5. Economic Outlook

Global growth is forecast to remain well below its historical average over the next two years, as high inflation and tighter monetary policy settings are expected to continue to weigh on demand. The forecast for growth in Australia's major trading partners has been revised up a little, largely because of an upward revision to the outlook for Chinese GDP growth. The previously very weak outlook for economic growth in major advanced economies has also been upgraded in response to stronger-than-expected economic activity data in early 2023; however, the outlook in these economies remains subdued (see Chapter 1: The International Environment).

Growth in Australian economic activity is expected to have slowed in the March quarter and is forecast to remain subdued through this year as higher interest rates, the higher cost of living and earlier declines in household wealth continue to weigh on growth. The pace of growth is expected to increase gradually over the remainder of the forecast period as these headwinds fade. There has been a further upgrade to the population estimate, which mainly affects population growth in recent quarters rather than over the forecast period.

The labour market remains tight and employment growth remained solid through the March quarter. That said, the balance between labour demand and supply has improved; the recent pick-up in overseas migration may be helping to alleviate shortages in some areas. The unemployment rate is forecast to rise over coming years because of subdued economic growth.

Consumer price inflation in Australia eased in the March quarter, confirming that inflation has passed its peak. Goods prices have accounted for most of the disinflation so far and this is forecast to continue over 2023 as the resolution of supply disruptions flows through to prices paid by consumers. By contrast, services and energy inflation remains strong and this is expected to continue in the near term. The outlook for inflation over coming years is similar to three months ago, although its composition has shifted. Non-housing inflation is expected to be slower because of downgrades to the outlook for activity, the labour market and labour costs. This is offset, however, by a stronger outlook for rent inflation, reflecting the strength in recent data and the upward revisions to the population growth estimate.

Inflation is expected to decline to around the top of the 2–3 per cent target range over coming years. Inflation could turn out to be more persistent if productivity growth remains weak, the high inflation environment leads to firms expanding margins as their costs ease, there is greater feedback between higher prices and wages than expected, or if rents increase by more than expected. On the other hand, inflation could turn out to be lower than expected if the easing in goods inflation is faster or more widespread than anticipated, including because consumer spending is weaker.

A key source of uncertainty for the domestic activity outlook is the competing forces affecting household spending. Household incomes have been supported by strong labour demand and higher population growth. But

Table 5.1: Output Growth and Inflation Forecasts[(a)]

Per cent

	Year-ended					
	Dec 2022	June 2023	Dec 2023	June 2024	Dec 2024	June 2025
GDP growth	2.7	1¾	1¼	1½	1¾	2
(previous)	(2¾)	(2¼)	(1½)	(1½)	(1½)	(1¾)
Unemployment rate[(b)]	3.5	3½	4	4¼	4½	4½
(previous)		(3½)	(3¾)	(4)	(4¼)	(4½)
CPI inflation	7.8	6¼	4½	3½	3¼	3
(previous)		(6¾)	(4¾)	(3½)	(3¼)	(3)
Trimmed mean inflation	6.9	6	4	3¼	3	3
(previous)		(6¼)	(4¼)	(3¼)	(3)	(3)
	Year-average					
	2022	**2022/23**	**2023**	**2023/24**	**2024**	**2024/25**
GDP growth	3.7	3¼	1¾	1¼	1½	1¾
(previous)	(3¾)	(3½)	(2¼)	(1½)	(1½)	(1¾)

(a) Forecasts finalised 1 May. 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 peak at around 3¾ per cent before declining to around 3 per cent by mid-2025. Other forecast assumptions (assumptions as of February *Statement* in parenthesis): TWI at 60 (62); A$ at US$0.66 (US$0.69); Brent crude oil price at US$78bbl (US$82bbl). The rate of population growth is assumed to be in line with forecasts from the Australian Government's Centre for Population. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter.

Sources: ABS; RBA

consumption growth has slowed recently as high inflation and rising interest rates have weighed on households' disposable incomes in real terms and household wealth has fallen alongside housing prices over the past year. Another important source of uncertainty for the Australian economy is the outlook for global growth. Most notably, there is uncertainty around the pace of disinflation and so the future path of monetary policy and economic growth abroad. While financial stability concerns related to banking sector stresses have subsided, they would pose downside risks to the global economic outlook if the situation were to deteriorate again and financial conditions were to tighten substantially.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing prior to the May Board meeting. The cash rate is assumed to peak at around 3¾ per cent before declining to around 3 per cent by mid-2025, broadly in line with the assumed path in February. The exchange rate is assumed to be unchanged at its level prior to the May Board meeting, which is 4 per cent below its level three months ago on a trade-weighted basis. Petrol prices are assumed to be broadly unchanged around their recent level, which is around 10c/L higher than in early February. The level of the population has been revised higher and population growth projections are broadly in line with the latest Australian Government's Centre for Population forecasts. Higher migration reflects the recent faster-than-expected recovery of temporary migrants, especially students and working holiday makers, with a strong recovery in arrivals alongside low levels of departures.

Inflation in Australia has peaked

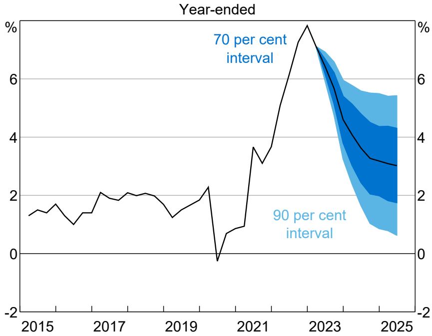
Consumer price inflation in Australia eased in the March quarter, confirming that inflation has passed its peak (Graph 5.1). Goods price disinflation has driven most of the moderation in inflation outcomes in early 2023, consistent with but a little later than the experience overseas. Nonetheless, inflation remains high and broadly based and services inflation continues to pick up. The outlook for headline and underlying inflation has been revised lower in the near term due to the slightly weaker-than-expected March quarter outcome. Further out, the outlook is similar to a few months ago, with the effect of the downgrades to the labour market and labour costs offset by a stronger outlook for rent inflation and a small depreciation in the exchange rate.

Energy prices are expected to add significantly to inflationary pressures over the coming year. Regulators released draft determinations of the default offers for electricity prices in the 2023/24 financial year and these were largely in line with prior expectations. Energy prices in the CPI (which includes both electricity and gas) are expected to add ¼ percentage point to headline inflation over the 2023/24 financial year. Energy price changes are expected to be relatively small in the 2024/25 financial year, based on current wholesale prices in futures markets.

Graph 5.1

Headline Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

Goods price inflation is forecast to moderate further in the period ahead, consistent with the experience overseas. Information from liaison and other timely indicators signal that pricing pressures have eased since mid-2022. This is largely driven by an easing in non-labour input cost pressures, which has been most notable for international freight and some imported goods. However, domestic cost pressures such as energy, wages and logistics remain a source of upward pressure in firms' pricing decisions. Compared with a few months earlier, retailers have increasingly cited weaker demand as a constraint on their ability to increase prices.

Services inflation is forecast to remain high in 2023, before moderating slowly over the forecast period; as a result, inflation is expected to be above the target band over most of the forecast period. Growth in unit labour costs is expected to be solid over the forecast period, adding to cost pressures for labour-intensive market services. Rental vacancy rates are low and stronger population growth will contribute to further tightness in the rental market in the period ahead. As a result, rental price inflation is expected to increase further over coming quarters as higher rents work their way through the stock of outstanding rental agreements.

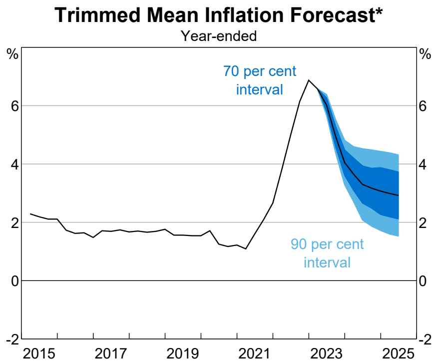
Underlying inflation is expected to decline over coming years to be around the top of the inflation target range by mid-2025 (Graph 5.2). The disinflation in 2023 is expected to be driven by the resolution of supply disruptions (Graph 5.3). Ongoing tightness in the labour market and further energy price increases are expected to keep domestic price pressures elevated in the near term before they start to ease later in the forecast period. There is a high degree of uncertainty around the speed and extent of the disinflation expected in the period ahead. On the one hand, lower goods prices from the resolution of supply chain issues could come through sooner and swifter than anticipated. On the other hand, domestic price pressures may be stronger and more persistent than expected. These risks are discussed further in the section on 'Key domestic uncertainties', below.

Economic growth is expected to slow this year

GDP growth is expected to slow to around 1¼ per cent over 2023, with GDP per capita declining over the year (Graph 5.4). The weaker near-term outlook relative to three months ago reflects the softness in recent activity data. Domestic demand growth stalled in the December quarter, and timely indicators suggest subdued growth in early 2023. Household consumption growth is expected to remain sluggish through this year as inflation and higher interest rates weigh on real disposable income. Consumption growth is expected to increase to around its pre-pandemic trend over 2024 as the effect of the earlier monetary policy tightening wanes and the cash rate decreases, inflation moderates, household wealth recovers and tax cuts support disposable income.

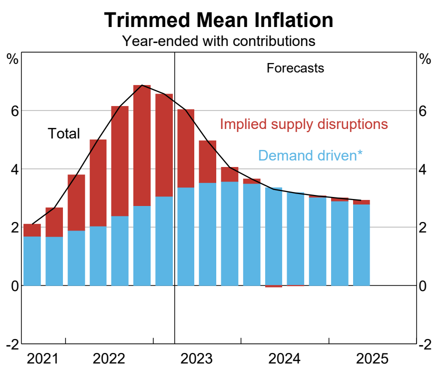
The recovery in consumption, alongside faster growth in public demand, supports a forecast pick-up in GDP growth in 2024. The outlook for non-mining business investment over the forecast period remains positive but has softened in response to weaker demand conditions. Export volumes are expected to grow strongly, driven by the ongoing rebound in tourism and education-related travel. Broadly corresponding growth in imports, including travel services, means trade is expected to have little net effect overall on GDP growth over most of the forecast period.

Graph 5.2



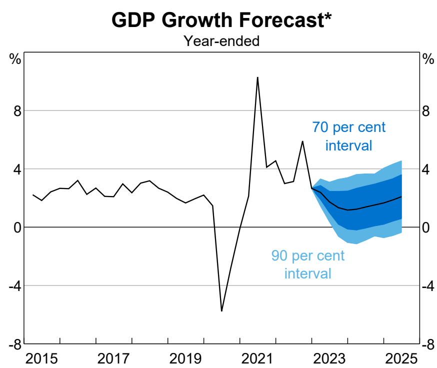
* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

Graph 5.3



* Predicted by Phillips curve model.
Sources: ABS; RBA

Graph 5.4



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

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

Household consumption growth is expected to remain subdued in 2023, and slowly increase over the rest of the forecast period (Graph 5.5). While strong labour market outcomes continue to support household income growth this year, consumption growth is expected to be dampened by higher consumer prices, net interest expenses, tax payable and the decline in housing prices seen over 2022. From the second half of 2023, consumption growth is expected to gradually increase towards its average rate prior to the pandemic, as a range of factors support both wealth and household disposable income growth. The recent stabilisation in housing prices supports household wealth relative to expectations in February. Additionally, a pick-up in real household disposable income growth is supported by lower inflation, as well as the legislated 'Stage 3' tax cuts from mid-2024.

The household saving ratio is expected to continue to decline over the next year or so, before increasing gradually from mid-2024.

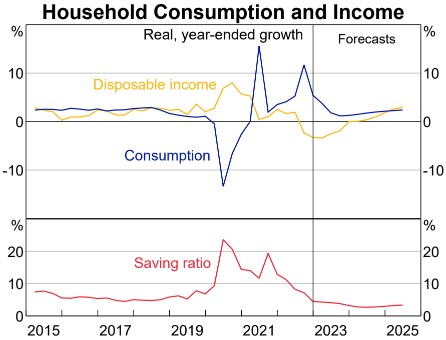
The outlook for private investment has softened

A large pipeline of residential and non-residential construction projects is expected to support activity over 2023. While the recent flow of data and information from the Bank's liaison program indicates that materials shortages and related supply chain issues have largely been resolved, shortages of skilled tradespeople remain a significant constraint on activity and are limiting the pace at which the pipeline of projects can be worked through. Most construction firms continue to report that they are operating at around full capacity.

Dwelling investment is expected to decline once the backlog of construction is worked through, consistent with the very weak demand for new detached dwellings (Graph 5.6). High construction costs, construction delays and housing price declines over 2022 have reduced the incentive to build new dwellings. This is consistent with the recent decline in building approvals, greenfield land sales and new home sales. Information from liaison with developers suggests that investor demand for higher density dwellings has been very weak in recent months. Although an increase in rental yields since the start of 2022 and strong inward migration may support investor demand in future, higher density housing supply is expected to respond with a significant lag due to long planning and construction lead times. After gaining planning approvals and pre-sales, the average apartment building takes more than two years to build.

Graph 5.5

Household Consumption and Income

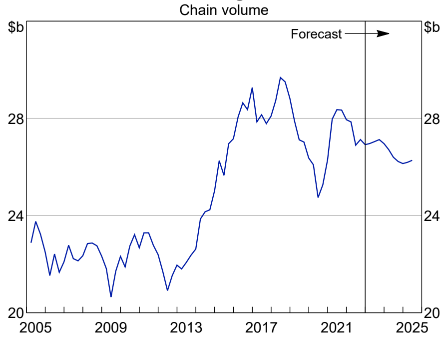


Sources: ABS; RBA

Graph 5.6

Private Dwelling Investment

Chain volume



Sources: ABS; RBA

Non-mining machinery and equipment investment is expected to remain at a high level over the forecast period. Information from the ABS Capital Expenditure survey suggests that firms' nominal investment intentions for the current financial year remain robust, though this partly reflects the higher cost of undertaking a given volume of investment. Intentions for the 2023/24 financial year are significantly weaker, and forward-looking measures of business conditions and confidence have softened. The resolution of supply chain pressures is expected to support investment in machinery and equipment in the near term.

Mining investment is expected to be broadly unchanged over coming years. While expansionary iron ore and LNG projects are expected to drive some growth over 2023, the vast majority of mining investment remains sustaining in nature and is intended to replace ageing infrastructure.

Public demand is forecast to remain at a high level

Public demand as a share of nominal GDP is expected to remain at a high level over the forecast period. A decline in pandemic-related spending is expected to weigh on public consumption throughout most of 2023. Further out, public consumption is expected to resume expanding, partly due to public spending programs such as the National Disability Insurance Scheme.

Public investment is expected to grow over the forecast period. The pipeline of public engineering work is anticipated to support a high level of public capital expenditures for several years. The speed of the rollout will continue to be affected by capacity constraints in the construction sector, particularly in the near term.

Education and travel exports will continue to recover

Export volumes are expected to continue to grow strongly over 2023, driven by services exports, as travel continues to recover to pre-pandemic levels. The expected number of international students studying in Australia over the next couple of years has been upgraded significantly. Resource exports are expected to grow gradually from the second half of 2023, supported by drier weather. Rural export volumes are expected to decline throughout the forecast period as growing conditions normalise following the conclusion of the third consecutive La Niña event.

The terms of trade are expected to increase in the March quarter, mostly driven by lower import prices, and to remain elevated but decline over the remainder of the forecast period as commodity prices decline, partly offset by a gradual easing in import prices (Graph 5.7).

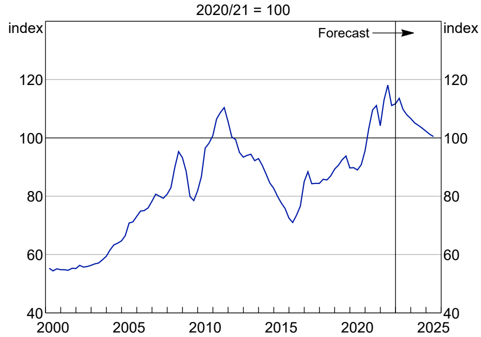
The unemployment rate is expected to increase as economic growth slows

Labour market spare capacity remains around multi-decade lows. Labour underutilisation (as measured by the unemployment rate and by people working fewer hours than they want) is expected to gradually increase as a result of subdued economic growth over coming years;

Graph 5.7

Terms of Trade

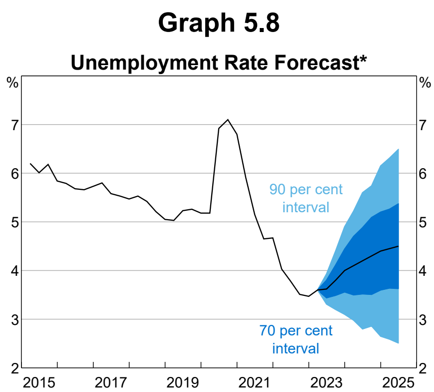
2020/21 = 100



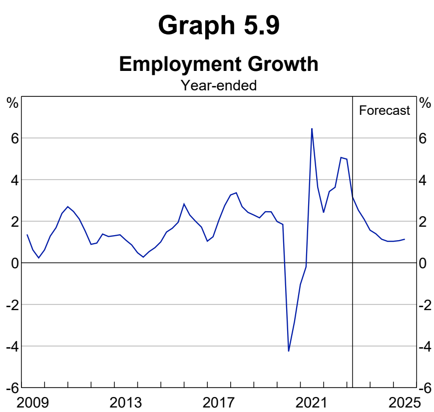
Sources: ABS; RBA

the unemployment rate is nonetheless expected to remain below pre-pandemic levels (Graph 5.8). Employment growth is expected to moderate, with average hours worked also expected to resume its longer term downward trend from late 2023 (Graph 5.9).

The balance between labour demand and supply has improved recently. The pick-up in overseas migration since the reopening of the international border should further help alleviate labour shortages in some industries over time in the face of solid demand for labour, while also adding to aggregate demand in the economy. Participation in the labour force is expected to be sustained around historically high levels over the forecast period. The effect of the cyclical slowing in the labour market is expected to be partly offset by structural trends, including higher female and older worker participation.



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA



Sources: ABS; RBA

Labour cost growth is expected to be solid

Labour cost growth picked up throughout 2022. The December quarter outcomes for wages and broader measures of labour income were generally softer than expected, suggesting that the very strong September quarter outcomes had overstated the underlying momentum in labour cost growth to some extent. Nonetheless, year-ended labour cost growth reached its highest levels in over a decade at the end of 2022. With productivity growth very weak over 2022, growth in unit labour costs was around multi-decade highs.

Timely indicators suggest that wages growth was solid in the March quarter of 2023. Firms in the Bank's liaison program report their wages growth has stabilised at around 4 per cent and expect growth to moderate in the year ahead. Market economists and unions expect wages growth to be around 3¾ to 4 per cent over the year ahead and to then moderate over the following year. Developments in state government wages policies have evolved broadly as expected a few months ago and support the view that public sector wages growth will increase over coming years.

Growth in the Wage Price Index (WPI) – a measure of changes in base wage rates for a given quantity and quality of labour – is expected to reach 4 per cent in the second half of 2023 before declining to 3¾ per cent in mid-2025 (Graph 5.10). The near-term outlook is lower than a few months ago, reflecting the weaker-than-expected December quarter WPI outcome, the signal from timely indicators of wages growth and the softer labour market outlook. The annual minimum and award wage decision by the Fair Work Commission and the 15 per cent wage increase for aged care workers will support wages growth later in 2023.

WPI growth is expected to ease in the second half of the forecast period as labour market capacity constraints become less binding. However, the expected easing in wages growth remains relatively modest, reflecting inertia in the wage-setting process, elevated inflation putting upward pressure on nominal wages in the near term and a still relatively tight labour market.

Broader measures of labour cost growth are expected to increase at a faster rate than the WPI over the forecast period as employers use bonus payments to retain or attract staff and as more hours are worked at overtime rates. These broader measures imply less of a decline in real incomes than suggested by the WPI measure (Graph 5.11). The forecast for labour costs is consistent with inflation returning to the Bank's target, provided productivity growth picks up back to pre-pandemic trends.

Key domestic uncertainties

Global financial instability could weigh on growth

If recent global financial stability concerns were to re-emerge and prompt tighter financial conditions and slower growth in the global economy, this could pose a downside risk to domestic economic activity. There could be direct effects on Australia's exports due to a slowdown in the growth of Australia's major trading partners, as well as a decline in the terms of trade if demand for commodities were to soften. Widespread financial instability elsewhere could also affect business and consumer sentiment. A loss of confidence in the global banking system or a rise in risk aversion could cause a tightening in domestic financial conditions, including by causing bank funding costs to increase and credit to become more expensive or less easily available, which could affect consumption and investment. However, the risk of financial contagion to Australia may be limited because, as set out in the April *Financial Stability Review*, Australia's banks are well regulated, well capitalised, profitable and highly liquid. As a result, they are well placed to continue supporting the domestic economy, even if economic conditions were to become materially worse than expected.

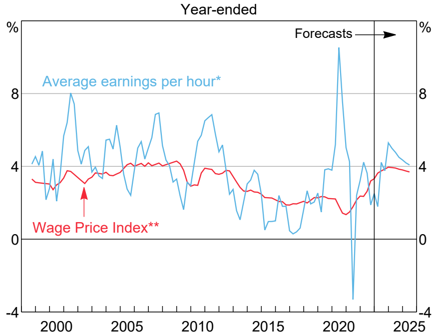
The outlook for household consumption is subject to competing forces

The outlook for household consumption remains a key uncertainty for domestic activity. Housing prices have stabilised recently and could increase faster than previously expected over the forecast period. This could lead to a

Graph 5.10

Wages and Earnings Growth

Year-ended

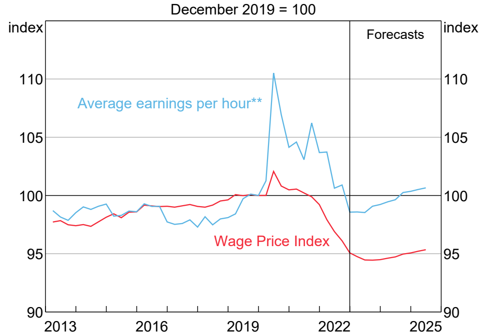


* Non-farm; includes social contributions.
** Excluding bonuses and commissions.
Sources: ABS; RBA

Graph 5.11

Real Labour Income*

December 2019 = 100



* Deflated using the headline Consumer Price Index.
** Non-farm.
Sources: ABS; RBA

more rapid turnaround in household consumption growth, including via increased housing turnover and increased ability to obtain credit. Further, many households built savings buffers during the pandemic; if households are more willing to spend from these liquid savings than from other forms of wealth, spending could be stronger than anticipated for a time. This would be reflected in a larger fall in the household savings ratio. Stronger-than-expected growth in domestic demand would see domestic inflationary pressures build further.

On the other hand, weakness in household consumption could persist for longer than expected if there is a resumption of housing price declines, or if weak real disposable income growth has a larger effect than expected, particularly on low-income households that typically have lower savings buffers. Many households are well placed to absorb higher interest rate costs without significant spending cuts. However, interest rates have risen quickly and there is a risk that some households with low savings buffers and high debt relative to incomes will have to adjust their spending sharply.

Inflation could be more persistent than expected

Underlying inflation is expected to take a couple of years to return to the inflation target. However, it is possible that the easing in inflation takes longer than this, consistent with the persistence in services inflation experienced overseas so far. In a high inflation environment, it is easier for firms to increase prices; people also tend to pay closer attention to changes in costs and prices than when inflation is low, and so may come to expect further large price increases. While margins outside of the mining sector have been broadly stable in recent years, firms may expand their margins as costs ease if demand remains sufficiently strong. Alternatively, there could be stronger feedback between wages and prices. In either case, inflation would be persistently higher throughout the forecast period, which increases the risk that inflation expectations become de-anchored. Recent outcomes for private sector labour cost growth suggest that the risk that prices and wages start to chase each other is lower than a few months ago. However, larger increases to minimum and award wages and the lifting or removal of wage caps by state governments could have greater spillover effects on the wages of other workers than currently expected.

Inflation could also be more persistent if productivity growth does not pick up, which would make the current outlook for labour costs more inflationary than anticipated. The forecasts presented above require productivity growth to increase to the relatively slow rates recorded in the years preceding the pandemic. Productivity growth is currently weaker than this, and that weakness could persist; that said, the effects of the pandemic have made it difficult to discern the underlying trend. Conversely, productivity growth could rise above the typical pre-pandemic rate if innovations implemented by firms during the pandemic begin to pay dividends.

Rent inflation could also be higher and more persistent than forecast. The pick-up in population growth is occurring at a time when the rental market is already very tight, and it will take time for supply to respond. Higher rents are likely to encourage the average number of people living in each dwelling to increase, which would be a reversal of the decline that occurred during the pandemic as people sought more space. It is possible that rents need to rise by more than expected to bring about this increase in household size. On the other hand, a larger increase in household size would moderate demand and price increases by more than expected.

Goods prices could decline significantly and weigh on inflation outcomes

The inflation forecasts presented above assume that goods prices stabilise at a high level but do not decline over coming years. Supply chain conditions are back around pre-pandemic norms and goods inflation has eased in most advanced economies. Large or widespread declines in goods prices would moderate inflation outcomes by more than currently expected. One way this could occur is if the simultaneous tightening of monetary policy across many economies affects demand by more than the sum of individual-economy effects would imply. Alternatively, strong competition for customers in an environment of weaker domestic demand could cause larger-than-expected price discounting. To give 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 inflation would be around the middle of the target range in the second half of 2024, instead of being above it.