Overview

Conditions are in place for a sustained global recovery. The spread of the Delta variant of COVID-19 through the middle of the year had set this recovery back in some countries, but only temporarily. Rapid increases in vaccination coverage in many countries have allowed restrictions to be eased, and economic activity has bounced back strongly. Alongside these better health outcomes, expansionary fiscal and monetary policy have assisted the recovery and continue to support the outlook. Most advanced economies are expected to return to their pre-pandemic paths for output next year, but a number of emerging market economies are likely to still be short of pre-pandemic trends. Health-related risks remain an uncertainty for the period ahead.

Global goods demand has remained strong even as services activity rebounds. This has strained global supply chains and logistics networks, as have disruptions to supply in some sectors. These capacity constraints have been surprisingly persistent. In recent months, shortages in energy markets in Europe, the United Kingdom and China have added to these issues, and have constrained production in downstream industries such as manufacturing. Base metals and other goods with energy-intensive production processes have been especially affected. As a result of these bottlenecks, many commodity and producer prices have risen sharply, including for some of Australia's key exports. Higher upstream prices have also pushed up consumer price inflation in several economies to well above inflation targets. Central banks generally expect these pressures to subside and inflation to moderate over the year ahead. Market-implied inflation expectations and private sector inflation forecasts have risen, but for the longer term they are in line with central banks' targets.

In Australia, the recovery from the Delta outbreak is also underway. The setback to the economy from this outbreak was significant; GDP is expected to have contracted by around 2½ per cent in the September quarter, and hours worked declined by 3 per cent. The economic impact was highly uneven, being concentrated in contact-intensive industries in the south-eastern part of the country. Now that vaccination rates are rising quickly to very high levels, and restrictions on activity have been eased significantly, the economy is recovering rapidly. The speed of this recovery is consistent with the strong underlying momentum in the economy prior to the outbreak. GDP is expected to grow by around 3 per cent over 2021. Growth is expected to be around 5½ per cent over 2022, before returning to around 2½ per cent over 2023 – a rate closer to pre-pandemic averages.

The labour market was materially affected by the recent lockdowns, but already these effects are receding. Hours worked began to recover in New South Wales in September; Victoria is likely to follow shortly after, now that the lockdown in Melbourne has also ended. Reported unemployment rates have declined; however, this is because stood-down workers and those who had lost their jobs did not tend to look for alternative employment during lockdowns, so they were recorded as having left the labour force. Alternative measures of spare capacity

that include these workers peaked above 11 per cent. The unemployment rate is expected to be a little below 5 per cent at the end of 2021, and is forecast to decline steadily from there, reaching 4 per cent by the end of 2023. The participation rate is expected to bounce back quickly to historically high levels, in contrast to the experience of some other advanced economies.

Australia has experienced some of the same upward pressure on prices as seen globally, but to a much lesser extent. The factors pushing up non-oil energy prices in some other economies are less relevant here. Labour supply has recovered quickly, which has meant less upward pressure on wages, and it will expand further as the borders reopen. In addition, the pre-pandemic starting points for both wages growth and inflation were lower in Australia than they were in many other advanced economies. Demand for labour has remained strong and shortages have been reported for particular skills. Even so, spare capacity remains in the labour market, which can be drawn on as the economy opens up.

Given this spare capacity and the inertia in the wage-setting process, wages growth is expected to increase only gradually. As measured by the Wage Price Index, wages growth was only 1.7 per cent over the year to the June quarter. It is forecast to pick up above 2 per cent by the end of this year and then lift further, reaching around 3 per cent by the end of 2023. Other measures of average earnings are likely to be a little higher, in part reflecting the effects of job switching.

Inflation was higher than expected in the September quarter. Headline inflation was 0.8 per cent in the quarter and 3 per cent over the year. Underlying inflation was 0.7 per cent in the quarter and 2.1 per cent over the year. About two-thirds of the quarterly increase in headline CPI was accounted for by sharp rises in two components: petrol prices; and home-building costs. Earlier in the year, the effects of rising cost pressures in home-building were being muted by the HomeBuilder subsidy, but this effect lessened in the September quarter. Rising global prices for building materials also boosted costs in the quarter. Although prices of some consumer durables have increased over the past year, overall inflation in this category was lower in Australia than in some other advanced economies.

The outlook is for underlying inflation to pick up gradually over the next couple of years, as the economy recovers further and spare capacity is absorbed. In the central scenario, trimmed mean inflation is forecast to be 2¼ per cent at the end of 2022 and around 2½ per cent by the end of 2023.

With the economy now opening up, the solid momentum evident before the Delta outbreak is expected to resume. Consumer spending is already picking up, and will be supported by rising incomes as employment recovers, even as fiscal support for income is wound back. Strong growth in household wealth this year should add impetus to consumption. The household saving ratio has been high during lockdown periods, but is expected to return to around pre-pandemic levels over the next couple of years.

How much consumption responds to higher household wealth is a key uncertainty for the outlook; this question provides the basis for an upside scenario presented in the chapter on the 'Economic Outlook'. A stronger response than has been the case on average historically would support stronger economic growth and the unemployment rate falling well below 4 per cent by the end of 2023. Trimmed mean inflation would rise a little above 3 per cent under that scenario. A downside scenario considers instead the effects of another bad health outcome, such as a new strain of the virus or a decline in vaccine effectiveness, and lingering uncertainty about the economy. These factors could combine to reduce activity and

spending. In that scenario, unemployment would be above 5 per cent for most of the next few years and inflation would fall below the 2 to 3 per cent target range.

Dwelling and business investment are both expected to lend momentum to the recovery, as they had done prior to the Delta outbreak. Although both residential and non-residential construction were disrupted during lockdowns, they are likely to have recovered quickly as restrictions were eased. Fiscal support measures, including state and federal subsidies for housing construction and tax incentives for business investment, have encouraged some of this planned activity. A considerable pipeline of construction work remains, as is also the case for public infrastructure. Reported shortages of materials and labour could slow the pace at which this pipeline is worked through.

Established housing market conditions have also been resilient through the recent lockdowns, and new listings and other sales activity have rebounded as lockdowns eased. Housing prices have continued to rise rapidly in most capital cities. Strong growth in housing prices has been a feature of the recovery globally, including in Australia. Fiscal support to incomes and low interest rates have both contributed to this outcome.

Consistent with rising housing prices and with higher turnover of properties, household demand for housing finance remains high in Australia. Housing credit growth has picked up, although the pace of new borrowing has declined somewhat from the earlier peak, in part reflecting the end of the HomeBuilder program. The Bank welcomes APRA's recent decision to increase the interest rate serviceability buffer on home loans. It is important that lending standards are maintained at a time of historically low interest rates.

Financial conditions globally remain expansionary, even though government bond yields have risen markedly over recent months, including in Australia. Yields have reached or surpassed the levels seen earlier this year. This increase in yields reflects rising inflation expectations and, related to this, expectations that central banks will begin to reduce stimulus earlier than previously anticipated. At the same time, uncertainty about the outlook for inflation and monetary policy has increased, which has led to a significant rise in risk premia and in the volatility of bond yields.

Central banks' policy actions have varied according to their assessments of the inflation pressures their economies face and whether they are responding to the inflation outlook or actual inflation outcomes. Central banks in some advanced economies have begun to increase their policy rates and/or scale back their bond purchases, or are contemplating doing so. Some emerging market central banks have tightened policy significantly, although policy rates in emerging market economies in Asia have remained low.

An exception to the accommodative global financial conditions has been the situation faced by property developers in China. The Chinese authorities have been trying to rein in risks and leverage in this area for some time. In recent months, concerns about the financial health of Evergrande, a large developer, led to volatility in global bond markets. Concerns also spilled over to other highly leveraged developers. More broadly, growth has slowed in China of late. Among other factors, regulations to limit pollution and emissions have constrained manufacturing and construction activity.

In Australia, the package of monetary policy measures introduced by the Bank in response to the pandemic continues to support the economy. By lowering the structure of interest rates, funding costs across the economy remain very low, despite the recent rise in market yields, and the exchange rate is lower than it would otherwise be. Interest rates on outstanding

business and housing loans are at record lows, which is positive for the cash flows of businesses and households overall. Very low interest rates have also supported asset prices, which has strengthened the balance sheets of firms and households. Banks' funding costs will continue to benefit from the Term Funding Facility until mid 2024, when the funding previously drawn under this scheme matures.

At its September meeting, the Reserve Bank Board announced that purchases of government bonds at a pace of $4 billion per week would continue until at least mid February, reflecting the delay in the economic recovery and the increased uncertainty associated with the Delta outbreak at that time. At its November meeting, the Board reviewed the economy's faster-than-expected progress in its early stages of reopening, as well as the updated forecasts. While many uncertainties remain, a rapid trajectory of recovery from the recent setback seems increasingly likely. If the economy evolves in line with the central scenario, wages growth is expected to have edged up to around 3 per cent and underlying inflation would have only just reached the middle of the 2 to 3 per cent target band by the end of 2023, for the first time in seven years. Depending on the trajectory of the economy at that time, the Board judges that this outcome could be consistent with the first increase in the cash rate being in 2024.

In some other plausible scenarios, wages growth and inflation could be higher than implied by the central scenario. If this were to eventuate, an increase in the cash rate in 2023 could be warranted. However, in the Board's view, the latest data and forecasts do not warrant an increase in the cash rate in 2022.

In light of the faster-than-expected progress towards its goals and the revised outlook for inflation, the Board decided at its November meeting to discontinue the target for the yield on the April 2024 Australian Government bond. The yield target was introduced in the extraordinary times at the beginning of the pandemic. Credible forecasts at the time pointed to a severe global recession and implied that unemployment in Australia would rise to double-digit rates. As part of the broader package of policy measures introduced since March 2020, the yield target has been effective in lowering funding costs and supporting the economy through this exceptional period. Given the progress towards its goals, the Board now judges that it is no longer appropriate to maintain the target of 10 basis points for the April 2024 bond.

The Board is committed to maintaining highly supportive monetary conditions in order to achieve a return to full employment in Australia and inflation consistent with the target. For inflation to be between 2 and 3 per cent on a sustainable basis, the labour market will need to be tighter and wages growth materially higher than they are at present. The Board will not raise the cash rate until these criteria are met, and is prepared to be patient.