit cycle (i.e. only a modest rise in company defaults) (Graph 1.11). The decline in spreads and risk-free rates has left corporate bond yields in the United States and Europe at their lowest levels in about a year, while they have been little changed for Australia over the same period.

Graph 1.9

Equity Prices*

1 January 2018 = 100



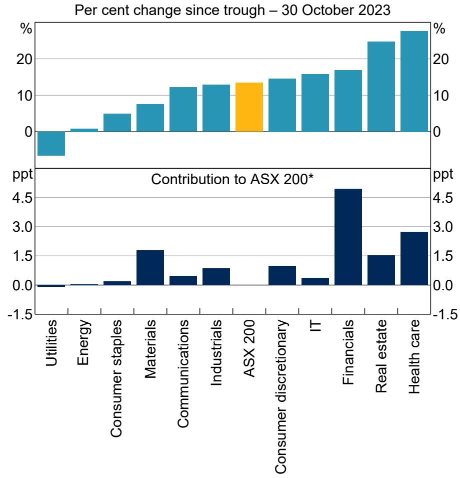
* Total return basis.

Sources: Bloomberg; LSEG.

Graph 1.10

Australian Equity Prices

Per cent change since trough – 30 October 2023



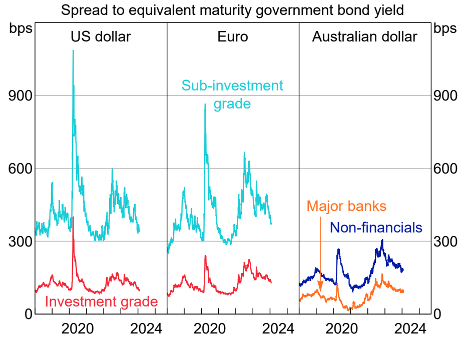
* Approximate measure based on current sectoral index weights.

Sources: Bloomberg; RBA.

Graph 1.11

Corporate Bond Spreads

Spread to equivalent maturity government bond yield



Sources: Bloomberg; ICE Data used with permission; RBA.

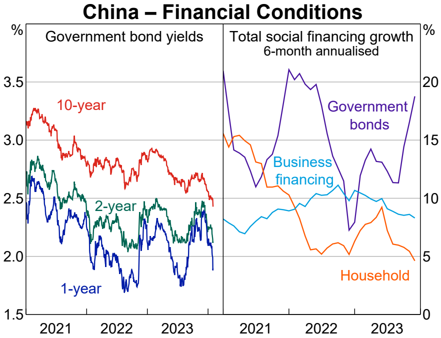
Overall issuance of corporate bonds in the United States and Europe has been lower than pre-pandemic averages of late, while it has remained strong in Australia. Bank credit growth remains positive in the United States and Europe but has fallen below pre-pandemic levels, particularly in Europe. Credit growth has also declined in Australia since 2022, but it has stabilised around its post-GFC average (see below).

Chinese financial conditions have eased a little alongside further policy support to address significant economic headwinds, including the considerable stress in the property sector.

Chinese Government bond yields have declined over recent months alongside some additional policy support and market expectations of a further easing of monetary policies (Graph 1.12). The People's Bank of China (PBC) lowered the required reserve ratio by 50 basis points and has encouraged banks to lend to priority sectors, such as manufacturing and affordable housing, through 'window guidance' and its Pledged Supplementary Lending facility (which is used by the PBC to provide long-term funding to policy banks in exchange for collateral). Additional funding has also been made available through the PBC's medium-term lending facility to assist banks to absorb a large increase in government bond issuance to support investment; in China, banks hold around 70 per cent of all government bonds (see Chapter 2: Economic Conditions). Overall, the scale of monetary policy easing to date has been moderate, with more substantive support being delivered through fiscal policy.

Graph 1.12

China – Financial Conditions



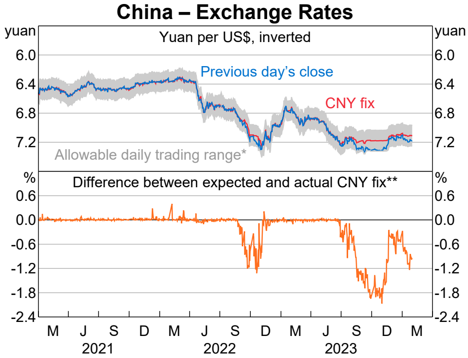
Sources: CEIC Data; RBA.

While the increase in government bond issuance has supported overall growth in total social financing, demand for credit by households and businesses has remained soft and household credit growth has declined further amid ongoing stress in the property sector. To provide further financial assistance to that sector, authorities have introduced additional measures to encourage banks to lend to the property sector, including the release of a 'whitelist' of projects deemed eligible for additional funding. Nevertheless, property developer asset prices have remained at severely distressed levels and ongoing challenges in meeting upcoming debt repayments have led many into extended negotiations with creditors. Evergrande (previously one of China's largest and most leveraged developers) was recently forced into liquidation by a Hong Kong court order after two years of negotiations with creditors. It is unclear the extent to which this will impinge on Evergrande's operations in mainland China. Stress in the property sector has largely been contained; however, there are some concerns about possible spillovers to other sectors. This includes local governments (which have historically relied on land sales revenue), trust companies, and small regional banks with weak capital positions and narrow profit margins that remain particularly exposed to stresses in the property sector.

The renminbi has appreciated modestly against the US dollar since the previous *Statement* alongside a narrowing interest rate differential between US and Chinese government bonds. Even so, the renminbi remains near its historical lows (Graph 1.13). A rise in bond investment inflows from foreign investors has more than offset further equity investment outflows that have contributed to a decline in equity prices to around levels last seen in early 2019. It has been reported that the authorities will allocate CNY2 trillion to fund mainland share purchases via offshore trading links to support equity prices and the renminbi.

Graph 1.13

China – Exchange Rates



* Since early 2014 the CNY has been allowed to trade in a daily range of +/- 2 per cent from the CNY fix.

** Negative value indicates official fix was stronger then expected by market economists, supporting the yuan against the US dollar.

Sources: Bloomberg; CEIC Data; RBA.

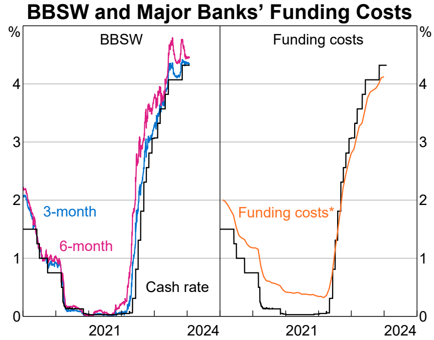
1.3 Australian banking and credit markets

November's cash rate increase has been passed through to bank funding costs, while financial institutions have been raising funding at favourable spreads in wholesale markets.

Banks' overall funding costs rose in recent months as the November cash rate increase was passed through to bank bill swap rates (BBSW) and deposit rates (Graph 1.14). Money market rates and the spread between BBSW and OIS rates have been little changed since the December Board meeting. If BBSW remain at current levels, bank funding costs are expected to plateau, suggesting that the direct impact of cash rate increases to date on bank funding costs has largely run its course.

Graph 1.14

BBSW and Major Banks' Funding Costs



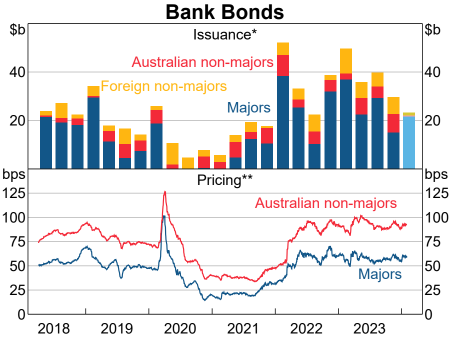
* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks.

Sources: ABS; AFMA; APRA; ASX; Bloomberg; LSEG; major bank liaison; major banks' websites; RBA; Securitisation System; Tullett Prebon; US Federal Reserve.

Conditions in wholesale funding markets remain favourable for financial institutions. Bank bond issuance continues to be strong after reaching its highest level in over a decade in 2023. Strong issuance has occurred partly in response to large maturities in Term Funding Facility (TFF) funding over 2023 and forthcoming TFF maturities in the first half of 2024. The spread of bank bond yields to the swap rate – a reference rate for the pricing of fixed-income securities – has been little changed and remains around its average of the past two years (Graph 1.15). Banks generally swap fixed-rate payments on newly issued bonds into floating-rate payments to match their floating-rate loans, and so the spread to swap is an important component of bank wholesale funding costs. Issuance of asset-backed securities, by both banks and non-bank lenders, has also been strong in recent months, with 2023 recording the highest level of issuance since the GFC.

Graph 1.15

Bank Bonds



* Quarterly. Includes senior unsecured and covered issuance. March quarter 2024 observation is to 31 January.

** Spread to swap; domestic secondary market; three-year target tenor.

Sources: Bloomberg; Private Placement Monitor; RBA.

Higher interest rates have also been passed through to borrowers and depositors.

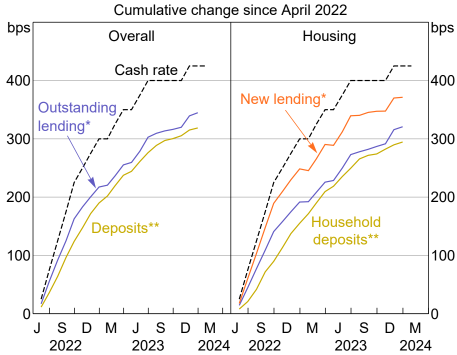
Australian households and businesses have seen substantial pass-through from increases in the cash rate to borrowing and deposit rates (Graph 1.16). Overall pass-through to borrowing and deposit rates has been substantial by international comparison, consistent with the prevalence of variable-rate mortgages in Australia. Nevertheless, both average outstanding mortgage interest rates and deposit rates have increased by less than the cash rate since May 2022. For mortgage rates, this is due to the high number of fixed-rate mortgages taken out at low rates during the pandemic as well as lenders competing for mortgage customers.

- Rates on outstanding **housing loans** have increased by around 105 basis points less than the 425 basis point increase in the cash rate over the hiking phase. Banks increased variable rates by a little less than 25 basis points in November following the cash rate increase. Competition for new and refinancing borrowers has eased since mid-2023, although banks have remained willing to offer discounts to retain existing customers. Pass-through to mortgage rates is expected to eventually reach similar proportions to previous hiking phases as the fixed-rate loans taken out at low rates during the pandemic expire.
- Rates on outstanding **business loans** have increased by around 35 basis points less than the cash rate over the hiking phase. Business rates have increased further since November, reflecting increases in three-month BBSW (ahead of the November cash rate increase) and the cash rate.
- The average rate paid on **deposit accounts** has increased by 105 basis points less than the cash rate over the hiking phase. The pass-through to deposit rates has been in line with the broad range of outcomes in previous hiking phases. Since May 2022, banks have increased rates on term deposits and conditional savings accounts by more than on other accounts. The Australian Competition and Consumer Commission's Retail Deposits Inquiry, concluded in December 2023, noted there had been limited pricing competition between banks, and that banks strategically set introductory and bonus interest rates on retail deposits to retain and attract customers.[1]

Graph 1.16

Change in Selected Bank Interest Rates

Cumulative change since April 2022



* Includes non-banks.

** Excludes deposits in housing loan offset accounts, includes non-interest bearing deposits.

Sources: APRA; RBA.

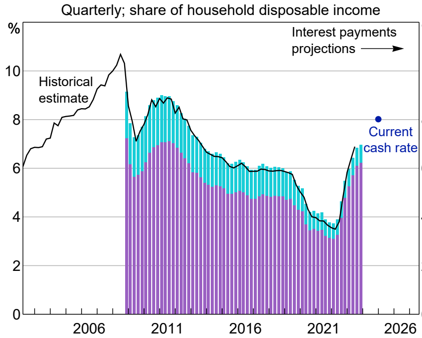
The tightening in monetary policy since 2022 has led to a significant rise in household debt payments, and households have been saving less of their incomes.

Interest payments on household debt – including both mortgage debt and consumer credit products – have increased by around 3¼ percentage points as a share of household disposable income over the tightening phase to around 7 per cent. These interest payments remain below their estimated historical peak as a share of total household disposable income, largely owing to a significant decline in the use of consumer credit since 2008. Even so, interest payments on household debt will increase further as expiring fixed-rate mortgages roll off onto higher rates and the November cash rate increase continues to flow through to mortgage payments. Based on the current cash rate, total interest payments are projected to increase to around 8 per cent of household disposable income by the end of 2024, which is slightly below the 2010–2011 peak when the cash rate reached 4.75 per cent (Graph 1.17).

Graph 1.17

Household Debt Interest Payments

Quarterly; share of household disposable income



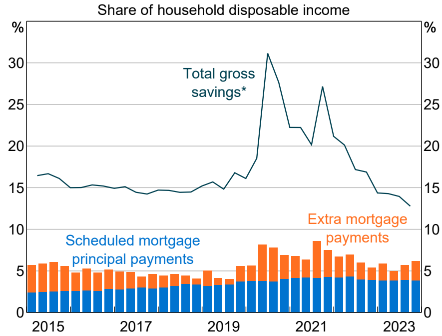
Sources: ABS; APRA; RBA.

Total scheduled payments (interest plus scheduled principal) for mortgages by themselves reached around 10 per cent of household disposable income in the December quarter, which is a record high. Although net payments into mortgage offset and redraw accounts have declined relative to 2020–2022, extra payments increased in the second half of last year to around the pre-pandemic average of 2 per cent of household disposable income (Graph 1.18). Both households with mortgages and households more generally have reduced their saving rates over the tightening phase to support consumption in response to cost-of-living pressures (see Chapter 2: Economic Conditions).

Graph 1.18

Saving Rates

Share of household disposable income



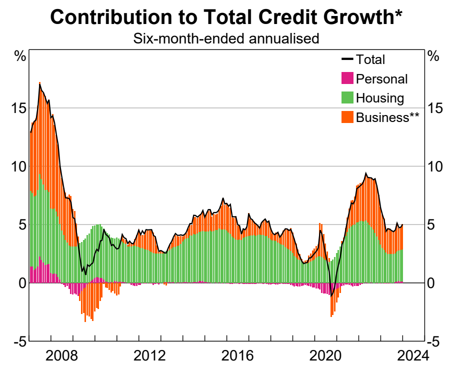
* Total gross savings for all households.

Sources: ABS; APRA; RBA.

Total credit growth has stabilised at a lower level since mid-2023 in the face of higher interest rates, although new lending has picked up over the past year.

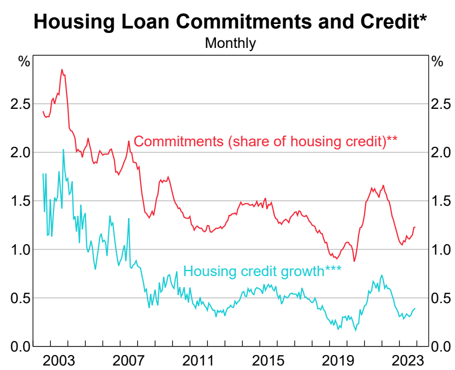
- **Housing credit growth is much lower than in early 2022, but it has edged up more recently.** It is likely to pick up a little further in the near term if the recent increase in new housing loan commitments is sustained (Graph 1.19). Housing loan commitments are around 20 per cent higher than their February 2023 trough, consistent with the rebound in national housing prices (Graph 1.20). The pick-up in housing loan commitments has been broadly based across states, with the increase most pronounced for investors and first home buyers.
- **Personal credit growth has picked up a little in recent months, driven by financing for vehicles** as disruptions to the supply of new cars have eased. The share of credit card balances accruing interest has remained low by historical standards, which suggests that most households are not making use of additional personal credit in response to cost-of-living pressures. Personal credit comprises less than 5 per cent of total credit.
- **Business credit growth has remained around its 20-year average**, supported by lending for purchases of vehicles and equipment. Corporate bond issuance (a source of funding for larger corporations) has been strong in recent months.

Graph 1.19



* Seasonally adjusted and break-adjusted.
** Excludes credit to the finance industry.
Sources: APRA; RBA.

Graph 1.20



* Seasonally adjusted and break-adjusted.
** Excludes refinancing.
*** Month-on-month growth.
Sources: ABS; APRA; RBA.

Endnote

[1] See ACCC (2023), 'Retail Deposits Inquiry 2023, Final Report', December.

2. Economic Conditions

Summary

- **Economic growth softened in many advanced economies from mid-last year, largely in response to the earlier tightening in monetary policy.** The United States was a notable exception, recording robust growth throughout 2023.
- **Inflation remains above central banks' targets in many advanced economies, but has declined further and, in some cases, faster than expected.** The easing in inflation has been largely driven by energy and core goods prices. Core services price inflation has eased more gradually but remains elevated.
- **The Chinese economy rebounded in 2023, but growth is likely to slow in the year ahead.** This reflects weakness in the property market and slowing household consumption growth, despite policy measures expected to support investment. Recent policy measures have supported Chinese steel production and, in turn, the prices of iron ore and coking coal received by Australian exporters.
- **In the Australian economy, we assess that demand has continued to exceed supply, but subdued growth is closing this gap.** Demand has been supported by strong growth in business investment, public sector spending and spending by international students and tourists. But household consumption growth has been weak, as high inflation, higher interest rates and tax payments have weighed on household income.
- **Labour market conditions remain tight, but have continued to ease over recent months.** Slower economic growth has slowed growth in labour demand, while the labour supply has increased. However, the labour market is assessed as still tight relative to what is consistent with full employment. See section 2.4 below for the assessment of spare capacity in the economy and labour market.
- **Wages growth remains robust, reflecting the tight labour market and high inflation.** While aggregate wages grew strongly in the September quarter, there was evidence of wages growth slowing in some parts of the labour market. Growth in unit labour costs remains too high, reflecting weak productivity outcomes.
- **Inflation eased further in the December quarter but remains too high.** Recent high inflation is consistent with excess demand in the economy and strong domestic cost pressures. Services inflation remains high despite having passed its peak, while goods inflation has recorded substantial declines.

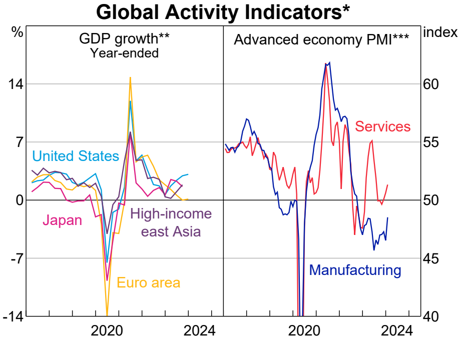
2.1 Global economic conditions

Economic growth has softened in many advanced economies, although growth in the United States has been robust.

Growth in economic activity has slowed in many, but not all, advanced economies. In some cases, the slowing has been sharper than expected, and a contrast to the surprising resilience in the first half of 2023. This slowing has been evident both in GDP data and in partial indicators such as retail sales and investment intentions. However, there is some variation across economies, with soft outcomes in the euro area, Canada, United Kingdom and New Zealand contrasting with ongoing resilience in the United States and high-income economies in east Asia (Graph 2.1). Recent survey measures indicate that business conditions in manufacturing sectors of advanced economies remain weak. While the services sector has recovered slightly over recent months, it is not expected to provide the same support to growth as it did during the early post-pandemic reopening period.

Graph 2.1

Global Activity Indicators*

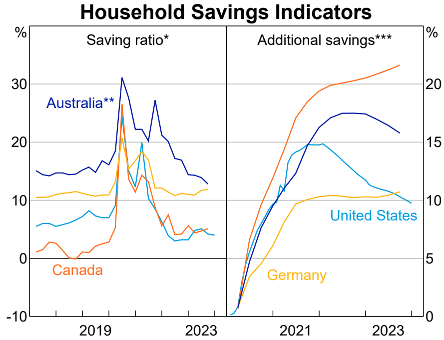


* Outliers during the COVID-19 pandemic are truncated.
** High-income east Asia is a PPP-weighted average of South Korea, Taiwan, Singapore and Hong Kong.
*** Purchasing Managers' Index; PPP-weighted average of the United States, euro area, United Kingdom and Japan.
Sources: CEIC Data; LSEG; RBA; S&P Global.

A common driver of the recent softer growth in economic activity has been weaker household consumption growth, with the United States a notable exception. Consumption growth has been modest in several advanced economies, in part driven by weakness in goods consumption. This is despite positive growth in real household incomes throughout 2023 in many economies and household balance sheets remaining healthy overall. Household balance sheets have been bolstered by stabilising (and, in some cases, rising) housing prices and continued positive rates of household saving. Outside the United States (and Australia), saving rates remain above pre-pandemic norms and the additional savings balances that were accumulated during the pandemic have typically not been drawn down (Graph 2.2). By contrast, US households have been saving at a slower rate than prior to the pandemic and have drawn down some of their additional pandemic savings to support their more robust consumption (these drawdowns are similar to the Australian experience, discussed below). Looking ahead, further moderation in inflation should reduce cost-of-living pressures on household incomes and, in turn, support consumption growth. However, this is likely to be at least partly offset by lower nominal disposable income growth as the cumulative effect of tighter monetary policy leads to further easing in labour market conditions and as higher loan repayments drag on spending power.

Graph 2.2

Household Savings Indicators



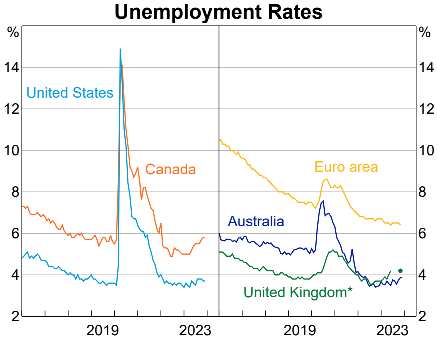
* Share of disposable income.
** Australian saving ratio is gross of depreciation.
*** Share of annual disposable income; cumulation of additional savings, estimated using the deviation of the saving ratio from its 2014–2018 average.
Sources: ABS; LSEG; RBA.

Labour market conditions are easing gradually, but remain tight overall.

Unemployment rates have increased from their recent lows in most advanced economies. Unemployment rates have increased noticeably in the United Kingdom and Canada, while others have recorded modest increases in recent quarters (Graph 2.3). Job vacancy-to-unemployment ratios, which are another key measure of labour market tightness, have declined from their peaks, though they generally remain above pre-pandemic levels. Consistent with this, wages growth has declined from its peaks in a number of advanced economies but remains strong in most.

Graph 2.3

Unemployment Rates



* Official unemployment rate data used up to June 2023; latest observation (November 2023) uses experimental labour market estimates produced by the UK Office for National Statistics.

Sources: LSEG; ONS; RBA.

Inflation remains above target in advanced economies, but has declined, faster than expected in some cases.

Lower energy and core goods price inflation have been the main drivers of easing inflation in advanced economies. In a number of economies, headline and core inflation rates have declined to around 2–3 per cent on a six-month-ended annualised basis, though they remain slightly higher in Canada and New Zealand. Recent inflation outcomes in some advanced economies have also surprised central banks to the downside. Consistent with this, several central banks have acknowledged that policy rates are likely to have peaked (see Chapter 1: Financial Conditions).

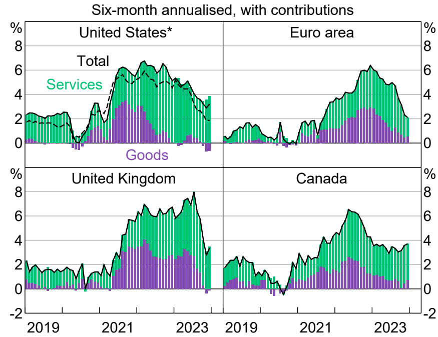
Headline inflation has declined as energy prices have eased from their September quarter peaks. In turn, the decline in energy prices reflects ample supply of oil and gas. Food price inflation has also been easing, though it remains high, especially in Europe.

A significant slowing in core goods price inflation has seen core inflation moderate further, but core services price inflation remains relatively elevated (Graph 2.4). In the United States and the United Kingdom, core goods prices have recorded outright declines in recent months. By contrast, core services price inflation has continued to ease more gradually across most advanced economies. Rent inflation is yet to show clear signs of easing (outside of the United States) and could remain high for some time as the supply of housing can be slow to respond to changes in demand. Non-housing services price inflation has eased from its peaks, consistent with gradual easing in labour market tightness and an improvement in the balance of demand and supply for services, but is still elevated relative to pre-pandemic rates.

Graph 2.4

Core Consumer Price Inflation

Six-month annualised, with contributions



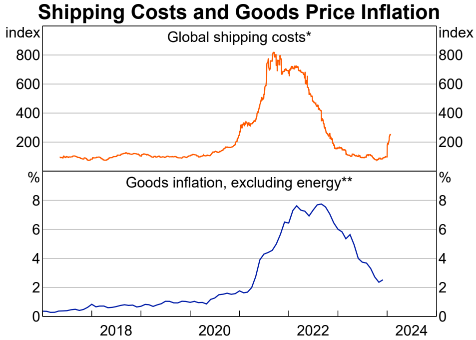
* Dashed line shows core PCE inflation.

Sources: BEA; BLS; Eurostat; LSEG; ONS; RBA; Statistics Canada.

Global shipping costs have increased recently as attacks on vessels in the Red Sea and capacity restrictions in the Panama Canal have resulted in some ships using longer, more costly shipping routes (Graph 2.5). While this poses some upside risk to tradable goods inflation, the increases to date have been small relative to those seen during the pandemic, when supply chain disruptions were much more widespread.

Graph 2.5

Shipping Costs and Goods Price Inflation



* Container; 2017–2019 average = 100.
** GDP-weighted aggregate of G7 countries; year-ended.
Sources: LSEG; RBA; Statistics Canada.

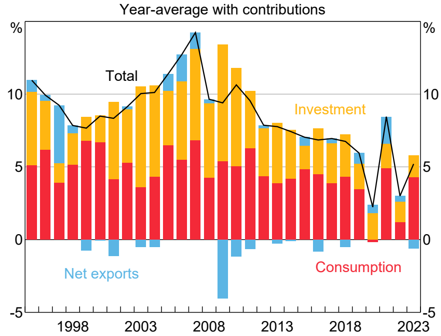
Chinese economic growth rebounded in 2023, with supportive fiscal measures and some easing of financial conditions offsetting ongoing weakness in the property market.

Household consumption was the main driver of economic growth in China in 2023, led by a recovery in demand for services after pandemic restrictions were lifted in late 2022 (Graph 2.6). Accordingly, services price inflation picked up in 2023, but has been more than offset by declines in food prices, resulting in deflation in headline year-ended terms in recent months. Consumption growth slowed significantly at the end of last year, suggesting that the rebound in consumption has largely run its course. Persistently low consumer confidence, partly related to weakness in property market conditions, likely also contributed. Investment contributed positively to economic growth in 2023, supported by policy measures that boosted infrastructure and manufacturing investment. This support has offset significant weakness in real estate investment over the past two years. Chinese authorities have stepped up their support for the economy through fiscal and monetary policy, especially through the issuance of government bonds to finance infrastructure investment (see Chapter 1: Financial Conditions). However, policy support for investment is likely to be offset by slowing consumption growth and ongoing property sector weakness, leading to slower growth in the Chinese economy this year and next (see Chapter 3: Outlook).

Graph 2.6

China – GDP Growth

Year-average with contributions



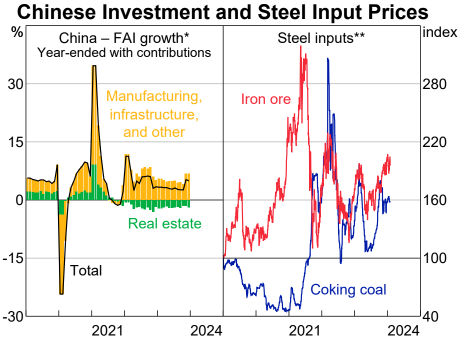
Sources: CEIC Data; RBA.

Policy stimulus in China continues to support iron ore and coking coal prices.

Chinese steel production has remained resilient for most of 2023 despite the weakness in the property sector, reflecting policy support for infrastructure and manufacturing investment (Graph 2.7). This ongoing strength in Chinese demand for steel, and expectations of ongoing policy measures, has continued to support iron ore and coking coal prices. In turn, this is supporting Australia's terms of trade, which are expected to have increased in the December 2023 quarter, with higher LNG prices and lower import prices also contributing.

Graph 2.7

Chinese Investment and Steel Input Prices



* Nominal fixed asset investment.

** January 2019 = 100; indexed to SDR prices on a free-on-board (FOB) basis; FOB prices do not include shipping or insurance costs.

Sources: Bloomberg; CEIC Data; McCloskey by OPIS; RBA.

2.2 Domestic economic activity

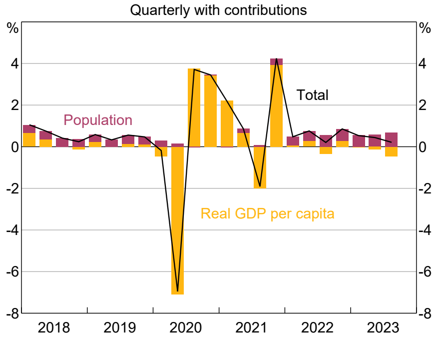
Growth in the Australian economy remains subdued.

Our assessment is that the level of demand continues to exceed the economy's ability to supply goods and services (see 2.4 Assessment of spare capacity for more details). However, similar to many other advanced economies, growth slowed over 2023 and this is helping to lessen the imbalance between demand and supply (Graph 2.8). GDP per capita declined over this period.

Graph 2.8

GDP Growth

Quarterly with contributions



Sources: ABS; RBA.

The slowing in GDP growth over the past year has primarily been driven by weak growth in household consumption amid cost-of-living pressures. Growth in dwelling investment was also subdued due to ongoing labour constraints in the residential construction sector. This was partly offset by strong growth in business and public investment, supported by a large pipeline of work and easing supply constraints.

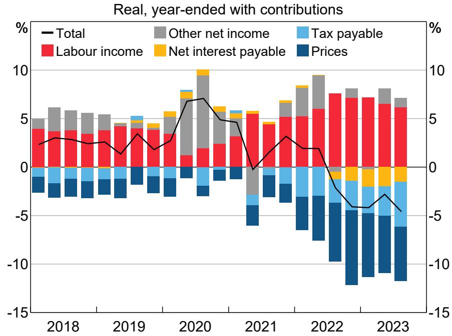
Household consumption growth remains weak amid high inflation, strong growth in tax payments and higher interest rates.

Real disposable incomes have been declining for around two years and this has put pressure on household budgets. Strong growth in nominal labour incomes has been more than offset by the high rate of inflation, tax payments growing faster than incomes and the effects of higher interest rates (Graph 2.9).

Graph 2.9

Household Disposable Income Growth

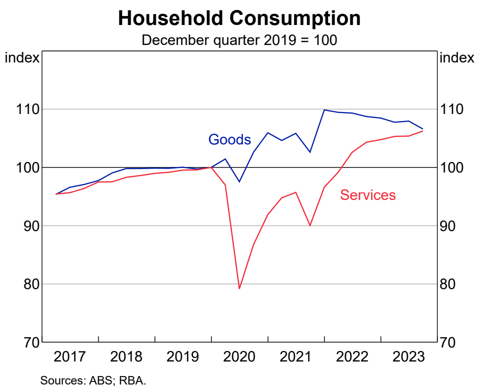
Real, year-ended with contributions



Sources: ABS; RBA.

Many households have responded to budget pressures by curbing their spending, particularly for discretionary items. Consumption growth was weak over the past year and consumption has declined in per capita terms. This slowdown has been driven by a decline in goods purchases; car sales have been an exception, though this largely reflects the delivery of earlier orders as supply constraints have eased (Graph 2.10). By contrast, consumption of services has been more resilient, consistent with services inflation remaining elevated (see below). Retail sales and other timely indicators show that consumption growth remained weak in the December quarter. Retail sales temporarily picked up in November as 'Black Friday' promotions brought forward spending from the Christmas sales.

Graph 2.10



Households have also responded to lower real incomes by saving less or in some cases drawing down on their savings. The household savings ratio has declined in recent quarters and is below pre-pandemic levels. However, households' deposits and other liquid assets remain large in aggregate, supported by the additional savings accumulated during the pandemic. This suggests there is scope for savings rates to decline further to support consumption (see Chapter 3: Outlook).

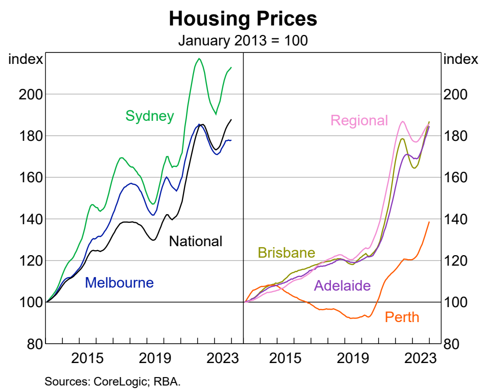
Timely transaction-based spending data suggest that nominal spending growth has slowed across most households. While mortgagors have faced a large increase in their mortgage payments, many have been able to offset the impact of this on their spending by saving less or drawing down on their savings.[1] For lower income households and renters, the strong labour market has helped to support spending. Nonetheless, many households have had to make difficult adjustments in response to the challenging conditions, particularly households with lower financial buffers.

Growth in total consumer spending in Australia – which includes spending by temporary residents such as foreign students – has slowed recently after growing strongly in early 2023. Total spending determines the demand conditions that feed into the price-setting behaviour of Australian consumer-facing businesses. The increase in temporary residents has also been supporting the supply side of the economy as many students participate in the labour force. The slowdown in spending growth has been partly driven by a moderation in the pace of overseas visitors arriving in Australia, as well as Australian residents spending less domestically as they return to travelling abroad.

The rebound in housing prices has continued to support household wealth, although growth has slowed.

National housing prices increased strongly over 2023 to be above their April 2022 peak (Graph 2.11). Prices have increased across most capital cities and regional areas, supporting household wealth, although price growth has slowed more recently in Sydney and Melbourne. The rebound in housing prices reflected a combination of stronger demand for established housing (partly due to strong population growth) and a limited supply of dwellings.

Graph 2.11

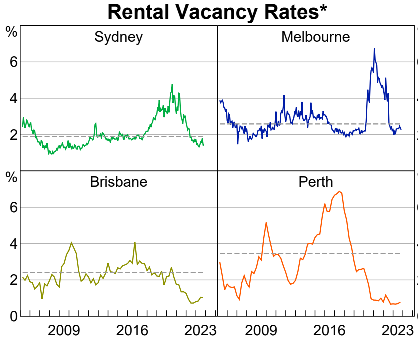


The rental market remains tight and the ongoing weakness in dwelling investment suggests this is unlikely to ease in the near term.

Rental vacancy rates remain low in most areas (Graph 2.12). This is consistent with a limited supply of new dwellings, strong population growth and a shift in preferences during the pandemic towards more residential space that has led to a lower average household size. Although average household size has increased in capital cities over the past year, it remains well below pre-pandemic levels.

Graph 2.12

Rental Vacancy Rates*



* Data is monthly for Sydney and Melbourne, and quarterly for Brisbane and Perth; dashed lines represent historical (2005–2019) averages.

Sources: RBA; REIA; REINSW; REIV.

The supply of new dwellings has remained constrained, with dwelling investment below pre-pandemic levels. Quarterly commencements are at their lowest level in over a decade and capacity constraints have continued to limit the pace at which builders can work through the existing pipeline of residential construction, with labour shortages acute in the latter stages of construction.

Demand to purchase new dwellings has remained subdued. Uncertainty around higher interest rates, elevated construction costs and longer building times have weighed on buyer sentiment. However, some firms in the RBA's liaison program expect demand for new dwellings to increase over the coming year, supported by inward migration and low rental vacancy rates (see Box A: Insights from Liaison for an overview of liaison messages). This is consistent with the pick-up in greenfield lot and new home sales observed over 2023.

Business investment has grown strongly over the past year, supported by an easing in international supply chain disruptions and a large pipeline of construction work.

Business investment has grown strongly in both the mining and non-mining sectors. A backlog of orders and further easing in supply chain disruptions has supported increased expenditure on machinery and equipment over recent quarters. Non-residential construction has also increased, reflecting continued progress on the still-elevated pipeline of yet-to-be-done construction work as well as investment in offshore LNG projects. Spending on software, alongside projects for automation and digitisation, has also supported growth in investment.

Growth in business investment is likely to slow. Investment intentions reported by firms in the RBA's liaison program have softened over recent months and are around their long-run average. This is consistent with the recent easing in surveyed measures of business conditions, which are around their longer run averages. Some firms have cited high prices for construction, rising financing costs and uncertainty around the outlook as weighing on their investment plans.

2.3 Labour market and wages

Labour market conditions are continuing to ease gradually but remain tight.

A broad range of labour market indicators have eased further over recent months, as growth in labour demand has responded to a slowing economy and labour supply has increased. Despite the easing from the very tight conditions of late 2022, the labour market is assessed as tight relative to what is consistent with full employment – that is the maximum level of employment consistent with low and stable inflation. (For more details, see 2.4 Assessment of spare capacity, below, and Chapter 4: In Depth – Full Employment.)

The unemployment rate was 3.9 per cent in December, ½ percentage point above its 50-year low of 3.4 per cent in late 2022. Underemployment has also edged up further, with the hours-based underutilisation rate – a broader measure of labour market spare capacity – also around ½ percentage point higher than its late-2022 trough. Components of unemployment that tend to better reflect cyclical labour market conditions – like the medium-term unemployment rate and the youth unemployment rate – have risen alongside the aggregate unemployment rate.

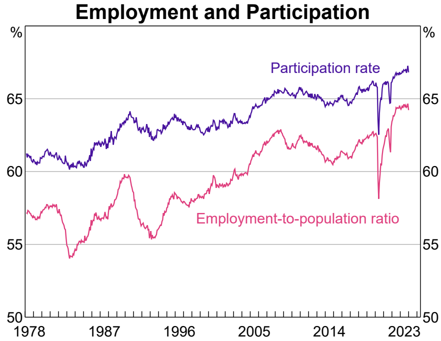
Indicators of labour demand have also eased further over recent months. Job ads and vacancies continue to trend lower from their 2022 highs but remain above pre-pandemic levels. Hiring intentions of firms in the RBA's liaison program have declined further to be around their long-run average levels. Consistent with an easing in labour demand, the share of voluntary resignations has decreased, while the proportion of employed persons switching jobs has declined to its pre-pandemic average.

Hours worked have continued to act as an important margin of adjustment to the moderation in labour demand growth in recent months. In line with this, average hours worked have fallen from their recent peak in April 2023.

Elevated population growth and record high labour force participation are boosting labour supply, though population growth also adds to demand. Information from the RBA's liaison program and business surveys point to improvements in the availability of labour. Employment has been increasing at a broadly similar pace to the working-age population over the past 18 months such that the employment-to-population ratio has remained relatively steady (Graph 2.13). That said, growth in employment in recent months has largely been driven by part-time workers, unlike the recovery from the pandemic when full-time employment accounted for almost all employment growth.

Graph 2.13

Employment and Participation



Source: ABS.

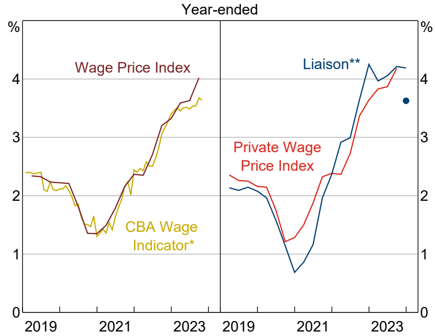
Growth in the working-age population was at a multi-decade high of around 3 per cent over 2023, owing to strength in net overseas migration. The resumption of migration following the pandemic period has added to labour supply and helped relieve labour shortages in some industries, although migrants also add to overall demand in the economy. Recent migrants tend to have a high rate of labour force participation relative to the general population. Cost-of-living pressures and a strong labour market have also likely contributed to the labour force participation rate remaining near record highs, with a notable increase in participation for females aged over 25 years.

Wages growth picked up further in the September quarter, but it has begun to moderate in some industries and there are indications of a broader moderation over the year ahead.

The Wage Price Index (WPI) recorded its largest quarterly increase since the beginning of the series in the late 1990s. The WPI grew by 1.3 per cent in the September quarter, to be 4 per cent higher in year-ended terms (Graph 2.14). Strong growth in the quarter resulted from the Fair Work Commission's decision to increase award wages by 5.75 per cent generally and 15 per cent for aged care workers. On the whole, wages growth has been robust because of the tight labour market and high inflation outcomes. WPI growth increased in both the private and public sectors.

Graph 2.14

Measures of Wages Growth



* Changes in base wages based on a sample of CBA retail banking transactions.

** Private sector; trimmed mean; rescaled to have the same mean as the private Wage Price Index; dot represents liaison expectations over the year ahead.

Sources: ABS; CBA; RBA.

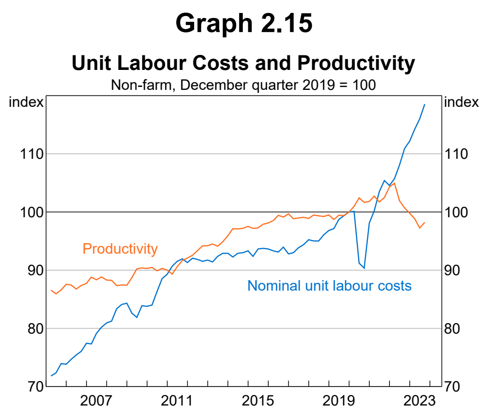
Wages growth remained robust across all methods of setting pay, though growth has moderated in parts of the private sector. Wages growth was strongest in the September quarter in industries with a high share of award workers, such as accommodation and food, retail, and health care. By contrast, wages growth has stabilised for workers on individual arrangements and moderated a little in some industries with a higher share of these workers, such as in business services.

Wages growth in the outstanding stock of enterprise bargaining agreements (EBAs) increased in the September quarter, with newly lodged EBAs pointing to another firm outcome in the December quarter. Wages growth in EBAs tends to be affected by the labour market with a lag; the strong labour market conditions of recent years are continuing to flow through to EBA wages growth as multi-year agreements are reset. Recently, there has been an increased share of agreements being lodged with higher wage increases in their first year than in later years, implying that these agreements are contributing more to current wages growth than they will in a year's time.

Some indicators suggest that wages growth is likely to ease a little over the year ahead. Market economists and firms in the RBA's liaison program expect wages growth to decline a little, with average wage expectations around 3½ to 3¾ per cent for the year ahead. Firms that expect a decline in wages growth have noted declining inflation, an improvement in labour availability and an increased focus on cost control as reasons for this.

Unit labour cost growth remained very high in the September quarter, and remains a source of upward pressure on inflation.

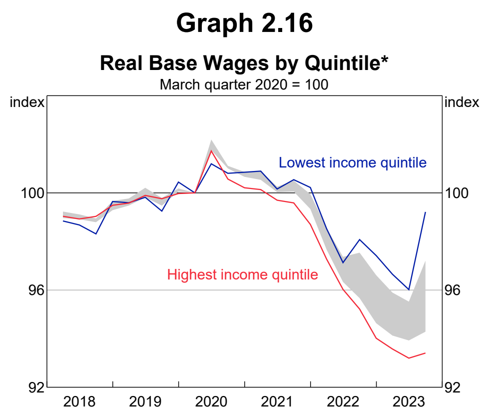
Recent weak productivity outcomes have contributed to very strong growth in unit labour costs, placing upward pressure on inflation (Graph 2.15) (see Chapter 3: Outlook for further discussion of productivity). Growth in nominal unit labout costs was around 7 per cent over the year to the September quarter, and continues to be well above its average over the inflation-targeting period.



Sources: ABS; RBA.

Real base wages increased in quarterly terms, following large declines.

Real wages increased in the September quarter for the first time since early 2021 (as measured by the difference between the seasonally adjusted WPI and Consumer Price Index (CPI)). Households in the lowest income quintile have seen the highest real base wages growth over the past year, largely due to the recent award increases. Real base wages for the lowest income quintile are slightly below their pre-pandemic level, whereas real base wages for other income quintiles remain well below their earlier level (Graph 2.16). Real employment income – which includes base wages as well as the effects of changes in jobs or promotions or hours worked – increased over the past year across all quintiles.



* Quintiles constructed by income levels; grey range denotes wage levels for income quintiles 2–4.

Sources: ABS; RBA.

2.4 Assessment of spare capacity

As outlined in the recently agreed *Statement on the Conduct of Monetary Policy*, the RBA will regularly publish its assessments of full employment and potential output.

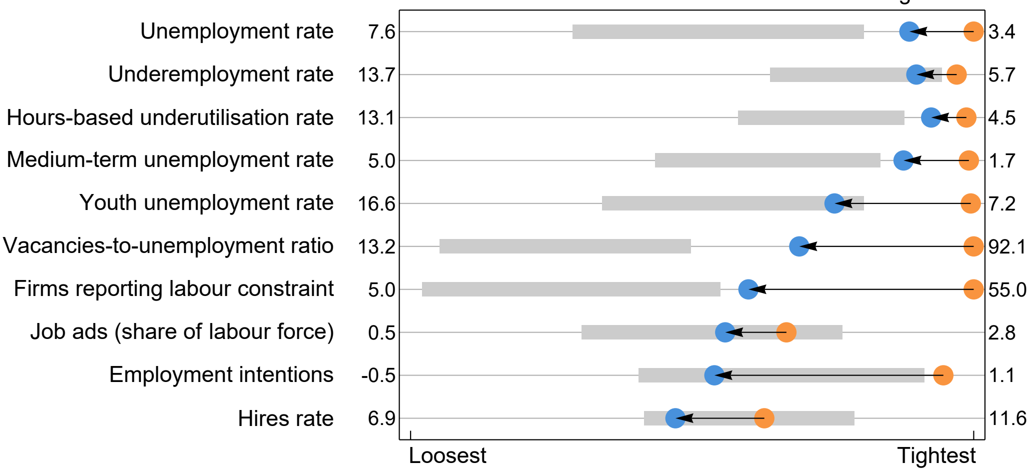
The labour market is assessed to be tight relative to full employment.

The labour market is tight, but conditions have continued to ease over recent months based on a broad range of indicators (see Chapter 4: In Depth – Full Employment for more detail on how this assessment is made). A range of indicators provide a consistent message that labour market conditions have eased since late 2022, at which time many measures were around their tightest levels of the past 50 years (Graph 2.17). The easing in conditions is most evident in job ads and employment intentions, which tend to be leading indicators. Overall, most indicators appear 'tight' relative to historical norms (with the historical range given for each indicator by the span of the graph). But there is nevertheless a degree of uncertainty around this assessment, which is likely to increase as the economy moves closer to balance.

Graph 2.17

Full Employment Indicators*

Current conditions relative to 2000–2024 range



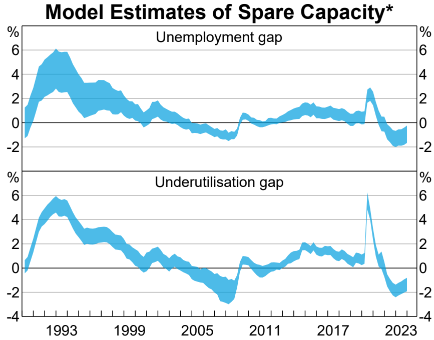
* Blue dots represent current outcomes, orange dots show outcomes at October 2022 and light grey shaded regions cover the middle 80 per cent of observations since 2000.

Sources: ABS; JSA; NAB; RBA.

Model-based estimates suggest labour market conditions are still tighter than full employment, consistent with elevated domestic inflationary pressure and robust wages growth. Both the unemployment rate and the broader hours-based underutilisation rate remain lower than a range of model-based estimates indicate is consistent with low and stable inflation, resulting in negative 'gaps' (Graph 2.18).[2] These estimates of the unemployment and underutilisation gaps have narrowed in recent quarters, indicating that the labour market is moving towards full employment but is still tight. Given the substantial uncertainty involved with each of the model estimates, it is possible that labour market conditions are already consistent with full employment, but the probability is relatively modest.

Graph 2.18

Model Estimates of Spare Capacity*



* Blue-shaded region shows illustrative range of central gap estimates from a selection of models; December quarter 2023 values are partial estimates; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

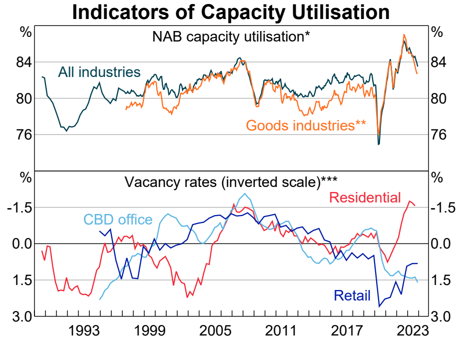
Sources: ABS; OECD; RBA; Ruberl et al (2021).

The level of overall demand remains above the economy's level of potential output.

Our overall assessment is that aggregate demand remains above the economy's capacity to supply goods and services thereby putting pressure on inflation. This assessment of capacity utilisation is informed by a range of indicators, including inflation outcomes, survey measures of capacity utilisation (which have been easing from their historical highs but remain elevated). Vacancy rates for residential real estate – buildings are part of the economy's capital stock – also suggest high utilisation, which is placing pressure on residential rents (Graph 2.19).

Graph 2.19

Indicators of Capacity Utilisation



* Quarterly data prior to May 1997, three-month moving average thereafter; excludes mining.

** Goods industries include manufacturing, construction, wholesale and retail.

*** Series are standardised to measure the number of standard deviations each series is from its mean value; retail refers to regional retail centres.

Sources: JLL Research; NAB; RBA; REIA.

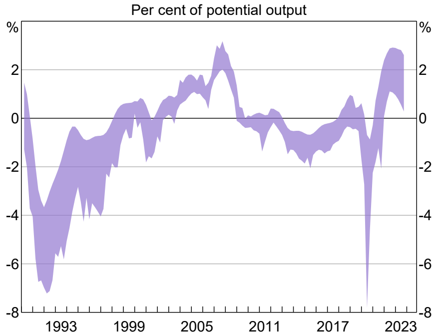
A range of model-based estimates of potential output also suggest the level of economic demand is above its supply capacity. Potential output is a measure of the productive capacity of the Australian economy to supply goods and services; it is the highest level of economic activity consistent with maintaining low and stable inflation over the medium term. Like full employment, potential output cannot be measured directly. The productive capacity of the economy evolves with trends in the labour force, capital stock and technological change. The 'output gap' is the difference between the level of actual and estimated potential output and a positive gap indicates that there is excess demand in the economy.

A range of model estimates suggest that the output gap has been positive since late 2021, consistent with excess demand in the economy contributing to elevated domestic inflationary pressures (Graph 2.20). The RBA's assessment is that the level of output remained above potential in the September quarter of 2023 – both labour and capital resources were being utilised beyond the maximum levels that can be sustained without creating inflationary pressures. However, the output gap has narrowed over the past year, suggesting demand and supply in the economy are moving closer to balance. This has occurred as earlier disruptions to supply have continued to be resolved and as demand growth in the economy has slowed in response to higher interest rates and other headwinds. The extent of spare capacity contributes to the overall assessment of pressures on inflation, which are discussed in the next section.

Graph 2.20

Model Estimates of Output Gap*

Per cent of potential output



* Violet-shaded region shows illustrative range of central gap estimates from a selection of models encompassing different measures and definitions of the output gap; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

Sources: OECD; RBA.

2.5 Inflation

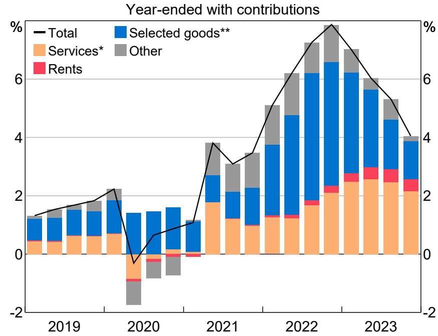
Inflation eased further in the December quarter, but remains too high.

Inflation eased in the December quarter, driven by a further easing in goods inflation and some moderation in services inflation from its high level. The CPI increased by 0.7 per cent in the quarter to be 4.1 per cent higher over the year, down from 5.4 per cent in the September quarter (Graph 2.21). Measures of underlying inflation (which are designed to better capture the trend in inflation) also eased; trimmed mean inflation was 0.8 per cent in the quarter to be 4.2 per cent over the year (Graph 2.22). These outcomes were lower than expected three months ago, and show further progress in the decline in inflation from its peak in late 2022. Nevertheless, the rate of inflation remains well above target. Services price inflation in particular remains high, consistent with the assessment that there is excess demand in the economy and strong domestic cost pressures.

Graph 2.21

CPI Inflation

Year-ended with contributions



* Includes market services and administered items; excludes rents and holiday travel & accommodation.

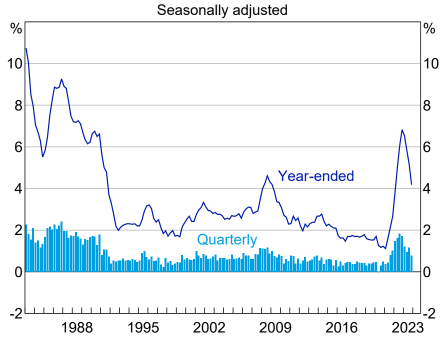
** Includes groceries, alcohol & tobacco, consumer durables and new dwellings.

Sources: ABS; RBA.

Graph 2.22

Trimmed Mean Inflation*

Seasonally adjusted



* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

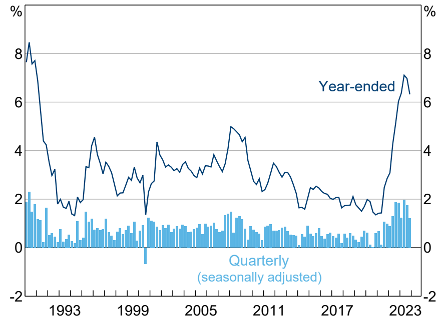
Inflation outcomes for volatile items and those influenced by changes in government policies helped to moderate inflation in the December quarter. Government electricity rebates for some households came into effect this quarter, partly offsetting the impact of higher electricity prices; increased Commonwealth rent assistance also lowered rental price inflation. Fuel prices declined, after increasing sharply in the previous quarter, and will subtract further from inflation in the March quarter if they remain around their current level.

Services inflation has passed its peak, but remains elevated due to the still-robust level of demand and strong domestic cost pressures.

Market services inflation remains high and broadly based across categories (Graph 2.23). Inflation remains above its historical average in dining out and takeaway, insurance and financial, telecommunications, and a range of other household services. High inflation in market services reflects the strong level of demand exceeding supply and continued pressure from both labour and domestic non-labour input costs such as insurance, legal, accounting and administrative services. Retail and office rents are some of the few non-labour costs that are not adding materially to inflationary pressures. Unit labour costs represent a large share of input costs for market services firms and have grown strongly of late, as discussed above.

Graph 2.23

Market Services Inflation*



* Excludes domestic holiday travel & accommodation and telecommunications; adjusted for the tax changes of 1999–2000.

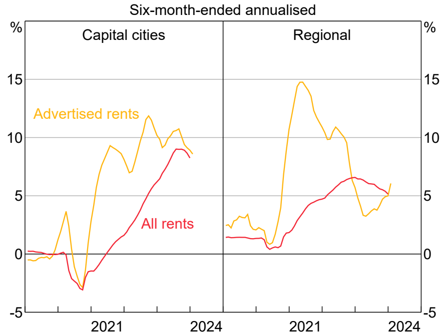
Sources: ABS; RBA.

Rent inflation remains high, and this is expected to persist because of the ongoing tightness in rental market conditions. Rent inflation for the stock of rents captured in the CPI (which excludes regional areas) was 0.9 per cent in the quarter and 7.3 per cent over the year (Graph 2.24). This would have been 1½ percentage points higher over the year if not for the increase to Commonwealth Rent Assistance that came into effect in September 2023. Tight rental market conditions across the capital cities are expected to contribute to continued high rent inflation, as recent increases in monthly advertised rental growth flow through to CPI rents.

Graph 2.24

Housing Rent Inflation

Six-month-ended annualised

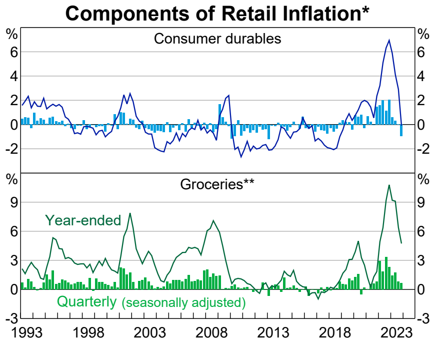


Sources: ABS; CoreLogic; RBA.

Goods price inflation declined further in the December quarter as earlier issues in global supply chains improved and goods demand moderated.

Goods price inflation eased in the December quarter for both consumer durables and groceries (Graph 2.25). The easing in goods inflation is consistent with the moderation in demand for goods and an easing in price inflation of imported consumption goods as global supply chain issues improved last year. Shipping costs remain far below their pandemic peak despite a recent increase (see 2.1 Global economic conditions). Nonetheless, domestic labour and non-labour costs continue to put some offsetting upward pressure on final goods prices. As with firms in the services sector, firms selling goods have faced increases in some domestic costs, including for electricity, services inputs and warehousing and logistics rents, though retail rents have remained subdued.

Graph 2.25



* Adjusted for the tax changes of 1999–2000.
** Excludes fruit & vegetables.
Sources: ABS; RBA.

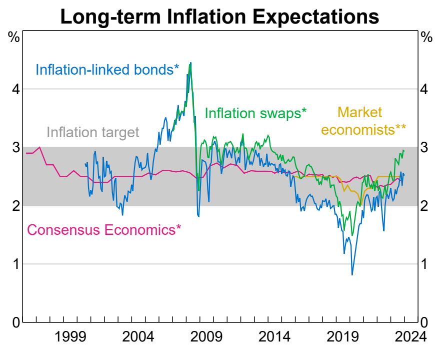
Consumer durables prices declined in the December quarter. Information from the RBA's liaison program suggests that demand for discretionary items has moderated and competition among retailers has increased over the past year, making it harder for retailers to raise prices. Grocery price inflation (excluding fruit and vegetables) has eased considerably over the past year, and meat prices declined in the December quarter. Nevertheless, grocery prices are considerably higher than they were a few years ago; grocery prices have increased by 20 per cent since early 2020, compared with an increase of 8 per cent over the prior decade.

New dwelling cost inflation has stabilised in recent quarters, above its inflation-targeting average. Liaison suggests that labour costs and energy-intensive materials are driving ongoing cost growth, partly driven by the large pipeline of work and ongoing capacity constraints in residential construction (as discussed above). Even so, inflationary pressures have eased from their peak in mid-2022.

Inflation expectations remain consistent with achieving the inflation target over time.

Measures of short-term expectations have declined notably from their mid-2022 peaks, though they continue to suggest that inflation over the next year is expected to remain above the RBA's inflation target. Measures of medium- and long-term expectations remain consistent with the inflation target (Graph 2.26).

Graph 2.26



* Average over the five years starting from five years ahead.
** Average over the next 5–10 years.
Sources: Bloomberg; Consensus Economics; RBA.

Endnotes

[1] See Beckers B, A Clarke, A Gao, M James and R Morgan (2024), 'Developments in Income and Consumption Across Household Groups', RBA *Bulletin*, January.

[2] The suite of models primarily comprises models developed within the RBA – such as Cusbert T (2017), 'Estimating the NAIRU and the Unemployment Gap', RBA *Bulletin*, June – but also includes RBA estimates of Ruberl H, M Ball, L Lucas and T Williamson (2021), 'Estimating the NAIRU in Australia', *Treasury Working Paper* 2021-01, and estimates from the OECD.

Box A
Insights from Liaison

This Box highlights key messages collected by teams based in Adelaide, Brisbane, Melbourne, Perth and Sydney during discussions with around 200 businesses, industry bodies, government agencies and community organisations over the period from the beginning of November 2023 to the end of January 2024.

In recent liaison discussions, firms have generally reported a clear slowing in demand over the past 12 months, though some have indicated that they are in a better position than they had previously expected. Demand conditions in most industries are generally expected to stabilise over coming months. The moderation in demand is making it more difficult for firms to increase prices. Together with continued reports of upward pressure on the costs of labour and other inputs, this is weighing on profit margins, and firms are widely reporting an increased focus on reducing costs where possible. Consistent with this, there has been a clear softening in firms' employment intentions and expected wages growth over the next 12 months.

Consumer spending remains subdued and is increasingly price-sensitive.

Discussions with contacts suggest that household consumption has been fairly flat over recent months after growth eased through most of 2023. Contacts report that consumers remain more budget-conscious in their spending than earlier in this cycle, particularly for more discretionary consumption.

Over recent months, retailers continued to report lower sales volumes than a year earlier, despite extensive promotions during the Black Friday, Christmas and Boxing Day sales. Contacts note that consumers are concentrating their spending during these and other promotional periods as they search for bargains. Retailers generally expect current conditions to persist over coming months and that consumers will remain budget-conscious.

Domestic leisure travel spending remains elevated but below the post-pandemic highs seen in 2022; this decline over the past year has been more pronounced in Queensland and the Northern Territory. In recent months, some contacts have noted a trend towards shorter holidays closer to home as travellers try to keep household costs down.

Household demand for assistance from community services organisations remains very strong, driven by constrained housing availability and affordability, as well as broader cost-of-living pressures. Contacts in this sector continue to see requests from people who have not previously sought assistance, including wage earners and those with mortgages.

International student numbers have largely recovered to pre-pandemic levels, with slower growth expected over the next 12 months.

Further growth in new international student university enrolments is anticipated for the upcoming academic year, but at a slower pace than seen over the past two years. A number of contacts in the tertiary education sector have flagged concerns around the availability of suitable student accommodation. While not currently a binding constraint on further enrolment growth, demand for accommodation is nevertheless very strong and increasing. Several contacts have also noted that recent and pending changes to student visa policy settings could affect the outlook for international enrolments.

International tourism has picked up over the past year but remains below pre-pandemic levels. International visitor arrivals are expected to reach pre-pandemic levels later in 2024, supported by a strong recovery in Chinese demand.

Home building is expected to slow over 2024 as builders work through the backlog of construction work.

Contacts in the detached housing industry generally report that they are still busy as backlogs continue to be worked through. While builders' margins are improving and supply chains have largely normalised, firms continue to report some challenges in sourcing contractors and labour, particularly for finishing trades. Builders and civil contractors also regularly note competition from non-residential construction activity in sourcing materials and labour, which is maintaining upwards pressure on costs.

Overall, contacts in this industry are expecting less activity in the coming year due to slower land and building contract sales in 2023. Regional variation in the outlook across housing industry contacts became more apparent over the second half of 2023, as the effects of pandemic-related policy measures faded and other demand drivers (such as population flows and relative affordability) increased in importance.

For higher density residential developments, contacts are still reporting an unfavourable commercial environment for new projects due to elevated costs for land, financing and construction, as well as constrained purchasing capacity by prospective owners. Looking ahead, some contacts suggest that apartment building activity could pick up relatively quickly in some markets once construction costs stabilise, given the strong underlying demand for housing.

Infrastructure construction activity remains strong and capacity remains stretched.

Contacts working in the infrastructure sector note that capacity to deliver the large amount of current and prospective projects remains stretched. A few firms supplying this sector have recently reported some easing in demand conditions, consistent with some delays and reductions in government spending. Private sector resource and energy sector investment intentions remain solid, but some firms note concerns around adding pressure to an already capacity-constrained industry, as well as noting uncertainty around the timing of expenditures given ongoing regulatory and approvals processes.

With regards to non-infrastructure business investment, firms report ongoing expenditure on a broad range of projects including those relating to digitisation and automation, technology, fitouts and refurbishments. Some firms have reported slowing their investment plans, however, citing concerns over input and financing costs.

Firms are finding it more challenging to increase prices, while overall cost pressures remain elevated.

As growth of demand has slowed, an increasing number of firms along domestic supply chains have noted that their customers have become less willing to accept cost increases being passed through to prices, and contacts generally expect to make smaller average price increases over the year ahead than over the past 12 months.

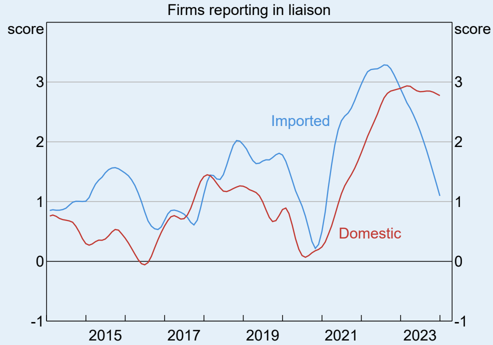
For firms sourcing imported goods, supply chains have largely normalised and shipping costs remain lower than in the peak of the pandemic, which has slowed price increases for downstream customers (Graph A.1). Most liaison contacts have reported only limited supply chain problems associated with either domestic port disputes or the recent disruptions in international shipping routes, although some firms have experienced delays in recent weeks.

Firms otherwise generally note that overall input cost growth remains elevated, which is intensifying their focus on cost discipline. Key non-labour cost drivers that have been called out by contacts include logistics, fuel, utilities, insurance and professional services fees. Some – typically larger – firms have reported being able to push back on increases from upstream suppliers, but other firms are experiencing a long tail of cost increases that is challenging to absorb or offset. Overall, though, firms report that growth in non-labour input costs has been gradually easing, with further easing expected over the next 12 months.

Graph A.1

Indicators of Non-labour Costs*

Firms reporting in liaison



* Over the past 12 months; smoothed with a 13-month Henderson trend; a score of 0 indicates a firm has reported no change in average non-labour input costs, while a score of 2 indicates a firm has reported around-average increases.

Source: RBA.

Firms are managing labour costs more tightly, which is feeding through to a moderation in their employment intentions and wage expectations.

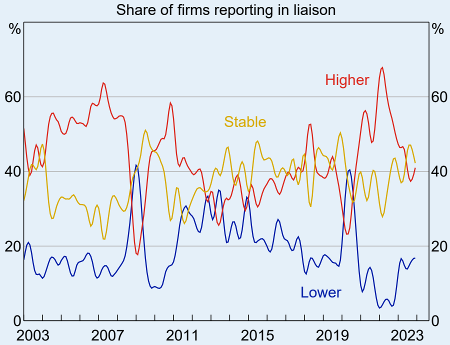
Firms continue to report strong growth in labour costs over the past couple of years. As part of controlling this, and in response to slowing demand, fewer firms are looking to expand headcount over the next 12 months, and employment intentions have declined to around longer run levels after peaking in 2022 (Graph A.2). Firms report that voluntary staff turnover rates have continued to decline and that labour availability has improved in recent months, though contacts across a broad range of industries note that finding suitable labour generally remains more difficult than prior to the pandemic.

Higher labour costs also reflect ongoing strong wages growth, which liaison suggests averaged a little above 4 per cent for the private sector over the year to the December quarter. Firms continue to note that wages growth for staff on individual agreements has been slowing but that this is being offset by a pick-up in award and collective agreement wages. The majority of contacts are anticipating slower wages growth over the next 12 months, with average expected year-ended growth currently around 3½ per cent. This slowing reflects expectations of lower inflation and award rate outcomes in the coming 12 months, as well as an increased need to reduce business costs and a slowing labour market.

Graph A.2

Employment Intentions*

Share of firms reporting in liaison



* Over the next 12 months; smoothed with a 13-month Henderson trend.

Source: RBA.

3. Outlook

Summary

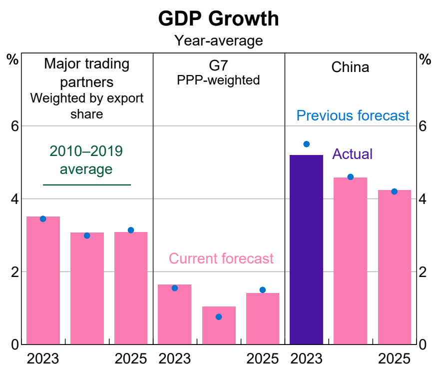
- **Most advanced economy central banks judge their policy rates to be restrictive and expect inflation to return to target over the next year or so.** Global growth is expected to be soft over the next two years, contributing to slower growth in demand for Australian goods and services.
- **Economic growth in Australia is expected to remain subdued in the near term as inflation and higher interest rates continue to weigh on demand.** The forecast for GDP growth is softer than three months ago, largely reflecting a weaker outlook for household consumption in the near term. From late 2024, growth is expected to pick up gradually as inflation declines and the pressures on household incomes ease.
- **Conditions in the labour market are expected to ease further to be broadly consistent with full employment in the next couple of years.** Nominal wages growth is expected to remain robust in the near term and then gradually ease.
- **Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and reach the midpoint in 2026.** The forecasts are based on the technical assumption that the cash rate will remain around the current level until the middle of 2024. Inflation is anticipated to decline a little quicker than previously thought, because goods price inflation has declined more than expected and domestic demand is also a little softer than previously anticipated. But, services inflation remains high and is still expected to decline only gradually as demand moderates and growth in labour and non-labour costs ease.
- **The risks to the domestic outlook are broadly balanced, though the costs associated with these risks differ.** The key risks are: (i) demand could be softer than expected, leading to costs to our full employment objective, though inflation would decline faster than expected in this case; and (ii) inflation could take longer to return to target than anticipated, which would be costly (in terms of both the employment and inflation objectives) if this led to inflation expectations drifting upwards.

3.1 Global outlook

Global growth is expected to be below average and inflation to decline to be consistent with central bank targets in many economies.

Year-average GDP growth in Australia's major trading partners is expected to ease in 2024, contributing to weaker growth in demand for Australian goods and services. This overall outlook is little changed from three months ago, with stronger forecast growth in the United States and high-income economies in east Asia offset by weaker growth in some other advanced economies (Graph 3.1).

Graph 3.1



Sources: ABS; CEIC Data; Consensus Economics; LSEG; RBA.

Central banks are generally forecasting that inflation in advanced economies will decline to be consistent with central bank targets over the next year or so, though flag upside risks. This expectation of a decline in inflation is alongside expectations of softer economic growth and a moderate easing in labour markets. Reflecting this, market expectations are that policy rates have peaked (see Chapter 1: Financial Conditions). In particular, GDP growth in advanced economies is forecast to slow substantially this year, partly reflecting the effects of tighter monetary policy on demand. In most G7 economies, private sector economists' forecasts of growth for 2024 are well below the average growth of the decade prior to the pandemic, although US growth is expected to slow only moderately. Overall G7 economic growth is forecast to pick up moderately from the latter half of 2024 and is expected to be supported by less restrictive monetary policy settings in a number of economies.

Growth in China is expected to slow over the next two years as the rebound in services consumption fades and the property sector remains weak. Weakness in these sectors is expected to be partly offset by continued strength in manufacturing investment and further policy support for infrastructure investment.

Risks to the outlook for global economic growth are tilted to the downside.

- **Key risk #1: Inflation may not decline as quickly as expected, even as demand slows further, leading to more restrictive monetary policy and softer global economic growth than anticipated.** Recent progress towards inflation targets has been faster than expected in some economies, but services inflation – which remains a key focus of many central banks – has eased only gradually and may remain stubbornly high. Recent disruptions to global shipping routes pose an additional modest upside risk to global inflation and downside risk to growth; this risk could become more material in the event of a significant escalation of the conflict in the Middle East.
- **Key risk #2: It remains uncertain how much further the earlier tightening in monetary policy will weigh on economic activity.** Recent further progress towards central bank inflation targets has reduced the likelihood that additional monetary policy tightening will be required in major advanced economies. However, lags in monetary policy transmission mean uncertainties remain (in both directions)

about the full impact on economic activity of the tightening that has occurred to date.

- **Key risk #3: Economic growth in China could slow more than forecast due to continued weakness in the property sector and weaker-than-anticipated household consumption.** Demand for housing in China remains weak despite further policy measures to support the sector. A deeper and more prolonged contraction in the property sector could weigh more heavily on household consumption, particularly if consumer confidence remains subdued and further policy support is limited. If weakness in Chinese demand were to compound the effects of soft demand from advanced economies, this could weigh on exports (and so economic growth) of other trade-exposed economies in east Asia.

3.2 The domestic outlook

Economic growth is expected to remain subdued in the near term as inflation and earlier interest rate increases weigh on demand.

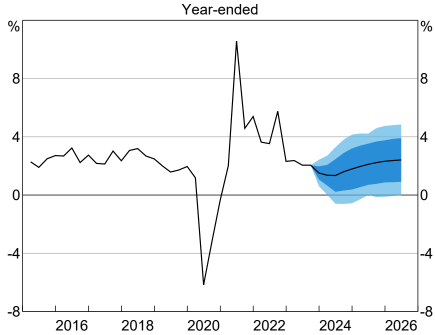
The near-term outlook for GDP growth has been revised down modestly from three months ago, reflecting a weaker outlook for consumer spending. The soft outlook for GDP growth in the near term reflects subdued domestic final demand growth (Graph 3.2). The pressure on household budgets from declines in real incomes over the past couple of years is expected to weigh on consumption, particularly in the first half of 2024. High construction costs and ongoing capacity constraints – reflecting shortages for skilled trades – are forecast to continue weighing on new building approvals and dwelling investment. Growth in non-mining business investment and public investment is forecast to soften from the high rates seen over the past year. However, the level of investment is expected to remain high, as firms continue to work through the large pipeline of construction work. Strong population growth – driven by growth in international students – and the continued recovery in inbound tourism is expected to support domestic activity in the near term and provide some offset to weak spending by Australian residents.

While *growth* in demand has slowed, the *level* of demand is still robust and is assessed to be above the economy's capacity to supply goods and services, thereby creating inflationary pressures (discussed further below). The forecast period of subdued growth relative to trend is expected to help bring demand and supply in the economy back into balance.

Graph 3.2

GDP Growth Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

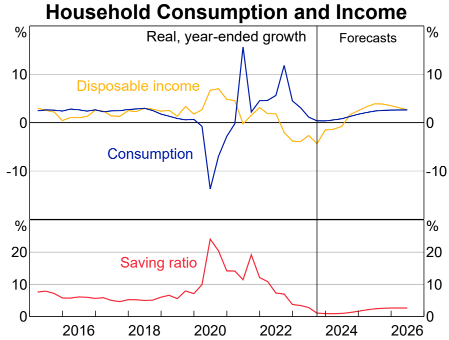
Sources: ABS; RBA.

The forecasts are based on the technical assumption that the cash rate is around its peak in the current cycle and will remain around this level until the middle of 2024; the cash rate path is based on financial market pricing and a survey of market economists (see Table 3.1: Detailed Forecast Table for more information). While high inflation affects all households and businesses, monetary policy tightening affects the cash flows of groups of households in different ways. Our assessment is that most of the two-fifths of households that have a mortgage are well placed to manage mortgage rates around their current levels, by continuing to curtail spending, saving less or drawing down on savings buffers.[1] But, around 5 per cent of borrowers are currently estimated to have insufficient income to meet their most essential expenses and mortgage payments, and so are drawing down on savings or finding other ways to increase their income or reduce expenditure. Some of these borrowers are at risk of depleting their buffers within six months, which would see them fall behind on mortgage payments. Conversely, households that are net savers are benefiting from higher interest earned. The other channels of monetary policy are also working to slow the growth of demand and contributing to the decline in inflation, such as by increasing incentives to save and by supporting the value of the Australian dollar.

GDP growth is forecast to pick up gradually from later this year, largely reflecting stronger growth in household consumption and public demand. Household consumption growth is forecast to pick up to around its pre-pandemic average over the next year or so, supported by a recovery in real income growth as inflation continues to moderate (Graph 3.3). The household saving ratio is expected to decline further in the near term before increasing gradually from mid-2024 as real income growth turns positive. Dwelling investment is forecast to increase from 2025 onwards as earlier strong population growth and higher prices for established housing lead to a pick-up in demand for new housing. The forecasts for GDP growth beyond the near term are broadly similar to three months ago.

Graph 3.3

Household Consumption and Income



Sources: ABS; RBA.

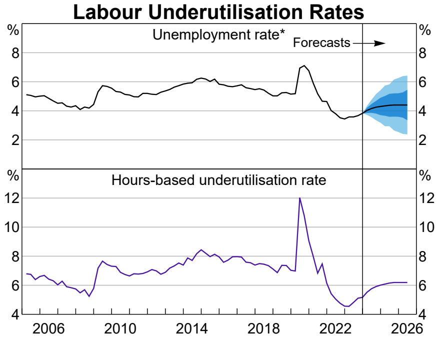
Labour market conditions are expected to ease further to be broadly consistent with full employment in the next couple of years …

Employment is expected to increase further, but at a slower pace than last year. Much of the labour market adjustment to subdued growth in economic activity is expected to occur through a decline in average hours worked. But employment growth is also forecast to slow and to be below growth in the working-age population for a time. The rate of participation in the labour force is expected to decline a little over the forecast period as conditions soften, but it is expected to remain at a high level. (Changes in the assumption for growth in the working-age population have been small relative to the large upward revisions that occurred last year because of stronger-than-expected net overseas migration.)

Labour underutilisation rates are expected to rise as employment growth moderates and average hours worked decline. Both the broader hours-based underutilisation rate (i.e. people working fewer hours than they want) and the unemployment rate have increased since late 2022 when labour market conditions were very tight, and a further increase is expected over coming quarters in response to slower economic growth (Graph 3.4). That said, the underutilisation rates forecast over the next few years are well below the typical rates of the past five decades.

The labour market forecasts are broadly consistent with a return to full employment conditions that can be sustained over time without adding to inflationary pressures. It appears that the economy will be able to sustain lower levels of labour underutilisation than were typically seen over the past five decades. The assessment of the labour market relative to full employment is based on a broad range of indicators, models and judgement (see Chapter 4: In Depth – Full Employment for more detail).

Graph 3.4



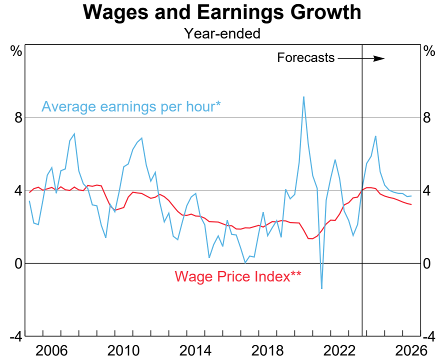
* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

… leading to a gradual easing in nominal wages growth.

Nominal wages growth is expected to remain robust in the near term, and then decline gradually in line with the easing in the labour market. Wages growth has already begun to moderate in some parts of the private sector and the moderation is expected to deepen and broaden out over the coming year (Graph 3.5).

Graph 3.5



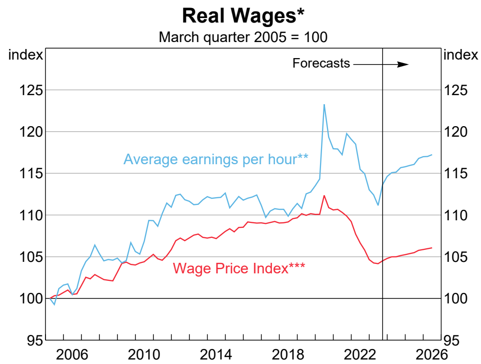
* Non-farm; includes social contributions.

** Excluding bonuses and commissions.

Sources: ABS; RBA.

The recent increase in real wages is expected to continue over the next couple of years; nominal wages are expected to increase at a faster pace than inflation (Graph 3.6).

Graph 3.6



* Deflated using the headline Consumer Price Index.

** Non-farm; includes social contributions.

*** Excluding bonuses and commissions.

Sources: ABS; RBA.

Growth in broad measures of labour costs is high because recent labour productivity outcomes have been weak. Recent growth in nominal unit labour costs – the measure of labour costs that matters most for inflation – has been at the highest rate since 1990 (excluding pandemic-impacted outcomes in 2020). Growth in unit labour costs is expected to slow gradually over the next few years.

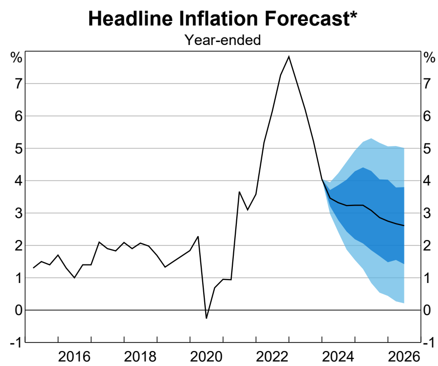
The forecasts for nominal wages growth remain consistent with the inflation target, provided labour productivity growth returns to around long-run averages; this assumption is embedded in the forecasts. While productivity growth is difficult to forecast and there are risks that productivity will be weaker than anticipated (see 3.3 Key risks to the domestic outlook), much of the recent weakness in productivity has been a by-product of the pandemic and the economic cycle and will likely unwind over the next few years. For example:

- The strong labour market has drawn in new workers and allowed others to change jobs more easily. This boost to employment is a good social and economic outcome, but it requires a transition period as people are trained in a new role. In time, job mobility can boost productivity through the benefits of better matching of people's skills with jobs.
- Some industries that faced capacity challenges in recent years, partly related to the pandemic and weather disruptions, could see an improvement in productivity as these challenges dissipate. For example, activity in the construction industry has been hampered by shortages that have led to delays in the way work is completed. But the improvement in the availability of materials and skilled labour is gradually reducing delays. In some industries – such as tourism– capacity has been insufficient to meet demand given the lags for firms (such as tourism operators) to re-establish infrastructure and resources, after a period of low demand.
- In recent years, the increase in hours worked has outpaced the growth in the capital stock; less capital per worker has been a key driver of the weakness in productivity. For example, high demand for wholesale trade services has contributed to a strong rise in hours worked, but the capital stock in that industry has yet to catch up. This is broadly expected to rebalance over the next few years, contributing to a pick-up in productivity.

Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and reach the midpoint in 2026.

Inflation is expected to be within the target range in 2025 (Graph 3.7; Graph 3.8). The decline in inflation is based on the expectations that in the next couple of years the labour market will be around levels consistent with full employment and that subdued economic growth will balance demand and supply of goods and services. Inflation expectations are assumed to remain consistent with achieving the inflation target in this timeframe.

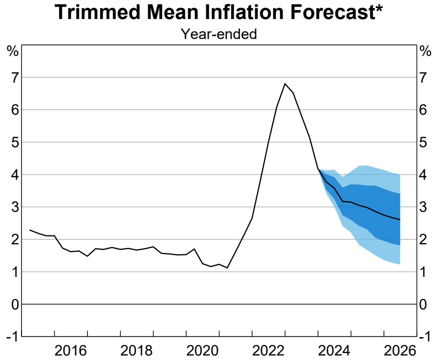
Graph 3.7



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

Graph 3.8



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

Inflation is expected to decline a little quicker than previously thought. Goods price inflation has declined more quickly than expected three months ago, as the earlier easing in global upstream costs was passed through to consumer-facing prices; domestic demand is also a little softer than previously anticipated. The recent decline in fuel prices will lower headline inflation in the March quarter this year; together with the scheduled expiry of government electricity rebates in 2024, this creates some volatility in the progress of headline inflation to target.

But, services inflation remains high and is expected to decline only gradually as domestic inflationary pressures moderate. A further decline in services inflation is required for the inflation target to be achieved over time. Recent high inflation outcomes reflect the still-strong level of demand for services as well as strong growth in domestic costs. These costs include labour (partly because of poor productivity outcomes) and non-labour business inputs such as insurance and administrative services. There was a moderation in services inflation in the December quarter and a further easing is expected over the forecast period as cost growth eases, and as the demand for services moderates. Services inflation is expected to be slower to decline than goods inflation, consistent with the experience of other countries.

Goods price inflation is expected to be subdued over coming years. Recent inflation outcomes for many categories of goods have now returned to around pre-pandemic averages. Firms in the RBA's liaison program have reported a sustained improvement in supply chains and an easing in imported goods inflation. Domestic cost pressures remain a source of upward pressure in firms' pricing decisions, though these cost pressures are expected to ease over time.

Rent inflation is expected to remain high over the year ahead, before easing gradually. Growth in advertised rents remains strong. Housing supply has not kept pace with the increased demand for housing arising from robust nominal income growth and strong population growth in recent years, as well as the decrease in average household size since the beginning of the pandemic. This imbalance between supply and demand is contributing to very low vacancy rates and high rent inflation.

3.3 Key risks to the domestic outlook

The risks to the domestic outlook are assessed to be broadly balanced, though the costs associated with these risks differ. While some of the downside risks to the outlook would see a faster return to the inflation target, this would likely be accompanied by a cost to our employment objective. On the other hand, it would be costly (in terms of both our employment and inflation objectives) if a sustained period of high inflation led to inflation expectations drifting upwards.

Key risk #1 – If demand is weaker than expected, it could lead to spare capacity in the labour market and a faster decline in inflation.

With the labour market expected to be around the level consistent with full employment during the forecast period, materially weaker demand conditions would lead to spare capacity in the labour market. At the same time, weaker demand would also temper inflationary pressures, resulting in inflation returning to target earlier.

Some key channels through which demand could be weaker than expected include:

- **The recent weakness in household consumption could persist for longer than expected.** This could occur if the decline in real disposable incomes over the past couple of years has a larger or more persistent effect on consumption than anticipated. While many households with mortgages are well placed to absorb the increases in interest rates that have taken place, there is a risk that these households, especially those with low savings buffers and high debt relative to incomes, will adjust spending by more than expected. The increase in interest rates to date could also encourage all households to save more than expected, resulting in lower consumption growth; this has been evident across a number of peer economies.
- **International demand for Australian goods and services could be weaker than expected.** The outlook for global economic growth remains uncertain, with risks tilted to the downside. If services price inflation remains high despite further easing in demand growth, interest rates could be higher for longer than expected, and global economic growth could, in turn, slow by more than anticipated.

  The expected slowing in China's growth also continues to create uncertainty around the outlook for demand for commodities and, accordingly, the prices of Australia's key exports and terms of trade. Real estate investment has been a persistent drag on overall investment since 2021 and this is expected to continue for another year or so. The outlook for household consumption in China also remains weak, which could pose additional downside risks to Australia's education and tourism exports. While recent policy stimulus announcements have signalled further commitment by the Chinese authorities to support economic growth, constraints on local government finances could limit their ability to continue to do so. A prolonged cyclical downturn in China could further weigh on Australia's exports through its effect on output growth in Australia's major trading partners in the east Asian region, compounding the effects of slower growth in advanced economies.

Goods prices could decline significantly if domestic demand or international demand eases by more than anticipated. The inflation forecasts broadly assume that goods prices stabilise at a high level rather than decline over coming years. However, price declines have been recorded for some categories of goods in recent months. Larger or widespread declines in goods prices would moderate inflation outcomes by more than currently forecast. To provide a sense of the magnitude of this risk, if prices for consumer durables reversed one-third of the price increases recorded since the onset of the pandemic, year-ended headline inflation would be around ½ percentage point lower than the current forecast. This would mean that headline inflation would be in the target range in 2024.

Key risk #2 – If inflation takes longer to return to target than anticipated, it could cause inflation expectations to drift upwards, which would impose costs for our employment objective.

Inflation is expected to be above the target range for around four years in total according to staff forecasts. If inflation expectations remain anchored – as assumed in the baseline forecasts – then inflation is expected to decline alongside an easing in the labour market. But, there is a risk that inflation will be above the target range for longer than this, which could result in inflation expectations drifting higher. A drift higher in inflation expectations would lock in a rate of inflation and nominal wages growth that is persistently higher, with no benefit to real wages. History suggests that it would require a sustained and costly period of spare capacity where labour is less than fully employed to reset expectations.

Some key channels through which inflation could be higher for longer than forecast include:

- **Supply shocks could boost inflation.** While the pandemic-related disruptions to supply chains have largely resolved, the risk of other supply shocks have increased. If there were an escalation of the recent disruptions to global shipping routes, goods price inflation could be higher than forecast for a time, which could further delay the return of inflation to target.
- **Inflation could be more persistent than expected if productivity growth does not pick up.** The baseline forecasts include an assumption that labour productivity growth increases to the rate recorded in the decades preceding the pandemic. Productivity growth could prove weaker than forecast if capital deepening does not eventuate (i.e. the rate of investment is insufficient relative to employment growth) or if the structural factors that were key drivers of the productivity growth slowdown since the mid-2000s persist (e.g. declining business dynamism and slowing technology adoption). If productivity is weaker than assumed, businesses could find themselves facing continued strong growth in labour costs, putting upward pressure on prices paid by consumers.
- **Demand could be stronger than expected and inflation could be higher for longer than anticipated as a result.** Household consumption could turn out to be stronger than forecast if households are more willing to maintain a low saving rate or draw down on their savings in order to support their spending. There is also a large amount of work in the construction pipeline that could be worked through more quickly than anticipated, increasing the competition for scarce labour and materials. These scenarios would result in inflation declining by less than anticipated and employment growth being stronger than forecast in the near term. In particular, there is a risk that services inflation could remain stubbornly higher than forecast; the evidence from other countries suggests that services inflation has moderated only gradually, despite progress on other aspects of inflation.

3.4 Detailed forecast information

The forecasts incorporate several technical assumptions:

- The cash rate is assumed to move broadly in line with expectations derived from surveys of professional economists and financial market pricing. Using this methodology, the cash rate remains around its current level of 4.35 per cent until mid-2024 before declining to around 3¼ per cent by the middle of 2026. This cash rate path is a little lower than at the November *Statement*.
- The exchange rate is assumed to be unchanged at its current level, which is 1.7 per cent higher than the November forecasts on a trade-weighted basis.
- Crude oil prices are assumed to be broadly unchanged around their current levels for the rest of the forecast period, which is around 4 per cent lower than at the November *Statement*.
- The assumed level of the population has been revised slightly higher. Recent net overseas migration has been stronger than expected while migration policy changes are expected to provide some offset over the forecast period; year-ended population growth is assumed to have peaked in the September quarter at around 2½ per cent, after which it is expected to decline back to its pre-pandemic average of around 1½ per cent.

Table 3.1 provides additional detail on forecasts of key macroeconomic variables (see Box B: Greater Transparency about Our Forecasts and Assumptions). The forecast table from current and previous *Statements* can be viewed, and data from these tables downloaded, via the Statement on Monetary Policy – Forecast Archive.

Table 3.1: Detailed Forecast Table[a]

Percentage change through the four quarters to quarter shown, unless otherwise specified[b]

	Dec 2023	Jun 2024	Dec 2024	Jun 2025	Dec 2025	Jun 2026
Activity						
Gross domestic product	1.5	1.3	1.8	2.1	2.3	2.4
Household consumption	0.4	0.8	1.7	2.4	2.6	2.6
Dwelling investment	–0.2	–1.6	–1.5	0.3	2.0	3.5
Business investment	7.6	1.2	1.2	1.6	1.8	2.2
Public demand	4.0	2.2	1.1	2.1	2.8	3.0
Gross national expenditure	1.4	1.5	1.9	2.4	2.7	2.7
Major trading partner (export-weighted) GDP	3.5	3.1	3.1	3.1	3.0	3.0
Trade						
Imports	6.0	2.6	3.9	4.0	3.9	4.2
Exports	5.3	2.1	3.1	2.5	2.4	2.7
Terms of trade	–4.1	–1.1	–4.2	–5.0	–3.6	–2.5
Labour market						
Employment	3.0	2.0	1.2	1.2	1.4	1.5
Unemployment rate (quarterly, %)	3.8	4.2	4.3	4.4	4.4	4.4
Hours-based underutilisation rate (quarterly, %)	5.2	5.8	6	6.2	6.2	6.2
Income						
Wage Price Index	4.1	4.1	3.7	3.6	3.4	3.2
Nominal average earnings per hour (non-farm)	5.5	7.0	4.3	3.9	3.8	3.7
Real household disposable income	–1.5	–0.8	2.5	3.9	3.5	2.7
Inflation						
Consumer Price Index	4.1	3.3	3.2	3.1	2.8	2.6
Trimmed mean inflation	4.2	3.6	3.1	3.0	2.8	2.6
Assumptions						
Cash rate (%)[c]	4.2	4.3	3.9	3.6	3.4	3.2
Trade-weighted index (index)[d]	60.9	61.6	61.6	61.6	61.6	61.6
Brent crude oil price (US$/bbl)[e]	83.2	80.4	80.4	80.4	80.4	80.4
Estimated resident population[f]	2.4	2.0	1.6	1.4	1.4	1.4
Memo items						
Labour productivity[g]	–0.5	3.0	1.4	1.1	1.2	1.1
Household savings rate (%)[h]	0.9	1.0	1.7	2.4	2.7	2.7
Real Wage Price Index[i]	0.1	0.8	0.4	0.5	0.6	0.6
Real average earnings per hour (non-farm)[i]	1.4	3.5	1.0	0.8	1.0	1.1

(a) Forecasts finalised on 31 January.

(b) Forecasts are rounded to the first decimal point. Shading indicates historical data.

(c) The cash rate is assumed to move broadly in line with expectations derived from surveys of professional economists and financial market pricing.

(d) The daily exchange rate (TWI) is assumed to be unchanged at its current level going forward.

(e) Oil prices are assumed to remain constant at the current price over the current quarter. For the rest of the forecast period oil prices are expected to remain around the price implied by the six-month-forward rate.

(f) The population assumption draws on a range of sources, including partial indicators from the Australian Bureau of Statistics, migration policies, and estimates made by the Australian Government.

(g) GDP per hour worked (non-farm).

(h) Household savings rate refers to the ratio of household saving (disposable income minus consumption) to household disposable income, net of depreciation.

(i) Real Wage Price Index and non-farm average earnings per hour worked are both deflated by Consumer Price Index.

Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; LSEG; RBA.

Endnote

[1] See RBA (2023), Financial Stability Review, October.

Box B

Greater Transparency about Our Forecasts and Assumptions

The RBA has expanded the economic and forecast information we regularly publish, to give greater insight into our economic assessment and enhance transparency. This information will provide a richer view of the inputs to monetary policy, including how we generate our forecasts and the assumptions on which they are based. We will regularly publish our assessments of potential output and full employment and continue to publish insights from our liaison programs. We will also increase the range of forecast data published, make these data more easily accessible, and publish an annual evaluation of our forecasts. This Box explains these changes.

The improved transparency is consistent with the recommendations of the 2023 RBA Review and the agreement between the Reserve Bank Board and the Government in the recently updated *Statement on the Conduct of Monetary Policy*.

We will publish our assessments of potential output and full employment.

We will regularly provide the RBA's assessment of spare capacity in the economy. This includes an assessment of output relative to potential output, and employment relative to full employment as well as other indicators of resource utilisation.

Spare capacity is discussed in detail in Chapter 2: Economic Conditions. The RBA's approach to assessing full employment is set out in Chapter 4: In Depth – Full Employment and in recent speeches.[1] Future publications will further explain the RBA's approach to assessing potential output, as well as the range of models the RBA uses as inputs to assess spare capacity.

We will increase the availability and accessibility of forecast data.

The RBA forecasts many economic variables and makes assumptions about others. For greater insight, transparency and accessibility around these forecasts and assumptions, we have:

- *Increased the range of forecast variables and assumptions published in the Statement on Monetary Policy* (see Table 3.1: Detailed Forecast Table). The RBA publishes detailed forecasts for economic activity, trade, the labour market, income and wages, and inflation. We have expanded the information in the Detailed Forecast Table to include our forecast for the hours-based labour underutilisation rate and our assumptions for household savings, real wages growth and productivity. We are also publishing technical assumptions that underpin the staff forecasts, including the assumed path for the cash rate (which reflects expectations derived from financial market pricing and surveys of professional economists), the exchange rate, oil prices and population growth.

- *Enhanced our publicly available data files with more accessible historical forecasts to aid external researchers* (see Statement on Monetary Policy – Forecasts Archive). Data files of historical forecasts (back to 2018) are being published in an easily downloadable format in conjunction with the *Statement on Monetary Policy*.

We will regularly publish an evaluation of the staff forecasts.

Each year, we conduct an internal review of the RBA staff economic forecasts. This helps us to assess what we have learned about the economy and improve our forecasting methods. Insights from these reviews have been published for the past two years, and we will publish these reviews annually going forward.[2]

We will continue to publish insights from our business and community liaison program.

Since 2001, the RBA has been running a liaison program through which staff based in our offices across the country meet frequently with local firms, industry bodies, government agencies and community organisations.[3] Information from liaison is an important complement to data sources and helps to inform the RBA's assessment of economic conditions. We will continue to share this information publicly in a quarterly box in the *Statement on Monetary Policy* (see Box A: Insights from Liaison) and through other channels such as speeches and *Bulletin* articles.

Endnotes

[1] Bullock M (2023), 'Achieving Full Employment', Speech at the Ai Group, Newcastle, 20 June; Bullock M (2023), 'Monetary Policy in Australia: Complementarities and Trade-offs', 2023 Commonwealth Bank Global Markets Conference, Sydney, 24 October; Kohler M (2023), 'The Outlook for the Australian Economy', UBS Australasia Conference, Sydney, 13 November.

[2] For last year's review, see RBA (2023), 'Box B: Has the Economic Outlook Evolved as Forecast a Year Ago?', *Statement on Monetary Policy*, November.

[3] For further detail on the liaison program, see Dwyer J, K McLoughlin and A Walker (2022), 'The Reserve Bank's Liaison Program Turns 21', RBA *Bulletin*, September.

4. In Depth – Full Employment

Summary

- **Full employment is a longstanding objective of monetary policy.** There are large financial and social costs when the economy operates away from full employment.
- **The Reserve Bank Board sets monetary policy to achieve its objectives of both price stability and full employment.** As agreed in the *Statement on the Conduct of Monetary Policy*, the RBA will regularly communicate its assessment of labour market conditions relative to full employment.
- **The Board aims to achieve the maximum level of employment consistent with low and stable inflation.** This complements the Government's broader objective to lift the level of employment that can be sustained over the longer term.
- **The RBA does not have a numerical target for full employment**, like it does for inflation. Full employment cannot be summarised by a single measure that can be observed directly. Full employment also changes over time as the structure of the economy evolves.
- **The RBA looks at a broad set of information to assess how close the labour market is to full employment**, including a range of labour market indicators and model-based estimates.

4.1 Full employment is an objective of monetary policy in Australia

The RBA has objectives of price stability and full employment.

The RBA has always had a mandate for full employment, and the Board has historically set monetary policy to achieve both low and stable inflation and full employment. However, the 2023 Review of the RBA recommended that the 'dual mandate' be made more explicit. This has been adopted in the newly updated *Statement on the Conduct of Monetary Policy* agreed between the Reserve Bank Board and the Treasurer.[1]

There are large financial and social costs when the economy operates away from full employment.

When someone cannot find work, or the hours of work they want, they suffer financially. Work can also provide people with a sense of purpose and help to foster mental and physical wellbeing. The costs of the economy operating away from full employment tend to be borne disproportionately by particular groups in the community, such as the young and people on lower incomes and with less wealth. The effects can be long-lasting – a spell of unemployment can reduce workers' earnings for several years afterwards and people who are unemployed for an extended period are more likely to leave the labour force altogether, so called 'hysteresis' or 'scarring effects'.[2] There are also broader economic and societal benefits from higher workforce involvement, such as an increased prospect of new, and more diverse, ideas being generated and greater social inclusion.

The RBA will regularly communicate its assessment of spare capacity in the labour market and the economy.

The Board agreed in the *Statement on the Conduct of Monetary Policy* to regularly communicate its assessment of how conditions in the labour market stand relative to sustained full employment; this is set out in Chapter 2: Economic Conditions. Alongside this assessment, the RBA will publish additional information on current economic conditions and forecasts to enhance the transparency of monetary policy, in line with the RBA Review recommendations and as agreed in the *Statement on the Conduct of Monetary Policy* (see Box B: Greater Transparency about Our Forecasts and Assumptions).

4.2 The role of monetary policy in achieving full employment

The RBA aims to achieve the maximum level of employment consistent with low and stable inflation.

The RBA uses monetary policy to achieve a balance between demand and supply in the labour market and in the markets for goods and services. Monetary policy influences aggregate demand – that is, total spending on goods and services in the economy. A shortfall in aggregate demand relative to supply leads to a relative lack of demand for labour, more limited work opportunities and low wages growth, putting downward pressure on inflation. Conversely, if total spending is high relative to supply, inflation will typically rise above target, wage pressures will increase in the face of high vacancies and staff turnover, and firms may struggle to meet demand for their products. Additional spending beyond what is consistent with full employment increases inflationary pressure without a sustainable improvement in living standards, so at any given point in time there is a limit to the level of economic activity that can be sustained.

The RBA and the Government's full employment objectives are complementary. The RBA aims to achieve the maximum level of employment consistent with low and stable inflation by minimising economic cycles, which is consistent with the Government's short-term objective for the labour market. Over the longer term, the Government can also aim to influence the level of employment that can be sustained without creating inflationary pressure. The Government recently set out its inclusive full employment objective – that is, to broaden labour market opportunities and lift the level of employment that can be sustained over time. Monetary policy has little direct effect on labour supply or structural features of the job market, and so generally takes the current level of full employment as given.

The RBA does not have a numerical target for full employment.

Full employment cannot be observed directly or summarised by a single statistic. It also changes over time as the structure of the economy evolves. Any individual indicator, such as the unemployment rate, provides only partial information on the state of the labour market, while model-based estimates provide a broad guide of how the labour market stands relative to full employment. Given these limitations, the RBA does not target a fixed level of full employment. The broad set of information that the RBA uses to assess how close the economy is to full employment is discussed below. This information, along with judgement, form important inputs into monetary policy decisions.

Price stability and full employment are closely intertwined objectives.

In the long run, low and stable inflation is required for strong and sustainable employment growth because it creates favourable conditions for households and businesses to make sound decisions about how to spend, save and invest. Over the short-to-medium term, the two monetary policy objectives are also often complementary; the policy response that returns inflation to target often also moves the labour market towards full employment. This tends to be the case when economic cycles are being driven by fluctuations in demand (employment and inflation rise and fall together). By acting to reduce the severity and duration of economic downturns, monetary policy may be able to limit the extent of more permanent effects on workers who may otherwise lose their jobs during these episodes. So despite having little direct effect on the level of full employment, monetary policy can contribute to stabilising employment around that level, thereby preventing costly scarring or hysteresis. And by slowing demand when it exceeds supply, monetary policy ensures that a strong labour market can be sustained without causing undue inflationary pressure in the economy.

However, there can be a trade-off between the two objectives in the short-to-medium term when supply shocks are the dominant economic influence. For example, an adverse supply shock such as disruptions to energy supply or natural disasters can cause inflation to rise above target at the same time as it reduces the demand for labour. When there is a trade-off, policy must strike a balance between maintaining employment against the costs of high inflation and the risk of it becoming entrenched. The RBA's mandate acknowledges this trade-off by requiring both inflation and employment to be considered. If inflation expectations are well anchored, a central bank is more able to look through an adverse supply shock – even those that take some time to resolve. But the longer inflation is above the target, the more likely it is that inflation expectations will drift higher. And if they do, it will require higher interest rates and unemployment to bring inflation back to target than otherwise. So, even when there are short-term trade-offs, over a longer horizon the two monetary policy objectives tend to align.

The complementarities and trade-offs of monetary policy objectives have been particularly evident over the past year or two. In mid-2022, demand was strong at a time when adverse supply shocks had reduced the capacity of domestic and international production and distribution networks. With inflation well above target and the labour market the tightest it had been in several decades, monetary policy was tightened to slow demand while the supply-side disruptions were being resolved. But the Board has sought to slow demand gradually, opting for a measured pace of returning inflation to the target range to preserve the employment gains of recent years in a sustainable manner.[3]

4.3 Assessing how close we are to full employment

Full employment is a moving target.

We cannot directly observe the level of full employment. But we know it grows with the population – as population growth adds to both supply of and demand for labour – and also varies over time due to structural changes in the labour market. For example, the ongoing increase in labour market participation, which has been driven by a structural increase in female participation, has been accommodated in a way that can be sustained over time; that is, demand has risen alongside supply. There are also a range of search and matching frictions, such as skills mismatches between vacant positions and jobseekers, that can change over time. Such frictions are a key reason why some people are still unemployed, or lacking the hours of work they desire, when the labour market is at full employment. Determining the level of full employment is complicated by these underlying trends across a range of features of the labour market. Our primary focus is on assessing spare capacity in the labour market; that is, the short- to medium-term deviations of labour market conditions from full employment.

We draw on a broad information set to assess labour market conditions.

Full employment is best understood with reference to a suite of information rather than a single indicator. The RBA draws on a wide range of information to form a comprehensive assessment of how close the labour market is to full employment. This information set is regularly included in the *Statement on Monetary Policy* and includes labour market data, survey measures, model-based estimates, and liaison with businesses. Research and views of academics, market economists, government agencies, international organisations and other central banks, alongside engagement with key stakeholders that represent the interests of workers and groups that typically find it harder to find employment, are also important inputs into this assessment.

Our overall assessment of labour market conditions relative to full employment is introduced in Chapter 2: Economic Conditions of this *Statement* and will be covered in the chapter regularly. Drawing on the broad set of information, the labour market is assessed as easing towards a more sustainable balance of demand and supply. An important aspect of this assessment is how we bring together various indicators and models into a useful format, which is detailed below. Each indicator and model provides only a partial view of labour market conditions – and additionally requires careful judgement to interpret – so it is important to consider the full range of information when making an assessment.

A suite of indicators is used to assess the state of the labour market.

There are a wide range of economic indicators that capture different features of the labour market. These indicators can be broadly summarised into a few high-level (though often overlapping) categories:

- **Labour demand:** Indicators such as the number of job advertisements, job vacancies and liaison information on firms' employment intentions provide relatively timely information on changes in firms' labour demand and employment growth.
- **Labour supply:** Changes in labour force participation affect labour supply and can add to or reduce spare capacity. We try to distinguish the participation response to the economic cycle (such as people joining the labour force or being willing to work more hours when labour demand is strong) from longer run trends (such as the structural increase in female participation over recent decades).
- **Labour market spare capacity:** These are key indicators that help us assess the balance of demand and supply. We look at a range of measures to gauge labour market spare capacity (or conversely, labour market tightness):
    - *The unemployment rate has traditionally been a key measure of spare labour capacity.* However, structural trends in the labour market mean that the unemployment rate that is consistent with full employment changes over time. More detailed components of unemployment add to the picture of spare capacity. For example, medium-term unemployment tends to better reflect cyclical labour market conditions, while long-term unemployment is more related to structural factors. Youth employment also tends to respond more to cyclical conditions.

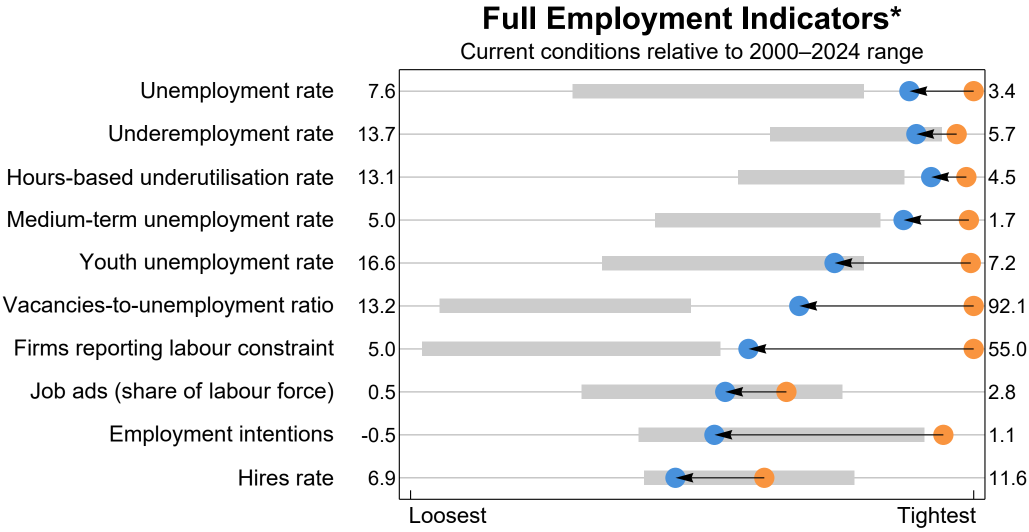
- *Broader measures, such as the underutilisation rate, are important for a full picture of labour market spare capacity.* In addition to unemployed workers, there are also workers who currently have jobs but would like to work more hours – the underemployed. To account for these workers, we look at the hours-based underutilisation rate, which captures the shortfall of hours worked due to both unemployment and underemployment. Like unemployment, underutilisation measures also have structural trends that need to be considered when interpreting the data.
- *Job opportunities and ability to change jobs also provide an indication of labour market tightness.* The number of vacancies relative to the number of unemployed people effectively captures the number of job opportunities for each person looking for work. An increase in this ratio generally indicates a tighter labour market. That could be due to higher labour demand leading to higher vacancies, or because of an increase in labour shortages or skill mismatches in the labour market. Rates of hiring, and voluntary and involuntary job separation can also help us understand changes in the overall amount of spare capacity, and the extent to which it is being driven by labour demand. Survey data that report the extent to which labour is a constraint on output for firms also provides an indication of tightness.

- **Price indicators of the overall balance of demand and supply in the labour market:** Related to labour market tightness, wages growth – in combination with productivity – provides insight into the balance of supply and demand in the labour market. Detailed wages data can also be useful to gauge the breadth of imbalance and whether particular sectors or occupations are tighter than others. Inflation outcomes are also informative in gauging the balance of demand and supply in the labour market and economy more broadly.

Drawing together a range of labour market indicators provides a broad overview of spare capacity.

Any single labour market indicator provides only a partial view of spare capacity in the labour market. Looking at the pattern across a range of indicators can provide a more comprehensive picture. The history of each indicator provides some context for its current level. Graph 4.1 provides a visual summary of some of the key indicators.[4] It compares the latest observation of each indicator (blue dots) with the middle 80 per cent of observations since 2000 (grey bars). It suggests that the labour market remains tight but has eased relative to when the labour market was very tight in late 2022 (shown as orange dots). This easing is most evident in measures that tend to be leading indicators, such as firms' employment intentions and the number of vacancies per unemployed person. In practice, careful judgement is required when interpreting the graph because each indicator may have trended up or down over time, so the historical range may not be an accurate guide to the current full employment level.

Graph 4.1



* Blue dots represent current outcomes, orange dots show outcomes at October 2022 and light grey shaded regions cover the middle 80 per cent of observations since 2000.

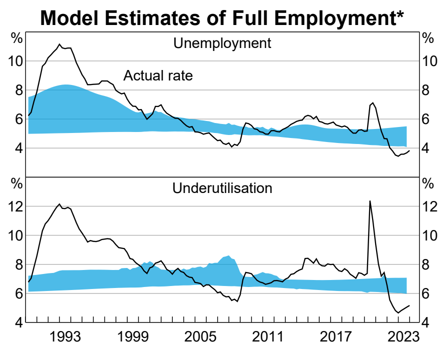
Sources: ABS; JSA; NAB; RBA.

We also use economic models to infer spare capacity.

As part of the broad set of information, we maintain a suite of models that provide a range of estimates of spare capacity in the labour market. Each model has its own strengths and weaknesses, and no model sufficiently captures all dimensions of labour market spare capacity. Using a suite captures a range of perspectives. The suite includes models developed within the RBA, as well as models developed externally and estimates from third parties, such as the OECD.

The models estimate what labour market outcomes would be consistent with full employment based on historical relationships and economic theory. These models primarily estimate the rate of unemployment or underutilisation that puts neither upward nor downward pressure on inflation or labour cost growth (incorporating a role for productivity growth).[5] The models impose structure on the data to infer estimates of spare capacity that are consistent with sustained full employment, which can vary over time to account for structural change. By comparing the range of central estimates of full employment from these models to actual unemployment or underutilisation, we get an indication of how conditions in the labour market stand relative to full employment (Graph 4.2).

Graph 4.2



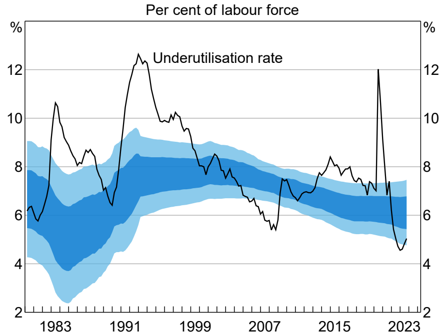
* Blue-shaded region shows illustrative range of central estimates from a selection of models; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

Sources: ABS; OECD; RBA; Ruberl et al (2021).

Each model estimate, however, is subject to considerable uncertainty that is not captured in Graph 4.2. For example, Graph 4.3 shows the range of uncertainty around one model of underutilisation that feeds into our suite. The wide range from this one model is typical of the range of uncertainty around the central estimate of other models. Model estimates also change over time as new data are incorporated. Over the past 20 years, for example, the estimated levels of unemployment and underutilisation consistent with full employment have drifted down in response to structural changes in the economy. However, this was less obvious at the time. ✠

Graph 4.3

Uncertainty around Model Estimates of Full Employment*



* Shaded areas represent one and two standard error bands for smoothed estimates of a single model, accounting for filtering and parameter uncertainty.

Sources: ABS; RBA.

Endnotes

[1] The Treasurer and the Reserve Bank Board (2023), Statement on the Conduct of Monetary Policy, 8 December.

[2] There has been increased interest in this aspect of the labour market in recent years. For a review, see Borland J (2020), 'Scarring Effects: A Review of Australian and International Literature', Australian Journal of Labour Economics, Volume 23, Number 2.

[3] Bullock M (2023), 'Monetary Policy in Australia: Complementarities and Trade-offs', 2023 Commonwealth Bank Global Markets Conference, Sydney, 24 October.

[4] This graph is also included in Chapter 2: Economic Conditions to complement the discussion on current employment conditions.

[5] Some models are based on the Phillips curve, which describes an inverse relationship between the unemployment rate and wage growth or inflation. However, other structures are also used, such as the Beveridge curve, which describes an inverse relationship between the unemployment rate and the vacancy rate.