Statement on Monetary Policy

FEBRUARY 2022

RESERVE BANK OF AUSTRALIA

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Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. The International Environment

Global economic growth picked up in the second half of 2021, supported by the widespread lifting of activity restrictions following increases in vaccination coverage. While there have been and continue to be challenges arising from the rapid spread of the Omicron variant of COVID-19, the impact on economic activity is less than in earlier outbreaks. The recovery is most progressed in advanced economies, underpinned by strong household balance sheets, a rapid recovery in labour markets, and supportive fiscal and monetary policies. Economies in the Asian region have also resumed growing in recent months, following the disruptions associated with the outbreak of the Delta variant in the middle of last year. Economic growth in China picked up in the December quarter, though headwinds remain. The Chinese authorities have eased monetary policy, and domestic economic policy settings are expected to be less of a drag in 2022 as greater emphasis is placed on supporting growth. However, broader and more frequent lockdowns in response to COVID-19 outbreaks could disrupt growth, and longer-term policy challenges in China remain. More generally, GDP in Australia's major trading partners is forecast to grow strongly in the coming year, before slowing to slightly below average rates in 2023.

Global supply chains remain under pressure, particularly as the spread of COVID-19 disrupts labour supply and transportation networks. Inventories remain low across a number of commodity and non-commodity sectors, including in the retail supply chain. Even so, some sources of upstream price pressures, such as shipping costs and semiconductor prices, appear to have peaked. While wages growth has picked up sharply in only a few countries, inflation has generally been higher, more persistent and more broad-based than central banks previously expected.

Central banks in advanced economies generally expect inflation to moderate in 2022; however, a number forecast inflation to exceed their targets for a time and for labour markets to continue to tighten. Given this, central banks in most advanced economies have ceased or reduced the pace of asset purchases. Some have also increased their policy rates and market pricing suggests that a number of others are expected to do so soon. Yields on government bonds have increased in advanced economies; financial conditions have tightened but overall remain accommodative. In emerging market economies, a number of central banks outside Asia have continued to tighten policy in response to inflation that remains persistently above target.

Economic activity has been relatively resilient to the Omicron outbreak …

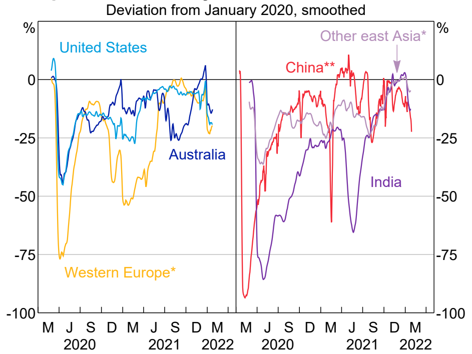
The emergence of the Omicron variant in November 2021 has led to declines in population mobility in many advanced economies over recent months (Graph 1.1). However, these declines have generally been smaller than during previous outbreaks, reflecting the lighter role for state-mandated lockdowns during this current wave. This can be traced to Omicron infections generally resulting in lower rates of hospitalisations and deaths, compared with earlier strains of COVID-19. Surveys of business conditions and other timely indicators signal an ongoing but slower expansion in economic activity in most advanced economies around the turn of the year (Graph 1.2). Mobility in India declined in January, though by much less than it did during its mid-2021 Delta outbreak. Economic activity in much of east Asia has continued to recover from that region's Delta outbreaks, with Omicron infections only recently beginning to increase. In China, where authorities have continued to impose intermittent localised lockdowns in an effort to suppress the virus, overall mobility has been resilient in recent months.

Global economic activity had generally been robust prior to recent Omicron outbreaks. GDP in North America and Europe increased strongly over the second half of 2021 following the easing of activity restrictions around midyear (Graph 1.3). Likewise, economic growth rebounded in Japan, India and most of east Asia in the December quarter, after contracting or slowing sharply in the June and September quarters due to the effects of the Delta outbreaks in those areas. Chinese economic activity was subdued by historical standards throughout most of 2021 (as discussed below), but GDP in China recovered to pre-pandemic trends more quickly than other large economies. In a few large emerging market economies outside Asia (such as South Africa and Russia), GDP contracted or grew only modestly in the latter part of 2021. Output in most advanced economies is now back to or above its pre-pandemic level, though trends in activity in emerging markets have been more disparate.

Graph 1.1

Population Mobility – Retail and Recreation

Deviation from January 2020, smoothed



* GDP-weighted averages; other east Asia includes Australia's main east Asian trading partners and Western Europe includes the euro area and the United Kingdom.

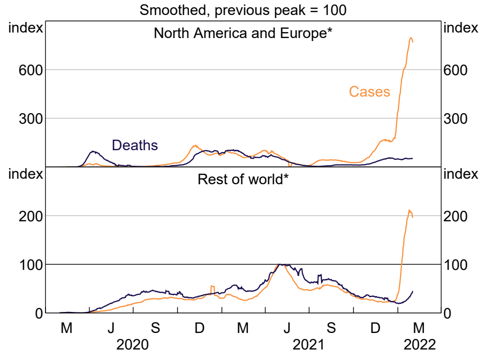
** Public transport (metro) passenger volumes in eight major Chinese cities.

Sources: Google LLC (2021), 'Google COVID-19 Community Mobility Reports', viewed 28 January 2022. Available at <https://www.google.com/covid19/mobility/>; RBA; WIND Information

Graph 1.2

COVID-19 – New Cases and Deaths

Smoothed, previous peak = 100



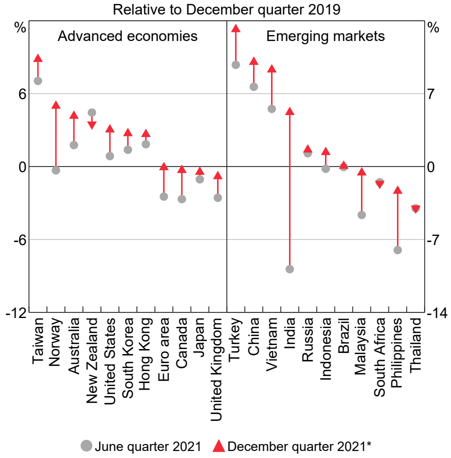
* Previous peak was in January 2021 for North America and Europe; previous peak was in May 2021 for rest of world.

Sources: JHU CSSE; Our World in Data; RBA

Graph 1.3

GDP

Relative to December quarter 2019



* Forecasts used where December quarter GDP has not yet been reported.

Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

… and is expected to grow strongly in 2022

GDP in Australia's major trading partners is projected to exceed its historical average in 2022 (with year-average growth of 4½ per cent), before easing to a slightly-below-average rate in 2023 (Graph 1.4). The overall GDP forecast for Australia's major trading partners remains broadly the same as in the November *Statement*, with limited near-term impact from the spread of Omicron.

In most advanced economies, GDP is forecast to return to its pre-pandemic trend path by mid-to-late 2022. The Chinese economy is also forecast to continue expanding around its pre-pandemic trend during 2022, though a gradual slowing in potential economic growth in China is expected over coming years. By contrast, the strong growth forecast for many emerging market economies over coming years is not expected to be sufficient to make up for the significant loss of output during the pandemic. This is especially evident for Asian emerging markets, in part because of their reliance on international tourism.

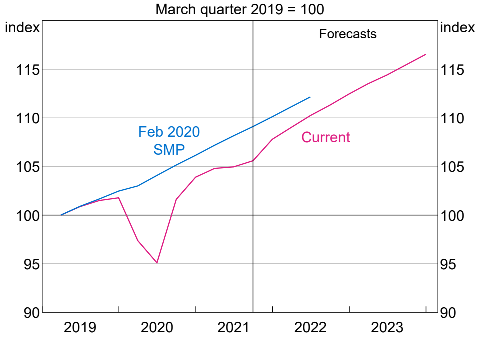
The global economic outlook is subject to a range of risks that are broadly balanced. On the upside:

- Household consumption could be stronger than anticipated over the next few years, given healthier household balance sheets, expansionary financial conditions and pent-up demand.
- It is also possible that the health impacts of COVID-19 in the period ahead are more benign than currently assumed in the forecasts, further supporting growth in private demand.

Graph 1.4

Australia's Major Trading Partner GDP

March quarter 2019 = 100



Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

On the other hand, there are a number of downside risks to the global economic outlook, including:

- Health-related developments could be worse than assumed. Though Omicron infections tend to be less severe than earlier strains, very high case numbers could affect mobility substantially as more people become ill, have to self-isolate or choose to restrict their activities to avoid infection. Tighter restrictions on activity could also be reintroduced. If the current Omicron wave persists, or a more dangerous strain of COVID-19 emerges, supply chains, labour supply and economic growth would all be disrupted.
- The upswing in global inflation could be larger and/or more persistent than currently forecast. If so, it would be likely to trigger an earlier and more significant tightening in global monetary policy than forecast. A sharp rise in policy rates, particularly in the United States, could in turn prompt a sharp rise in global bond yields and a broader tightening in global financial conditions via a range of channels, including higher financial market risk premiums and an increase in capital outflows from emerging market economies. Such an outcome could occur if demand remains strong and the productive capacity of the global economy is lower than assumed as a result of various changes induced by the pandemic, particularly to labour supply and product supply chains.

- Authorities in China may find it challenging to balance various policy trade-offs. There is the challenge of lifting the pace of economic growth through less-restrictive policy settings while continuing to address concerns about excessive leverage, particularly in the property sector. There are also risks to the economy if authorities struggle to control outbreaks of COVID-19, given China's current approach of seeking to suppress the virus through localised lockdowns.

Households are driving the recovery

Consumer spending maintained a strong pace of growth through the second half of 2021. Aggregate household consumption in advanced economies surpassed its pre-pandemic level in the September quarter of 2021, after falling by more than 10 per cent in the first half of 2020 (Graph 1.5). The recovery in consumption has been strongest in the United States. Goods consumption has remained very strong in advanced economies, even as services consumption has picked up.

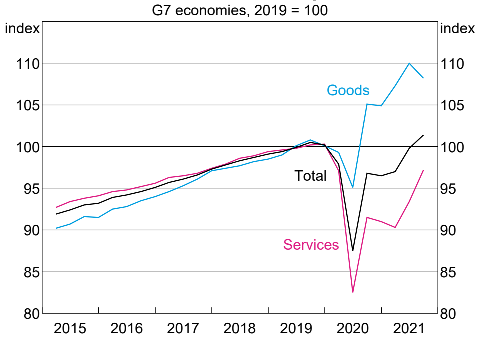
Household finances are supporting continued strong consumption growth in advanced economies. Many households accumulated significant savings during the pandemic as incomes rose and consumption opportunities were constrained. Outside the United States, saving ratios are still generally elevated (Graph 1.6). As a result, consumption could grow faster than income for a period while saving ratios return to historically normal levels; indeed, households might dip into the substantial extra savings they have accumulated over the pandemic, leading to even stronger consumption growth. Over the past year, strong growth in labour income in advanced economies has offset the effect of the unwinding of pandemic-related fiscal support to households. In addition, household wealth has risen strongly. Household income in Japan will be boosted further by the recently announced economic support package, which provides cash transfers to low-income households.

Business investment has increased only modestly in recent quarters, and remains well below pre-pandemic levels in a number of advanced economies. However, investment growth has been very strong in high-income Asian economies, as companies have expanded the capacity of semiconductor and other consumer goods manufacturing. Global business investment is likely to increase more robustly in 2022, supported by expectations for strong global growth and because the higher prices induced by supply constraints will

Graph 1.5

Household Consumption

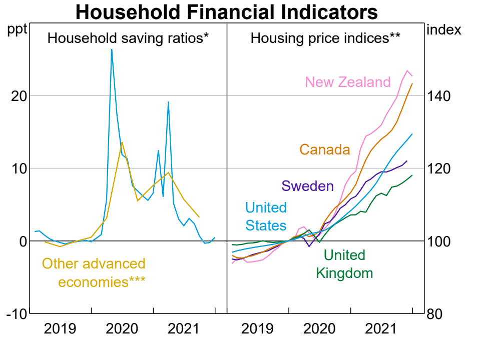
G7 economies, 2019 = 100



Sources: RBA; Refinitiv

Graph 1.6

Household Financial Indicators



* Deviation from 2015–2019 average ratio.

** December 2019 = 100.

*** GDP-weighted average of G7 economies excluding United States and Japan.

Sources: national sources; RBA; Refinitiv encourage an expansion in capacity to address those constraints. Fiscal policy is also shifting towards supporting investment. For instance, in the United States, the recently legislated Bipartisan Infrastructure Package will provide substantial support for infrastructure investment. Funding associated with the Recovery Plan for Europe and accelerated depreciation tax incentives in the United Kingdom should also contribute to a favourable environment for European business investment.

Chinese economic growth has stabilised but policy challenges remain

Economic growth in China was solid in the December quarter, after slowing considerably in the September quarter. Strong external demand continued to support manufacturing activity and exports (Graph 1.7). In addition, some earlier headwinds eased – specifically, automobile, steel and concrete production have all stabilised in recent months as supply constraints eased a little, targets for lower steel production were met and authorities relaxed the stance of fiscal policy. While the Chinese authorities have maintained a strategy of suppressing the virus, household consumption held up reasonably well through much of 2021 despite a number of localised COVID-19 outbreaks and the targeted lockdowns applied in response; these lockdowns have nonetheless slowed the pace of recovery in some parts of the services sector.

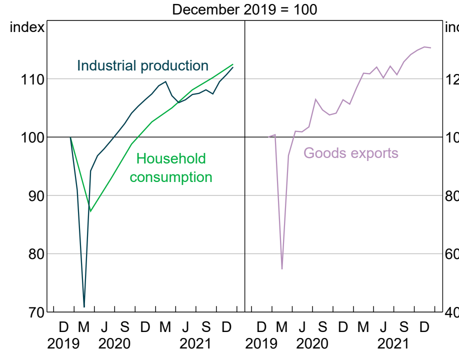
Conditions in China's residential property sector remain weak following a period of regulatory tightening. However, property sales have been steady since August, at around 2019 levels (Graph 1.8). Authorities have also eased financial conditions slightly to limit further falls in sales, by encouraging a modest relaxation of bank financing restrictions for healthy property developers, taking actions to assure buyers that pre-sales will be honoured and providing direct support to first home buyers. Regardless, the authorities have maintained their commitment to reducing leverage in the sector (sustaining pressure on developers' finances) and are not seeking to engineer a sharp recovery. Construction activity is still likely to fall over coming months, given sustained weakness in construction starts recently and a reduced pipeline of work. Nonetheless, expectations of a modest recovery in construction activity later this year appear to be providing some support to current demand for steel and, in turn, iron ore.

Fiscal policy has weighed on growth in China over the past year. The consolidated fiscal balance of Chinese governments was around 3 percentage points tighter in 2021 than in 2020 (Graph 1.9). The impact of fiscal tightening has been most apparent in infrastructure

Graph 1.7

China – Activity Indicators

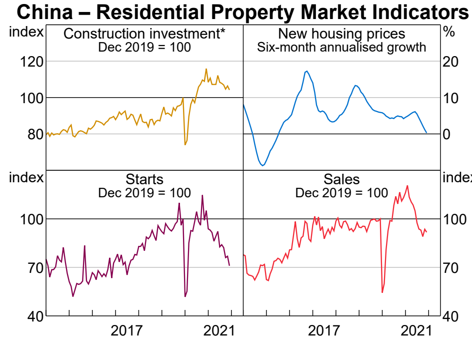
December 2019 = 100



Sources: CEIC Data; RBA

Graph 1.8

China – Residential Property Market Indicators



* Residential real estate investment excluding the purchase of land.

Sources: CEIC Data; RBA

investment, which has declined steadily since late 2020. However, fiscal expenditure has increased notably in recent months and issuance of infrastructure-linked government bonds has accelerated. Statements from Chinese authorities point to a further recovery in fiscal spending and infrastructure-related construction over the first half of this year, adding further support to demand for Australia's commodities exports.

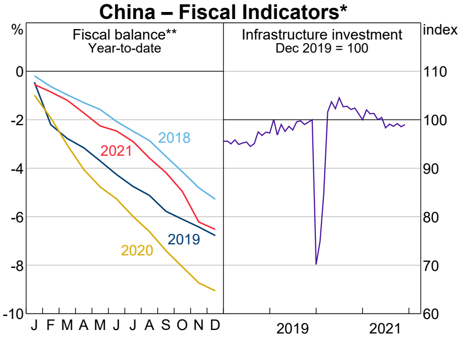
Chinese authorities have eased financial policies

Since the previous *Statement*, the People's Bank of China (PBC) has eased monetary policy in several ways. It has lowered the reserve requirement ratio for most banks by 50 basis points and reduced several of its main policy interest rates – the one-year medium-term lending facility (MLF), and the seven-day and 14-day reverse repurchase agreements – by 10 basis points (Graph 1.10). The policy rate reductions have passed through into Chinese Government bond yields, particularly at shorter maturities (Graph 1.11). There have been modest declines in lending rates to households and businesses, as reflected in reductions in the one-year and five-year Loan Prime Rates (LPRs) quoted by banks. The PBC also began some targeted funding programs in December, such as issuing low-cost loans to banks to fund projects that reduce carbon emissions, and it announced new tools to support small and micro enterprises by converting pandemic-related loan deferrals into longer-term funding. These measures have been accompanied by statements from officials emphasising the need for greater support for the economy.

The recent easing in Chinese financial conditions will support credit growth, which slowed a little over the past year (Graph 1.12). Indeed, growth in total social financing (TSF) has stabilised in year-ended terms since September, and over recent months has been supported by stronger government bond issuance after local authorities were encouraged to bring forward

Graph 1.9

China – Fiscal Indicators*



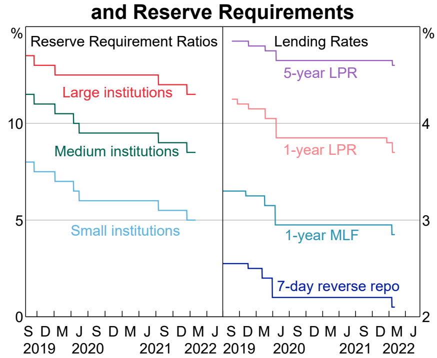
* Seasonally adjusted by the RBA.

** Consolidated measure that includes central government, local government and government funds; as a share of annual GDP.

Sources: CEIC Data; RBA

Graph 1.10

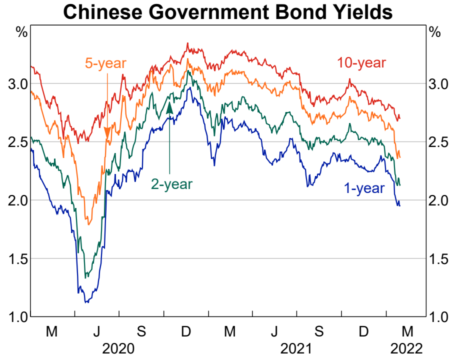
Chinese Lending Rates and Reserve Requirements



Sources: CEIC; RBA

Graph 1.11

Chinese Government Bond Yields



Sources: CEIC; RBA

their fiscal expenditure plans. Overall, TSF growth over 2021 was consistent with authorities' target for growth to be in line with nominal GDP.

The Chinese renminbi remains around its highest level in recent years against the US dollar, having appreciated by over 8 per cent on a trade-weighted basis since the beginning of 2021 (Graph 1.13). In December, the PBC increased the reserve requirement for foreign currency deposits for the second time that year. This requires banks to hold more foreign currency in reserve instead of converting it into renminbi, which should slow the renminbi's appreciation. Trade surpluses and foreign investment continue to support the renminbi, with significant foreign inflows to China's securities markets in the December quarter.

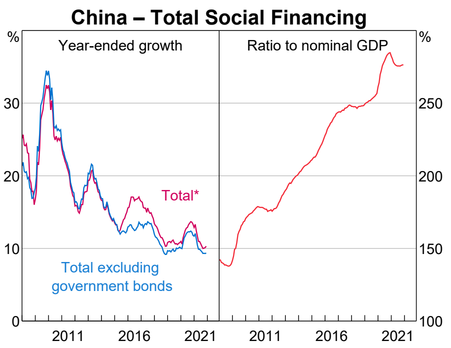
Private Chinese property developers remain under stress

Financial conditions have remained very tight for many private Chinese property developers. A number of major developers defaulted on US-dollar bonds (including Evergrande and Kaisa), extended maturities of bonds or defaulted on trust loans in recent months. To date, these developments have had limited effect on broader financial markets. The larger developers experiencing stress have around 40 per cent of their outstanding bonds coming due in 2022. Bond yields had increased sharply for several privately owned developers, including some of the country's largest developers, but retraced some of this increase on reports that authorities may relax restrictions on developers' access to deposits on pre-sold properties (Graph 1.14). Bond yields have remained stable for most state-owned developers. The PBC has indicated a preference for using project mergers and acquisitions to reduce risks in the sector, whereby more financially stable developers acquire projects from stressed developers. Equity prices for banks and state-owned property developers have increased amid signals of potential policy easing, while the broader equity indices have declined in line with global equity indices (Graph 1.15).

Upstream price pressures in the global economy remain strong, but may have peaked in some cases

Some non-labour input costs are showing signs of stabilising at elevated levels. This is particularly evident in shipping costs and the price of semiconductors, both of which rose rapidly in the year or so following the onset of the pandemic (Graph 1.16). Slowing growth of input costs will, over time, alleviate upstream

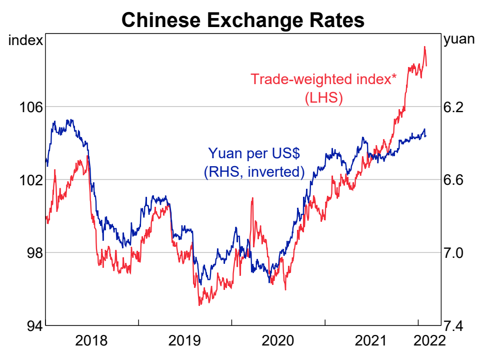
Graph 1.12



* Measure targeted by authorities, which incorporates net government bond issuance; includes local government bonds issued to refinance and substitute for state-backed corporate debt; RBA estimates prior to 2016.

Sources: CEIC; RBA

Graph 1.13



* Indexed to 1 January 2018 = 100.

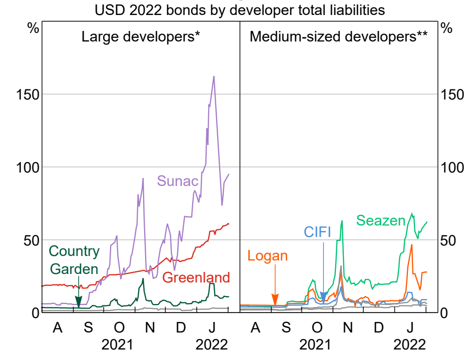
Sources: Bloomberg; China Foreign Exchange Trade System; RBA inflationary pressures for firms. However, some firms retain considerable pricing power because of the ongoing strength in goods demand and the persistence of supply chain bottlenecks; supplier delivery times remain stretched, and manufacturing output remains disrupted in sectors such as automobiles, where production has been relatively slow to recover. Retail inventory-to-sales ratios in the United States also remain very low (Graph 1.17). Low inventory levels would amplify the effects of any additional disruptions in global supply chains – including those arising from the Omicron outbreak – and prolong the resolution of supply bottlenecks as firms seek to rebuild inventories while simultaneously meeting ongoing strong demand for goods.

Energy prices remain elevated (Graph 1.18). The sharp increase in global gas prices over the past year has been driven primarily by developments in Europe, where strong demand and an inability to increase imports of gas has caused inventories to fall from already low levels. This has lifted prices globally, as LNG suppliers have diverted shipments from Asia, despite Chinese demand continuing to grow. Thermal coal prices also increased sharply in mid-2021, in response to a substantial increase in Chinese electricity demand and some disruptions to Chinese domestic supply. However, Chinese authorities

Graph 1.14

Chinese Developer Bond Yields

USD 2022 bonds by developer total liabilities



* Developers with liabilities more than CNY500 billion.

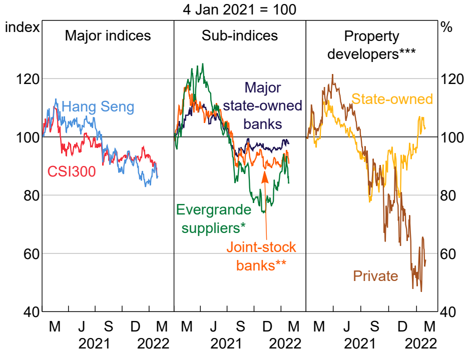
** Developers with liabilities of CNY100 billion–CNY500 billion.

Sources: Bloomberg; RBA

Graph 1.15

Chinese Equity Prices

4 Jan 2021 = 100



* Excluding Skshu Paint.

** Excluding China Merchants Bank.

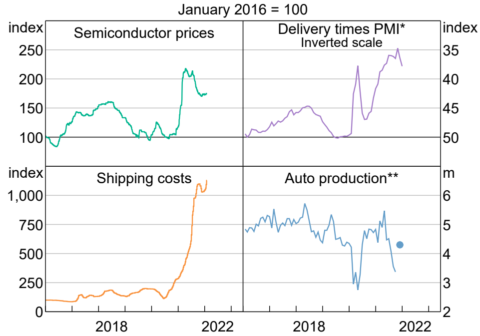
*** Largest developers excluding those that have defaulted on bonds.

Sources: Bloomberg; Macquarie Research; RBA

Graph 1.16

Supply Indicators

January 2016 = 100



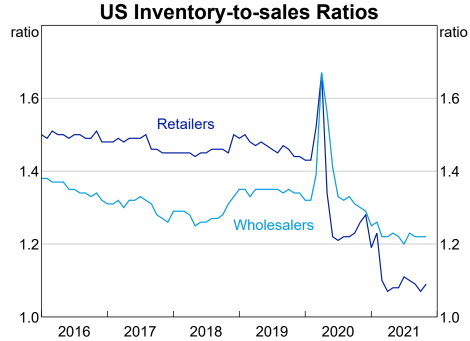
* Purchasing Managers' Index.

** Top five producing countries; dot indicates projection for November.

Sources: IHS Markit; RBA; Refinitiv

Graph 1.17

US Inventory-to-sales Ratios



Sources: RBA; US Federal Reserve

Table 1.1: Commodity Price Growth[(a)]
SDR terms; percentage change

	Since previous *Statement*	Over the past year
Bulk commodities	41	46
– Iron ore	58	–17
– Coking coal	10	343
– Thermal coal	57	219
Rural	3	29
Base metals	12	36
Gold	0	–2
Brent crude oil[(b)]	10	69
RBA ICP	8	26
– Using spot prices for bulk commodities	23	44

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices.

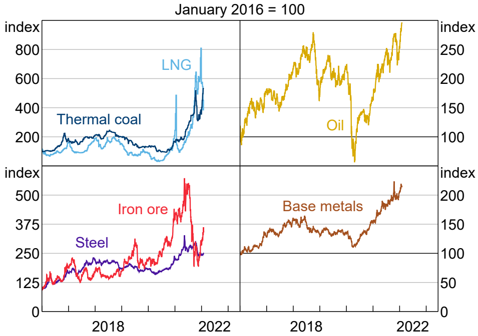
(b) In US dollars.

Sources: Bloomberg; IHS; RBA

subsequently facilitated an increase in coal production that has partially alleviated this pressure. Oil prices have similarly been volatile. Russia–Ukraine tensions and tight supply have contributed to prices climbing further, offsetting an earlier fall in November as reports of the Omicron variant emerged. Oil prices are currently at their highest level since 2014 and around 60 per cent higher than a year ago.

Iron ore prices have also been very volatile in recent months but, in contrast to energy commodities, remain well below the historically high level they reached in early 2021 (Table 1.1). Iron ore prices fell early last year as Chinese authorities enforced steel production curbs. However, prices have retraced about half of this in the past month or two as the outlook for steel demand from the real estate and infrastructure construction sectors strengthened. Base metal prices remain elevated due to strong demand and rising energy prices. Prices for rural commodities overall are well above pre-pandemic levels.

Graph 1.18
Commodity Prices
January 2016 = 100



Sources: Bloomberg; IHS Markit; RBA; Refinitiv

Labour markets are generally tight, but the strength of wages growth varies

Employment growth remains strong and broad-based in most advanced economies. Unemployment rates typically fell by 1–3 percentage points over 2021, and are back around the levels prevailing before the onset of the pandemic (Graph 1.19). By contrast, in a few economies participation rates have recovered only modestly over the past year and remain notably below pre-pandemic levels. This is particularly the case in the United States where health concerns and an increase in retirements have been prominent. Labour supply is also currently being disrupted in many countries by record high numbers of people isolating because of exposure to COVID-19. Job vacancies are likewise at record highs in many economies, exacerbated by labour-matching challenges such as higher-than-normal rates of retirements and resignations, changes in the composition of labour demand, vaccine mandates and reduced immigration.

Wages growth has picked up sharply in a few countries, notably in the United States and the United Kingdom (Graph 1.20). In these economies, participation rates remain well below pre-pandemic levels, while labour demand is strong. Wages growth has been broad-based across industries, though strongest in hospitality. In addition to paying higher wages, firms in these countries report paying hiring and performance bonus payments more commonly than before the pandemic. By contrast, wages growth has remained stable at low levels in a number of other countries where unemployment rates are low but labour supply has largely recovered, such as in the euro area, Canada and Australia.

Inflation has remained high as services inflation has picked up

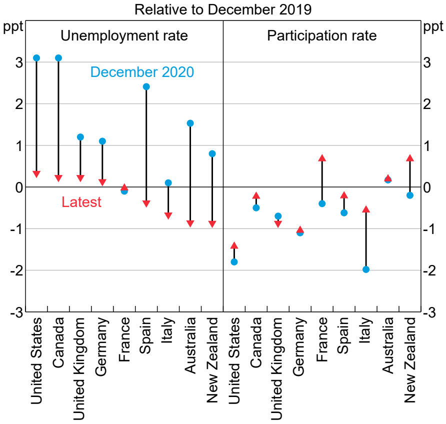
Consumer price inflation is well above central banks' inflation targets in a range of advanced and emerging economies (Graph 1.21). The substantial pick-up in both headline and underlying inflation in advanced economies was initially driven by higher goods price inflation. However, inflation in services has lifted significantly in recent months, driven by stronger housing services inflation and a recovery in the demand for, and prices of, some pandemic-affected services (Graph 1.22). The acceleration in services inflation has been a little faster in economies that are recording high wage inflation, but has also picked up strongly in economies where wages growth is contained. Headline inflation has increased more than core inflation, typically as a result of large increases in global fuel prices and electricity costs.

Asia has generally been an exception to these developments in global inflation. Underlying inflation in most Asian countries remains below its pre-pandemic average, especially in middle-income Asian economies where output remains depressed. Nonetheless, inflation has lifted to be above historical average rates in those economies where economic activity has rebounded more strongly, such as Taiwan, Korea

Graph 1.19

Labour Market Indicators

Relative to December 2019

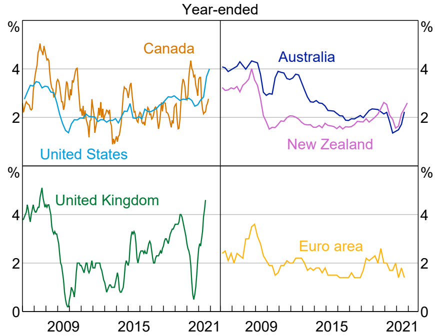


Sources: Destatis; RBA; Refinitiv

Graph 1.20

Wages Growth*

Year-ended



* Labour cost indices used where available; compositionally controlled average earnings for Canada and the United Kingdom.

Sources: BoE; RBA; Refinitiv; Statistics Canada and Singapore. The rise in inflation in these countries has been driven by services prices.

Central banks in most advanced economies have tapered or ceased asset purchases …

Central banks in advanced economies have provided significant monetary policy stimulus to support the economic recovery. But many central banks have tapered or ceased their asset purchases as employment has grown strongly and larger, more persistent inflationary pressures than initially expected have led central banks in most advanced economies to lift their inflation forecasts for 2022. Most central banks expect inflation to continue to exceed their targets for a time, but to moderate to be closer to their targets by the end of 2022 as supply constraints ease, aided in some cases by the modest withdrawal of monetary policy stimulus.

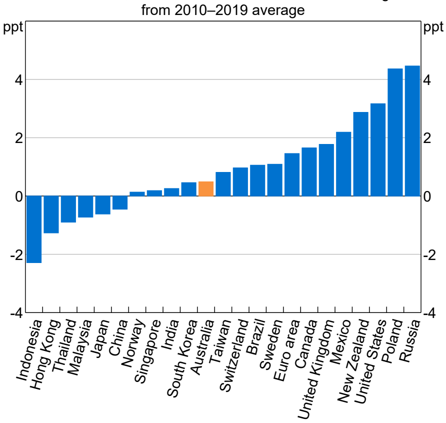
The Bank of England (BoE) and Sveriges Riksbank concluded net asset purchases in December 2021 as planned, while the Reserve Bank of New Zealand (RBNZ) and the Bank of Canada (BoC) ended their purchases earlier in 2021 (Graph 1.23; Graph 1.24). The US Federal Reserve (Fed) is now widely expected to complete net purchases in March, several months earlier than had been previously expected. At its December meeting, the Fed announced a doubling of the speed of its tapering process in response to an increased risk that elevated inflation outcomes will persist as well as further improvement in the labour market. The European Central Bank (ECB) also confirmed that it will cease purchases under its pandemic-era program in March 2022. In contrast, pre-pandemic-era asset purchase programs at the ECB and Bank of Japan (BoJ) are expected to continue for some time.

Even though central banks are tapering, or have concluded their pandemic-related asset

Graph 1.21

Core Inflation*

Year-ended, deviation of current three-month average from 2010–2019 average



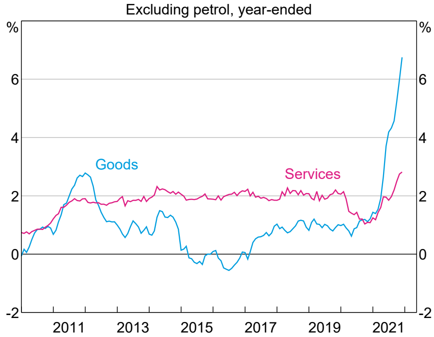
* Headline measure used for Hong Kong.

Sources: CEIC Data; RBA; Refinitiv

Graph 1.22

Goods and Services Inflation – G7

Excluding petrol, year-ended

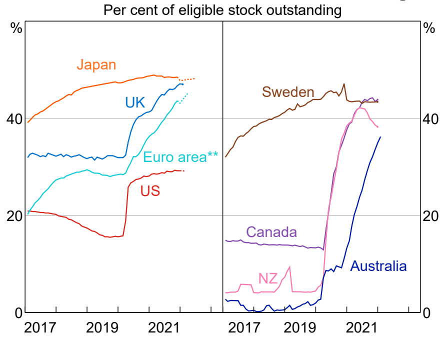


Sources: RBA; Refinitiv

Graph 1.23

Central Bank Government Bond Holdings*

Per cent of eligible stock outstanding



* Central government debt only for all countries except the euro area. Dashed lines represent forecasts based on announced purchase programs or recent pace of purchases.

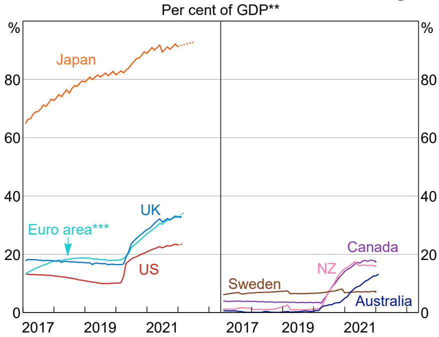
** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.

Sources: Central banks; debt management offices; RBA; Refinitiv purchases, their large holdings of assets will continue to contribute to accommodative financial conditions (alongside low policy rates and term funding schemes). Several central banks have announced plans to keep the total size of their asset holdings steady for a time by reinvesting proceeds from maturing bonds. For example, both the BoC and the BoE will maintain a roughly stable level of bond holdings until they increase their policy rate to a certain threshold. Fed Chair Powell has indicated that the Fed will use at least one meeting after it first raises the policy rate to make decisions about its plans for reinvestment and run-down of the balance sheet, suggesting that the Fed could begin reducing the size of its balance sheet from the middle of this year. This approach is in contrast to 2014–2017, when the Fed maintained a constant level of asset holdings until the policy rate had increased more substantially. Fed policymakers have noted that, relative to the past, the economy is starting from a position of higher inflation and a tighter labour market, and the Fed has a higher level of asset holdings.

Graph 1.24

Central Bank Government Bond Holdings*

Per cent of GDP**



* Central government debt only for all countries except the euro area. Dashed lines represent forecasts based on announced purchase programs or recent pace of purchases.

** Four-quarter rolling sum; forecasts are based on the IMF's World Economic Outlook.

*** Holdings data for euro area only include bonds held as part of asset purchase programs; holdings for other central banks also include bonds held for operational or liquidity purposes.

Sources: Central banks; IMF; RBA; Refinitiv

… while some have increased their policy rate or are expected to do so later this year

Central banks in advanced economies either began increasing policy rates in the second half of last year or market pricing suggests they are expected to do so in 2022 (Graph 1.25). Those central banks that had moved earlier to increase their policy rates have retained the approach of setting policy rates in response to their forecasts for inflation. This is in contrast to the Fed and the Reserve Bank, which have both indicated they will base the increase in their policy rate on actual inflation. Market pricing continues to suggest that policy rates are expected to peak at historically low levels in most advanced economies over the next few years.

Over recent months, the following policy rate movements have taken place:

- In November, the RBNZ increased its policy rate by 25 basis points to 0.75 per cent, noting that capacity constraints in the economy had been much greater than expected despite COVID-19-related restrictions. The RBNZ revised up its projected path of the policy rate and now expects it will reach 2 per cent by the end of 2022 and peak at around 2½ per cent by mid-2023.
- In December, the BoE increased its policy rate by 15 basis points to 0.25 per cent. Most members of the Monetary Policy Committee saw the decision as finely balanced given uncertainty surrounding the economic impact of the Omicron variant, but emphasised that the labour market continued to tighten and that domestic cost and price pressures had been more persistent than expected. The BoE indicated that it expects some modest tightening of policy is likely to be necessary over the next three years. Market pricing suggests that the

BoE will raise its policy rate by a further 25 basis points in February.

- In December, Norges Bank increased its policy rate by 25 basis points to 0.5 per cent. It noted that above-normal capacity utilisation, rising wages growth and higher imported goods costs are expected to increase underlying inflation. In January, Norges Bank reiterated that it expects to increase the policy rate further in March.
- In January, the Bank of Korea (BoK) increased its policy rate by 25 basis points to 1.25 per cent, following an increase of the same size in November. The BoK expects inflation to run above the target level for a considerable period and expects to continue to raise its policy rate over time.

Beyond those central banks mentioned above, the Fed will consider lifting its policy rate in March, shortly after the time that bond purchases cease. Market pricing suggests that the Fed is expected to raise rates at least four times this year. The BoC is also expected to begin increasing its policy rate from March. The ECB said it is very unlikely that it will raise the policy rate this year, in contrast to market participants' expectations that the ECB will raise rates in the second half of 2022. The Riksbank expects to leave its policy rate unchanged until late 2024. Likewise, market participants expect the BoJ to leave its policy rate unchanged until at least 2025.

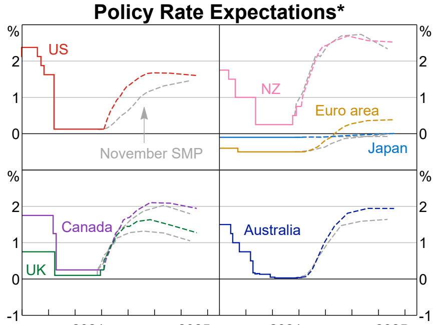
Government bond yields have risen notably

Longer-term government bond yields in most advanced economies have risen over recent weeks to be around their highest level since the onset of the pandemic (Graph 1.26). This reflects improved confidence that the effect of the Omicron variant on economic activity will be relatively modest and short lived, as well as the expectations of market participants that the Fed will reduce its asset holdings earlier, and then more rapidly, than previously anticipated. The rise in longer-term yields has not reflected an increase in compensation for inflation (see below). Shorter-term government bond yields have also increased in a number of advanced economies, most notably in the United States and the United Kingdom, alongside a shift higher in market-implied expectations for the path of central bank policy rates (Graph 1.27).

The rise in longer-term yields has primarily reflected a rise in real yields, while longer-term inflation compensation has been steady, and generally remains around the level consistent with central bank inflation targets (Graph 1.28). Even so, real yields remain around historically

Graph 1.25

Policy Rate Expectations*

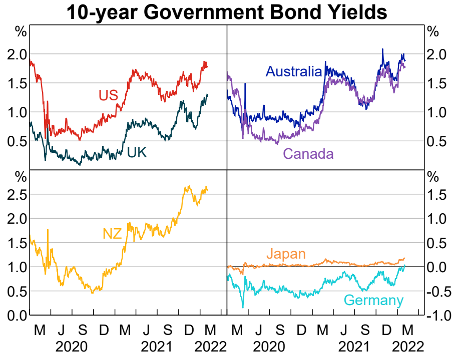


* Dashed lines show expectations implied by overnight indexed swap rates.

Sources: Bloomberg; RBA

Graph 1.26

10-year Government Bond Yields



Sources: Bloomberg; Yieldbroker

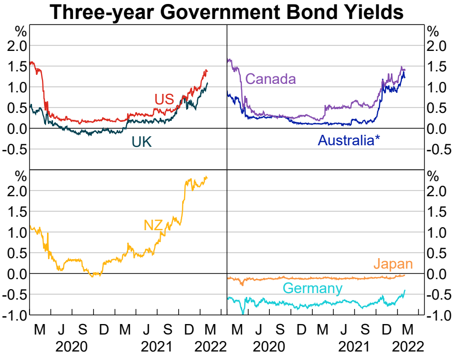
low levels across advanced economies and negative in most cases.

Private sector funding conditions have tightened but remain accommodative

Conditions in corporate bond markets remain accommodative. Over recent months, corporate bond yields have risen a little alongside increases in government bonds yields (Graph 1.29). Credit spreads on sub-investment grade bonds initially increased late last year following the emergence of the Omicron variant, but have since remained steady in the United States and Europe. Corporate default rates have declined to low levels relative to

Graph 1.27

Three-year Government Bond Yields

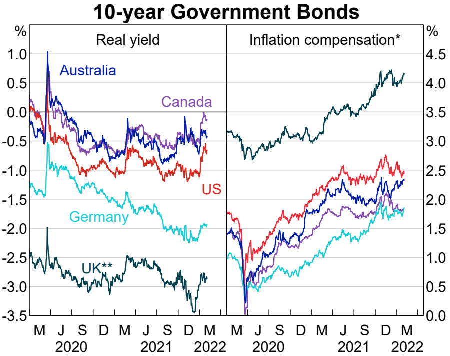


* The Australian three-year yield is an interpolated value. All other series are the yield on a benchmark bond.

Sources: Bloomberg; RBA; RBNZ; Yieldbroker

Graph 1.28

10-year Government Bonds



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

** UK inflation-linked bonds are linked to Retail Price Index inflation, which tends to be higher than Consumer Price Index inflation.

Sources: Bloomberg; RBA; Yieldbroker

history after rising noticeably through 2020. Corporations continue to take advantage of low borrowing costs and have issued debt at a steady pace in recent months.

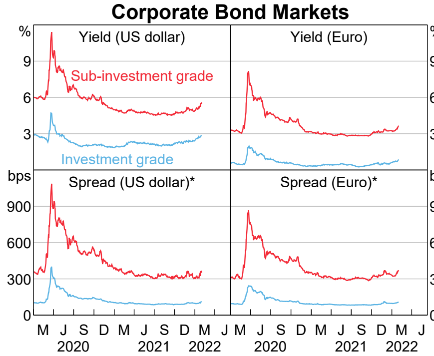
Equity prices in most major markets have fallen sharply since early January in response to market participants' expectations that the Fed will cease asset purchases and raise rates sooner than previously expected, as well as rising geopolitical tensions between Ukraine and Russia (Graph 1.30). Share prices of some companies that have had relatively high valuations – including some technology stocks – have been more sensitive to the rise in interest rates, in part because this increases the discount rate applied to their high expected earnings growth. More broadly, initial fourth quarter corporate earnings results have not grown by as much as expected, particularly in the United States where some financial and media companies reported a rise in earnings but by less than market expectations. Equity issuance in the United States and Europe has remained steady in recent months.

The US dollar is little changed

The US dollar has been little changed on a trade-weighted (TWI) basis since early November and is around 3 per cent higher than at the beginning of 2021 (Graph 1.31). The euro has

Graph 1.29

Corporate Bond Markets



* Spread to equivalent maturity government bond yield.

Source: ICE Data is used with permission depreciated on a TWI basis over the past three months. The UK pound appreciated on a TWI basis following the BoE's decision in December to increase its policy rate. The currencies of other advanced economies, including the Australian dollar, have generally depreciated since November on a TWI basis (see chapter on 'Domestic Financial Conditions' for recent developments in the Australian dollar).

Some emerging market economies outside Asia have continued to tighten monetary policy in response to rising inflation

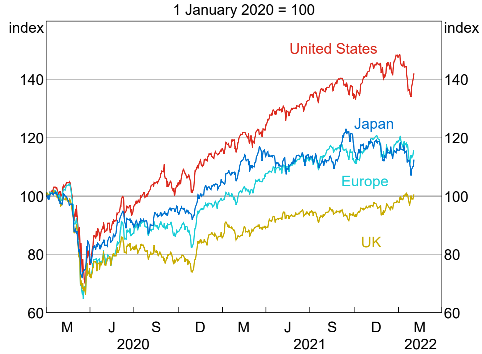
Some central banks in emerging markets have continued to tighten policy in response to persistently high rates of inflation. A number of central banks, particularly those in Latin America, have increased policy rates several times in recent months. Market pricing suggests that further sizeable policy rate increases are expected across Latin America and emerging Europe, consistent with inflationary pressures and forward guidance from those central banks (Graph 1.32).

Higher policy rates and rising inflation expectations have contributed to an increase in local currency government bond yields and tighter financial conditions more broadly outside Asia (Graph 1.33). Spreads between yields on US-dollar denominated government bonds and US Treasury bonds have also widened amid concerns of rising geopolitical risks and expectations for tighter monetary policy in advanced economies. Equity prices have been little changed, and there have been net portfolio outflows from emerging market bond and equity funds, particularly from Latin America.

By contrast, inflationary pressures have been limited in middle-income economies in Asia, which has allowed the central banks of the Philippines, Thailand, Malaysia and Indonesia to leave policy rates unchanged. Most central banks across the region continue to characterise inflation as subdued or transitory, although

Graph 1.30

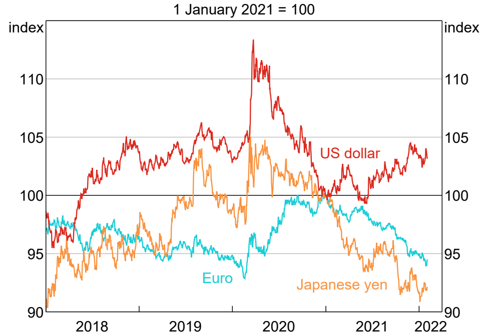
Equity Prices



Source: Bloomberg

Graph 1.31

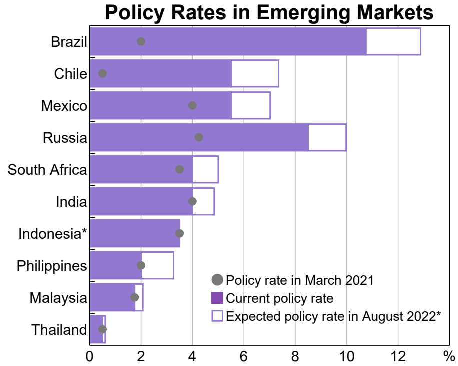
Trade-weighted Exchange Rates



Sources: Bloomberg; Board of Governors of the Federal Reserve System

Graph 1.32

Policy Rates in Emerging Markets



* Based on market-implied policy rate paths; expected policy rate unavailable for Indonesia.

Sources: Bloomberg; Refinitiv

some have noted risks to inflation are now tilted to the upside. Market-implied paths of policy rates in Asia have been little changed and continue to indicate that some central banks will start raising rates gradually this year. Financial conditions have remained broadly unchanged in the region, and net portfolio inflows have continued.

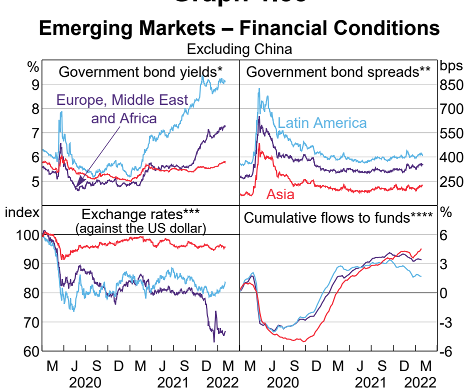
Despite changes in market expectations for the policy outlook in advanced economies, the currencies of most emerging market economies have been little changed against the US dollar since the November *Statement*.

Financial stress in Turkey has so far had limited spillover effects on other economies

In contrast to other emerging market central banks, the Central Bank of the Republic of Turkey (CBRT) has lowered its policy rate by 500 basis points since August 2021 even though inflation is well above target and has continued to increase, taking the real interest rate deeply negative (Graph 1.34). The Turkish lira has depreciated by around 45 per cent against the US dollar since the beginning of 2021, despite CBRT intervention in the foreign exchange market. In response to the sharp depreciation, the Turkish Government introduced measures to compensate households and businesses holding liras for further depreciation in the currency.

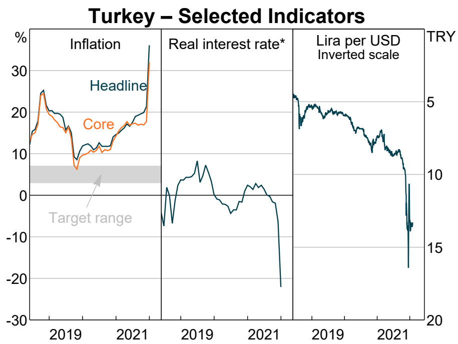
Financial stress in Turkey has not spread to other emerging markets. Direct exposures to Turkish assets by foreign investors and banks is limited. The Spanish banking system is most exposed but these claims account for only 3 per cent of Spanish banks' total foreign claims. Share prices of Spanish banks with Turkish exposures initially fell as volatility in the lira increased, but have since risen in line with other European banking stocks.

Graph 1.33



* Local currency bonds, weighted by market value.
** US-dollar denominated bonds; spreads to equivalent US Treasury.
*** 1 January 2020 = 100.
**** Per cent of assets under management; includes flows to bond and equity funds.
Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 1.34



* Constructed by subtracting headline inflation from the policy rate (one-week repo rate).
Sources: Bloomberg; Refinitiv

2. Domestic Economic Conditions

Economic activity bounced back strongly in the December quarter, supported by a recovery in consumption and investment following the easing of activity restrictions related to the outbreaks of the Delta variant of COVID-19. The labour market had also snapped back by December, with employment a little higher and the unemployment rate lower than pre-Delta levels. Leading indicators of labour demand suggest that underlying labour market conditions remain strong.

The emergence of the highly transmissible Omicron variant saw a substantial escalation in cases of COVID-19 in most states and territories in December and January. This led to disruptions in some industries – including retail, hospitality, health and goods distribution – because of employee illness and isolation requirements. There has also been increased precautionary behaviour on the part of consumers related to health considerations. However, initial indications are that the impact of Omicron on economic activity has been much smaller than previous waves of COVID-19. The high rates of vaccination among the adult population, as well as the rollout of booster shots, have been effective in limiting the incidence of severe illness. Consequently, there have been less restrictions on activity than in earlier outbreaks.

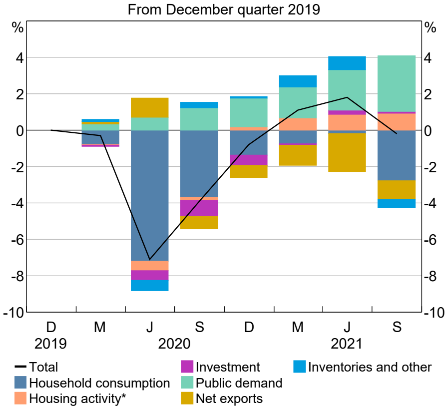
Restrictions weighed on domestic demand in the September quarter …

The Australian economy contracted by 1.9 per cent in the September quarter – one of the largest quarterly declines on record (Graph 2.1). Restrictions on activity led to a very sharp decline in state final demand in New South Wales, and to a lesser extent in Victoria. Elsewhere, in states without activity restrictions, state final demand continued to increase strongly. As in earlier lockdowns, household consumption of discretionary services – such as travel and restaurant meals – bore the brunt of the contraction (Graph 2.2). Business and dwelling investment were resilient as restrictions on construction were less binding than expected, and businesses viewed the disruptions as temporary. Resource exports increased, while imports of consumption goods fell sharply as lockdowns weighed on domestic demand and supply disruptions affected the availability of some goods, particularly motor vehicles.

Graph 2.1

GDP – Cumulative Contribution to Change

From December quarter 2019



* Dwelling investment and ownership transfer costs.

Sources: ABS; RBA

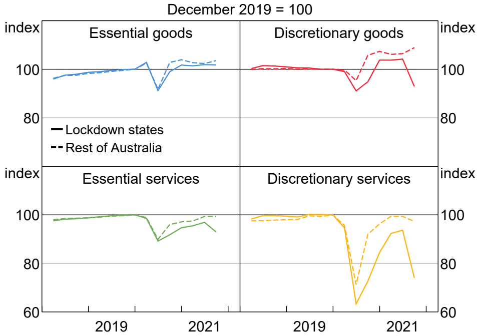
… but consumer spending rebounded sharply in the December quarter

Economic activity bounced back in the December quarter as restrictions were eased. Household spending increased as consumption opportunities broadened, with retail sales values growing by 9 per cent in the quarter (Graph 2.3). Consistent with the patterns observed following previous reopenings, spending at clothing & footwear shops, department stores and cafés & restaurants increased sharply, while food sales declined slightly. A strong recovery in spending on discretionary services such as entertainment and travel was also underway in the December quarter.

Graph 2.2

Household Consumption

December 2019 = 100

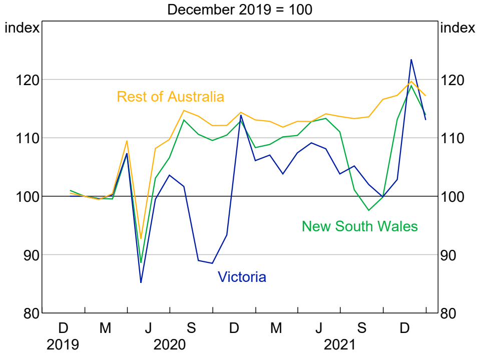


Sources: ABS; RBA

Graph 2.3

Retail Sales Values

December 2019 = 100



Sources: ABS; RBA

High-frequency indicators suggest the emergence of the Omicron variant began to affect economic activity from around the turn of the year. Population mobility – a timely indicator of economic activity – declined a little more through January than was seen this time last year (Graph 2.4). Information from the Bank's business liaison program and other timely indicators suggest that spending on a range of discretionary goods and services declined in January, particularly in hospitality and tourism, but the overall impact on consumer spending has been much smaller than during periods of lockdown. Consumer sentiment has declined a little to be around its long-run average (Graph 2.5). Business confidence declined in December, but measures of business conditions were little changed over recent months and remain broadly around average levels.

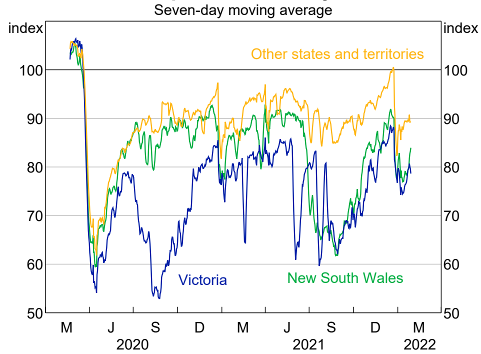
The labour market rebounded rapidly following the easing of lockdown restrictions

Employment and hours worked in December had recovered to be a little above levels seen prior to the Delta outbreak in mid-2021 (Graph 2.6). The snap back in labour market conditions was strong in contact-intensive industries in lockdown-affected states.

Graph 2.4

Population Mobility*

Seven-day moving average



* Google mobility; average from 3 January to 6 February 2020 = 100.

Sources: CEIC Data; RBA

Participation rates increased sharply in these states as people returned to their previous jobs, or took up or began searching for new employment opportunities. Outside of lockdown-affected states, labour market outcomes were relatively stable during the second half of 2021.

The labour market was able to recover quickly because many people who exited employment during the Delta outbreak remained connected, or 'attached', to their employers (that is, they were stood down without pay rather than retrenched) (Graph 2.7). Firms in the Bank's liaison program reported that they were reluctant to lay off staff in response to the Delta outbreak because of difficulty attracting suitable labour prior to the lockdowns and expectations that the disruptions would be relatively short lived.

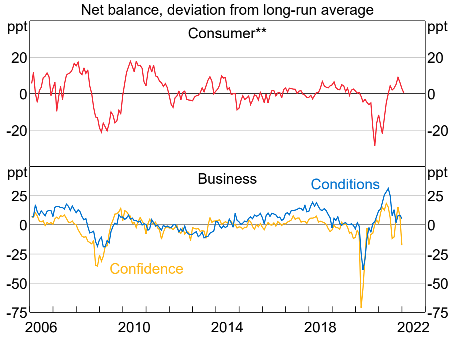
The unemployment rate declined to 4.2 per cent in December, following a period of volatility during the Delta outbreak. The measured unemployment rate did not give a clear indication of changes in labour market conditions for much of the second half of 2021 because of the effects of lockdowns and the lifting of restrictions. An alternative measure of spare capacity that captures flows into and out of the labour force as well as those working zero hours (either for economic or for 'other' reasons) declined to 5.2 per cent in December; this followed a peak of 11.7 per cent in August (Graph 2.8). Other measures of labour market spare capacity have also declined. The heads-based underemployment rate fell to 6.6 per cent in December – its lowest level since November 2008.

Worker absences due to Omicron-related illness and isolation requirements are expected to contribute to a sharp decline in total hours worked in January, with firms in the Bank's liaison program reporting elevated levels of

Graph 2.5

Consumer and Business Sentiment*

Net balance, deviation from long-run average



* Latest observation December 2021 for business confidence and conditions, and January 2022 for consumer confidence.

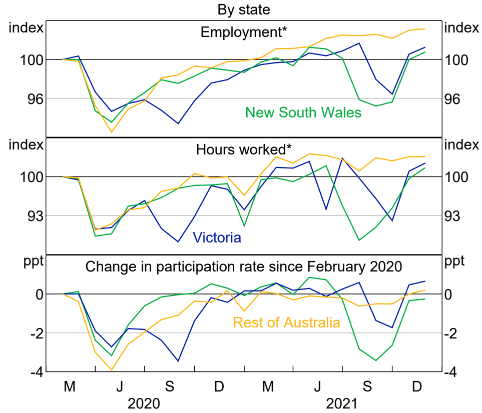
** Average of Westpac–Melbourne Institute and ANZ–Roy Morgan surveys.

Sources: ANZ–Roy Morgan; NAB; RBA; Westpac–Melbourne Institute

Graph 2.6

Labour Market Outcomes

By state



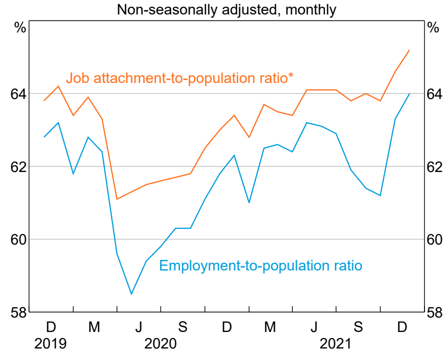
* February 2020 = 100.

Sources: ABS; RBA

Graph 2.7

Labour Market Outcomes

Non-seasonally adjusted, monthly



* Share of the population reporting that they have a job they are connected to (whether currently in that job or temporarily absent).

Source: ABS

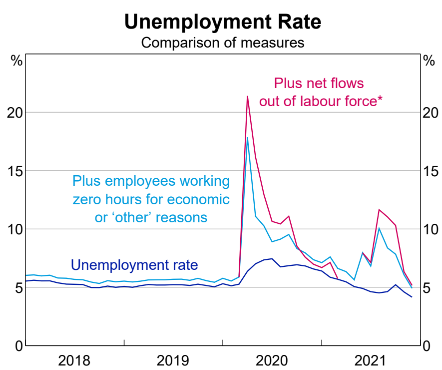
absenteeism. Some firms in the accommodation, hospitality and retail sectors have reported around 15–30 per cent of staff were temporarily unavailable due to illness or isolation requirements. This decline in hours is expected to be short lived and smaller than observed during the national lockdowns in 2020.

A range of indicators of labour demand remain strong

Leading indicators of labour demand suggest that labour market conditions were strong at the end of 2021 (Graph 2.9). Job vacancies as a share of the labour force reached a record high in November, with around one in five businesses reporting at least one vacancy – almost double the rate seen prior to the pandemic. Job vacancies were particularly strong in Western Australia, where the job vacancy rate far exceeded that observed during the mid-2000s mining boom. In aggregate, job vacancies were well above pre-pandemic levels in all industries, particularly in those most affected by lockdowns and border closures, such as accommodation & food services and arts & recreation. Job advertisements have also remained elevated. Consistent with this, information from the Bank's liaison program continues to suggest that around half of all firms intend to increase headcount over coming months and very few firms expect to reduce headcount. Firms continue to report difficulties finding workers for a range of roles, including in the construction, professional services, agricultural and hospitality sectors.

Job mobility remained at historically high levels in November and the share of workers expecting to change jobs in the next 12 months continued to increase. Elevated job mobility partly reflects workers catching up on planned job changes that had been put on hold due to disruptions associated with the pandemic, as well as workers feeling encouraged by stronger labour market conditions to change jobs. It also reflects labour market adjustments to the uneven effects of the pandemic on labour demand. High-skilled jobs in professional services sectors have experienced particularly sharp increases in job mobility since mid-2021, while job mobility rates in other sectors have remained in line with historical averages (Graph 2.10). Firms in the liaison program have also reported higher voluntary turnover in recent months, driven by a pick-up in staff leaving for higher pay, particularly in professional services and some construction and mining-related roles.

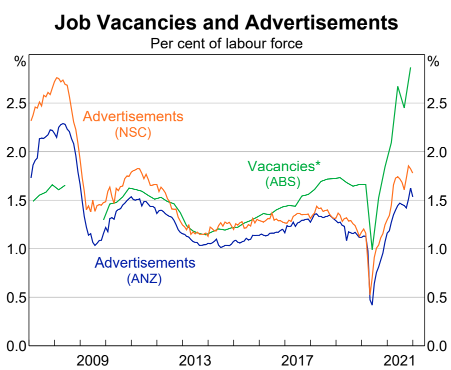
Graph 2.8



* Incorporates cumulative net flows out of the labour force between March 2020 and March 2021, and since June 2021.

Sources: ABS; RBA

Graph 2.9



* The survey was suspended between May 2008 and November 2009.

Sources: ABS; ANZ; National Skills Commission (NSC); RBA

Fiscal measures supported household and business incomes during lockdowns

Household income increased in the September quarter, as fiscal measures such as the COVID-19 disaster payments provided strong support to household and small business incomes (Graph 2.11). These measures have been subsequently wound down as key vaccination rate thresholds were met. Strong growth in disposable income and a fall in consumption saw the household saving ratio increase to 20 per cent in the September quarter. Total additional savings accumulated by households during the pandemic are estimated to amount to more than $200 billion. Many households have also benefited from large increases in housing wealth as prices have risen (Graph 2.12).

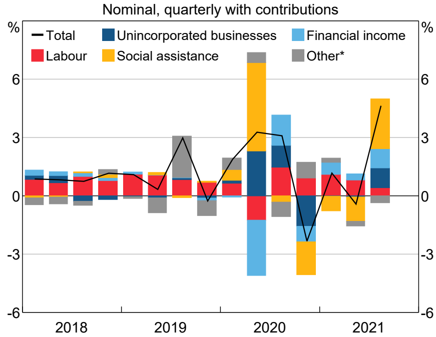
Business investment was resilient during the Delta outbreak

The decline in non-mining business investment in the September quarter was much smaller than expected at the time of the previous *Statement*, as many firms were able to adapt to lockdowns and other restrictions on construction activity. Non-mining business investment remained 2 per cent above its pre-pandemic level as the recovery in domestic demand and tax incentives from the Australian Government continued to underpin machinery & equipment investment. Non-residential construction increased, supported by renewable energy projects and new warehouses to facilitate the shift to online shopping (Graph 2.13). The Omicron outbreak is not expected to have significantly disrupted firms' longer-term investment plans, consistent with large firms' investment intentions having remained steady throughout the Delta outbreak in the second half of 2021.

Graph 2.11

Household Disposable Income Growth

Nominal, quarterly with contributions



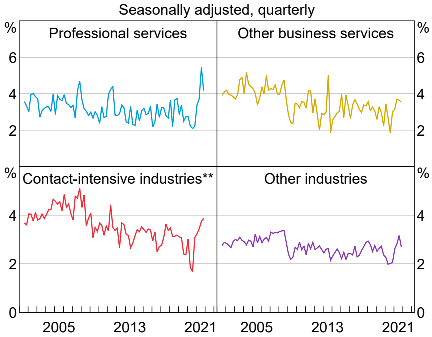
* Includes rent, tax payable, interest payable and other.

Sources: ABS; RBA

Graph 2.10

Job Mobility Rate by Industry*

Seasonally adjusted, quarterly



* Share of industry employment.

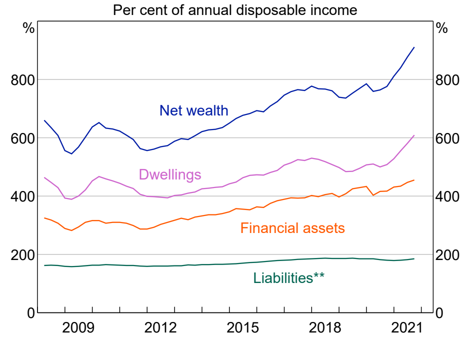
** Includes hospitality, arts & recreation and retail trade.

Sources: ABS; RBA

Graph 2.12

Household Assets and Liabilities*

Per cent of annual disposable income



* Disposable income before the deduction of interest payments.

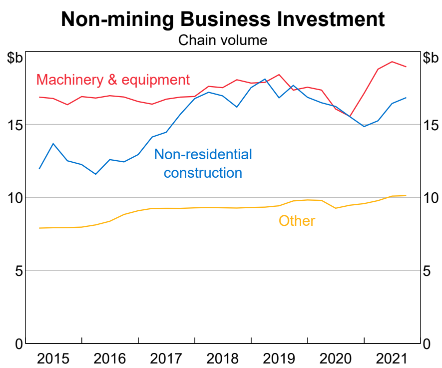
** Excludes unincorporated enterprises.

Sources: ABS; RBA

Public demand is providing strong support to the economy

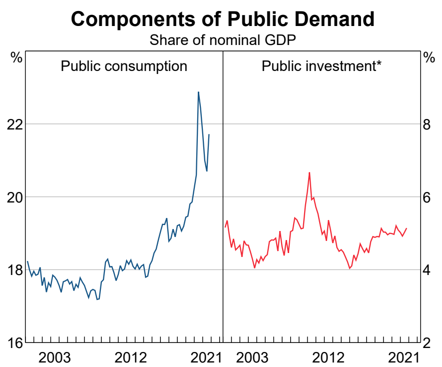
Public demand grew by 7 per cent over the year to the September quarter. Public consumption grew at its strongest quarterly rate in 25 years and remained at a very high share of nominal GDP. Recent increases have been driven by public health spending related to the Delta outbreak and the accelerated rollout of COVID-19 vaccines (Graph 2.14). Growth in public investment slowed as lockdowns and other restrictions on activity had some impact in the quarter. The pipeline of work to be done on public transport projects has increased substantially over the past year.

Graph 2.13



Sources: ABS; RBA

Graph 2.14



* Adjusted for second-hand asset transfers between the public and other sectors.

Sources: ABS; RBA

Recent federal and state government midyear budget updates included new spending, mainly health-related, alongside stronger-than-expected revenues. These budgets point to continued strong growth in both public consumption and public investment over coming quarters.

Residential construction was strong in 2021 despite disruptions from lockdowns

Dwelling investment was unchanged in the September quarter as renovation activity continued to expand and firms were largely able to adapt to restrictions on the construction of new dwellings in areas affected by the Delta outbreak. Alterations & additions have been supported by households' desire for extra space and increased savings accumulated during the pandemic. There is a large pipeline of residential construction work to be completed, with more than 120,000 new dwellings commenced across the June and September quarters (Graph 2.15). Building approvals have eased from the very high levels of early 2021 as the Australian Government's HomeBuilder scheme has now concluded; however, they remain above pre-pandemic levels. Information from the Bank's business liaison program suggests that detached housing projects are taking longer to complete than normal due to shortages of both workers and building materials.

Conditions in housing markets vary across the country

Housing prices increased by 22 per cent over 2021 (Graph 2.16). Housing price growth has been supported by low interest rates and the inherent inability of supply to respond immediately to increased demand. In recent months, housing price growth has moderated in Sydney, Melbourne and Perth from the high rates seen earlier in 2021; however, prices have continued to increase rapidly in some smaller

Table 2.1: Housing Price Growth

Percentage change, seasonally adjusted

	January	December	November	October	Year-ended	Five-year growth
Sydney	0.7	0.7	1.1	1.4	25.5	27
Melbourne	0.1	0.0	0.4	0.7	14.9	22
Brisbane	2.5	2.6	2.7	2.5	29.2	38
Adelaide	2.3	2.2	2.2	1.8	24.8	38
Perth	0.3	0.3	–0.1	0.1	11.2	11
Darwin	0.3	0.4	–0.1	0.4	12.6	2
Canberra	1.9	1.2	0.8	2.0	25.5	56
Hobart	1.2	1.4	1.0	1.7	27.6	72
Capital cities	1.0	0.8	1.0	1.3	21.3	25
Regional	1.7	1.9	2.0	1.8	26.1	42
National	1.2	1.1	1.2	1.4	22.4	29

Sources: CoreLogic; RBA

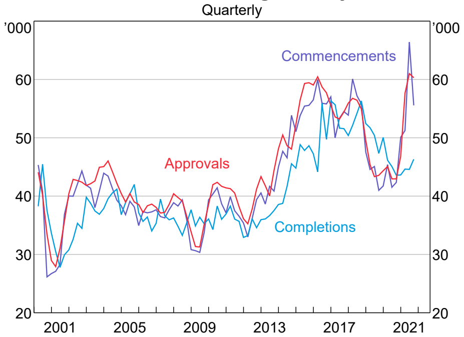
capital cities and regional areas (Table 2.1). During the pandemic, price growth for detached houses has been stronger than for apartments, partly reflecting changes in housing preferences. Housing turnover picked up strongly across most markets towards the end of the year, including in Sydney and Melbourne where restrictions on sales activity had weighed on turnover through the September quarter. Consequently, housing loan commitments are at an elevated level (see chapter on 'Domestic Financial Conditions'). The number of properties listed for sale had remained low in recent months as the rate of purchases outpaced new listings.

Advertised rents increased strongly over 2021, following earlier declines in some locations over 2020. Advertised rents have substantially outpaced increases in the CPI rents series (see chapter on 'Inflation'). That said, growth in advertised rents has eased in some capital cities over recent months. For a number of quarters,

Graph 2.15

Private Dwelling Activity

Quarterly

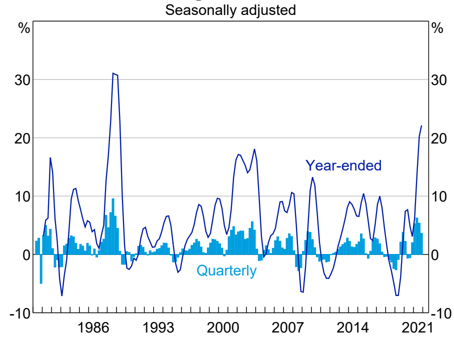


Sources: ABS; RBA

Graph 2.16

Housing Price Growth

Seasonally adjusted



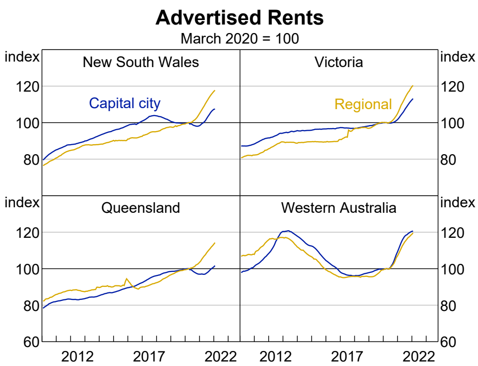
Sources: CoreLogic; RBA

the largest increases for advertised rents have been recorded in the smaller capital cities and regional areas, where vacancy rates are very low (Graph 2.17). Changes in the pattern of internal migration during the pandemic have contributed to demand in those areas. More broadly, survey data suggest that renters' average household size has declined since the onset of the pandemic, putting upward pressure on demand for rental properties. Growth in advertised rents has also been supported by the increase in household income and the declining availability of rental stock as listings have continued to decline in both capital cities and regional areas.

Production issues have weighed on resource exports

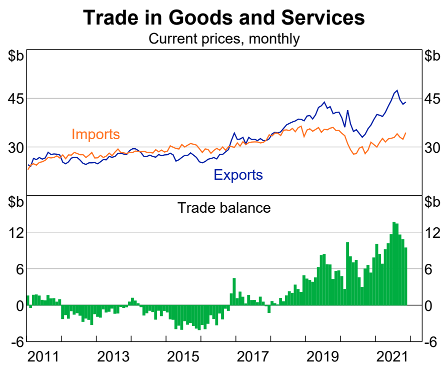
Partial data and information from the Bank's liaison program indicate that resource exports declined in the December quarter, as maintenance and wet weather weighed on production (Graph 2.18). Rural exports have continued to increase over recent months due to favourable growing and pasture conditions, as well as strong global demand for grains and meat. Trade in services remained depressed in the December quarter but is expected to increase as the international border is reopened to eligible travellers including Australian citizens and residents, students, skilled migrants and some tourists. The trade surplus has declined over recent months but remains elevated, supported by high prices for some key export goods, notably coal and LNG.

Graph 2.17



Sources: CoreLogic; RBA

Graph 2.18



Sources: ABS; RBA

3. Domestic Financial Conditions

The policy measures implemented by the Reserve Bank since the onset of the pandemic are providing important support to the Australian economy, having reduced funding costs across the Australian economy to very low levels. These measures include the reductions in the cash rate, the use of forward guidance, the Term Funding Facility (TFF), the yield target and the bond purchase program. In February, the Board decided to cease further purchases under the bond purchase program. The expansion of the Bank's balance sheet associated with the bonds purchased under the program and other policy measures will continue to support highly accommodative financial conditions.

Australian Government bond yields are little changed over the past three months. Yields declined in late 2021 as the emergence of the Omicron variant of COVID-19 led to increased uncertainty around the economic outlook. However, yields have since risen and reversed that decline, broadly in line with offshore developments. Bond markets continue to function reasonably well, although at times some market segments have been operating less effectively. Money market rates have risen slightly but remain close to historical lows. Australian equity prices have fallen recently following gains in 2021.

Overall, interest rates on outstanding loans declined by more than banks' funding costs over 2021. Both are at historic lows, supported by the Bank's policy measures. Meanwhile, demand for housing finance remains robust, and business debt has been growing at a fast pace, driven by the borrowing of larger firms.

The Australian dollar has depreciated in recent months, notwithstanding a rise in commodity prices, as market participants have brought forward their expectations for monetary policy tightening in the United States.

In February, the Board decided to cease further purchases under the bond purchase program

At the February Board meeting the Board decided to cease further purchases under the bond purchase program, with the final purchases to take place on 10 February.

Under the bond purchase program, the Bank has purchased $277 billion of longer-term government bonds since November 2020, consisting of $220 billion of Australian Government Securities (AGS) and $56 billion of semi government securities (semis) (Graph 3.1). The Bank also bought bonds in support of the yield target and market functioning. Total bond purchases since the start of the pandemic amount to $360 billion. The Bank currently holds 36 per cent of outstanding AGS and 18 per cent of outstanding semis. The stock of bonds purchased, along with other policy measures taken by the Bank, will continue to contribute to very stimulatory financial conditions.

AGS yields are little changed over the past few months

Yields on longer-term AGS are little changed over the past three months (Graph 3.2). Yields declined following the emergence of the Omicron variant late last year but then rose alongside a move higher in bond yields globally. US Treasury yields are currently around 20 basis points higher than the beginning of November. Consequently, over the same period the spread between 10-year AGS and US Treasury yields has declined by around 20 basis points. The increase in US Treasury yields reflects firming expectations of a number of policy rate increases in the United States in response to rising inflation and inflation expectations, alongside further signs of tightness and wages pressure in the US labour market (see chapter on 'The International Environment'). Short-end AGS yields have increased over recent months, having risen sharply in October last year in response to stronger-than-expected Australian inflation data, growing expectations that central banks around the world would need to tighten policy rates in the near future, and the Board's decision to discontinue the yield target. The Board's decision in February to cease further bond purchases under the bond purchase program was widely expected and had little effect on yields at the time.

The increase in longer-term AGS yields since the recent low in December has been driven by higher real yields, with longer-term inflation compensation (which captures both inflation expectations and inflation risk premia) little changed (Graph 3.3). Conversely, the increase in shorter-term AGS yields over this period has been driven by both higher inflation compensation and higher real yields.

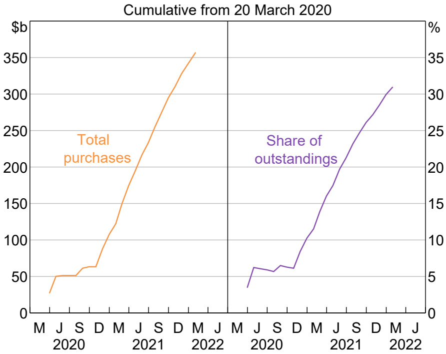
Government bond issuance has been steady as funding tasks have been revised slightly lower

Bond issuance by the Australian Office of Financial Management (AOFM) has been steady over recent months – other than for the usual hiatus over year-end – at around $2 billion to $2.5 billion per week, with auctions continuing to attract solid demand (Graph 3.4). Issuance is around that implied by the AOFM's mid-December update, where annual funding guidance was decreased to $105 billion for the

Graph 3.1

RBA Purchases of AGS and Semis*

Cumulative from 20 March 2020



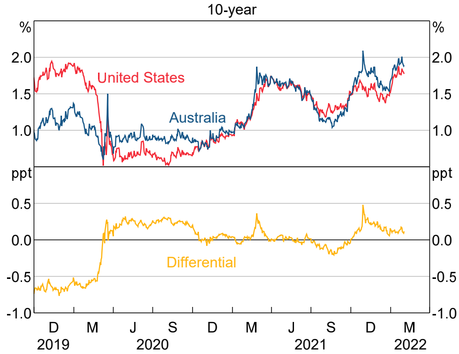
* Includes purchases made: under the bond purchase program; to support market function; and to support the yield target.

Sources: AOFM; Bloomberg; RBA; state and territory central borrowing authorities

Graph 3.2

Government Bond Yields

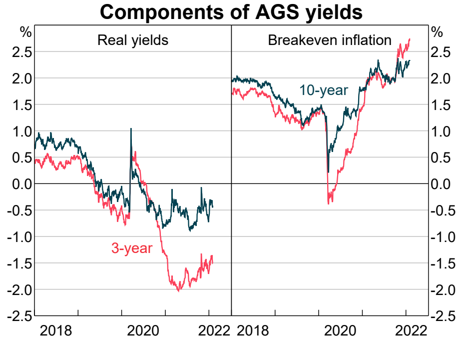
10-year



Sources: Bloomberg; RBA; Yieldbroker

Graph 3.3

Components of AGS yields



Sources: RBA; Yieldbroker

2021/22 financial year, from $130 billion previously. The broader increase in yields (including semi spreads over AGS) in October saw the pace of issuance by state and territory borrowing authorities slow for a time. This was followed by issuance blackouts ahead of funding updates over the first half of December, which showed a small decrease in the overall funding task for most semis issuers. A number of state authorities continue to be ahead of their implied funding schedules.

Spreads of yields on semis over those on AGS are little changed over the past few months (Graph 3.5). Spreads initially narrowed, with market contacts suggesting higher outright yield levels had encouraged buying from yield-sensitive investors, but more recently spreads have moved higher again alongside widespread expectations that the Bank would cease bond purchases in February. The Board's decision to cease further bond purchases under the bond purchase program had no additional impact on semis spreads.

Measures of market functioning have been mixed

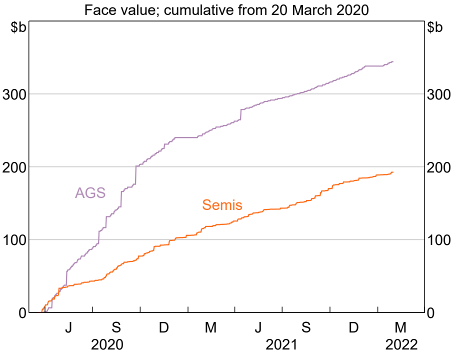
After a period of reduced functioning in the latter part of October and early November, there are measures of bond market functioning that have improved, with the November Board meeting clarifying the Board's outlook and policy settings, including the discontinuation of the yield target. In particular, bid-offer spreads have narrowed since early November to be in line with long-run averages (Graph 3.6).

Meanwhile, demand to borrow AGS from the Bank has increased over recent months, although the value of bonds lent by the Bank remains small relative to the size of the Bank's AGS holdings. An average of almost $4 billion of bonds was lent out to the market on any given day in December, and over $6 billion was lent out per day in January, with the Bank's share of total securities lending volumes in the Australian

Graph 3.4

Government Issuance

Face value; cumulative from 20 March 2020

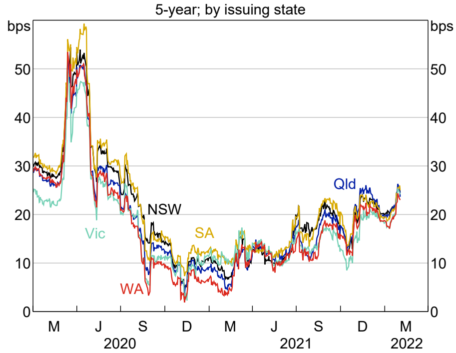


Sources: AOFM; Bloomberg; RBA; state and territory central borrowing authorities

Graph 3.5

Semi-government Bond Spreads to AGS

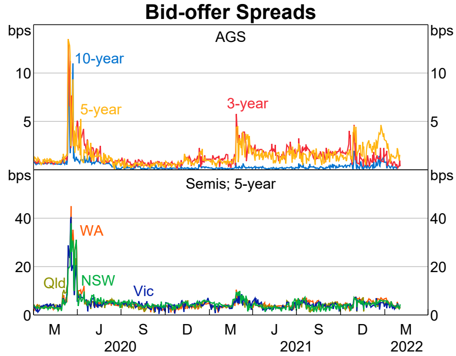
5-year; by issuing state



Sources: RBA; Yieldbroker

Graph 3.6

Bid-offer Spreads



* Average bid-offer spreads six months either side of the stated tenor for AGS and semis.

Sources: RBA; Yieldbroker

market likely to have increased over recent months (Graph 3.7). Volumes have been concentrated in the bonds underpinning the three-year futures contract (of which the Bank holds a sizeable share); market liaison suggests that a significant portion of the securities lending is a result of intermediaries facilitating demand for short-end AGS from medium- and longer-term investors. By lending these bonds back into the market for short periods, the Bank supports the functioning of the government bond market.

Measures for the bond futures market suggest relatively low levels of liquidity at times, especially for the three-year futures contract. This is evident in the number of three-year futures contracts available to trade at the best price, which fell over October 2021 and has remained low (Graph 3.8). Also, the implied yield on three-year futures contracts has diverged for a time from the yield on three-year bonds, whereas arbitrage should keep this difference close to zero in an efficient market (Graph 3.9). Market liaison suggests that strains evident in some measures of three-year futures market functioning may in part reflect an unwillingness and/or inability of market participants to take on risk following the earlier episodes of market volatility.

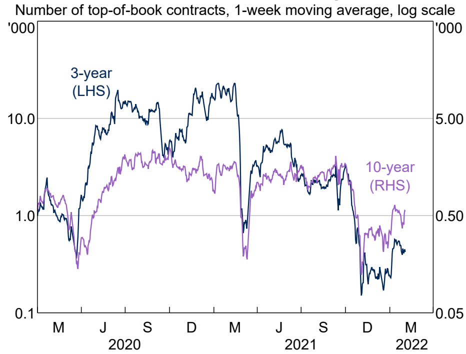
Cash market activity has increased moderately from a low level, while implied cash rate expectations have risen a little

Activity in the cash market has picked up moderately from a very low level, despite the high level of system liquidity. The past three months has seen average volumes increase from around $200 million per day to around $400 million per day, while the cash rate has risen slightly to 5 basis points. Along with the increase in cash market volumes, the proportion of days where the cash rate is determined by market transactions rather than expert judgement has increased, to slightly less than half of all days in this period. Market expec-

Graph 3.8

Bond Futures Market Depth*

Number of top-of-book contracts, 1-week moving average, log scale

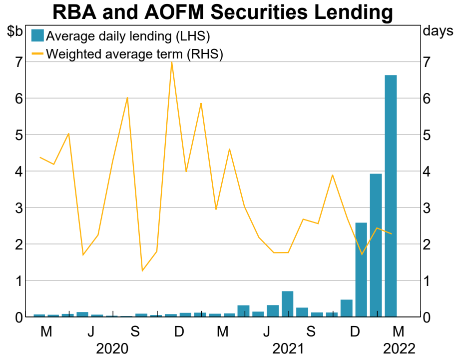


* Seasonally adjusted to remove predictable intra-quarter variation.

Sources: Bloomberg; RBA

Graph 3.7

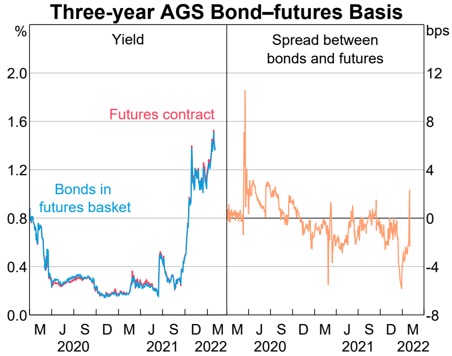
RBA and AOFM Securities Lending



Source: RBA

Graph 3.9

Three-year AGS Bond–futures Basis



Sources: RBA; Thomson Reuters

tations for the cash rate have increased a little over the past three months, with prices for overnight indexed swap (OIS) contracts implying that market participants expect the cash rate to be around 1 per cent by the end of 2022, and a little above 1¾ per cent by the end of 2023 (Graph 3.10).

Short-term money market rates remain low, though they have edged higher

The low level of the cash rate and the high level of liquidity in the banking system continue to underpin low money market rates. Even so, short-term money market rates have risen very slightly following an extended period around historic lows (Graph 3.11). In particular, three-month bank bill swap rates (BBSW) have moved a few basis points higher over the past three months, but remain very low. The costs of Australian dollar funding from offshore short-term issuance (via the foreign exchange swap market) have fluctuated around zero. Repo rates at the Bank's open market liquidity operations remain at 10 basis points, while repo rates in the private market are around zero for terms of up to three months. Demand for short-term liquidity at the Bank's regular open market liquidity operations increased moderately ahead of the end of the year.

The Bank's balance sheet has continued to grow

The Bank's balance sheet has grown considerably during the pandemic as a result of the Bank's policy measures (Graph 3.12). Since the previous *Statement*, the balance sheet has increased by $40 billion to around $640 billion. Over this period, growth in the Bank's assets has reflected a further increase in holdings of AGS and semis, owing to the Bank's bond purchases. Correspondingly, on the liabilities side, Exchange Settlement balances have continued to rise (Graph 3.13). 'Other liabilities' have risen because of an increase in securities lending, where the Bank lends bonds from its portfolio in exchange for cash.

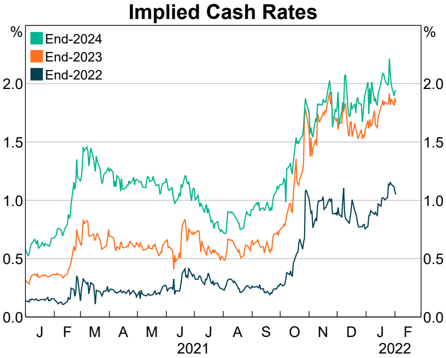
The bank bond market is returning to pre-pandemic issuance patterns

Australian banks' issuance of senior unsecured bonds increased in 2021 compared with 2020, but remained low by historical standards (Graph 3.14). The low level of bond issuance reflected the availability of low-cost funding from the TFF in the first half of the year and strong deposit growth.

The average tenor of banks' bond issuance in 2021 was six years, which is long by historical standards. Banks are likely to be seeking funding

Graph 3.10

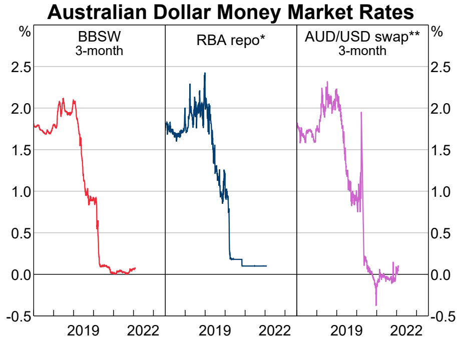
Implied Cash Rates



Sources: Bloomberg; RBA

Graph 3.11

Australian Dollar Money Market Rates



* Weighted average rate for morning open market operation repos.

** Implied AUD cost via commercial paper issuance and a cross-currency swap.

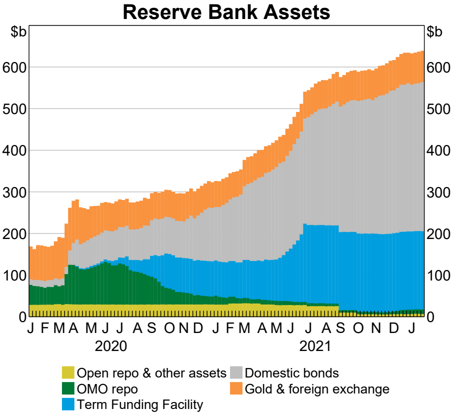
Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve at relatively long tenors to avoid additional maturities close to the periods when TFF funding will need to be refinanced, as well as to take advantage of historically low yields on longer-term debt. Issuance has been largely in offshore markets, which are typically deeper and more liquid for long-term funding.

Banks raised $22 billion of funding through bond markets in January 2022, including the largest single-maturity deal by a bank in the domestic market on record. January is typically a month with strong issuance and so banks need to fund a high level of maturities during this time. Issuance over 2022 is expected to be stronger than in the previous two years, when banks had access to new longer-term funding from the TFF. Banks might also seek to fund purchases of AGS to satisfy High Quality Liquid Asset requirements given the changes to the Committed Liquidity Facility.

Banks continued to issue Tier 2 hybrid securities in 2021, raising $21 billion in this form. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements, which will increase in January 2024. Spreads on these Tier 2 hybrid issues were lower compared with those in 2020.

Graph 3.12

Reserve Bank Assets



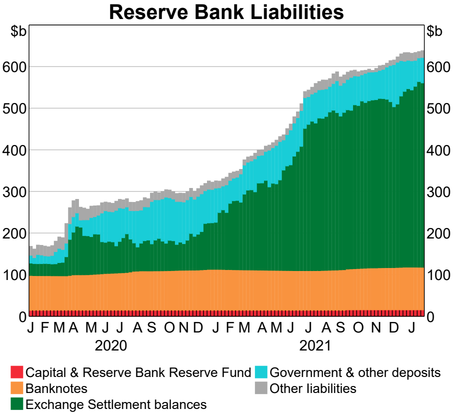
Source: RBA

RMBS issuance was high in 2021, driven by non-banks

Issuance of residential mortgage backed securities (RMBS) in 2021 was higher than in recent years, owing to the high level of issuance by non-banks (Graph 3.15). Non-bank issuance has been elevated during the pandemic, benefiting from strong demand given low issuance of bonds by banks, which are close substitutes for investors. Pricing on RMBS throughout 2021 remained at the most attractive levels for issuers seen in the post-GFC period.

Graph 3.13

Reserve Bank Liabilities

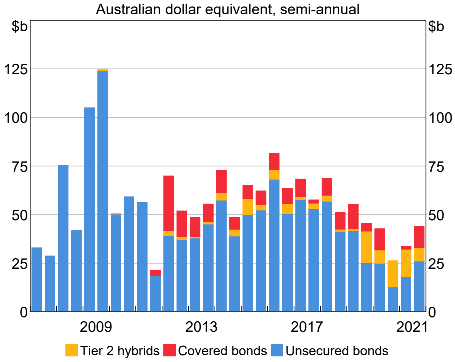


Source: RBA

Graph 3.14

Australian Banks' Bond and Hybrid Issuance

Australian dollar equivalent, semi-annual



Sources: Bloomberg; RBA

Banks' overall funding costs are at historic lows

Banks' outstanding funding costs declined a little further over the past year. BBSW rates, to which much of banks' wholesale debt funding is linked (either directly or via hedging), remained low consistent with the low level of the cash rate and the Bank's other policy measures (Graph 3.16).

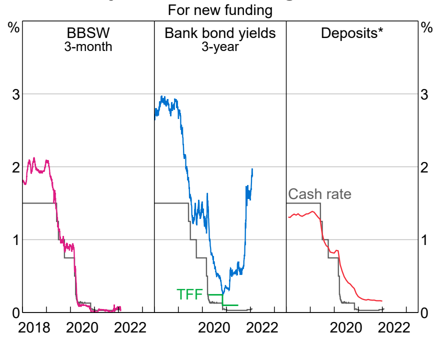
Low-cost funding from the TFF has contributed directly to lower funding costs for banks, and will continue to do so until mid-2024. In addition, the stock of low-rate deposit funding in the banking system continued to grow strongly over 2021, partly reflecting the Bank's policy measures. The Bank's bond purchases create deposits because payments for bonds purchased from the private (non-bank) sector are credited to deposit accounts of the sellers of these bonds. In addition, funds from maturing bank bonds also contributed to deposit growth, and net maturities were elevated during the period when banks were drawing on the TFF. These inflows of deposits have put downward pressure on banks' funding costs and have supported the very low level of interest rates on term and at-call deposits, which account for around 60 per cent of banks' overall funding. Rates on new term and at-call deposits fell by around 5–10 basis points over 2021. Most of this decline occurred early in the year, with rates on new term deposits rising slightly towards the end of 2021 (Graph 3.17).

Bank bond spreads to reference rates rose in late 2021, increasing the cost of new debt issuance for banks. However, this did not materially affect banks' overall funding costs due to limited new issuance over this period. That said, further wholesale issuance over 2022 (and any increases in issuance costs) would put upward pressure on banks' funding costs this year.

Graph 3.16

Major Banks' Funding Costs

For new funding

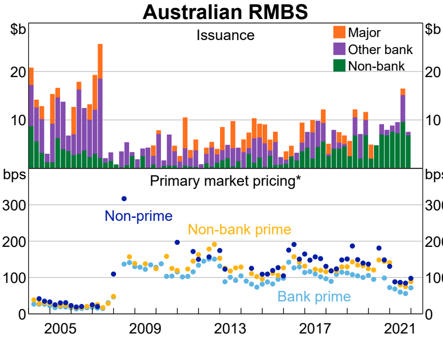


* RBA estimates; excludes deposits in housing loan offset accounts.

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

Graph 3.15

Australian RMBS

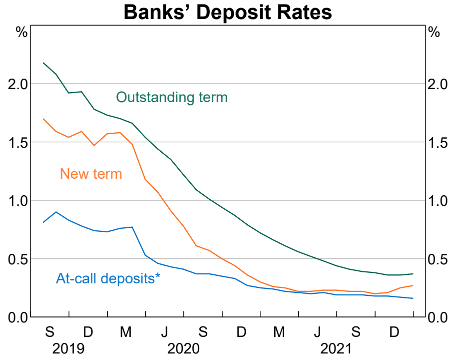


* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA-rated notes.

Sources: Bloomberg; KangaNews; RBA

Graph 3.17

Banks' Deposit Rates



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

Sources: APRA; RBA

Table 3.1: Average Outstanding Housing Rates

December 2021

	Interest rate (per cent)	Change since February 2021 (basis points)	Change since February 2020 (basis points)
Variable-rate loans			
– Owner-occupier	2.96	–16	–61
– Investor	3.28	–19	–68
All variable-rate loans	3.07	–17	–64
Fixed-rate loans			
– Owner-occupier	2.21	–42	–152
– Investor	2.57	–47	–144
All fixed-rate loans	2.34	–45	–152
By repayment type[(a)]			
– Principal-and-interest	2.72	–30	–91
– Interest-only	3.31	–34	–92

(a) Weighted average across fixed- and variable-rate loans.

Sources: APRA; RBA

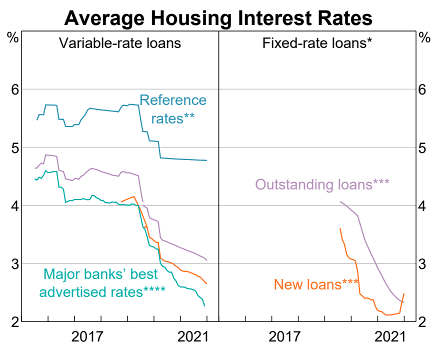
Interest rates on outstanding housing loans continue to drift lower …

Interest rates on outstanding housing loans drifted lower over 2021, as further declines in new lending rates encouraged both new housing borrowing and ongoing refinancing by existing borrowers to lower loan rates (Graph 3.18; Table 3.1). Price competition was particularly strong for fixed-rate loans for much of the year, partly reflecting the impact of the Bank's policy measures. Some banks also sought to attract new customers by offering cashback deals of around $2,000–$3,000 for refinancing.

… though interest rates on new fixed-rate loans have increased in recent months

Fixed rates for new housing loans increased sharply from November following the rise in swap rates (the pricing benchmark for fixed-rate loans). Pricing in swap rates and fixed-rate loans had been edging higher for a time – particularly for longer-terms of more than three years (Graph 3.19). The average interest rate paid on new fixed-rate loans remains around 15 basis points below that on new variable-rate loans, although this gap has narrowed quickly as changes in advertised fixed rates have flowed through to loans funded each month. The share of new fixed-rate housing lending, which was previously at an all-time high, also decreased towards the end of the year.

Graph 3.18



* Weighted average interest rate across all fixed-rate periods.
** Major banks' standard reference rates for variable-rate loans.
*** Series break in July 2019; thereafter, data based on EFS collection.
**** Includes low-cost brands.
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Meanwhile, banks have been offering increasingly large discounts on 'basic' variable-rate mortgages (which do not include features like offset accounts). These changes have meant that many banks' cheapest advertised variable rates for home loans are now below their cheapest advertised fixed rates. The average interest rate paid on new variable-rate loans has continued to drift lower over recent months, and in December it was 20 basis points lower than at the end of February 2021. Variable-rate loans account for two-thirds of the stock of total mortgages.

Interest rates on business loans are at historic lows

Interest rates on outstanding business loans are also at historically low levels (Graph 3.20). Since February 2020, interest rates on variable-rate loans to small- and medium-sized enterprises (SMEs) and large businesses have declined by around 110 basis points and 100 basis points, respectively. Over the same period, interest rates on fixed-rate loans to SMEs and large businesses have declined by around 95 basis points and 75 basis points, respectively. In the coming months, interest rates on new fixed-rate business loans may increase in response to the rise in swap rates, although fixed-rate loans account for just under 20 per cent of business loans.

Growth in total credit increased in 2021

Total credit growth picked up over 2021, to be around its fastest pace in some years on a six-month-ended annualised basis (Graph 3.21; Table 3.2).

In monthly terms, owner-occupier housing credit growth picked up in late 2021, after easing over the few months prior. Investor credit growth continued to move higher, increasing to 4¼ per cent in December in six-month-ended annualised terms. Demand for housing credit continues to be supported by the low level of interest rates and strong activity in housing markets. The easing of lockdown restrictions in New South Wales and Victoria in late 2021 may have also boosted demand for credit by facilitating a pick-up in housing turnover.

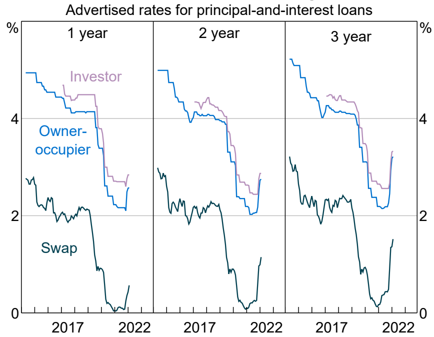
Growth in business credit picked up to around 12 per cent in late 2021 on a six-month-ended annualised basis – the strongest pace of growth seen over the past decade. The increase in demand for business loans has been particularly pronounced for larger firms and industries that are less exposed to the adverse economic effects of lockdowns and pandemic-related changes in behaviour.

Personal credit declined over the second half of 2021 and in the December quarter, despite

Graph 3.19

Fixed Advertised and Swap Rates

Advertised rates for principal-and-interest loans

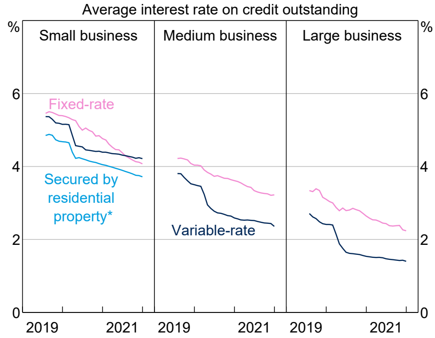


Sources: Banks' websites; Bloomberg; RBA

Graph 3.20

Business Lending Rates

Average interest rate on credit outstanding



* Small business loans secured by residential property can have fixed or variable interest rate terms and are included in the fixed-rate and variable-rate lines.

Sources: APRA; RBA

Table 3.2: Growth in Financial Aggregates

Percentage change[a]

	Three-month annualised		Six-month annualised	
	Sep 21	Dec 21	Jun 21	Dec 21
Total credit	8.1	9.4	5.6	8.8
– Household	6.8	7.6	6.0	7.2
– Housing	7.9	8.2	6.8	8.0
– Owner-occupier	10.4	9.8	9.0	10.1
– Investor	3.4	4.9	2.6	4.2
– Personal	–8.4	–0.8	–3.0	–4.7
– Business	10.6	13.4	4.9	12.0
Broad money	11.2	13.4	6.8	12.3

(a) Figures are break-adjusted and seasonally adjusted.

Sources: ABS; APRA; RBA

increasing in November after restrictions were eased in New South Wales and Victoria. Much of the decline in personal credit over the past six months has been driven by lower credit card debt, consistent with consumers having had reduced opportunities for spending during lockdowns.

Demand for housing loans remains high

Housing credit growth picked up in recent months, to around 8 per cent on a six-month-ended annualised basis. Investor credit growth has continued to increase since the middle of 2021, while owner-occupier growth has been little changed (Graph 3.22).

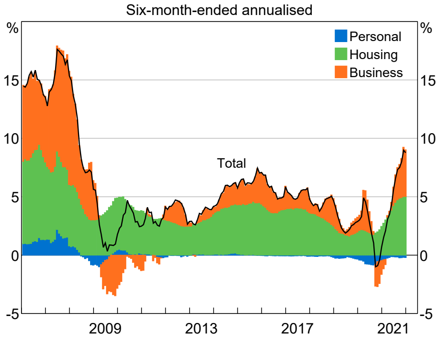
Commitments for new housing loans are at high levels (Graph 3.23). Owner-occupier commitments rebounded in New South Wales and Victoria in recent months, which may partly reflect the effect of the end of lockdowns on housing turnover. Investor commitments continued to rise throughout the second half of 2021 to a historically high level.

The higher serviceability assessment rate for new housing loans, announced by the Australian Prudential Regulation Authority in

Graph 3.21

Contribution to Total Credit Growth

Six-month-ended annualised

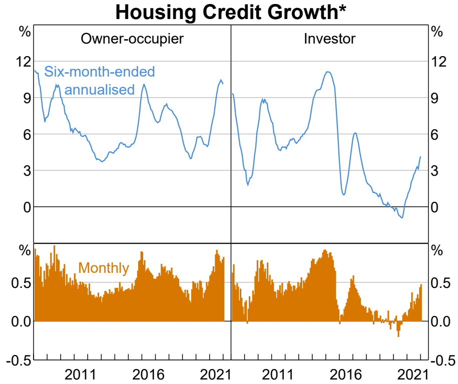


* Seasonally adjusted and break-adjusted.

Sources: APRA; RBA

Graph 3.22

Housing Credit Growth*



* Seasonally adjusted and break-adjusted.

Sources: APRA; RBA

early October, has been in effect since the beginning of November. Since the lag between housing loan applications to commitments is approximately six weeks, the policy change is expected to have started influencing the level of commitments by the end of 2021. However, the effect on overall housing credit is expected to be modest; while the measure will lower the maximum amount available to some borrowers, only a small proportion of households borrow at the maximum amount on offer.

Payments into housing loan offset and redraw accounts have declined

Net payments into offset and redraw accounts declined in the December quarter, after increasing to a high level in the September quarter. The decline in December quarter payments reflected the end of lockdowns and the associated increase in consumption opportunities. Since the onset of the pandemic in early 2020, mortgage borrowers' payments into offset and redraw accounts have been substantial, totalling about 3¾ per cent of disposable income (around $98 billion).

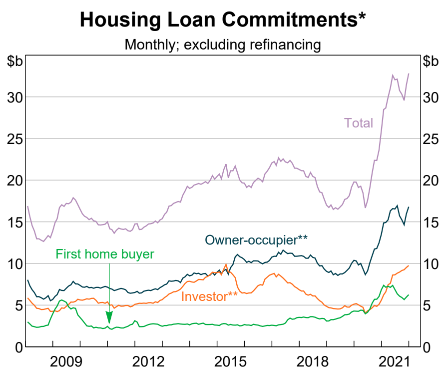
Reductions in housing loan interest rates since March 2020 have flowed through to borrowers in the form of lower interest payments (Graph 3.24). Interest payments have declined by around 1¼ percentage points as a share of disposable income, despite outstanding housing credit increasing over that period. This reflects the pass-through of the Bank's policy measures, borrowers refinancing to lower interest rates and growth in disposable income.

In response to the COVID-19 outbreaks and associated lockdowns in mid-2021, many banks offered affected household borrowers support, including payment deferrals. The uptake of these deferrals was very low, peaking at less than 1 per cent of outstanding housing credit, compared with a peak of 11 per cent in 2020. Almost all borrowers have returned to their regular repayment schedule following the expiration of their prior deferral arrangements.

Lending to businesses has picked up

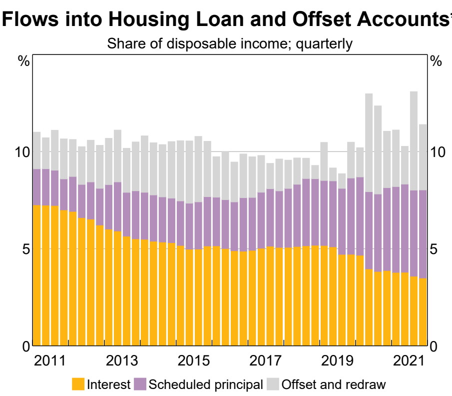
Business lending has picked up over recent months (Graph 3.25). The increase of late has been driven by lending to large businesses, while the volume of lending to medium-sized firms has also increased. Lending to small firms has been little changed for some time. The increase in lending has been driven by business services and financial firms. Lending has also increased to firms that were less hindered by lockdowns, such as those in goods production industries (particularly agriculture) and those

Graph 3.23



* Seasonally adjusted and break-adjusted.
** Excluding first home buyers.
Sources: ABS; RBA

Graph 3.24



* Seasonally adjusted and break-adjusted.
Sources: ABS; APRA; RBA

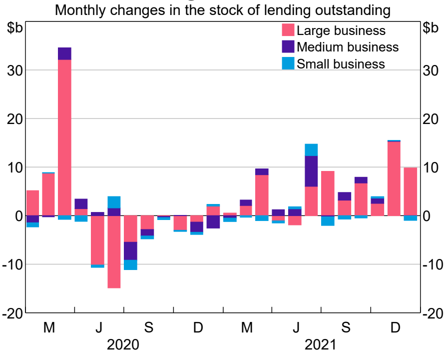
involved in goods distribution (including wholesale trade) (Graph 3.26).

Liaison suggests that demand for debt from some businesses and industries began to pick up in late 2021 as restrictions eased and spending recovered. Even so, lockdowns may have weighed on demand for debt for some firms, and these effects may linger for some time. Some businesses still have little immediate need to borrow, in part because of the cash they accumulated in 2020 and 2021. Recent outbreaks of the Omicron variant may weigh on firms' appetite for additional debt, as spending in some sectors weakens, supply chains are disrupted and businesses manage staff shortages.

Graph 3.25

Lending to Business*

Monthly changes in the stock of lending outstanding

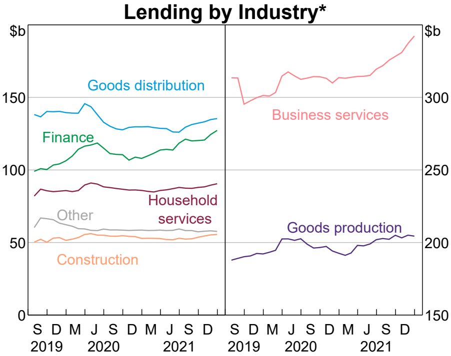


* Data cover financial institutions with $2 billion or more of business credit; not seasonally adjusted.

Sources: APRA; RBA

Graph 3.26

Lending by Industry*



* Excludes lending to ADIs, registered financial corporations and central borrowing authorities.

Sources: APRA; RBA

In December 2021, the Australian Government announced changes to the SME Recovery Loan Scheme (an extension of the SME Guarantee Scheme), with loans now available until 30 June 2022 (previously 31 December 2021) with a guarantee of 50 per cent (previously 80 per cent). As at December, around $2.8 billion of loan commitments had been made under the scheme. Take-up has picked up since the start of October, consistent with the government expanding the scheme to all SMEs adversely economically affected by the pandemic. The scheme was previously limited to firms that had received JobKeeper payments in the March quarter of 2021 or had been affected by the floods in New South Wales in March that year.

In July 2021, many banks reintroduced deferral arrangements for loan payments of up to three months for small business customers affected by lockdowns and other COVID-19-related restrictions. The take-up of deferral arrangements has been low compared with 2020. Deferrals peaked at around ½ per cent of the value of SME lending in September 2021, compared with around 18 per cent in June 2020; almost all loan deferral arrangements had expired by the end of November. The majority of loans that had repayment deferrals were located in New South Wales or Victoria.

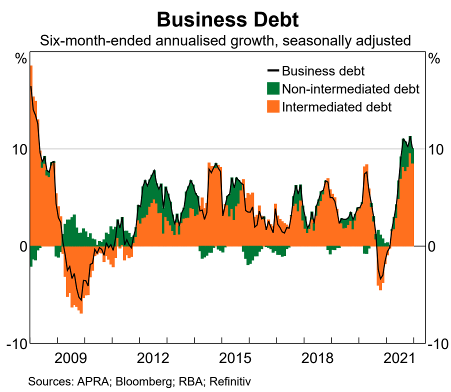
Growth of broader measures of business debt has been strong

The pick-up in business credit in recent months has contributed to an increase in growth in the broader measure of business debt, which remains well above the average of recent years (Graph 3.27). The volume of syndicated lending increased a little in December, while growth in non-intermediated debt has eased in recent months.

Corporate bond issuance increased in 2021

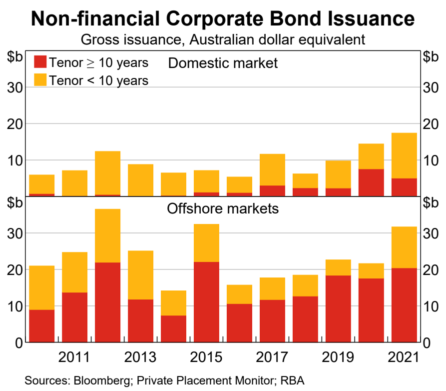
Bond issuance by non-financial corporations increased in 2021, driven partially by a pick-up in issuance from resource-related firms. Issuance in both the domestic and offshore markets was well above average, and the volume of bonds with a tenor of 10 years or longer remained high (Graph 3.28). Liaison suggests that the low level of interest rates has increased demand for long-term bonds as investors have sought higher yields. Corporate bond spreads increased in the second half of 2021 but remained at low levels. Issuance in January was low, as is common for that time of year.

Graph 3.27



Sources: APRA; Bloomberg; RBA; Refinitiv

Graph 3.28



Sources: Bloomberg; Private Placement Monitor; RBA

Australian equity prices have fallen recently following gains in 2021

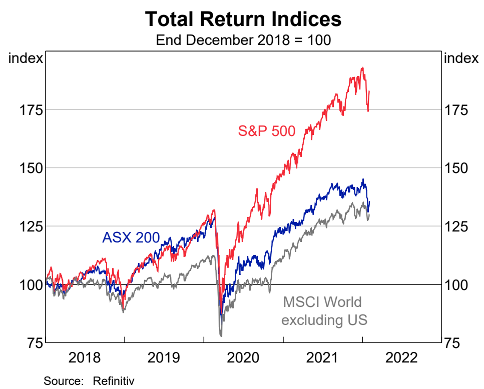
Over 2021, the ASX 200 increased by around 17 per cent on a total returns basis, underperforming US equity markets but roughly in line with the rest of the world (Graph 3.29). More recently, on a total return basis, the ASX 200 has fallen 5 per cent over the year to date, broadly in line with the US market over the same period. The ASX 200 price index is now 7 per cent lower than its most recent peak in August 2021.

Equity prices in the resources sector increased by around 3 per cent over 2021, with some volatility associated with moves in commodity prices, most notably iron ore (Graph 3.30). By contrast, energy stocks declined over the year, despite a rise in prices for oil, coal and LNG. The financial sector increased by around 20 per cent over 2021, with a number of major banks reporting higher profits, in line with the improved economic outlook. More recently, the price of technology stocks has declined alongside a rise in long-term bond yields.

Capital markets activity was at a high level in 2021

Over the course of 2021, there were over 1,200 merger and acquisition (M&A) deals announced with a total deal value of around

Graph 3.29



Source: Refinitiv

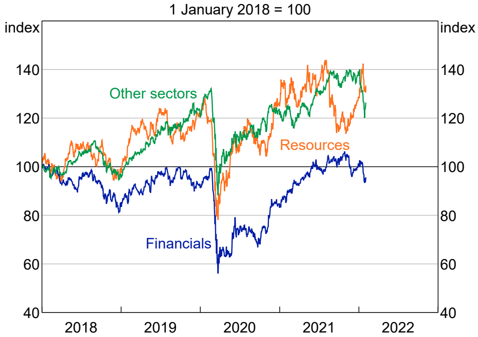
$320 billion (Graph 3.31). While it is unclear whether all of these deals will be accepted, the year ended with around the highest level of annual activity in the Australian market on record. Notable deals included Square's acquisition of Afterpay, the merger of BHP's oil and gas assets with Woodside Petroleum and the bid for Sydney Airport by the consortium led by IFM Investors. In addition, BHP removed its dual-listed company structure at the end of January.

During 2021, there were 207 initial public offerings (IPOs) with a total value raised of around $12 billion (Graph 3.32). This is significantly higher than the average over the past decade and is the highest level since 2014.

Graph 3.30

Australian Share Prices

1 January 2018 = 100

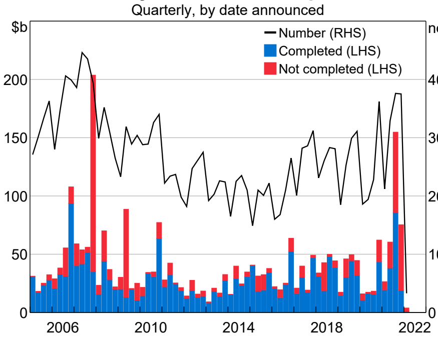


Source: Bloomberg

Graph 3.31

M&A by Australian Companies*

Quarterly, by date announced



* Excludes the Telstra–NBN transaction and BHP Ltd's acquistion of BHP Plc; latest observation is quarter to date.

Sources: RBA; Refinitiv

In addition, Australian companies raised around $58 billion in secondary offerings, which is slightly above the average over the past decade.

Buybacks and dividends were also at a record level in 2021

Buybacks in the second half of 2021 were at a record level of around $15 billion (Graph 3.33). This was driven mainly by the major banks after the constraints on capital distribution introduced early in the pandemic were relaxed and credit provisions from 2020 were partly written back. Some companies also announced buybacks following large cash windfalls due to the recent sale of assets. Dividends paid of over $100 billion during 2021 exceeded the previous high in 2019. This was in large part driven by the mining companies, which benefited from elevated commodity prices over the period.

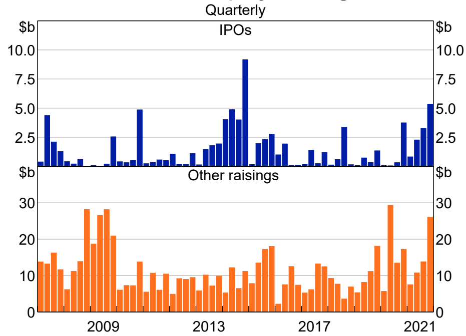
Price-to-earnings ratios are varied across sectors

The headline profits of ASX 200 companies were at a record level in the 2020/21 financial year, driven primarily by the major mining companies (Graph 3.34). Analysts forecast that earnings for energy and materials companies will increase this financial year to new highs, before declining in financial years 2022/23 and 2023/24. By

Graph 3.32

Australian Equity Raisings*

Quarterly



* All listed companies.

Sources: ASX; RBA

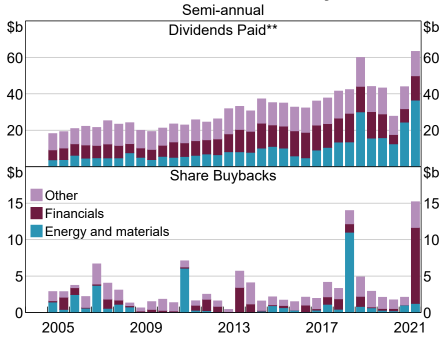
contrast, profits in the financial and other sectors were low relative to pre-pandemic levels.

These fluctuations in annual earnings have affected some common measures of valuations. For example, while the 12-month forward price-to-earnings ratio for resources is quite low, it is elevated for the financial and other sectors (Graph 3.35). In part, this is because earnings are forecast to remain high for resources and relatively lower elsewhere, although there are other influences. For example, the price-to-earnings ratio in other sectors has been trending up for a while, influenced by increases in the equity prices of sectors whose earnings are expected to grow, like health care.

Graph 3.33

Australian Dividends and Buybacks*

Semi-annual



* Dividends are for ASX 200 companies; buybacks are for ASX-listed companies.

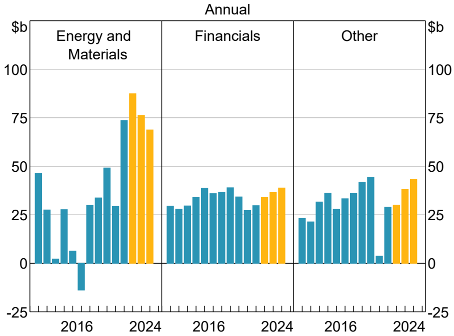
** Last observation is dividends announced.

Sources: ASX; Company Reports; Morningstar; RBA

Graph 3.34

ASX 200 Headline Earnings*

Annual



* Yellow bars are average forecast earnings by market analysts.

Sources: RBA; Refinitiv

The Australian dollar remains towards the lower end of its range over the past year

The Australian dollar depreciated from early November 2021, reaching its lowest levels for the year in December, as market participants brought forward their expectations for monetary policy tightening in the United States and commodity prices declined (Graph 3.36). This depreciation was consistent with a decline in yields on shorter-term Australian Government bonds relative to those of the United States. Although the Australian dollar subsequently appreciated a little, it has since returned to the lower end of its range over the past year amid a decline in equity prices and continued focus on withdrawal of policy stimulus in the United States. The Australia dollar is now lower than it was at the start of 2021, despite noticeably higher commodity prices since then and a rise in Australian interest rates relative to some major advanced economies.

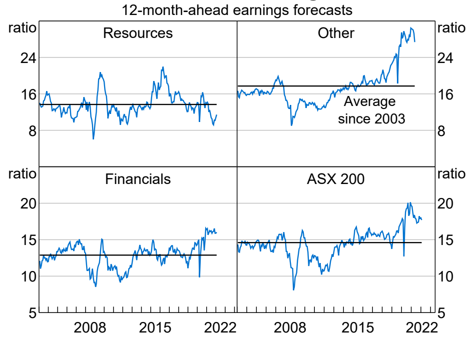
Australia continued to experience net capital outflows in the September quarter

Australia continued to record net capital outflows in the September quarter, the corollary to the current account surplus (Graph 3.37). Outflows reflected Australian investment funds

Graph 3.35

ASX 200 Price-to-earnings Ratios

12-month-ahead earnings forecasts



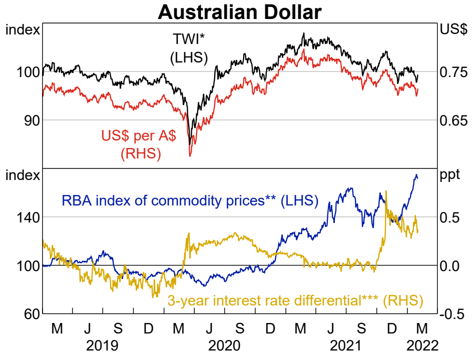
Sources: RBA; Refinitiv

continuing to increase their holdings of foreign equities. Partly offsetting this was a net inflow of capital to Australia as banks issued offshore debt.

Australia's net foreign liabilities decreased to around 40 per cent of GDP in the September quarter – its lowest level since the late 1980s (Graph 3.38). The decrease was driven primarily by an increase in the net foreign equity asset position. The net income deficit, which comprises net payments made on Australia's net foreign liability position, widened considerably over the quarter. This was driven by increased payments on foreign holdings of Australian equity, which were related to higher profits in the mining sector.

Graph 3.36

Australian Dollar



* Trade-weighted index, indexed to 1 January 2019 = 100.

** Indexed to 1 January 2019 = 100.

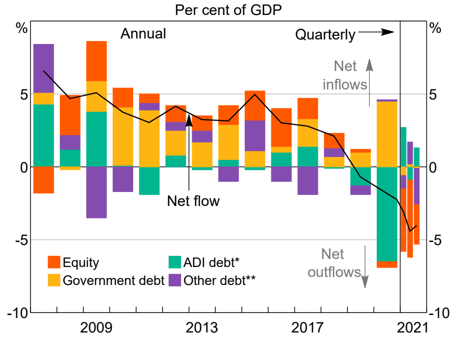
*** Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP. The Australian three-year yield is an interpolated series.

Sources: Bloomberg; RBA; Yieldbroker

Graph 3.37

Net Capital Flows

Per cent of GDP



* Adjusted for the US dollar swap facility in 2008–2009 and 2020.

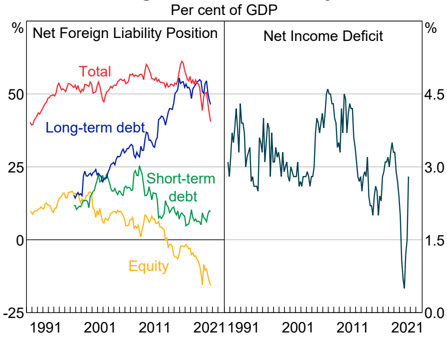
** Includes public corporations and private sector.

Sources: ABS; RBA

Graph 3.38

Net Foreign Position and Payments

Per cent of GDP



Sources: ABS; RBA

4. Inflation

Inflation was much stronger in the December quarter of 2021 than was expected at the time of the November *Statement*. The pass-through of upstream cost pressures – particularly for new dwellings and durable goods – has occured more quickly than anticipated and accounted for a large portion of the increase in inflation in recent quarters. Inflationary pressures have also broadened a little, with prices picking up for some market services.

Wages growth picked up in the September quarter (as expected in the previous *Statement*), returning to the low rate observed in the years leading up to the COVID-19 pandemic. Wages growth was stronger in those industries where there have recently been reports of labour shortages, notably professional services and construction. However, for most other industries there was little evidence that wages were rising beyond the relatively subdued rates of growth seen in the years leading up to the pandemic. Evidence from the Bank's business liaison program suggests that most firms are not anticipating wages growth to move beyond the 2 to 3 per cent range over the year ahead, although reports of strategies to attract and retain workers other than those involving raising base wages have become more common.

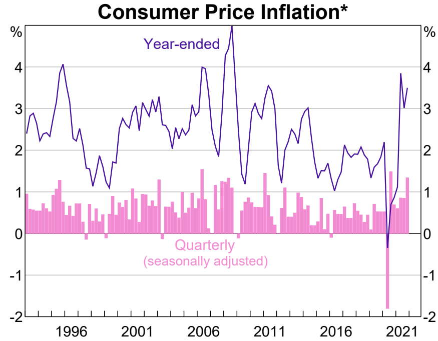
Inflation in the December quarter was much stronger than expected

The headline Consumer Price Index (CPI) increased by 1.3 per cent (seasonally adjusted) in the December quarter and 3.5 per cent over the year (Graph 4.1; Table 4.1). This outcome was higher than the 3¼ per cent annual inflation rate that was expected at the time of the November *Statement*. As was the case in the September quarter, large price movements in a small number of components accounted for a significant share of the increase in headline CPI; price increases for newly constructed dwellings, consumer durables and automotive fuel, which together comprise around one-third of the CPI basket, accounted for around two-thirds of the increase in the headline CPI in the quarter (Graph 4.2).

Although a few items made outsized contributions to growth in the CPI, inflationary pressures have broadened in recent quarters, with price increases picking up for many consumer durables and some market services. Around three-fifths of the CPI basket had an annualised inflation rate above 2.5 per cent in the December quarter, compared with two-fifths in the years leading up to the pandemic (Graph 4.3).

Graph 4.1

Consumer Price Inflation*



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

Sources: ABS; RBA

Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly(a)		Year-ended(b)	
	December quarter 2021	September quarter 2021	December quarter 2021	September quarter 2021
Consumer Price Index	1.3	0.8	3.5	3.0
Seasonally adjusted CPI	1.3	0.8	–	–
– Tradables	1.7	0.6	4.9	3.1
– Tradables (excl volatile items)(c)	1.3	0.0	2.2	0.8
– Non-tradables	1.2	0.9	2.8	3.2
Selected underlying measures				
Trimmed mean	1.0	0.7	2.6	2.1
Weighted median	0.9	0.8	2.7	2.2
CPI excl volatile items(c)	1.2	0.6	2.6	2.5

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS.

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median.

(c) Volatile items are fruit, vegetables and automotive fuel.

Sources: ABS; RBA

Measures of underlying inflation remove the effect of irregular or temporary price changes in the CPI. These measures indicate that underlying inflation rose by around 1 per cent in the quarter and 2.6 per cent over the year (Graph 4.4; Table 4.1); this was one of the strongest quarterly outcomes in decades and represents a material increase in underlying inflation relative to recent years.

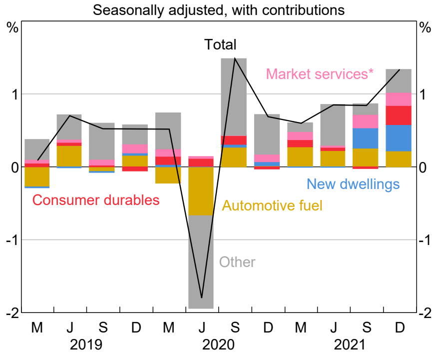
Pass-through of upstream cost pressures has driven the recent pick-up in goods inflation

Prices for new dwelling construction, which make up just under one-tenth of the CPI basket, increased significantly – up by 4.2 per cent in the December quarter. This was driven by further substantial increases in the prices charged by builders (exclusive of government subsidies) in

Graph 4.2

Quarterly CPI Inflation

Seasonally adjusted, with contributions



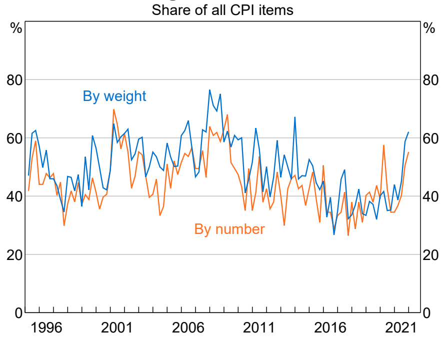
* Excludes domestic travel and telecommunications.

Sources: ABS; RBA

Graph 4.3

CPI Items Rising Faster than 2.5 Per Cent*

Share of all CPI items



* Based on seasonally adjusted data; CPI items with annualised quarterly growth greater than 2.5 per cent.

Sources: ABS; RBA

most capital cities. A key driver of the pick-up in these prices has been the strong rise in the cost of raw materials, which increased by 3.8 per cent in the December quarter and 12 per cent over the year (Graph 4.5). Domestic and global supply shortages have particularly affected prices of timber and steel inputs. Price increases also reflect a surge in construction activity in response to policy inducements – residential building commencements are at a record level, and capacity utilisation in the construction industry has been high (see chapter on 'Domestic Economic Conditions').

In addition, new dwelling inflation increased because fewer government grants were paid out in the December quarter than in the September quarter – this accounted for less than one-fifth of the total increase in new dwelling prices (Graph 4.6). The number of grants paid out is expected to decline over time, which will provide a boost to measured inflation as prices measured in the CPI converge to the prices charged by builders. However, the effect on inflation in a given quarter will vary depending on how many grants are paid out during that period.

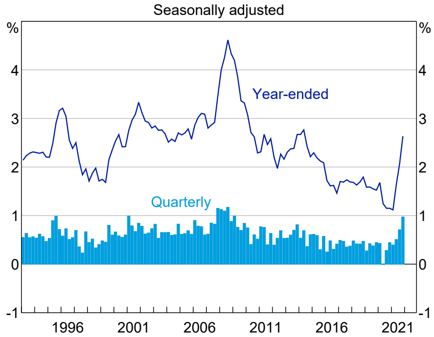
Prices also increased strongly for most consumer durable items on the back of ongoing supply chain disruptions at overseas factories, sustained global and domestic demand, and elevated shipping costs (Graph 4.7). Overall, prices of consumer durables increased by 1.5 per cent in the December quarter – the strongest quarterly outcome since 2009, following the large depreciation in the exchange rate during the global financial crisis. Clothing & footwear prices increased particularly strongly; retailers ceased some of the higher-than-normal discounting undertaken in the September quarter, which was introduced to clear excess winter stock that had built up during the lockdowns in the second half of 2021.

Reports of input cost pressures remain widespread across goods-importing firms and these pressures are expected to persist for a while yet. While some retailers have been

Graph 4.4

Trimmed Mean Inflation*

Seasonally adjusted

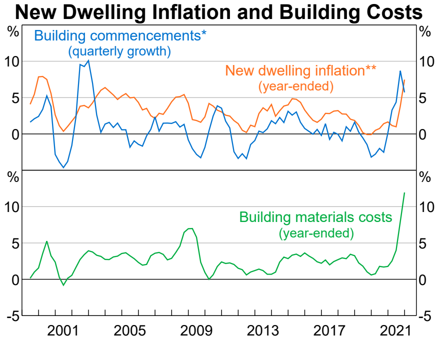


* Excludes interest charges prior to the September quarter of 1998 and deposit & loan facilities; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.5

New Dwelling Inflation and Building Costs



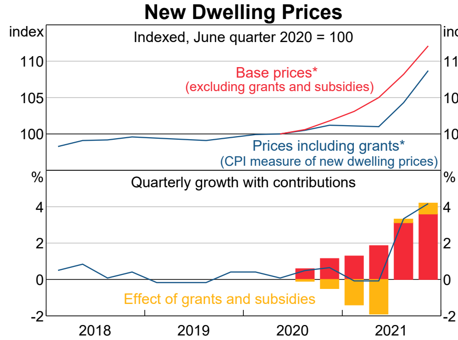
* Six-quarter average lagged by one quarter; detached only prior to 2017.

** Adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA

Graph 4.6

New Dwelling Prices



* Government housing construction grants include HomeBuilder and state government grants.

Sources: ABS; RBA

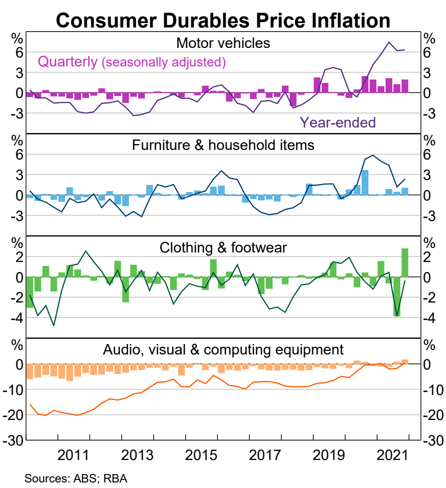
reluctant to pass on the higher costs to their customers, liaison reports that the proportion of sellers raising prices in response to sustained cost pressures is increasing. Many durable goods retailers have either increased prices, or are expecting to do so early this year. However, it remains uncertain whether these price increases represented a large, one-off, upward adjustment in prices of durable goods, a temporary increase in prices that will be reversed as a more normal balance between supply and demand is re-established, or the beginning of a series of ongoing price increases. Some firms continue to absorb cost increases for various reasons, including competitive pressures.

Inflationary pressure in market services picked up in the second half of 2021

Inflation in the prices of market services, which accounts for a little over one-fifth of the CPI basket, picked up in the second half of 2021 to be 2.4 per cent higher over the year – the fastest annual increase since 2013 (Graph 4.8). The prices of these services are generally driven by domestic factors such as labour costs and other domestically sourced inputs.

Prices of meals out & takeaway increased by 1 per cent in the quarter as firms sought to

Graph 4.7

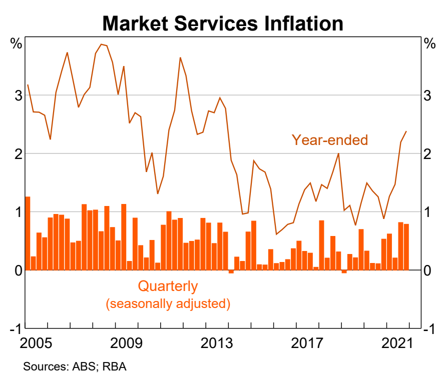


recoup increased labour and non-labour costs (Graph 4.9). The use of state government vouchers such as the NSW 'Dine & Discover' voucher weighed a little on measured hospitality prices in the December quarter. However, many of these vouchers are yet to be redeemed and will temporarily weigh on measured market services inflation as they are used in the first half of 2022. Prices for domestic travel and accommodation services decreased a little in seasonally adjusted terms, despite the strong increase in demand for domestic holidays as states emerged from lockdowns and borders reopened. Higher real estate agent fees, due to strength in the established housing market in late 2021, drove insurance & financial services prices higher in the quarter.

Rent inflation remained weak, although there are large differences across cities

Rents, which account for around 6 per cent of the CPI basket, increased by 0.1 per cent in the December quarter. CPI rents – which cover the entire stock of rental properties – declined a little in Sydney and Melbourne but increased in other capital cities (Graph 4.10). Following a strong increase in advertised rents for new tenants across most cities over 2021, the gap between advertised rents and CPI rents remains large by historical standards (see chapter on 'Domestic Economic Conditions'). This reflects

Graph 4.8



the ongoing impact of pandemic-related discounts, greater-than-usual discounting of advertised rents and the small share of rentals that are leased to new tenants each quarter. Stronger advertised rents are expected to contribute to a pick-up in CPI rent growth over 2022, although the timing and extent of this pass-through remains uncertain.

Grocery prices rose modestly

Grocery prices (excluding fruit & vegetables) increased by 0.6 per cent in the quarter to be 1.9 per cent higher than a year ago (Graph 4.11). While lockdowns in 2020 and the sharp increase in 'at home' food consumption contributed to a marked rise in grocery inflation, prices did not respond similarly during the lockdowns in the second half of 2021; liaison information suggests that supermarket discounting behaviour remained in line with pre-pandemic patterns. Growth in dairy prices increased, while growth in meat prices moderated somewhat. Price increases for most other fresh food categories were generally strong.

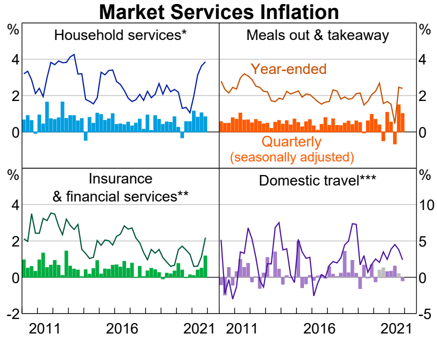
Prices of fruit & vegetables declined by 0.8 per cent in the quarter to be 0.2 per cent higher over the year. Favourable growing conditions have supported lower prices for fruit over recent quarters.

Fuel prices continued to increase, making a large contribution to headline inflation

Fuel prices increased by 6.6 per cent in the December quarter, contributing 0.22 percentage points to headline inflation (Graph 4.12). Over 2021, fuel prices rose by 32 per cent – the largest annual increase since 1990. Fuel prices have increased a little further since the beginning of 2022, and at current levels would make another positive contribution to quarterly headline inflation in the March quarter.

Graph 4.9

Market Services Inflation

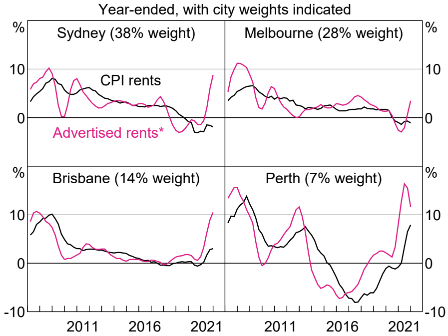


* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services.
** Excludes deposit & loans to June quarter of 2011.
*** Imputed using headline CPI in the June and September quarters of 2020 and September quarter of 2021.
Sources: ABS; RBA

Graph 4.10

Rent Inflation

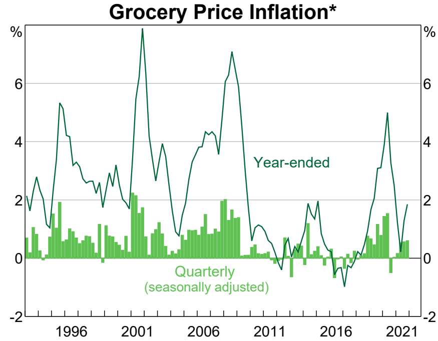
Year-ended, with city weights indicated



* Hedonic three-month average.
Sources: ABS; CoreLogic; RBA

Graph 4.11

Grocery Price Inflation*



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

Growth in administered prices has returned to pre-pandemic rates

Administered prices (excluding utilities) rose by 0.6 per cent in the December quarter and 2.4 per cent over the year; these increases were broadly in line with pre-pandemic trends (Graph 4.13). Increases in child care and school education prices, as well as prices for medical and hospital services, were also broadly in line with pre-pandemic rates.

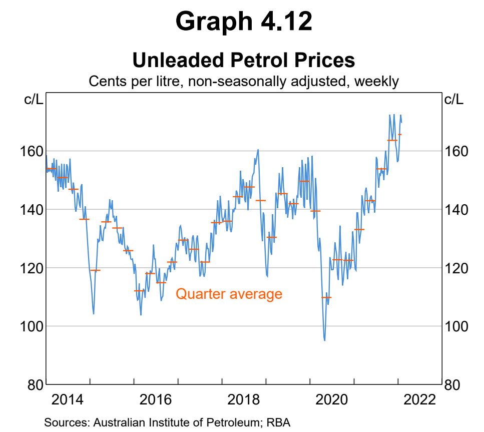
Retail electricity prices declined slightly in the December quarter, continuing the downward trend of recent years; prices are now around 10 per cent lower than their peak at the end of 2018, in part reflecting increased supply of renewable energy (Graph 4.14). Retail gas prices increased by 1.5 per cent in the quarter, following a spike in wholesale gas prices in the second half of 2021 that was driven partly by constrained supply. According to liaison information, the increase in wholesale prices is expected to be temporary.

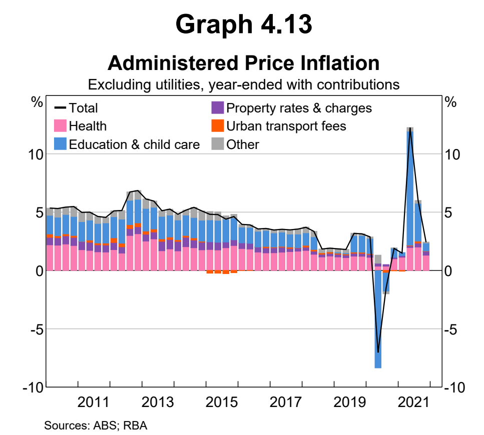
Short-term inflation expectations have increased further in recent months

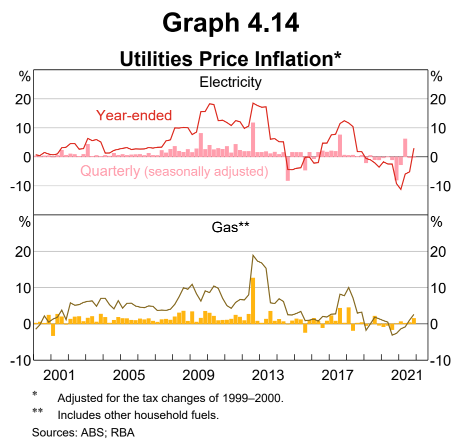
Survey-based measures of short-term inflation expectations have increased further over recent months to around their highest levels in some years (Graph 4.15). However, survey measures of long-term inflation expectations have remained around 2½ per cent, consistent with the Bank's medium-term inflation target (Graph 4.16). Long-term market-based measures of inflation expectations were also little changed over recent months.

Wages growth returned to pre-pandemic norms in the September quarter

The Wage Price Index (WPI) grew by 0.6 per cent in the September quarter, and 2.2 per cent in year-ended terms. Private sector wages increased by 2.4 per cent over the year, which is slightly above its pre-pandemic growth rate (Graph 4.17). Most industries saw a return to the low level of wage increases observed in the years leading up to the COVID-19 pandemic,







with only the professional services industry recording wages growth in excess of 3 per cent. Public sector wages growth remained subdued at 1.7 per cent, as public sector wages policies continued to weigh on outcomes.

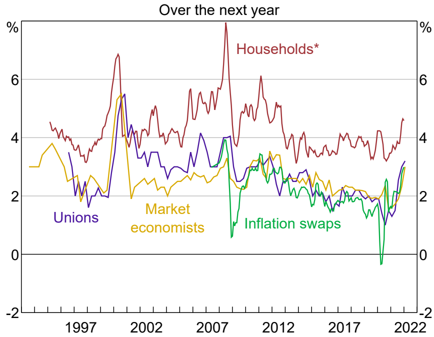
Wages growth has varied by pay-setting arrangements over the past year (Graph 4.18). Wages growth for workers on individual arrangements with their employer bounced back sharply in the year to the September quarter, reflecting the reversal of large wage cuts for a small number of jobs in 2020 and a faster response to the tightening labour market than other pay-setting methods; liaison reports suggest that some jobs in high demand have been receiving very large wage increases. WPI growth in the year to the September quarter was also boosted by award wage increases in many industries, including the delayed implementation of some increases announced in 2020. By contrast, aggregate WPI outcomes have continued to be weighed down by slower growth in wages for jobs covered by public and private enterprise agreements. These subdued outcomes are consistent with announced government wages policies and the multi-year duration of many private sector agreements.

Although the share of jobs subject to wage freezes declined in the September quarter, it remained at the upper end of its historical range

Graph 4.15

Short-term Inflation Expectations

Over the next year

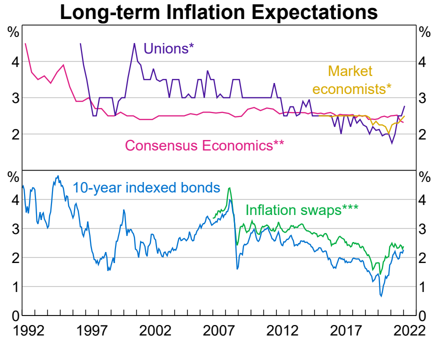


* Smoothed.

Sources: Australian Council of Trade Unions; Bloomberg; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

Graph 4.16

Long-term Inflation Expectations



* Average over the next 5 to 10 years.

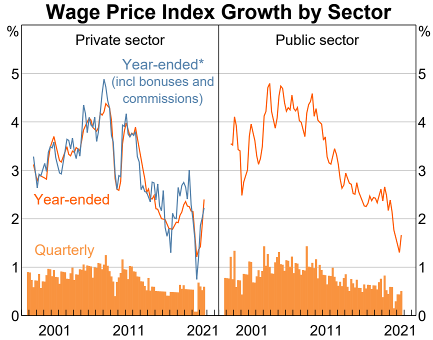
** Average over 6 to 10 years in the future.

*** 5- to 10-years forward.

Sources: Australian Council of Trade Unions; Bloomberg; Consensus Economics; RBA; Workplace Research Centre; Yieldbroker

Graph 4.17

Wage Price Index Growth by Sector



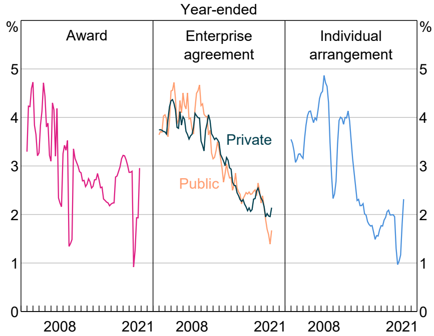
* Non-seasonally adjusted.

Source: ABS

Graph 4.18

Wages Growth by Pay-setting Method*

Year-ended



* Excludes bonuses and commissions.

Sources: ABS; RBA

(Graph 4.19). However, information from the Bank's liaison program suggests that the use of wage freezes declined further in the December quarter and few firms expect to have wage freezes in place over the year ahead.

Growth in private sector WPI showed little variation across the states and territories (Graph 4.20). States that were less affected by the Delta-related lockdowns in 2021, such as Western Australia and South Australia, did not experience a noticeable increase in wages growth despite a tightening in labour market conditions. Aggregate wages growth in these states was also restrained by weak growth in public sector wages.

With consumer price inflation picking up faster than wages growth over the second half of 2021, real (inflation-adjusted) wages have declined. Households whose spending is concentrated in the categories where prices have risen the fastest – such as fuel, some durables and dwelling construction – have experienced a larger decline in real purchasing power. However, growth in households' real incomes overall also depends on other income sources, including superannuation payments, which have increased significantly. Broad measures of growth in average earnings have remained highly volatile in recent quarters, due to large compositional changes in the workforce caused by the pandemic.

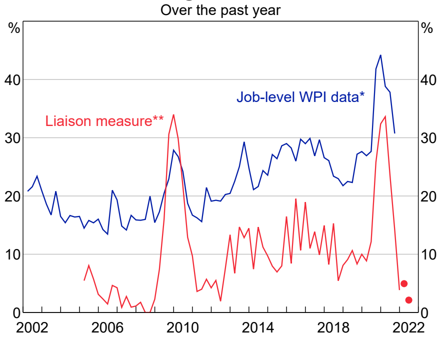
Despite ongoing reports of labour shortages, most firms in the Bank's liaison program are not anticipating wage increases to move beyond the 2 to 3 per cent range over the coming year (Graph 4.21). This is consistent with other surveys of wages growth expectations (Graph 4.22).

Instead of increasing growth in base wages, many firms continue to respond to labour shortages by implementing a range of non-base wage strategies – including targeted bonuses, flexible work policies (including work from home), more internal training and hiring staff

Graph 4.19

Wage Freezes

Over the past year



* Share of all jobs.

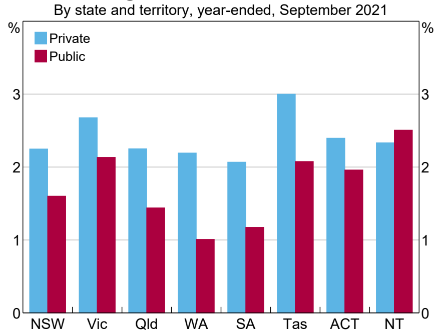
** Share of liaison firms with a recorded wage outcome; dots represent firms' expectations for March and June quarters of 2022.

Sources: ABS; RBA

Graph 4.20

Wage Price Index Growth*

By state and territory, year-ended, September 2021



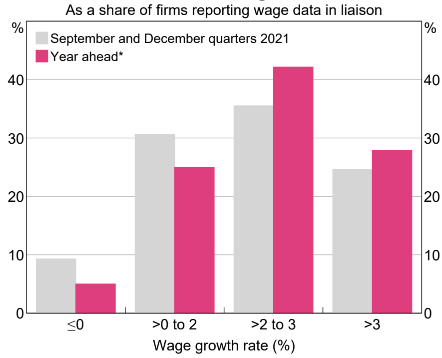
* Non-seasonally adjusted; excluding bonuses and commissions.

Source: ABS

Graph 4.21

Distribution of Wages Growth

As a share of firms reporting wage data in liaison

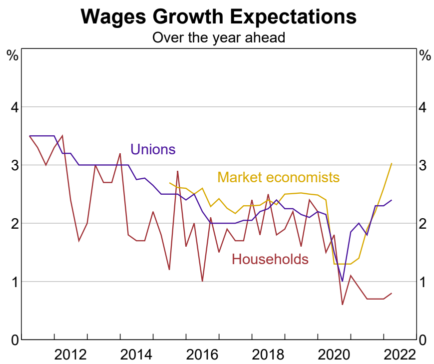


* Expectations for the year ahead for firms reporting in the September and December quarters of 2021.

Source: RBA

with less experience. In some industries, this has been in response to an increase in voluntary staff turnover, particularly in professional services and some construction and mining-related roles.

Graph 4.22



Sources: Australian Council of Trade Unions; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

5. Economic Outlook

Global economic growth picked up in the second half of 2021 following the lifting of mobility restrictions, and is forecast to remain above trend in 2022. The rapid spread of the Omicron variant of COVID-19 has been disruptive but is not anticipated to have a large or sustained impact on growth. Inflation in many countries has persisted at multi-year highs and has broadened in scope. Central banks in advanced economies still expect inflation to moderate, but have raised their inflation forecasts for 2022 and have emphasised the considerable uncertainty surrounding this outlook (see chapter on 'The International Environment').

The Australian economy had established solid momentum prior to the Omicron outbreak at the end of 2021. Domestic economic activity bounced back strongly in the December quarter, driven by a surge in household spending as restrictions relating to the Delta outbreak were eased. The spread of the Omicron variant will slow growth in the March quarter, but is expected to have a much smaller impact on economic activity than previous waves of COVID-19; activity is forecast to regain momentum in coming quarters. In the central scenario, GDP is forecast to have grown by 5 per cent over 2021, and to grow by around 4¼ per cent over 2022 and 2 per cent over 2023. The unemployment rate is forecast to decline gradually over the forecast period, to 3¾ per cent by the end of 2023 (Table 5.1).

Inflation picked up in the second half of 2021, by more than expected at the time of the November *Statement*, and the outlook for inflation has been revised higher. Consumer price inflation in the December quarter was 1.3 per cent and 3½ per cent over the year, led by increases in the prices of new dwellings, durable goods and fuel. Underlying inflation has also picked up in recent quarters and is forecast to increase further to 3¼ per cent in mid-2022, largely reflecting upstream cost pressures amid strong demand in housing construction and the durables goods sector. Further out, the drivers of inflation are anticipated to shift, with a steady pick-up in labour costs in response to strong labour market conditions forecast to sustain inflation in the top half of the 2 to 3 per cent target range.

In light of the ongoing uncertainty around health outcomes, alternative scenarios for the outlook are considered below. The upside and downside scenarios illustrate two plausible alternative paths for the economy based on different underlying assumptions about health outcomes and how household consumption responds to higher wealth. These factors have implications for the pace of improvement in the labour market and the rate of inflation. Other sources of uncertainty, including the extent of labour market spare capacity and how wages and prices respond to this in the period ahead, are addressed separately from the scenarios.

Domestic activity and inflation are forecast to increase in coming quarters

After a rapid recovery in activity in the December quarter, the effect of the Omicron variant is expected to drag on growth in economic activity during early 2022. With large

Table 5.1: Output Growth and Inflation Forecasts[a]

Per cent

	Year-ended					
	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023	June 2024
GDP growth	5	5	4¼	2½	2	2
(previous)	(3)	(4)	(5½)	(3¼)	(2½)	(n/a)
Unemployment rate[b]	4.7	4	3¾	3¾	3¾	3¾
(previous)		(4½)	(4¼)	(4)	(4)	(n/a)
CPI inflation	3.5	3¾	3¼	2¾	2¾	2¾
(previous)		(2¾)	(2¼)	(2¼)	(2½)	(n/a)
Trimmed mean inflation	2.6	3¼	2¾	2¾	2¾	2¾
(previous)		(2¼)	(2¼)	(2¼)	(2½)	(n/a)
	Year-average					
	2021	**2021/22**	**2022**	**2022/23**	**2023**	**2023/24**
GDP growth	4¾	4½	5½	4¾	2½	2
(previous)	(4¼)	(3¼)	(5)	(5)	(3)	(n/a)

(a) Forecasts finalised on 2 February. 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, and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2022 Board meeting. Other forecast assumptions (November *Statement* forecasts in parenthesis): TWI at 60 (62), A$ at US$0.71 (US$0.74) and Brent crude oil price at US$85bbl (US$80bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Mid-year Economic and Fiscal Outlook. 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

numbers of people isolating, many businesses' operations have been disrupted by worker shortages, and total hours worked are forecast to decline temporarily as a result. Household spending, particularly on services, is forecast to be lower than otherwise due to reduced spending by those in isolation and reduced discretionary spending more broadly. However, the effect of Omicron is expected to be limited compared with previous COVID-19 waves as high vaccination rates and less severe health outcomes mean that lockdowns are likely to be avoided.

GDP growth is forecast to strengthen through the middle of this year, with broad-based growth in domestic demand sustained across the forecast period. Consumption is forecast to be supported by strong labour income growth and the large increase in household wealth over recent years. Dwelling investment is expected to remain elevated across the forecast period as the large pipeline of work is progressed. The recovery in business investment that was underway before the Delta outbreak in mid-2021 is forecast to continue, supported by tax incentives, strong corporate balance sheets and the broader recovery in demand conditions. Federal and state midyear budgets point to a stronger outlook for public demand than was previously expected, adding to overall domestic demand growth over 2022. The external sector is forecast to drag on growth as the recovery in domestic demand sees imports grow rapidly, while exports recover more gradually.

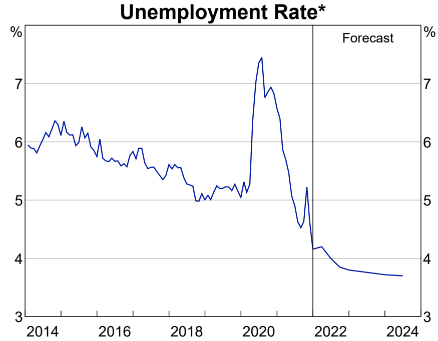
Average hours worked, rather than employment, is expected to bear most of the adjustment to labour supply disruptions in the March quarter. The average number of hours worked per worker is forecast to fall temporarily in early 2022, reflecting a surge in absences in some industries due to Omicron-related illness and isolation requirements. However, the spread of Omicron is expected to have no lasting impact on labour demand. Employment is forecast to grow strongly over the remainder of 2022 before moderating in 2023 in line with growth in activity. Participation in the labour force is forecast to be at a historically high level over the forecast period, supported by the strength in labour market conditions. The unemployment rate is forecast to decline to around 3¾ per cent in the second half of 2022 and edge a little lower thereafter (Graph 5.2). Broader measures of labour underutilisation that include workers who are underemployed are also forecast to decline to their lowest level in many years as firms increase hours of existing staff to meet demand.

The forecast profile for underlying inflation is noticeably higher in the near term, reflecting stronger pass-through of upstream cost pressures to consumer prices than was assumed in the November *Statement* (Graph 5.3). Underlying inflation is forecast to increase to 3¼ per cent by mid-2022 before easing as international and domestic supply chain pressures subside. Further out, the tightening labour market and resulting lift in labour costs is forecast to sustain underlying inflation in the top half of the target range of 2 to 3 per cent. Headline inflation is forecast to be above trimmed mean inflation in the near term (mainly due to fuel prices) but to be broadly in line with underlying inflation thereafter.

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. The forecasts also incorporate other elements of the Bank's monetary stimulus that are currently in place and are reflected in market pricing. The exchange rate and oil price are

Graph 5.2

Unemployment Rate*



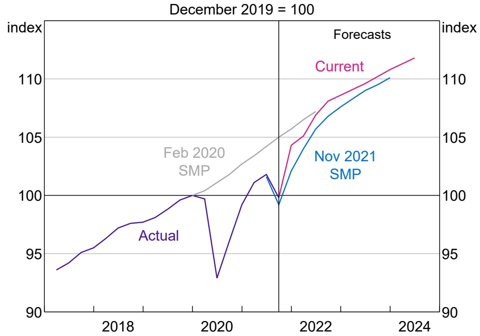
* Actual data is reported on a monthly basis; forecast is projected for each quarter.

Sources: ABS; RBA

Graph 5.1

GDP

December 2019 = 100

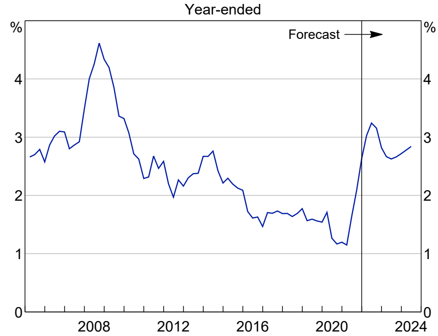


Sources: ABS; RBA

Graph 5.3

Trimmed Mean Inflation

Year-ended



Sources: ABS; RBA

assumed to remain unchanged at current levels. The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's Mid-year Economic and Fiscal Outlook; population growth is expected to recover gradually following the easing of international border restrictions in late 2021. The international border is assumed to reopen to tourists from a wider range of countries over the first half of 2022.

Household consumption, income and saving

Household consumption rebounded strongly in the December quarter as restrictions on activity related to the Delta outbreak were eased and consumption possibilities broadened. Household spending growth is forecast to slow in the March quarter because of precautionary behaviour and lower spending on discretionary goods and services in response to the spread of Omicron, before rebounding across the June and September quarters (Graph 5.4). Further out, the outlook for consumption is supported by strong labour market outcomes, recent increases in household wealth and reduced uncertainty. Strong conditions in the labour market continue to support the outlook for household income via labour income, and are anticipated to offset a decline in non-labour income from disaster payments and other temporary income support measures.

The household saving ratio is forecast to decline in the December quarter, reflecting increased consumption opportunities and lower income support payments. Further out, the saving ratio is expected to continue to decline, while remaining higher than its average level over the five years prior to the pandemic.

Investment

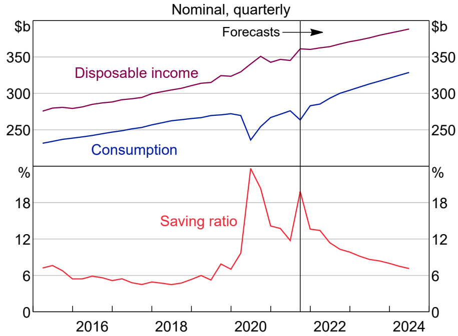
The outlook for investment remains strong with a large pipeline of public and private projects expected to boost activity over coming years (Graph 5.5). Construction activity was resilient in the September quarter as restrictions related to the Delta outbreak were less binding than expected; construction activity is forecast to have increased in the December quarter following the easing of restrictions. The Omicron outbreak is not expected to have a large impact on investment activity in the March quarter. Thereafter, investment is expected to be sustained at a high level across the forecast period.

Fiscal support and monetary easing over recent years have underpinned a strong upswing in housing activity. A large pipeline of residential construction work has commenced and will sustain a high level of construction of new dwellings and renovation activity over coming

Graph 5.4

Household Consumption and Income

Nominal, quarterly

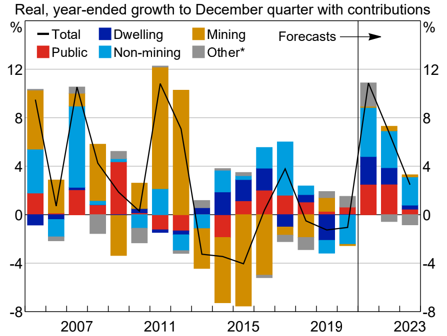


Sources: ABS; RBA

Graph 5.5

Investment

Real, year-ended growth to December quarter with contributions



* Includes ownership transfer costs, net purchases of second-hand assets, and other items.

Sources: ABS; RBA

quarters. While a significant share of these projects have been supported by fiscal subsidies such as HomeBuilder, there is also strong underlying demand for new housing and renovation activity. Some part of this is a response to people's experience of spending a greater amount of time at home during the pandemic and a subsequent desire to improve their residences. Recent increases in household income and wealth, alongside the resumption of population growth following the reopening of the international border, are forecast to lead to an elevated level of residential construction for several years.

The momentum established in non-mining business investment in 2021 is expected to be only slightly disrupted by Omicron and, further out, investment should be supported by the broader recovery in domestic demand. This is consistent with large firms' investment intentions having remained steady through the Delta outbreak in the second half of 2021 and firms' ability to adapt to significant restrictions in the September quarter. While the level of non-residential building approvals has picked up (from a low level) over recent months, there is a risk that businesses complete these projects more slowly than usual due to increased workplace absences related to the spread of Omicron. In addition, supply chain bottlenecks and labour shortages are expected to temporarily slow the ongoing expansion in machinery & equipment investment.

Mining investment is forecast to increase a little over coming years. This partly reflects firms undertaking investment to sustain their level of production, rather than to expand capacity. There is little evidence to date that recent large moves in commodity prices have affected the investment plans of the major miners.

Growth in public investment is forecast to remain strong over 2022. The pipeline of public engineering work yet to be completed is significant and will support a high level of public capital expenditure for several years. Infrastructure firms may face difficulty completing the projects as scheduled because of labour shortages in key roles, as well as constraints on the supply of key materials.

Public consumption

Public consumption is forecast to make a larger contribution to domestic final demand growth over the forecast period than was anticipated at the time of the November *Statement*. The upgrade reflects larger programs for public health spending announced in recent federal and state budgets, including additional spending on patient care and accelerated vaccination programs. The response to the Omicron variant, including the booster vaccination program, will further add to public consumption in the near term.

External sector

The volume of exports is forecast to recover gradually towards pre-pandemic levels over the forecast period, driven mainly by a recovery in travel and education exports as the international border reopens. Resource export volumes have been fairly resilient during the pandemic and resource export values were historically high in the second half of 2021, though maintenance and weather-related disruptions weighed on resource production at that time and are expected to persist in the near term. While growth in manufactured exports is forecast to remain subdued over the first half of 2022 due to ongoing global supply chain disruptions, the recent strength in rural exports is expected to be sustained in the near term because of favourable growing and pasture conditions, as well as strong global demand for grains and meat. Import volumes are forecast to increase strongly in line with domestic demand and the reopening of the international border, though this will be partly offset by the dampening impact from higher world prices for traded goods.

The terms of trade is expected to decline over the forecast period after reaching a record high level in the September quarter (Graph 5.6). An increase in energy-related export prices, particularly LNG and thermal coal, is offset by higher import prices in the forecasts. The price of iron ore has been above US$100 per tonne since the end of 2021, but is forecast to gradually decline to around US$80 per tonne by the end of the forecast period.

Labour market

The outlook for the labour market remains strong. By mid-2022, strong demand for labour is expected to translate into a lower unemployment rate, as well as a declining rate of underemployment as firms boost hours of their existing staff to meet demand.

The Omicron wave is expected to temporarily disrupt labour supply. Average hours worked are forecast to decline sharply in early 2022, reflecting a surge in absences due to Omicron-related illness and isolation requirements (Graph 5.7). However, the fall in aggregate hours worked in January 2022 is expected to be smaller than experienced during the formal lockdowns in 2020 and 2021, and hours are forecast to rebound in February and March.

Beyond the near-term, average hours worked are forecast to rise above their pre-pandemic level, consistent with a labour market that is tighter than it has been for more than a decade.

Employment growth is forecast to rise strongly throughout the year after the Omicron-related disruptions subside, before moderating in 2023 in line with slowing activity growth. The unemployment rate is forecast to decline to 3¾ per cent later in 2022; an unemployment rate this low has not been seen in Australia in nearly half a century. The participation rate is forecast to reach a historical high in late 2022, supported by strong labour demand and longer-run structural drivers, such as higher participation rates among females and older Australians.

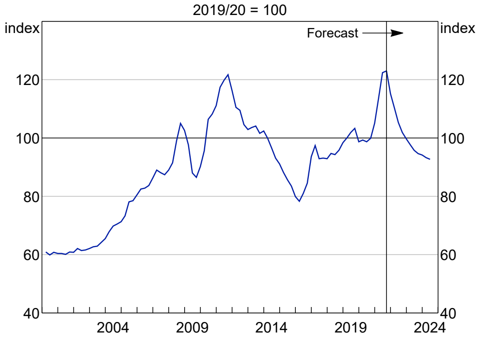
Wages and inflation

Wages growth is forecast to continue to pick up gradually. In the near term, remaining wage freezes are expected to unwind, but most employers in the Bank's liaison program are not expecting wages growth to move beyond the 2–3 per cent range this year. The medium-term outlook for private sector wages growth is stronger than at the November *Statement*, reflecting the upgrade to the labour market forecasts and further absorption of spare capacity. The outlook for broader measures of

Graph 5.6

Terms of Trade

2019/20 = 100

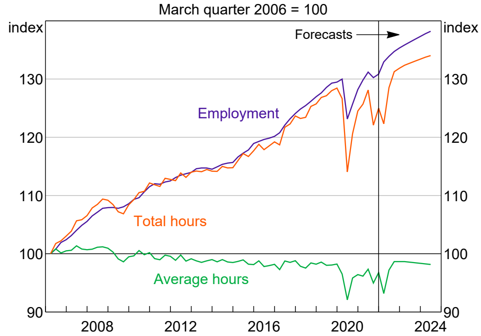


Sources: ABS; RBA

Graph 5.7

Employment and Hours Worked

March quarter 2006 = 100



Sources: ABS; RBA

employee earnings growth has been upgraded more substantially, as bonuses, allowances and other non-base wage payments are expected to respond more quickly to the tightening labour market. Aggregate wages growth outcomes continue to be weighed down by more muted wages growth in public and private enterprise agreements, consistent with announced government wages policies and the multi-year duration of private sector agreements.

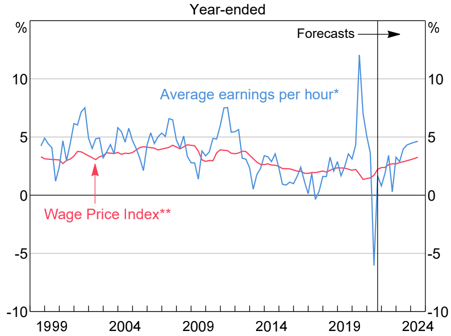
Growth in the Wage Price Index (WPI) is anticipated to pick up to close to 2½ per cent by the end of 2021, which is marginally above its pre-pandemic growth rate (Graph 5.8). WPI growth is then forecast to gradually strengthen further as the unemployment rate declines, to be 3¼ per cent by mid-2024; this would be the fastest pace since 2012.

As the unemployment rate declines, average earnings are forecast to increase at a faster pace than the WPI – the result of an increase in bonus payments, a larger share of hours being worked at overtime rates, and a pick-up in job turnover as workers are more willing to move jobs for higher pay. Increases in the superannuation guarantee rate over coming years are also estimated to increase average earnings growth relative to the WPI. These broader measures of average earnings per hour are forecast to be

Graph 5.8

Wages and Earnings Growth

Year-ended



* Non-farm; includes social contributions; uses hours worked from the Labour Account.

** Excluding bonuses and commissions.

Sources: ABS; RBA

growing strongly later in the forecast period, generating more upward pressure on firms' labour costs than implied by the measure of base wages from the WPI. Growth in firms' unit labour costs (labour costs adjusted for any increases in worker productivity) is expected to pick up in response; this is the measure of labour costs most relevant for inflation.

Near-term inflation outcomes are forecast to be significantly boosted by the pass-through to consumers of upstream cost pressures, including those caused by temporary disruptions to domestic supply chains. As in the latter half of 2021, price increases are forecast to be most evident in durable goods and in the prices of newly constructed homes. For the latter, materials and labour costs have increased as demand has surged and supply chain constraints (including internationally) have become more binding. The treatment of HomeBuilder and similar state government grants by the Australian Bureau of Statistics will continue to have an important effect on measured inflation over the year ahead. As these subsidies conclude and fewer grants are paid, more buyers will pay the full price for dwellings, which will contribute to measured inflation. Year-ended headline inflation in the near term is also supported by high fuel prices; however, headline inflation is expected to move back towards underlying inflation as the effect of the recent run-up in fuel prices wanes over the year ahead (Graph 5.9).

The underlying sources of inflation are expected to shift later in 2022. As the near-term impact from the pass-through of upstream price pressures eases, broader inflationary pressures are forecast to be supported by the gradual absorption of remaining spare capacity in the labour market. In the central scenario, inflation is expected to be around 2¾ per cent by the end of the forecast period.

Domestic risks and uncertainties

Upside scenario: Faster trajectory

A plausible upside scenario hinges on stronger consumption than in the central scenario, driven by a swift resolution of the Omicron outbreak and benign health-related developments further out. This would provide a strong boost to confidence and result in a greater desire on the part of households to spend out of unplanned savings and wealth accumulated during the pandemic. The bulk of this effect is likely to be seen in stronger consumption, although households are also assumed to tap some of the savings accumulated during the pandemic (including, for example, in offset and redraw accounts) to invest in housing renovations, which would further support dwelling investment.

In this upside scenario, stronger activity increases the demand for labour, pushing the unemployment rate down to 3 per cent by the end of the forecast period (Graph 5.10). However, supply constraints in the short term mean that the stronger aggregate demand does not translate one-for-one into output; instead, there is a sharper pick-up in near-term price pressures than typical historical relationships would suggest (Graph 5.11). Further out, the strong underlying demand impulse and tight labour market sees underlying inflation increase steadily to around 3¾ per cent by the end of the forecast period.

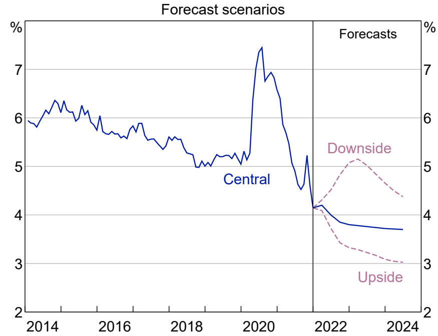
Downside scenario: Slower trajectory

A slower trajectory for the economy could eventuate due to a combination of heightened health-related risk aversion following successive virus outbreaks and a major negative health event, such as a more protracted and damaging Omicron outbreak or the emergence of a new variant. It is plausible that both demand and supply would be negatively affected as a result of a more challenging health situation that leads to a temporary reintroduction of activity restrictions and/or self-imposed restraint by individuals.

Graph 5.10

Unemployment Rate

Forecast scenarios

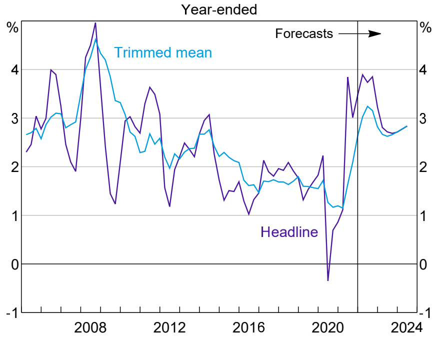


Sources: ABS; RBA

Graph 5.9

Inflation Forecasts

Year-ended

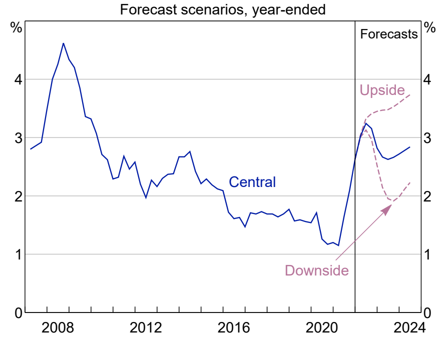


Sources: ABS; RBA

Graph 5.11

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

In this downside scenario, households rein in their discretionary spending on services sharply, which weighs heavily on labour demand. As such, the unemployment rate remains in the 4½–5 per cent range for the remainder of the forecast period, which places downward pressure on wages growth. The adverse health environment would be likely to exacerbate existing supply-side pressures, but persistent weakness in labour market conditions would be sufficient to keep inflation in the bottom half of the target range for most of the forecast period.

Other domestic uncertainties

A larger-than-expected slowing in China's economy would reduce demand for iron ore and other commodities. This would be particularly relevant to Australia if it was driven by a deeper-than-expected decline in construction activity. Alongside lower resource export volumes, this could result in a decline in commodity prices, impacting Australia's terms of trade, corporate profits and tax revenues. Further trade restrictions could also delay the recovery in Australian exports, including the education and tourism sectors.

A key near-term uncertainty for the domestic economy is the way firms and households navigate the challenges from the Omicron wave of infections. Worker absences due to illness and isolation requirements have hampered the ability of the economy to operate at normal capacity. It is possible that supply-side disruptions could be more widespread than assumed, particularly if case numbers increase again. Further disruption to supply chains from COVID-19 variants could have widespread ramifications for the economy, including limited spending due to a narrower range of goods and services available for consumers as well as deferred investment. Limited availability of some products could also lead firms to reduce discounting activity by more than expected, leading to additional inflationary pressure in the near term. While the central scenario assumes these effects are largely confined to the March quarter, the longer the disruption is sustained, the greater the risk of lasting effects on the economy.

An important source of uncertainty for the outlook is the extent of spare capacity in the economy and how prices and wages respond as this is absorbed. The available evidence suggests that supply constraints, such as in construction and durable goods markets, are mostly related to the combination of strong demand and the inability of supply to respond in a timely way, in part because of temporary disruptions caused by the virus. These constraints could intensify or persist for longer than expected, as they have in some other economies. Capacity pressures could lead to some investment projects being rationed or delayed, resulting in lower output growth than otherwise. With time, businesses will be able to invest to expand their capacity to deliver goods and services, but in the interim there could be a period of stronger-than-expected growth in prices due to binding capacity constraints. Price pressures could also be more material than has been assumed in the central scenario, particularly if increases in input costs faced by some firms feed through to larger and ongoing price increases for consumers.

In the labour market, the central scenario assumes that acute labour shortages remain confined to pockets of the economy, but these could become more widespread. Growth in labour supply could also be constrained, even as activity picks up, if there are persistent isolation requirements due to ongoing virus outbreaks. On the other hand, there could be more spare capacity in the labour market than expected if firms are able to rely more heavily on other margins of adjustment (such as increases in hours worked rather than headcount) or if labour market participation increases by more than forecast. Contributing to the uncertain outlook for the labour market is the timing of domestic and international borders reopening, and the resultant effects on labour supply across regions, industries and occupations.

The unemployment rate is forecast to decline below 4 per cent in the second half of 2022, resulting in a steady pick-up in wages growth and inflation. This rate of unemployment has not been seen in Australia since the 1970s. As there is little recent experience to draw on, and the longer-term effects of the pandemic on potential growth and full employment are uncertain, it is possible that wage and price pressures build more quickly or slowly than envisaged in the central scenario. The outlook for inflation could also be influenced by an extended period of high inflation outcomes in the near term, including internationally, resulting in workers demanding higher wages as compensation; if employers pass these increased wage costs on to consumers, this would feed back into higher inflation outcomes.

The outlook for asset prices and households' use of savings accumulated over the pandemic are further sources of uncertainty for the outlook. If the willingness of households to spend from these liquid savings is higher than from other forms of wealth, consumption (or dwelling investment) would be stronger than envisaged in the central scenario. More broadly, these additional savings are small relative to the increases in household wealth from higher housing prices over recent years. But asset prices could be higher or lower over the forecast period as a result of changes to housing demand and supply as well as other factors, with consequent implications for consumption and activity.