Overview

The successful development of COVID-19 vaccines has improved the medium-term outlook for global growth. Vaccination programs are underway in a number of countries. As these are rolled out, health-related restrictions can be eased and many types of activity can return to something close to their pre-pandemic trends. In the near term, however, some momentum in the global economy has been lost, as infection rates have surged in a number of economies and lockdown measures have again become necessary. The recovery is likely to be bumpy and uneven, and dependent both on the health situation and ongoing fiscal and monetary policy support. Spare capacity will remain for some years, dampening inflationary pressures.

The domestic economic recovery has run faster than previously expected. This has been consistent with the pattern seen globally, of unexpectedly fast (but partial) recoveries after lockdown measures were lifted, as well as Australia's relatively better health outcomes. Fiscal policy has supported household and business cashflows, and the Victorian lockdown measures weighed less on economic activity than earlier assumed. Consumption has recovered faster, and dwelling and business investment have not been as weak as had been anticipated.

The Bank's forecasts have been revised to incorporate this stronger starting point. GDP is expected to have contracted by 2 per cent over 2020, a smaller decline than earlier anticipated. Growth of around 3½ per cent is expected over each of 2021 and 2022 as the recovery progresses.

In line with this recovery in activity, the labour market has also performed better than expected. Employment grew strongly over the latter part of 2020, and the unemployment rate declined to 6.6 per cent in December. Although underemployment remains high, the sharp increase during the height of the activity restrictions has mostly reversed. The participation rate has already returned to the historic highs seen just prior to the pandemic. But over 900,000 Australians remain unemployed, around 220,000 more than at the onset of the pandemic. Employment is likewise yet to recover completely – especially full-time employment – and some workers are still on reduced hours. This shortfall is particularly evident in the industries that have been most affected by health-related restrictions on activity and travel.

The outlook for the labour market has improved as a result of the better starting point and growth outlook. It now appears that the unemployment rate has already peaked. Although the end of the JobKeeper program in March creates some uncertainty for the near term, over the whole forecast period employment growth is expected to remain solid, consistent with the ongoing recovery in activity. The unemployment rate is expected to continue declining, but will still be around 6 per cent at the end of this year and 5½ per cent at the end of next year, reaching around 5¼ per cent by mid 2023.

Headline inflation has been volatile since the pandemic started. The introduction and subsequent reversal of various temporary policy support measures, such as free child care, have resulted in large price movements. Working in the opposite direction, prices of some retail items, especially household goods, were initially boosted in response to strong demand and supply disruptions. Most of these effects have now run their course. Housing-related inflation increased a little, as discounting of the prices of newly built homes eased in response to strong demand, and some temporary rent reductions expired.

Underlying inflation pressures remain subdued and are expected to be fairly muted in the period ahead. Spare capacity in the labour market remains elevated, and wages growth has eased further from already low rates. Many employers have responded to the economic challenges of the pandemic by delaying wage increases, imposing wage freezes and, in some cases, applying temporary wage cuts. Forward indicators suggest wages growth will remain soft this year.

Both underlying price inflation and wages growth are expected to remain below 2 per cent over the forecast period, out to mid 2023. Trimmed mean inflation is expected to be 1¼ per cent over 2021 and 1½ per cent over 2022. For inflation to be sustainably within the Bank's target range of 2–3 per cent, a period of labour market tightness that leads to faster wages growth is needed. However, even the latest, upgraded, forecasts for economic activity and employment still imply a degree of spare capacity and slow wages growth over coming years.

The bounce-back in the Australian economy would not have been possible without the successful public health outcomes. Even so, the speed of the recovery has also underlined the importance of timely and substantial policy support. The JobKeeper program preserved employment relationships and supported the incomes of both households and businesses. Increased social assistance payments, temporary rent relief and loan repayment deferrals have also assisted, as did the lower debt-servicing costs resulting from the monetary policy measures.

Unusually for a period of rising unemployment, both household income and business profits increased. This supported the sharp recovery in household consumption, after many types of spending were constrained by health-related restrictions in the June quarter. How spending responds to the tapering of some fiscal support measures remains a source of uncertainty for the outlook.

Policy support has also been instrumental in moderating the declines in housing and business investment. Demand for detached houses has been brought forward in response to various government incentives. Tax incentives have also encouraged business investment in machinery & equipment, though business investment has been soft for some time and is still expected to lag the broader economic recovery. The outlook for public investment has strengthened, with several states foreshadowing a considerable increase in expenditure in their recent budgets.

Experience overseas has also highlighted the role of fiscal and monetary policy support, both during upsurges in infection rates and once the health situation improves. Governments in several countries have announced additional fiscal support packages in recent months, in response to renewed virus outbreaks or to support the economic recovery. Several central banks have recently increased the size and/or extended the timeframe of their asset purchase programs. Some have also introduced or enhanced lending facilities to support the flow of credit to households and businesses.

The COVID-19 pandemic has induced considerable shifts in the pattern of demand, most notably away from services, which have been most affected by activity restrictions, towards goods. This has supported a rapid recovery in global trade and industrial production. The export sectors in China and some other Asian economies have therefore expanded strongly, particularly for producers of semiconductors and household goods. These economies have also benefited from relatively good control over the virus, so their domestic economic recoveries are also generally more advanced than elsewhere.

The strong rebound in industrial demand has supported an increase in commodity prices in recent months. Strong growth in Chinese steel production, both for industrial uses and domestic construction, has boosted iron ore prices and thus Australia's terms of trade. It has also put upward pressure on the value of the Australian dollar, which is in the upper end of the range of recent years.

As in previous *Statements*, the forecasts are presented in the form of 3 scenarios, this time representing different outcomes related to the spread of the virus and the rollout of vaccines. The degree of uncertainty on this dimension has narrowed as the Australian public health system has prevented several small outbreaks from spreading more widely. The baseline forecast assumes that no further large outbreaks of COVID-19 occur in Australia, though there could be a few small outbreaks on the scale seen over the past couple of months. Domestic activity restrictions are assumed to ease over the course of this year. Australia's international borders are assumed to remain closed until at least the end of the year.

In the downside scenario, further large outbreaks require broad activity restrictions to be reimposed, though not the extended lockdowns contemplated in previous downside scenarios. In this scenario, the unemployment rate remains just below 7 per cent for most of 2021 and declines only gradually thereafter.

The upside scenario assumes a sequence of positive health outcomes that enable a faster easing of restrictions on activity and boost confidence and thus spending. The unemployment rate would fall more quickly under this scenario, falling below 5 per cent by the end of next year. Inflation would also rise a little faster, but would still be below 2 per cent by end of the forecast period in mid 2023.

Monetary policy has helped support the economy by ensuring that financial conditions remain highly accommodative. The Bank announced another package of monetary policy measures in November. This included lower rates for the cash rate target, bond yield target, Term Funding Facility and remuneration on exchange settlement balances. It also included a program to purchase $100 billion of government bonds over a period of about 6 months.

Last year's monetary policy package is working broadly as expected and is supporting the economy. The changes have contributed to a further easing in financial conditions and helped ensure that the banking system is able to provide the credit that is needed for the recovery. Short-term interest rates have declined further to historical lows; together with the reduced interest rate on the Term Funding Facility, this has lowered bank funding costs and flowed through to even lower borrowing rates for households and businesses, and thus stronger cash flows. With 3 months' experience, the bond purchase program is working as intended, and government bond markets continue to function well. While the brighter global outlook has lifted long-dated bond yields globally, Australian long-term government bond yields are about 30 basis points lower because of the program than they otherwise would have been. The exchange rate is also lower than it otherwise would have been.

Accommodative financial conditions have supported balance sheets and lifted asset prices, including housing prices. New lending to owner-occupiers has picked up noticeably in recent months, and growth in housing credit to owner-occupiers has also increased. Growth in investor credit and business credit is weak. Firms have been raising additional funds in debt and equity markets, and some firms have benefited from higher cash flows and retained earnings.

At its February meeting, the Reserve Bank Board decided to maintain the targets of 10 basis points for the cash rate and the yield on 3-year Australian Government bonds, as well as the parameters of the Term Funding Facility. The Board remains committed to do what it can to support the economy through the recovery, by maintaining highly supportive monetary conditions until its goals are achieved, which is still some way off. In light of the outlook and the international context, the Board decided to purchase an additional $100 billion of bonds issued by the Australian Government and states and territories when the current bond purchase program is completed in mid April. These additional purchases will be at the current rate of $5 billion a week.

The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest.