Overview

Inflation has passed its peak in Australia but remains very high. Headline inflation declined to 7 per cent in year-ended terms in the March quarter; trimmed mean inflation was 6.6 per cent over the same period. The decline was driven by goods prices, consistent with, but a little later than, the pattern in other economies. Somewhat offsetting this, cost pressures (both labour and non-labour) and strong demand continued to contribute to strong price increases for many services. CPI rent inflation has been picking up, consistent with tight rental markets.

Inflation is expected to return to the 2–3 per cent target range, but it will take some time. The central forecast is for headline inflation to decline to 4½ per cent by the end of 2023 and to reach 3 per cent by mid-2025. Goods price inflation is expected to decline further as the easing seen in global price pressures continues to be passed through in Australia. Services inflation is expected to be more persistent, although it is expected to ease in the latter part of the forecast period as interest rates weigh on demand and, in time, growth in unit labour costs eases. Energy costs are expected to increase in coming quarters, although government policy measures are expected to limit the increases. Rent inflation is expected to continue to pick up over the next year or so, and to add materially to inflation over the forecast period.

The labour market remains tight. The unemployment rate continues to be at its lowest level in almost 50 years, at 3½ per cent; measures of underemployment are also low relative to history. Employment growth remained solid through the March quarter, driven entirely by full-time employment. While job vacancies have declined a little, they remain at high levels. Even so, reports of difficulty finding suitable labour have become less pervasive. Wages growth continues to pick up in line with the tight labour market. A range of timely indicators suggest private wages growth was running at around 3½ to 4 per cent in the March quarter. Broader measures of labour costs increased at a faster pace than this, as employers continued to use non-base-wage payments to attract and retain workers. Moreover, unit labour costs are rising at a fast pace, with productivity growth remaining subdued.

Growth in the Australian economy moderated in the second half of 2022 as the recovery from pandemic-related restrictions had mostly run its course. Consumer spending has continued to slow more recently as the higher cost of living and higher interest rates have weighed on real household disposable incomes, and declines in housing prices over the past year have reduced household wealth. Over the period ahead, GDP growth is expected to be below trend. It is expected to trough at around 1¼ per cent and then to pick up gradually to 2 per cent by mid-2025 as the drag from higher inflation and interest rates wanes and household wealth recovers.

Consistent with the outlook for slower economic growth, the unemployment rate is expected to start rising later this year and reach 4½ per cent by late 2024. The Wage Price Index is expected to peak at around 4 per cent later this year and

ease a little after that. Growth in public sector wages is picking up, with several governments having increased their wage caps. The forecast for labour costs is consistent with inflation returning to the Bank's target, provided productivity growth picks up back to pre-pandemic trends.

The outlook is subject to a range of uncertainties. Growth in consumption is being influenced by competing forces, with higher interest rates and declines in real wages being offset by strong growth in employment and, for many households, still-high accumulated savings, which could be drawn down to support spending. Consumer spending, especially on services, has remained surprisingly resilient in some other advanced economies and it is possible that the Australian experience will be similar. In addition, housing prices have stopped falling at a national level, implying that the drag on consumption from declining wealth could be smaller than previously assumed.

Developments in the housing market more broadly also represent a source of uncertainty for the outlook. Demand for new housing has been weak recently and borrowing for housing has slowed. Over the medium term, however, it is expected to be supported by strong fundamentals, including a higher population than was previously expected. Despite higher rental yields, incentives to build have been impeded by high construction costs and construction delays. These factors have also placed pressure on builders, with liaison contacts reporting increased financial stress and elevated insolvency risks in parts of the construction sector. A shortfall in housing supply, relative to strong demand from a rising population, is expected to result in continued upward pressure on rents, adding to the inflation forecast. Average household size is an important margin of adjustment in the face of rising rents; in recent months, it has already reversed a little of the sharp decline seen during the pandemic.

While inflation is expected to decline further from here, there are a range of uncertainties about the pace of the decline. Goods inflation is expected to decline further in response to an easing in global price pressures. If global goods prices fall back closer to pre-pandemic trends, overall inflation could decline more quickly. In Australia so far, however, this process has lagged the experience in some other advanced economies. Wages growth remains consistent with inflation returning to target, provided productivity growth recovers. If this does not occur or higher prices and wages reinforce one another, domestic inflation would be more persistent than the central forecast.

Globally, inflation has declined from earlier peaks but remains high. Progress in lowering inflation has slowed in recent months, particularly for core measures of inflation. Goods price inflation is clearly slowing, and for some categories, prices have started to decline. This reflects a better balance of supply and demand following the resolution of the pandemic disruptions in supply chains, and some reversal in earlier increases in energy prices. But services price inflation remains strong and could prove to be quite persistent. Domestic drivers are underpinning this persistence in most economies, including strong demand from the ongoing recovery in services consumption and high wages growth. Wages growth is above rates consistent with inflation targets in a number of economies. Most central banks in advanced economies expect inflation to return to target, but not in the coming year.

Despite economic growth slowing in advanced economies, labour markets are still very tight. Historically low unemployment rates and relatively strong household balance sheets, including increased savings buffers, have helped counter the pressures that households have faced from high inflation and increases in

interest rates. Real disposable incomes are no longer declining in most major advanced economies. These factors could mean the slowdown in consumption in advanced economies could be milder than was the case in previous tightening cycles.

Volatility in bond markets, including in Australia, increased sharply for a short period in response to the emergence of stress in parts of the banking system in the United States and Switzerland, but has since declined. Corporate bond spreads have widened a little, including for Australian banks, though these spreads remain within usual ranges. Conditions in foreign exchange markets have been relatively stable. The Australian dollar has depreciated over recent months, partly in response to declines in the prices of Australia's key commodity exports, while the differential between Australian Government bond yields and those of the major advanced economies is little changed from the levels of three months ago, having increased of late.

Growth in Australia's major trading partners is expected to remain below historical averages over the next few years. The near-term outlook has been upgraded somewhat, however, and the trough in growth in advanced economies is expected to occur slightly later. Central banks in many advanced economies have increased policy rates further, although some have emphasised greater uncertainty about the outlook following the recent banking stresses. If stresses intensify, financial conditions could tighten by more than currently expected, which could have implications for policy rates in these economies.

The Chinese economy has been recovering slightly faster than had been expected, largely due to the economy being less affected by the COVID-19 restrictions late last year than had initially been reported. The authorities are targeting growth of 'around 5 per cent' over 2023, which is expected to be achieved comfortably. Real estate investment in China is still quite weak, however, despite some nascent signs of a pick-up in housing market activity. The resulting outlook for Chinese steel production has weighed on iron ore and coal prices over the past three months. More broadly, the softer outlook for global growth implies that Australia's terms of trade are expected to decline over the period ahead. However, this could be partly offset by lower import prices as global goods price pressures ease.

Over recent meetings, the Reserve Bank Board has continued to take action to ensure inflation returns to the target range in a reasonable timeframe. Throughout this period, it has been mindful that inflation is a long way from the target range and domestic demand pressures on inflation are at a high level. The Board raised interest rates by 25 basis points at its March meeting – its 10th consecutive increase. It then held interest rates steady at the April meeting. The decision to pause provided the Board with some time to assess the pulse of the economy (both in Australia and globally) and the outlook, as well as to assess the impact of the cumulative 3½ percentage points increase in interest rates that had occurred to that point. It is also consistent with the practice of earlier interest rate cycles, where it was common to pause in order to assess the flow of information and then move again if circumstances warranted doing so. The Board is conscious that monetary policy operates with a lag and that the full effects of the cumulative increase in interest rates are yet to be felt. It therefore considered that, given the significant uncertainties around the outlook, it would be helpful to have additional data and an updated set of forecasts before again considering when and how much more monetary policy would need to be tightened to bring inflation back to target within a reasonable timeframe.

Since then, the Board has received further evidence that the Australian labour market is still

very tight. Moreover, there are signs that asset prices – including the exchange rate and housing prices – have been responding to the expectation that interest rates may not increase. While goods price inflation is slowing, the pass-through from lower global price pressures to prices in Australia has been limited so far. In addition, services price inflation is turning out to be more persistent than expected in some other advanced economies, and it is possible that this experience could be repeated in Australia. Domestically sourced price pressures are high, especially for rents and for market services. These pressures are expected to increase further over the course of this year before easing. And unlike in some other advanced economies, energy price inflation is anticipated to remain high in Australia over the next year or so. The revised forecasts continued to have inflation above target for an extended period. With the benefit of this information, at the May meeting the Board judged that it was appropriate to increase interest rates again, by a further 25 basis points.

The Board is still seeking to keep the economy on an even keel as inflation returns to the 2–3 per cent target range, but the path to achieving a soft landing remains a narrow one. The Board is mindful that a considerable adjustment to interest rates has already been made and that monetary policy affects activity and inflation with a lag and through different channels. Many households are experiencing a painful squeeze on their budgets, in part because of the fast pace of the rate increases so far. The Board has also been taking into account the benefits of preserving as much of the gains in the labour market as possible, which is in the collective interests of all Australians.

So far, medium-term inflation expectations remain consistent with inflation returning to target. It is important, but not assured, that this remains the case. On current forecasts, inflation is not expected to return to target until mid-2025. The longer inflation remains above target, the greater the risk that inflation expectations rise and price- and wage-setting behaviour might adjust accordingly. If this were to eventuate, the end result would be even higher interest rates and a larger rise in unemployment would be required to bring inflation back to target.

The Board's priority is to return inflation to target. High inflation makes life difficult for people and damages the functioning of the economy. And if high inflation were to become entrenched in people's expectations, it would be very costly to reduce later. Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe, but that will depend upon how the economy and inflation evolve. The Board will continue to pay close attention to developments in the global economy, trends in household spending and the outlook for inflation and the labour market. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that.