Overview

Strong global growth is expected this year and next as the global economy recovers from the pandemic. Vaccine supply is increasing, which is allowing some economies to ease restrictions and open up. Substantial policy stimulus is also supporting the recovery. But the recovery is expected to remain uneven. Many economies are contending with serious new virus outbreaks and the outlook for some emerging market economies is clouded by slow rollouts of vaccines and limited scope for expansionary fiscal policy.

In Australia, the recent activity data have been significantly better than expected. Since the previous *Statement*, the starting point for the forecasts has been revised higher and the outlook further out has strengthened. GDP growth was faster than anticipated in the December quarter and is expected to have remained solid in the March quarter. GDP growth is now forecast to be 4¾ per cent over 2021 and 3½ per cent over 2022.

Employment outcomes have been strong. Employment increased by around 200,000 between December and March, and in March the unemployment rate declined to 5.6 per cent, although this is still around ½ percentage point above its pre-pandemic level. Other measures of spare capacity in the labour market, including underemployment and the share of workers on reduced hours, are generally around pre-pandemic levels. Some job losses from the end of the JobKeeper program are anticipated, but these are expected to be more than offset by demand for labour elsewhere in the economy. The unemployment rate is expected to fall further over the forecast period, reaching around 5 per cent by the end of this year and 4½ per cent by mid 2023.

Wages growth and inflation remain subdued and, unlike the real side of the economy, have been broadly in line with earlier expectations. Wages growth has been especially slow in recent times, at 1.4 per cent over 2020. Headline CPI inflation was 0.5 per cent (seasonally adjusted) in the March quarter. Trimmed mean inflation was weak at 0.3 per cent in the quarter, and both measures were 1.1 per cent over the year.

Most of the volatility stemming from the introduction and expiry of pandemic-related subsidies has washed through the quarterly inflation outcomes. However, year-ended CPI inflation for the June quarter will spike above 3 per cent temporarily as the effect of measures such as last year's temporary free childcare program drop out of the calculation. Higher petrol prices will also boost inflation in the quarter.

Despite the stronger outlook for output and the labour market, inflation and wages growth are expected to remain low, picking up only gradually. Underlying inflation is expected to be 1½ per cent over 2021 before gradually increasing to close to 2 per cent by mid 2023. Some pick-up in wages growth is expected as the unemployment rate falls further. However, it is likely to be some years before wages growth is at a rate consistent with achieving the inflation target.

The JobKeeper program and various social assistance measures played an important role in boosting household incomes over the past year. While these programs have largely expired, strong growth in employment has broadly cushioned the effect of the winding down of these programs on household income. Consumption spending has therefore rebounded rapidly as restrictions have eased, and is expected to continue expanding strongly over the next few years.

How far households might draw on their strengthened balance sheets to support their spending represents an important source of uncertainty around the outlook for consumption. This source of uncertainty forms the basis for the 3 forecast scenarios presented in the 'Economic Outlook' chapter. Household wealth has increased strongly of late, mostly because housing prices have risen, but also because households accumulated an unusually large amount of additional savings out of income over 2020. If the spending response to increased wealth is stronger than usual, a stronger economic path than the one envisaged in the baseline forecasts would eventuate. Conditions supporting a faster pick-up in consumption would also support stronger private investment. In this upside scenario, the unemployment rate declines and wages growth rises at a faster pace than in the baseline scenario. Inflation picks up to around 2¼ per cent by the middle of 2023 and remains on an upward trajectory at that point.

Conversely, a weaker path could instead eventuate if higher wealth stimulates spending by less than historical experience implies; households could instead continue to strengthen their balance sheets, by purchasing assets or paying down debt. In this downside scenario, subdued consumption and private investment result in the unemployment rate remaining a little above pre-pandemic levels. Underlying inflation remains broadly steady, and is still around 1½ per cent by mid 2023.

Globally, there has been a swift recovery in international trade as people switched their spending away from services and towards goods. This has been positive for export-oriented economies including China and some economies in east Asia. It has also boosted demand for many commodities and other inputs to production of final goods, such as semiconductors. Oil prices have reversed the falls of last year. The price of iron ore has increased to be close to its historical peak a decade ago, reflecting strong demand from Chinese steel producers. Australia's terms of trade have increased and are expected to remain high at least until the end of this year, supporting national income.

These shifts in demand, as well as disruptions to production from the pandemic, have resulted in some bottlenecks and cost pressures through supply chains, both globally and in Australia. Some of these are taking time to resolve and firms are reportedly becoming more willing to pass on cost pressures to their output prices. Historical experience suggests that if supply problems are resolved reasonably promptly, pricing pressures will remain transitory; it remains to be seen if this will be the case in the current situation. An offsetting influence on inflation outcomes is the subdued demand conditions in many services industries. More broadly, the current significant spare capacity in the labour market in many economies is likely to take a while to be absorbed. This is likely to weigh on underlying inflation pressures globally.

The major central banks have all maintained highly accommodative monetary policy settings, and reiterated their commitments to keep policy accommodative until sustained progress has been made on employment and inflation. Sovereign bond yields increased earlier in the year in response to the improvement in the economic outlook and an increase in inflation expectations, which are now more in line with central banks' targets. Even so, financial conditions remain accommodative. Corporate bond spreads remain narrow and equity prices have risen further.

Fiscal policy has played an important role during the pandemic, although the size and composition of this support has varied across economies. The US authorities legislated a large fiscal stimulus in March, and further measures are also likely to be approved later in the year. Several other countries have also announced additional fiscal stimulus in recent months, including to bolster the recovery phase.

In Australia, fiscal policy has supported incomes and encouraged specific categories of spending. Machinery & equipment investment has been responsive to tax incentives and has begun to recover sooner than earlier expected. More generally, strong surveyed business conditions, high commodity prices, low interest rates and tax incentives should all help create the conditions for business investment to recover, after it fell last year to its lowest share of GDP for decades. Business credit has started to increase a little recently, following a period of weakness while lines of credit drawn down earlier in the pandemic were repaid.

Dwelling investment has also been boosted – and possibly brought forward – by accommodative monetary policy and fiscal support, including the HomeBuilder subsidy and various state government programs. The HomeBuilder subsidy closed to new applications at the end of March. The deadline to commence construction was recently extended, however, so activity will remain high over 2021. The strong demand induced by these subsidies has led to cost pressures and some delays to construction timelines. This has pushed base prices for newly constructed detached homes higher, but the effect on measured inflation has been offset by the treatment of government construction grants.

Strong demand is also a feature of the established housing market, consistent with the low level of interest rates, government support programs and the positive outlook for employment. Housing prices are rising in all major markets. Prices in Sydney and Melbourne have now surpassed their earlier peaks, following a period where they lagged the recovery in the smaller cities and regional areas. Price increases have been strongest for detached houses and higher-priced properties. Housing turnover has increased, and many properties are on the market for only a short time before being sold.

In this environment of strong demand for housing, rising prices and low interest rates, it is important that lending standards are maintained. The Bank will be monitoring trends in borrowing closely. Housing credit growth has picked up, with strong demand from owner-occupiers, especially first-home buyers. Investor credit has also been growing, but at a slower pace than credit to owner-occupiers; conditions in rental markets have been quite uneven, which has been weighing on investor demand for properties in some markets. While rents have increased strongly in some parts of the country, vacancy rates remain high in Sydney and are rising sharply in Melbourne. Both markets have been affected by lower inward migration.

The closure of Australia's international border and the related abrupt decline in inward migration has reduced growth in some areas of domestic activity, especially the tourism and education sectors. It has also constrained labour supply in a few sectors where temporary migrants have typically been a relatively large share of the workforce, such as hospitality. While these effects are important in some areas, they are as yet fairly small for the overall economy. The longer border restrictions remain in place, though, the more likely that localised labour shortages could translate into some wage pressures as the economy continues to strengthen.

While the outlook for output and the labour market has improved considerably since last year, the economy remains short of full employment. The baseline scenario in the forecasts still implies that inflation will remain below the target range for some time. And even at the end of the forecast period in mid 2023, wages growth is likely to remain below the rates that would be consistent with inflation being sustainably within the target range. Accordingly, monetary policy will need to remain highly accommodative for some time yet.

The current package of monetary policy measures continues to support the economy in part by keeping financing costs very low. Interest rates on business and housing loans continue to drift down from already low levels, which is positive for the cash flows of firms and households overall. Ample liquidity conditions are also supporting the supply of credit and household and business balance sheets, including through higher asset prices. As well as lowering domestic funding costs, by lowering the structure of interest rates, the policy package is contributing to a lower exchange rate than otherwise. The Australian dollar has moved within a narrow range since the start of the year, a period in which commodity prices have tended to increase. Together, monetary and fiscal policy are supporting the recovery in aggregate demand and the pick-up in employment.

At its recent meetings, the Reserve Bank Board has decided to maintain the targets of 10 basis points for the cash rate and the yield on 3-year Australian Government bonds. In May, the Board announced that it will consider at its July meeting whether to retain the April 2024 bond as the target bond for the 3-year yield target or to shift to the next maturity, the November 2024 bond; in either case, the 10 basis point target will be maintained. At its July meeting, the Board will also consider whether to undertake further government bond purchases following the completion in September of the second $100 billion of purchases under the government bond purchase program. The Board is prepared to undertake further bond purchases under this program to assist with progress towards the goals of full employment and inflation.

Also following its May meeting, the Board confirmed that the date for final drawings under the Term Funding Facility is 30 June 2021. The Board had previously indicated that it would consider extending the facility if there were a marked deterioration in funding and credit conditions in the Australian financial system. Financial markets are operating well, so an extension is not called for. Banks have drawn $102 billion under the facility so far and a further $98 billion is currently available. Given the facility provides funding for 3 years, it will continue to help keep funding costs in Australia low until mid 2024.

The Board is committed to maintaining highly supportive monetary conditions to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, the labour market will need to be tight enough to generate wages growth that is materially higher than it is currently. This is unlikely to be until 2024 at the earliest.