Overview

Global inflation is high and is likely to remain so for a while, given recent supply-side shocks. Energy and food prices have increased sharply following Russia's invasion of Ukraine. The spread of COVID-19 in China is disrupting production there, which will add to existing challenges in global supply chains. Core inflation is also high in a number of economies where strong demand has outpaced growth in supply capacity, although it is not quite as high as headline inflation. Many central banks have responded to inflation developments by withdrawing some of the extraordinary policy support that was put in place during the height of the pandemic.

Despite low unemployment rates, wages growth has not kept pace with inflation, so real wages have declined – in some cases noticeably. Consumer sentiment has fallen significantly in many advanced economies, with concerns about declining real incomes and the cost of living frequently cited as the reason for this. The dampening effect on consumer spending can be expected to be cushioned to some extent by the strength of household balance sheets and, in some economies, continuing fiscal support and scope for current high rates of household saving to return to more normal levels.

Inflation in Australia remains lower than in many other advanced economies, but it has picked up faster and to a higher level than previously expected. Headline inflation was 2 per cent (seasonally adjusted) in the March quarter and 5.1 per cent over the year. While petrol prices and other global factors contributed significantly to the quarterly outcome, the sources of inflation are broadening. Firms are increasingly passing on cost increases as supply chain pressures have persisted and demand has remained strong. Trimmed mean inflation was 1.4 per cent in the quarter and 3.7 per cent over the year.

The outlook for inflation is also materially higher than envisaged three months ago. Headline inflation is now expected to peak at around 6 per cent in the second half of this year, partly driven by higher petrol prices and sharp increases in the cost of new dwellings. Trimmed mean inflation is expected to peak at around 4¾ per cent. As the supply-side disruptions start to ease, inflation is expected to decline from these peaks. However, with labour market conditions being the tightest they have been for a long time, growth in labour costs is expected to pick up further in the period ahead. Inflation is expected to return to the top of the 2 to 3 per cent target range in 2024.

The labour market has improved further and demand for labour is strong. The unemployment rate reached 4 per cent in recent months and measures of underemployment have also declined. The level of job vacancies is very high, at a time when the participation rate and the ratio of employment to working-age population are already at historical highs. The unemployment rate is therefore forecast to decline further, to around 3½ per cent in early 2023. This would be its lowest level in almost 50 years.

Wages growth was subdued through 2021, recovering to the low rates seen before the pandemic. Labour cost pressures are building, however, with an increasing share of liaison contacts now reporting that they are paying larger wage increases or that they expect materially higher wages growth over the coming year. Business surveys are also consistent with a pick-up in labour costs, as is the rise in job turnover. Many employers are reporting difficulties finding workers with the appropriate skills and that they are having to offer higher wages and other non-wage remuneration to attract and retain staff.

More broadly, the Australian economy remains resilient and is expected to grow strongly this year. GDP is forecast to expand by 4¼ per cent over 2022. Growth is expected to moderate thereafter, to 2 per cent over 2023, as the recovery matures and as extraordinary policy support is withdrawn. The expansion is likely to be driven by robust consumption growth as spending on discretionary goods and services continues to recover, underpinned by strong household balance sheets and high real household disposable income, despite rising prices.

Housing construction has been supported by specific policy measures and the low level of interest rates, as well as an apparent increased preference for more space in homes. The resulting large pipeline of work yet to be done will underpin a high level of dwelling investment over the period ahead. However, shortages of labour and materials are limiting the pace of work and contributing to delays in completions. Demand for housing finance has been robust and housing credit growth remains strong, but broader housing market conditions vary across the country. In Sydney and Melbourne, established housing prices are declining and rental inflation has been subdued. Elsewhere, housing markets are tight, with prices and rents both increasing strongly and the available stock for sale or rent at low levels.

The outlook for business and public investment spending is also positive; although, in both cases, capacity constraints and disruptions to supply chains are posing an increasing challenge. An upswing in non-mining business investment is expected to resume in the period ahead, after pausing in the second half of 2021. Growth in business debt remains strong. Public investment is expected to be strong for several years as the current pipeline of large infrastructure projects is worked through and new projects commence.

Both the global and domestic outlooks for growth and inflation involve considerable uncertainties stemming from various supply-side factors. The challenges arising from the pandemic are being exacerbated by renewed disruptions in China, and developments associated with Russia's invasion of Ukraine are unpredictable. It is uncertain how consumer demand will react to rising prices and to the withdrawal of policy stimulus that can be anticipated in many economies in response to heightened inflationary pressures. Relatedly, in tight labour markets and given high and rising inflation, workers might seek larger wage increases to compensate for the loss of purchasing power; however, it is difficult to predict how successful these efforts will be and, if they are, how quickly that could occur. These uncertainties are salient in Australia, where there is little recent experience of how the labour market and inflation might behave when unemployment is as low as it is currently.

Even as many central banks begin to withdraw some of the substantial stimulus implemented during the pandemic, macroeconomic policy settings remain supportive of growth across advanced economies. Globally, financial conditions have become slightly less accommodative but have generally remained supportive, including in Australia. Bond yields have increased and equity prices have declined as market participants have revised their expectations about global inflation and growth and, relatedly, the paths for policy interest rates. The

Australian equity market has outperformed other markets, as resources companies have benefited from high commodity prices. Fixed borrowing rates have increased broadly in line with bond yields and other market interest rates; however, overall, interest rates remain low for most borrowers in Australia and in other advanced economies. China has been an exception to the shift towards withdrawing policy stimulus; monetary and fiscal policy are being eased there to support growth in the context of the current disruptions. The US dollar has appreciated significantly this year, particularly against the yen, reflecting that there has been very little change to the expected path of policy rates in Japan. The Australian dollar is higher than at the start of this year, despite depreciating recently.

The economic impact of Russia's invasion of Ukraine outside those two economies has been manifested in higher commodity prices. High commodity prices are adding to upstream price pressures but, in commodity-exporting economies such as Australia, they are also boosting national income. As a result, Australia's terms of trade are likely to reach a new peak in the first half of 2022 and thereafter remain generally higher than previously envisaged.

At its recent meetings, the Reserve Bank Board considered the rapidly evolving outlook. Inflation has increased faster than expected as global supply-side disruptions persist and multiply in the face of strong demand. Indeed, there are signs that domestic price and labour cost pressures are broadening and building. The economy has been more resilient than expected in recent months, and is much stronger now than when the current very supportive policy settings were put in place. Australia is also closer to full employment.

The tight labour market and environment of higher inflation mean that an increasing number of firms are paying higher wages and other benefits to attract and retain staff. While aggregate wage growth picked up during 2021, it was no higher than prior to the pandemic. However, the more recent evidence from liaison and business surveys is that larger wage increases have been occurring, or are planned, in many private-sector firms.

At its May meeting, the Board judged that some withdrawal of the monetary support provided through the pandemic and a start to the process of normalising interest rates is appropriate, given both the progress towards full employment and the evidence on prices and wages so far. It therefore increased the cash rate target by 25 basis points to 35 basis points. It also increased the interest rate on Exchange Settlement balances from zero per cent to 25 basis points.

Consistent with this assessment, the Board will not reinvest the proceeds of maturing government bonds and expects the Bank's balance sheet to decline significantly over the next couple of years as the Term Funding Facility comes to an end. The Board is not currently planning on selling the government bonds that the Bank has purchased during the pandemic.

The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time. This will require a further lift in interest rates over the period ahead. The Board will continue to closely monitor the incoming information and evolving balance of risks as it assesses the timing and extent of future interest rate increases.