

Statement on Monetary Policy

NOVEMBER 2021



RESERVE BANK OF AUSTRALIA

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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. 🌱

1. The International Environment

The ongoing rollout of COVID-19 vaccines and significant policy stimulus has laid the groundwork for a sustained global economic recovery. Activity has generally recovered quickly once vaccination coverage has risen, allowing mandated restrictions and health concerns to be eased. GDP is expected to return to its pre-pandemic trend in many advanced economies over the next year. GDP in China has already returned to its pre-pandemic path; however, growth has slowed of late, in part because of authorities' efforts to reduce leverage in the economy, as well as other recent policy shifts that have introduced considerable uncertainty to the outlook in China. Concerns about the financial health of Evergrande, a large private Chinese property developer, led to some volatility across global financial markets since the last *Statement*. There are similar concerns about a number of other Chinese property developers, but risk sentiment outside the property development sector has stabilised.

Capacity constraints in many countries could result in the recent increase in global inflation pressures persisting for longer than initially expected, and pose a downside risk to the growth outlook. Strong global demand this year has run up against a lack of spare capacity in manufacturing and transportation networks, while shortages have also emerged more recently in energy markets. This has seen a sharp rise in the price of shipping, energy, base metals and other inputs with energy-intensive processes. Some economies have also experienced a pick-up in wages growth. Consumer price inflation has increased to its

highest rate in several years in a number of economies, though central banks still generally expect inflation to return to levels consistent with their targets next year.

Central banks in some advanced economies have begun to increase their policy rates, and market pricing suggests that some others will do so in the next few quarters. A number of these central banks assess their economies to have limited spare capacity and that inflationary pressures will persist beyond the next year, while some have pointed to concerns about the build-up of financial imbalances at very low interest rates. Central banks in most advanced economies have implemented or discussed the timing of reductions in the pace of asset purchases. The market-implied path of expected policy rates has shifted higher in recent months as upside risks to the inflation outlook have increased. Yields on government bonds have increased in advanced economies, although financial conditions overall have remained very accommodative. Financial conditions among emerging market economies have continued to diverge, with a number of central banks outside Asia having tightened policy substantially in response to rising inflation. Central banks in emerging Asia have kept policy rates unchanged, but some are expected to begin raising rates before the end of the year.

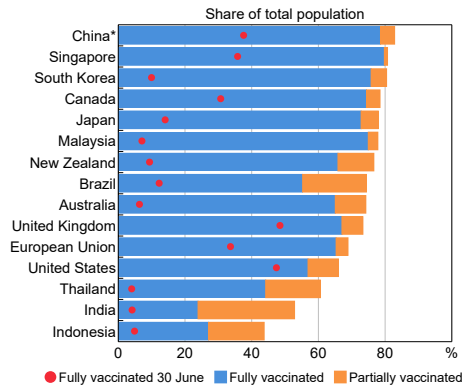
As vaccination rates rise, COVID-19 restrictions have been reduced

Vaccination coverage has increased in many economies over recent months (Graph 1.1). This has enabled restrictions to be eased in advanced

economies from around mid year. While the number of COVID-19 cases subsequently increased as a result of this easing, hospitalisations and deaths have remained much lower than in earlier waves, reflecting the protection provided by the vaccines (Graph 1.2). In China, localised restrictions have been introduced intermittently to manage COVID-19 outbreaks. Case numbers and deaths have been declining in the rest of Asia since August, which has allowed restrictions to ease there.

Graph 1.1

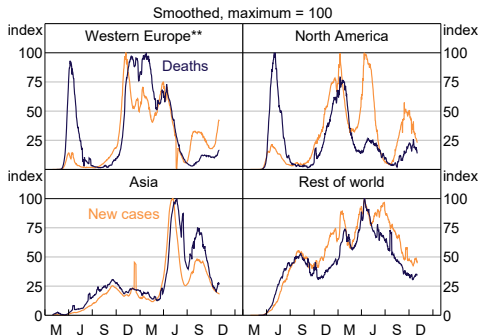
Vaccinations – Selected Countries



* First and second doses estimated from total vaccinations and recommended delay between doses
Sources: CEIC Data; Our World in Data; RBA

Graph 1.2

COVID-19 – New Cases and Deaths*



* Jurisdictions in some continents likely have less effective testing regimes leading to more conservative case and death counts
** Includes the Schengen Area, the United Kingdom and Ireland
Sources: JHU CSSE; Our World in Data; RBA

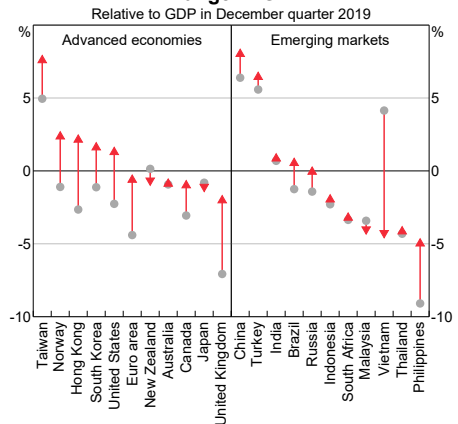
Activity has been recovering in countries with high vaccination rates

The improvement in health outcomes and the easing of restrictions over the course of the year have enabled a strong recovery in many advanced economies (Graph 1.3). Policy measures implemented early in the pandemic supported private incomes and balance sheets, which limited the amount of scarring on the economy from the COVID-19 shock. Fiscal measures have since largely pivoted towards those aimed at driving the recovery and stimulating private demand. Consumption has led the recovery, but business and dwelling investment have also picked up strongly and in some countries are back above pre-pandemic levels. Economic activity in the United States has now more than retraced its decline. Activity throughout Europe, the United Kingdom and Canada has risen substantially but is still slightly below pre-pandemic levels. There are signs that supply constraints are limiting activity in some industries.

The recovery in consumption in advanced economies has been driven by a recovery in discretionary services (Graph 1.4). Consumer

Graph 1.3

Change in GDP



● December quarter 2020 ▲ September quarter 2021*
* Forecasts used where September quarter GDP has not yet been reported
Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; RBA; Refinitiv

spending on many services has now returned to pre-pandemic levels, with air travel a notable exception. Nonetheless, goods consumption has remained strong even as discretionary services consumption has recovered. It is expected that the share of consumption spent on goods will fall back over time, although the pandemic may have prompted some changes in expenditure patterns that persist for a while.

Consumption will be supported in the period ahead by the general improvement in household balance sheets seen during the pandemic and as wages growth picks up; this experience stands in contrast to previous economic downturns. Overall, household wealth has risen because of the increased savings during the pandemic and the strong growth in housing and equity prices (Graph 1.5). An upswing in housing prices has been a feature of the recovery globally. Strong housing demand has been supported by low interest rates, growth in incomes from fiscal support and a recovery in labour market conditions, as well as changes in household preferences.

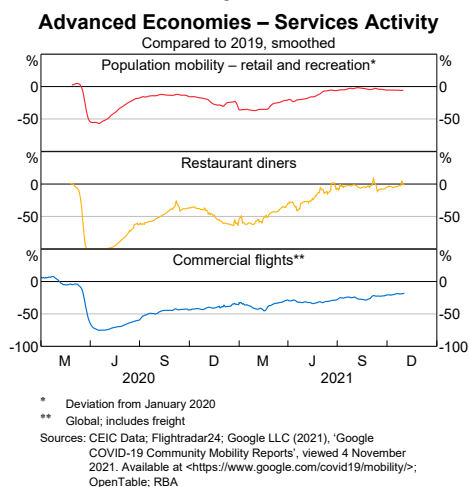
The extent of recovery has been mixed in the Asia-Pacific region. The recovery in most advanced economies in Asia has continued,

underpinned by strong export growth and investment in manufacturing capacity, despite disruptions caused by COVID-19-related restrictions and some supply shortages. Activity in India is likely to have recovered strongly following a sharp contraction mid year related to its Delta wave. In contrast, a tightening in COVID-19 containment measures stalled the recovery in some economies in the region in recent months, including New Zealand, Thailand and Indonesia. Mobility data throughout Asia has picked up as containment measures have eased, which should support consumption and overall activity in the December quarter.

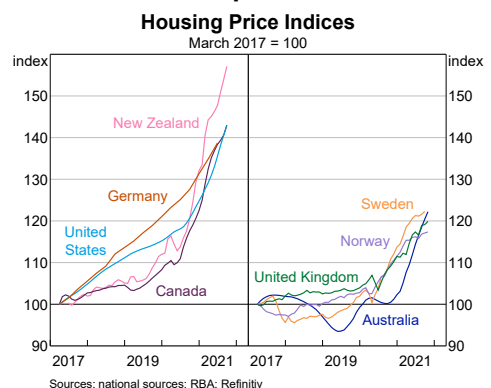
China's economic growth has slowed amid targeted regulatory tightening ...

GDP in China has already returned to its pre-pandemic path. However, growth slowed considerably in the September quarter, in part because of authorities' efforts to reduce leverage in the economy. Localised restrictions imposed in response to short-lived COVID-19 outbreaks also weighed on growth over this period, particularly household spending on services (Graph 1.6). The weakness was concentrated in July and August, with retail sales rising in September after activity restrictions were eased. Strong global demand for goods has provided some offset by continuing to support industrial production and exports, and manufacturers

Graph 1.4



Graph 1.5



have increased investment in response. However, power shortages have weighed on manufacturing output over the past month or so.

The decline in consumption growth during the September quarter compounded the dampening effect of longstanding efforts by the Chinese authorities to reduce leverage in the economy, most prominently in the residential property sector. From late 2020, the authorities have restricted the capacity of developers to finance new projects if those developers cross one of ‘three red lines’ – that is, for having leverage or gearing ratios that are too high, or cash holdings that are too low. This has resulted in a decline in both construction starts and the pipeline of work under construction (Graph 1.7). New home sales have also fallen sharply in Tier 2 and Tier 3 cities since late July.^[1] This policy has had a particularly adverse effect on one property developer – China Evergrande – and has increased funding costs for a number of other highly leveraged property developers (see ‘Box A: Stress in the Chinese Property Development Sector’). While the slowing in China’s real estate sector has been moderate to date, there is a risk that construction activity could decline sharply, particularly if households become reluctant to purchase from property developers in the current environment. Chinese authorities

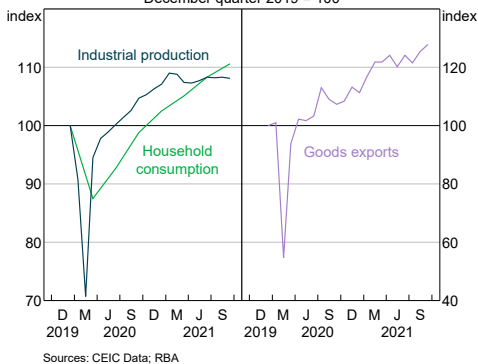
also appear to be less likely than in the past to respond to slowing construction activity by easing credit conditions, given the trade-off that would imply for leverage in the economy.

Regulatory restrictions have also slowed growth in some other sectors. Restrictions on the ability of local governments to commence and finance new infrastructure projects have induced a steady decline in infrastructure investment over the past year. Steel output caps introduced by the authorities to reduce air pollution and carbon emissions over recent months have also contributed to the sharp fall in steel production. As a result, iron ore prices have fallen by more than 50 per cent since their recent peak in May (Graph 1.8). At the same time, Chinese steel prices have been elevated. This divergence implies that the decline in steel supply has more than offset a small decline in domestic steel demand. Production of a range of other materials, most notably aluminium, has also been hampered by power shortages. These shortages are the result of strong demand for energy from other sources, as well as disruptions to energy supply – including because of the authorities’ efforts to restrict energy usage.

Over this year, there has been an increased public focus on ‘common prosperity’ goals, which has been interpreted as reducing inequality and improving living standards for the

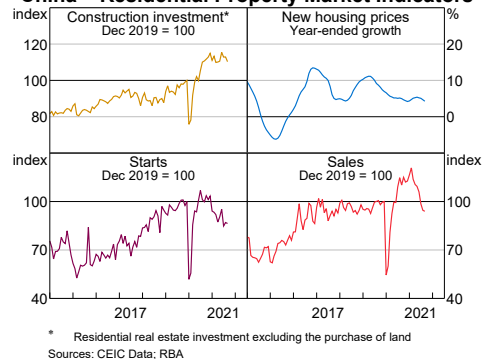
Graph 1.6

China – Activity Indicators
December quarter 2019 = 100



Graph 1.7

China – Residential Property Market Indicators



broader population. Another policy focus has been on stricter enforcement of anti-monopoly and consumer protection rules in the technology sector. While these objectives may enhance growth in the medium term, the breadth of policy adjustment recently has created uncertainty and raised the risk of an unintended slowing in the economy.

... but financial conditions in China overall remain stable

While financing conditions have tightened for property developers and some companies directly exposed to Evergrande, overall financial conditions in China have remained stable. Yields have increased only slightly for investment-grade corporate bonds (both onshore and offshore), in contrast to the sharp rise for high-yield offshore Chinese bonds, which are predominately issued by property developers. Money market rates have also been largely stable, in part reflecting liquidity injections by the People’s Bank of China (PBC). Equity prices have been little changed since the August *Statement*, although offshore-listed equities have been more volatile than onshore equities; this is partly because mainland Chinese property developers make up a sizeable portion of Hong Kong’s exchange.

Financing restrictions for real estate companies and off-balance sheet investment activities of local governments have contributed to a gradual slowing in the growth of debt. Total social financing (TSF) has been stable as a share of GDP over the past year, in line with the target set by Chinese authorities earlier this year (Graph 1.9).

Over recent months, the PBC announced a number of targeted easing policies to help support credit provision, particularly for small businesses and disadvantaged provinces in China. At the same time, China’s national cabinet has requested that local governments accelerate their investment and expenditure plans, which may support TSF growth over coming months, as authorities utilise more of their unspent annual special bond quotas.

The Chinese renminbi remains around its highest level in recent years against the US dollar and it has appreciated around 6 per cent on a trade-weighted basis since the start of the year (Graph 1.10). Trade surpluses and foreign investment continue to support the currency, although foreign inflows into China’s securities markets moderated in the September quarter (Graph 1.11). This is in contrast to the episode in the mid 2010s when financial stability concerns were also elevated. During that earlier

Graph 1.8

Chinese Steel and Iron Ore Spot Prices

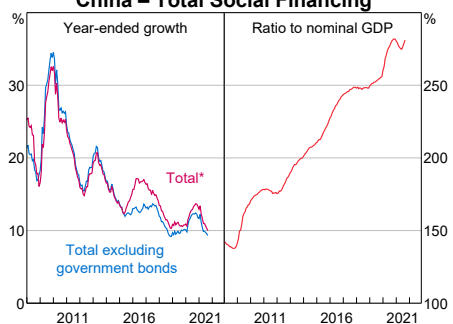


* Average of hot-rolled steel sheet and steel rebar prices
 ** 62% Fe fines index; free-on-board basis

Sources: Bloomberg; RBA

Graph 1.9

China – Total Social Financing

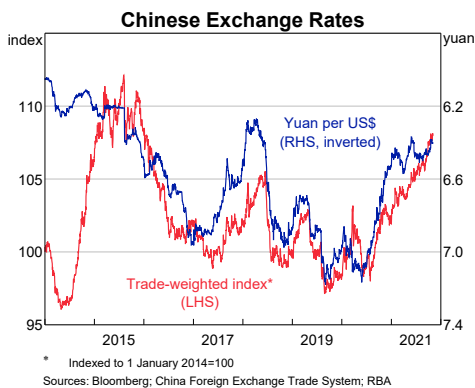


* Measure targeted by authorities which incorporates net government bond issuance; includes local government bonds issued to refinance and substitute for state-backed corporate debt; RBA estimates prior to 2016

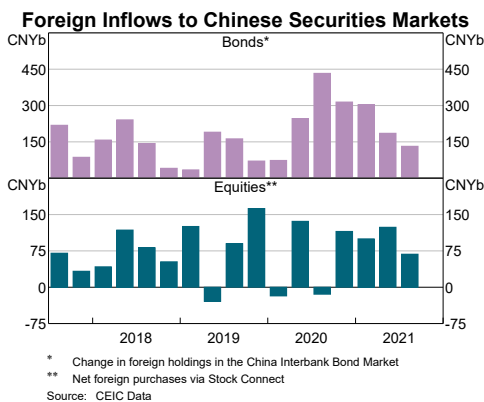
Sources: CEIC; RBA

period, capital controls were tightened to support the exchange rate in the face of large capital outflows and exchange rate depreciation. In September, the authorities proceeded with further easing of controls on cross-border portfolio flows as planned. Additional outbound investments are now allowed, with mainland banks and institutional investors able to purchase certain bonds in Hong Kong's market. This is in line with the long-stated goal of capital account liberalisation, and may boost liquidity and offshore issuance of renminbi-denominated debt. In addition, individual investors in Hong Kong will also be allowed to purchase wealth management products in select cities in South China, and vice versa.

Graph 1.10



Graph 1.11



Capacity limits to global production are boosting commodity and other prices

Capacity constraints in global goods markets have been surprisingly persistent and have broadened in recent months, straining transport networks and weighing on downstream production in a number of areas. Container shipping costs, the backlog of unfinished work and supplier delivery times all remain around historically high levels (Graph 1.12; Graph 1.13). The supply of semiconductors has not kept pace with demand, which has increasingly disrupted downstream manufacturing in an environment of strong demand for finished goods. Most notably, global automotive production declined by around 15 per cent over the first half of this year, across a wide range of countries. More recently, there have been reports of shortages in the supply of building materials and furniture in various countries. Inventories of finished goods have declined further from already low levels, as retailers struggle to secure enough supply to meet strong demand for goods.

Capacity constraints have also substantially boosted the prices of energy-related commodities since the middle of the year (Graph 1.13; Table 1.1). The prices of thermal coal and LNG – key Australian exports – have increased sharply in recent months and, despite

Graph 1.12

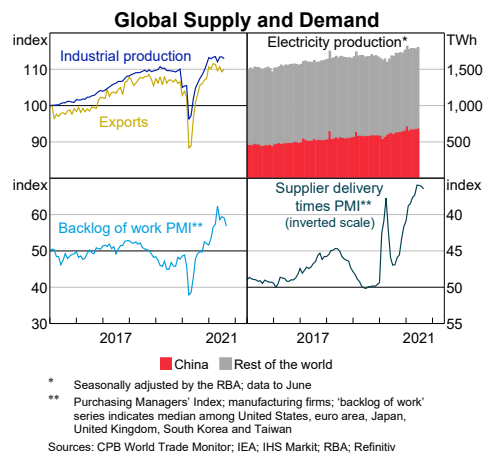


Table 1.1: Commodity Price Growth^(a)

SDR terms; percentage change

	Since previous <i>Statement</i>	Over the past year
Bulk commodities	–6	52
– Iron ore	–43	–21
– Coking coal	87	289
– Thermal coal	34	262
Rural	6	28
Base metals	5	38
Gold	–1	–9
Brent crude oil ^(b)	14	104
RBA ICP	–3	35
– Using spot prices for bulk commodities	–2	45

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

(b) In US dollars

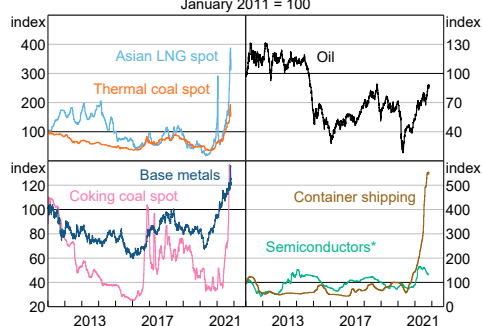
a recent easing, are still higher than at any other time in over a decade. The tightness in gas markets has been most evident in the United Kingdom and Europe, where it has adversely affected production, compressed margins and started to flow into significant rises in prices for some downstream industries. Similar increases in gas prices have not been seen in Australia because the domestic and export gas markets are segmented. China experienced widespread power shortages during September and October that curtailed production of energy-

intensive products like aluminium, other base metals and cement. High prices for coal and LNG have also contributed to oil prices rising to around their highest level in seven years, with OPEC oil supply only increasing gradually. The rise in energy prices has also amplified the rise in base metals prices in recent months.

The broad and persistent nature of these capacity constraints in goods and energy markets primarily reflects ongoing strength in global demand for goods as economies have reopened – and the resulting impact on the energy intensity of the economic recovery. This is illustrated by global merchandise trade, industrial output and electricity production all having increased or remaining elevated as capacity constraints have tightened (Graph 1.12, top panel). Demand for energy has recently been exacerbated by unseasonably warm weather in the northern hemisphere.

Persistent supply disruptions have played some part in these constraints. COVID-19-related shutdowns to factories and ports in Asia have continued, delaying the ability of firms to increase shipments of a wide range of goods. Idiosyncratic supply disruptions – such as

Graph 1.13
Commodity and Input Prices
January 2011 = 100



* Dynamic Random Access Memory (DRAM) chips
Sources: Bloomberg; IHS Markit; RBA; Refinitiv

weather-induced reductions in the supply of renewable energy and China's efforts to reduce pollution from coal-fired electricity generation – have also contributed to tightness in energy markets of late. Firms have been significantly increasing investment to expand production of items such as semiconductors, ships and containers, but this is unlikely to add materially to supply until well into next year.

The combination of strong global goods demand and supply pressures has resulted in high producer price inflation in many economies (Graph 1.14). Goods producer price inflation has risen to the highest rates in many years, with the rise in prices for energy-related commodities further amplifying these price pressures.

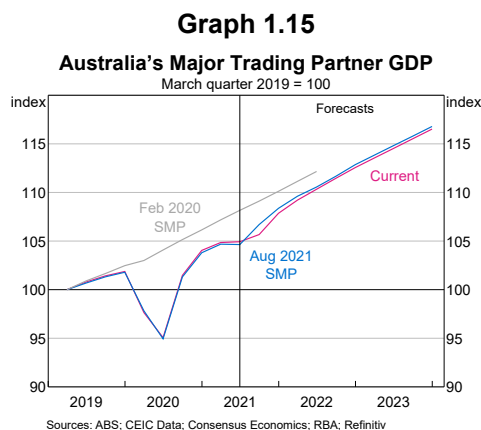
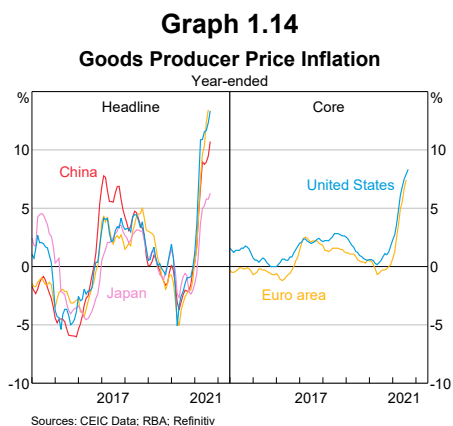
GDP is expected to converge towards pre-pandemic trends in a number of advanced economies

Further recovery in the global economy is expected over the next few years. Growth in Australia's major trading partners (MTP) slowed in mid 2021, largely due to the effects of Delta outbreaks in Asia, as well as capacity constraints in some advanced economies. However, as the disruptions caused by the Delta variant have generally peaked, most economies are expected to continue or resume their earlier recoveries.

The expected level of GDP for Australia's MTP by the end of the forecast period is little changed compared with three months ago, though the timing of the recovery has been pushed out slightly in the near term. Year-average MTP growth is expected to be strong in 2021 and 2022 (6 per cent and 5 per cent, respectively) (Graph 1.15).

Quarterly GDP growth in advanced economies is expected to remain elevated through to mid 2022, before easing to more typical (pre-pandemic) rates. Most advanced economies are expected to regain their pre-pandemic path for GDP during 2022. China is expected to continue growing along its pre-pandemic path over the forecast period, with a slowdown in real estate construction broadly offset by stronger consumption and infrastructure investment. The pace of growth in China is expected to continue to moderate, in line with the trend before the pandemic.

By contrast, many emerging market economies in Asia and elsewhere are not expected to return to their pre-pandemic paths over the forecast horizon. Regionally, this shortfall is most pronounced for India, Indonesia and the Philippines. In these economies, vaccination rates remain low, private sector balance sheets have deteriorated and international tourism is expected to resume only slowly.



There are three main risks to the outlook for global growth:

1. Capacity constraints could restrain the recovery and result in price pressures remaining high for longer than assumed. The central assumption in the global outlook is that labour supply and production capacity lift over the coming year, allowing a period of strong growth but without triggering persistent inflationary pressures. However, it is possible that the global economic recovery could be held back by supply constraints in product and labour markets, and more persistent inflationary pressures could reduce household purchasing power or trigger an earlier or larger tightening in global monetary policy than currently anticipated.
2. The outlook for global consumption remains uncertain. The emergence of a vaccine-resistant strain of COVID-19 could require mobility restrictions to be re-imposed and, even in the absence of this, consumers might remain cautious about resuming the consumption of a wide range of services. On the other hand, the recovery in consumption could be stronger than expected as a result of pent-up demand, the accumulation of savings during the pandemic and the large increase in housing and financial wealth. It is also uncertain whether, or how quickly, the share of consumption allocated between goods and services returns to pre-pandemic norms; this could affect the global inflation outlook given price pressures have been concentrated in goods markets where demand has been unusually strong.
3. In China, the number of policy adjustments that have taken effect in recent times could weigh on growth by more than currently expected. This could result in a larger-than-expected decline in construction activity. Residential construction activity directly accounts for slightly over 10 per cent of

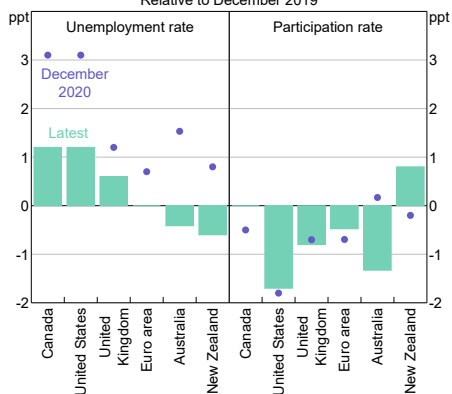
China's economy (and a larger share after taking into account indirect links); a slowing in this sector would dampen demand for upstream manufacturing and, in turn, commodities. Increased uncertainty about economic policy, or unintended economic consequences from recent political directives, could also result in a sharper slowing in activity than envisaged. A broad-based growth slowdown in China would weigh on demand throughout the region and reduce commodity demand, including from Australia.

Labour markets are tightening, with increasing reports of labour shortages

Employment in advanced economies has continued to recover, and unemployment rates have declined to be either close to, or back at, pre-pandemic levels (Graph 1.16). However, job furlough schemes have wrapped up recently in the United Kingdom and will end in some euro area countries in coming months. As workers who were furloughed re-enter the labour force, they will add to available labour supply, which could temporarily slow progress in reducing measured unemployment rates. Regardless, labour demand remains strong globally, with job vacancies at elevated levels in many economies.

Graph 1.16

Labour Market Indicators
Relative to December 2019



Source: Refinitiv

Participation rates remain well below pre-pandemic levels in some other economies, including the United States, the United Kingdom and Germany. Reports of shortages of available labour are widespread in these countries, particularly for customer-facing roles and in industries where activity has lifted sharply as economies have reopened. The shortfall in participation rates in these countries, compared with pre-pandemic levels, is most evident among older age groups, suggesting early retirements or lingering health concerns that may be weighing on people’s willingness to participate in the labour force. In contrast, prime-age participation rates generally returned to pre-pandemic levels earlier this year; the United States is the exception, possibly because school closures and limited day-care availability have been more widespread and extensive, constraining the participation of those with child care responsibilities.

A number of other factors are making it hard to match workers to jobs in these countries. The rate of resignations has been significantly elevated in the United States, across a wide range of jobs but particularly for roles where demand for workers has been strong and new jobs are easy to find. Vaccine mandates for certain industries or jobs in the United States and the United Kingdom, and a relatively high (though falling) share of workers having to isolate because of possible COVID-19 exposure, are also constraining labour supply. In addition, reduced supply of foreign labour in the United Kingdom has exacerbated labour shortages in certain sectors, most prominently fuel and goods distribution.

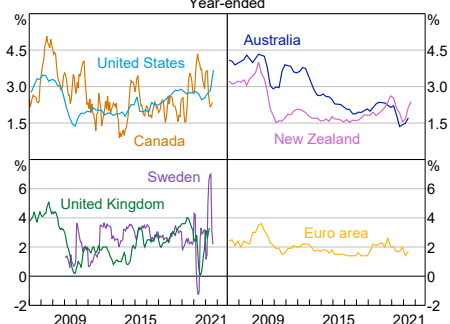
Wages growth has increased in economies where reports of labour shortages have been most prominent, such as the United States, the United Kingdom and New Zealand (Graph 1.17). In the United States, these wage increases have been reasonably broad-based across industries and occupations, but have been fastest for low-

wage workers. This in part reflects an increase in the relative wages of customer-facing and some other roles, possibly owing to increased health risks or less stable hours during the pandemic. These factors help to explain why measured wages growth in the United States and the United Kingdom has picked up despite still elevated unemployment rates. On the other hand, and as has been the case in Australia, wages growth has been subdued in Canada and the euro area, despite strong labour market recoveries.

Inflation has increased, but medium-term inflation expectations are still consistent with targets

Consumer price inflation in advanced economies has increased to elevated rates in recent months (Graph 1.18). A sizeable portion of this increase has been driven by large rises in prices for new and used cars and for services such as travel and hospitality (where supply has been slower to recover than demand as these economies reopen). Central banks expect most of these price increases to moderate, and some to reverse, during 2022. Sharp increases in petrol and energy prices have also added to headline inflation measures since the beginning of the year. Nevertheless, the pace of inflation has

Graph 1.17
Wages Growth*
Year-ended



* Compositionally controlled labour cost indices used for United States, Australia, New Zealand and euro area; Canada, United Kingdom and Sweden are compositionally controlled average earnings measures that capture more volatility and cyclicality than labour cost indices
Sources: BoE; RBA; Refinitiv; Statistics Canada

increased across a broad range of other items compared with pre-pandemic outcomes (Graph 1.19). Consistent with this, underlying measures of consumer price inflation have also increased and in some cases are above central bank targets.

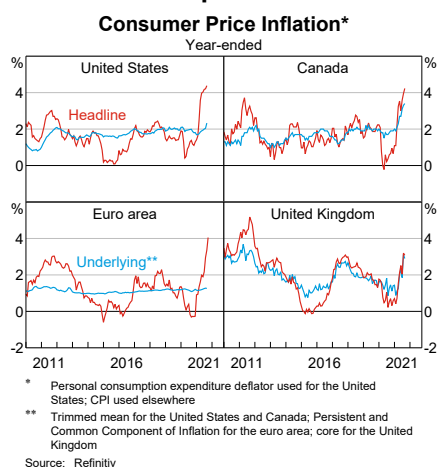
Supply shortages for energy-related commodities are likely to contribute significantly to inflation in coming months, particularly in the euro area and the United Kingdom. Related supply disruptions in downstream industries, if prolonged, have the potential to generate

second-round inflationary pressures. Housing inflation, which tends to be more persistent, is also picking up across advanced economies. More generally, if wages growth remains stronger than expected it would see inflation remain high for a prolonged period.

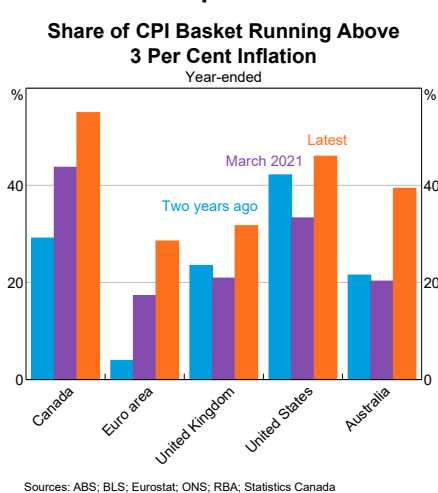
Most central banks still expect inflation to return to target next year, although risks are tilted to the upside and developments in inflation expectations and labour markets are being closely monitored. Market economists forecast inflation in the United States and the United Kingdom to be moderately above target next year, but forecasts in coming years are consistent with targets in most other advanced economies; the range of forecasts among economists has increased sharply for US inflation, consistent with a rise in uncertainty. Financial market measures of expected inflation over the next three years have risen in a number of advanced economies, but most notably in the euro area and the United Kingdom, reflecting compensation for both higher expected inflation and the increase in upside risks to inflation. Medium-term inflation expectations have also increased, in some cases to their highest levels in many years, but are still mostly consistent with central bank targets (Graph 1.20).

Inflation in many emerging markets has also increased significantly. The increase has been most pronounced in countries where inflation expectations are not well-anchored, such as throughout Latin America, Russia and Turkey. In contrast, consumer price inflation has risen only modestly throughout Asia.

Graph 1.18



Graph 1.19



Government bond yields have risen

Yields on longer-term government bonds have increased over recent months in advanced economies, reaching or surpassing levels reached earlier in the year (Graph 1.21). This reflects the expectations of market participants that inflation will be higher and central banks

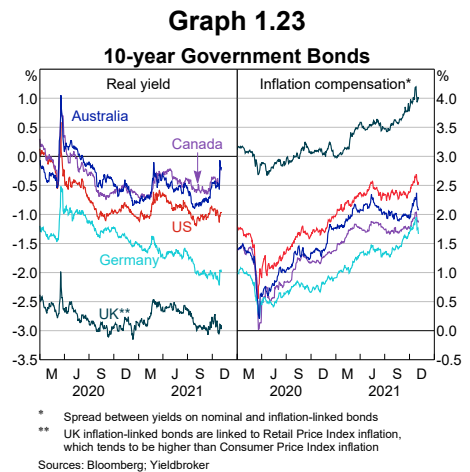
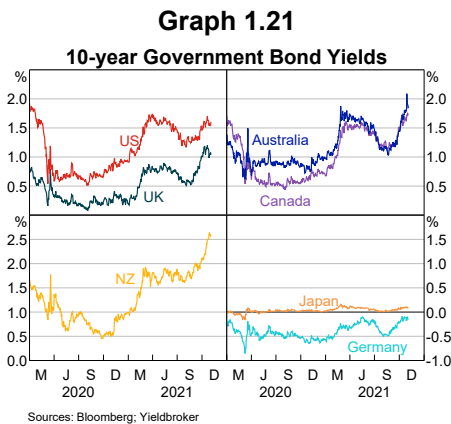
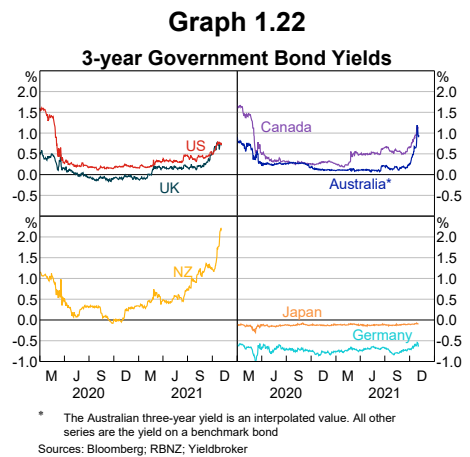
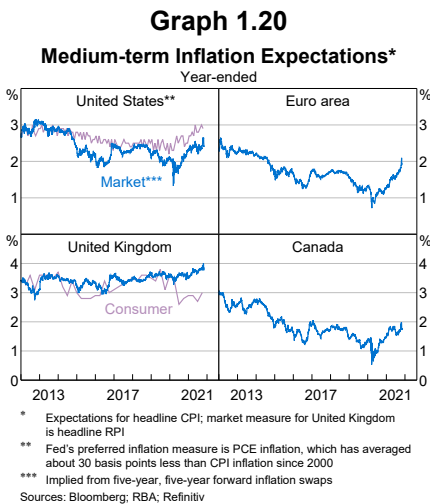
will tighten policy earlier than previously envisaged, as well as increased compensation for the risk that inflation or policy rates increase by more than anticipated. Shorter-term government bond yields have also increased in most advanced economies alongside a shift higher in market-implied expectations for the path of central bank policy rates (Graph 1.22).

Longer-term real yields have increased somewhat in most advanced economies over recent months, though they remain negative and around historically low levels (Graph 1.23). In recent years, the low level of real yields has been attributed to a range of slow-moving changes in advanced economies – including a decline in

potential growth rates, a decline in the risk appetite of firms, rising inequality and the ageing of the population. Moreover, expectations of a prolonged period of monetary stimulus, including sizeable bond holdings by central banks, have exerted downward pressure on yields in both nominal and real terms.

Central banks in some advanced economies have increased policy rates ...

Central banks in advanced economies continue to provide significant monetary policy stimulus through low policy rates, large holdings of assets (primarily government bonds) and term funding



schemes. However, in response to progress in the economic recovery and rising inflationary pressures, some central banks have begun reducing stimulus by raising policy rates, or are expected to start doing so soon. Central banks continue to indicate that inflation is likely to ease over time to be close to inflation targets as supply constraints are resolved. However, a number of central banks have acknowledged that there is an increased risk that a lack of spare capacity will persist longer than expected, and that inflation will be higher and economic activity lower as a result.

A few central banks have raised their policy rate or have flagged that they expect to do so soon. These central banks have retained their approach of setting policy rates in response to their forecasts for inflation, unlike the US Federal Reserve (Fed) and the Reserve Bank of Australia (RBA), which both have forward guidance on policy rates explicitly linked to actual inflation outcomes. A number have said that spare capacity is now limited and that this is leading to upward pressure on underlying inflation, including through rising wage growth (see above). Some central banks have also noted that concerns about financial imbalances – in particular strong growth of housing prices and credit – have played a role in their decisions. Over recent months:

- The Bank of Korea (BoK) increased its policy rate by 25 basis points to 0.75 per cent in August, reflecting progress in the economic recovery, rising inflationary pressures and the need to curb financial imbalances. The BoK has indicated that it could raise rates by a further 25 basis points in November.
- Norges Bank raised its policy rate by 25 basis points to 0.25 per cent in September, in line with its earlier communication, and indicated that it is likely to raise the policy rate again in December. Norges Bank said the increase was motivated by continued progress in the economic recovery and a

desire to counter the build-up of financial imbalances.

- The Reserve Bank of New Zealand (RBNZ) raised its policy rate by 25 basis points to 0.50 per cent in October as was widely expected. The RBNZ assessed that capacity pressures remain evident in the economy, particularly in the labour market, despite recent COVID-19-related restrictions. The RBNZ indicated that it expects to raise its policy rate further if the medium-term outlook for inflation and employment evolves as expected.
- Minutes from the Bank of England's (BoE) September meeting noted that the policy rate could be increased before the end of the year. Subsequent comments from BoE officials indicated that the recent increase in inflationary pressures has strengthened the case for a tightening of policy. As a result, market expectations of an increase in the BoE's policy rate have been brought forward to late this year (Graph 1.24).
- The Bank of Canada (BoC) indicated in October that it expected spare capacity to be absorbed and an increase in the policy rate to be appropriate in the second or third quarters of 2022. This was somewhat earlier than the BoC had projected in its previous forecasts in July.

Elsewhere, market pricing suggests that the Fed is expected to raise its policy rate around mid 2022 while the European Central Bank (ECB) is expected to do so in the second half of 2022. Market participants expect policy rates to be unchanged until at least 2025 in Japan.

... while others are focused on tapering their asset purchases

Most advanced economy central banks have purchased significant amounts of government bonds in secondary markets during the COVID-19 pandemic. These purchases have

contributed to easier financial conditions by lowering government bond yields and putting downward pressure on yields on other assets.^[2] As economic recoveries have progressed, most central banks have either reduced the pace of their purchases or are expected to do so soon. The pace of net asset purchases by the RBA is currently quicker than most other central banks in advanced economies, as a proportion of the eligible stock and relative to GDP, although the level of the Bank's holdings remains lower than most (Graph 1.25; Graph 1.26). Recent announcements include:

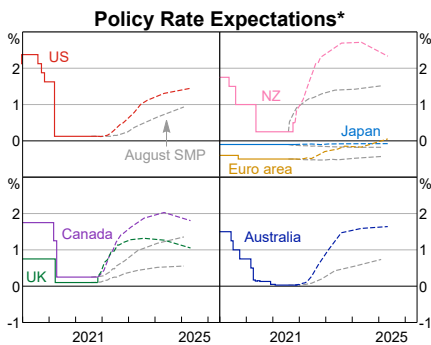
- In November, as was widely expected, the Federal Open Market Committee (FOMC) announced a reduction in the pace of the Fed's asset purchases, because there had been substantial further progress towards the FOMC's inflation and employment goals. The pace of purchases of Treasury securities will be reduced by US\$10 billion per month (from US\$80 billion currently) in both November and December, while the pace of mortgage-backed security purchases will also be reduced by a proportionate amount. The FOMC indicated that similar reductions are likely to be appropriate in subsequent months, implying that net purchases are likely to reach zero in mid 2022. The FOMC noted that the pace of purchases could be

adjusted if there were changes to the economic outlook.

- In September, the ECB announced that it would moderately reduce the pace of its asset purchases under the Pandemic Emergency Purchase Programme and that it would review the future of the ECB's asset purchase programs at its December meeting.
- In October, the BoC announced an end to the quantitative easing phase of its bond purchase program and the start of the reinvestment phase. It will now purchase bonds only at the rate required to offset maturities over time, and so keep its holdings constant until at least the first policy rate increase.

The BoE's government bond purchase program is scheduled to finish by December this year, when the target stock of purchases is reached. In August, the BoE said that it will continue to reinvest proceeds from maturing government bonds until the policy rate reaches at least 0.5 per cent, and that it will not consider actively selling bonds until the policy rate reaches 1 per cent.

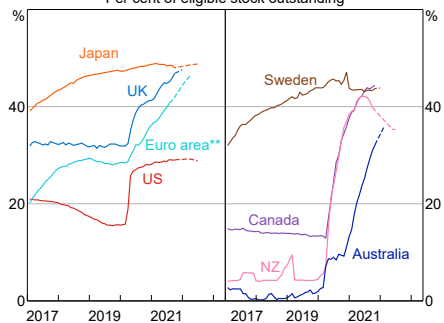
Graph 1.24



* Dashed lines show expectations implied by overnight indexed swap rates
Sources: Bloomberg; RBA

Graph 1.25

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

Private sector funding conditions in advanced economies remain accommodative

Conditions in corporate bond markets remain accommodative. Over recent months, corporate bond yields have risen alongside increases in government bond yields (Graph 1.27). Credit spreads on sub-investment grade bonds denominated in euros have also widened a little but remain close to their post-pandemic lows. Corporations have continued to issue debt at a steady pace in recent months. Corporate default rates have declined since early 2021 after rising noticeably through 2020.

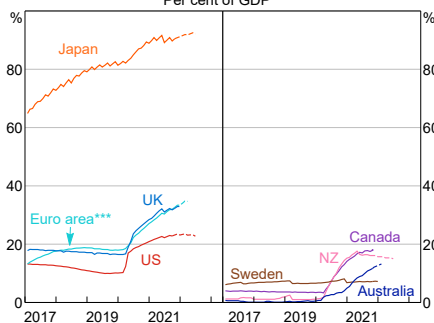
Equity prices in most major markets have remained around record highs, supported by positive corporate earnings results in the banking sector in particular (Graph 1.28). Concerns about the Chinese property sector caused some volatility in late September. Equity prices in Japan have fluctuated as political change has created uncertainty about the outlook for fiscal policy. Meanwhile, the value of mergers and acquisitions deals has reached a record high this year in the United States.

The US dollar has appreciated further over recent months

The US dollar has appreciated a little further over recent months on a trade-weighted (TWI) basis, and is around 2½ per cent higher than at the beginning of 2021 (Graph 1.29). Over the same period, the euro and Japanese yen have depreciated, recently reaching their lowest levels on a TWI basis since the start of the year. These movements are consistent with the smaller increase in bond yields in the euro area and Japan relative to those in the United States and other advanced economies. The euro area and Japan have also experienced a deterioration in their terms of trade recently, owing to rising natural gas and oil prices. The currencies of

Graph 1.26

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

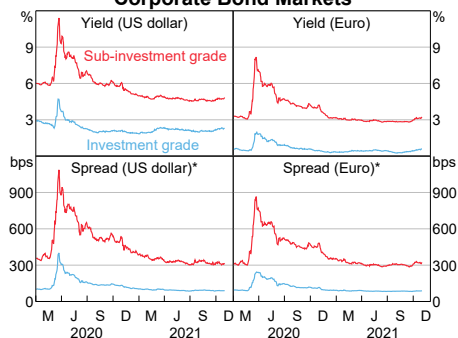
** Four-quarter rolling sum; forecasts are based on the IMF's World Economic Outlook

*** 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

Graph 1.27

Corporate Bond Markets

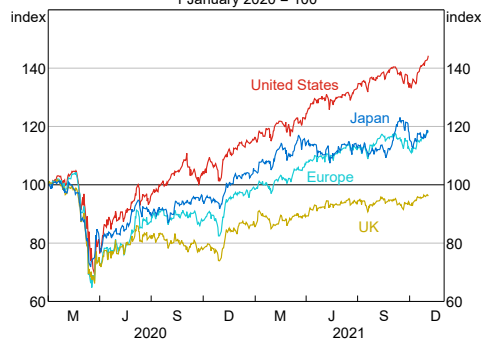


* Spread to equivalent maturity government bond yield

Source: ICE Data is used with permission

Graph 1.28

Equity Prices 1 January 2020 = 100



Source: Bloomberg

other advanced economies, including the Australian dollar, have generally appreciated or been little changed from their levels a few months ago on a TWI basis.

Some emerging market economies have tightened policy further in response to inflation ...

In response to rising inflation and inflation expectations, some emerging market economy central banks outside Asia have continued to tighten policy over recent months. A number of central banks in Latin America and emerging Europe have raised their policy rates several times this year in response to inflation rising to be well above target levels. The central banks of Brazil and Russia now assess that policy rates are above their neutral rates despite sizeable slack remaining in both economies. By contrast, the central bank of Turkey surprised markets by lowering policy rates by a total of 3 percentage points over September and October despite inflation remaining significantly above target.

Market pricing implies that further rate increases are anticipated, and the expected path of rates has shifted higher in Latin America and Russia in recent months (Graph 1.30). In particular, markets expect the Central Bank of Brazil to increase the policy rate by another 250 basis

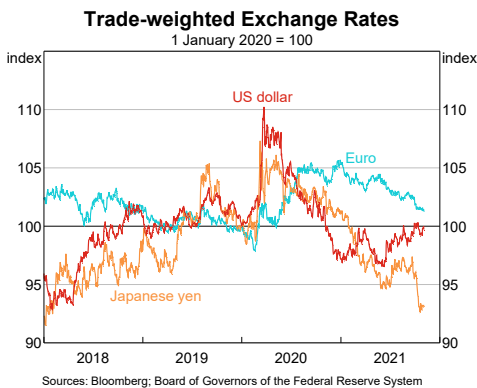
points by the end of the year, which is a faster pace than the central bank has indicated.

Broader financial conditions have also tightened for emerging market economies outside Asia (Graph 1.31). Yields on local-currency government bonds have continued to increase, particularly in Latin America where they are significantly above the peaks seen in March 2020. This mainly reflects the domestic inflation and monetary policy outlook rather than investor concerns over sovereign credit risk. Indeed, spreads between US dollar-denominated bonds issued by emerging market economies and equivalent US Treasury bonds remain near the low levels that prevailed before the pandemic. Equity prices in Latin America have fallen to be below their pre-pandemic levels, while currencies have depreciated over recent months alongside net portfolio outflows.

... while others have kept rates at historic lows

In contrast, central banks in emerging Asian economies have left policy rates unchanged. These central banks have either characterised inflation pressures as subdued and/or viewed recent increases as temporary. Market-implied paths of policy rates in these economies have

Graph 1.29



Graph 1.30

Market Implied Policy Rate Expectations*

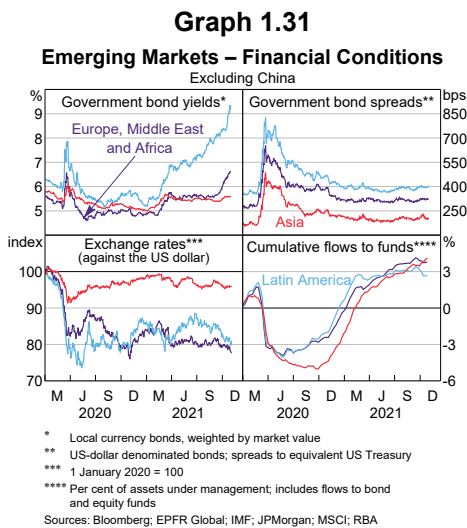


been little changed since August and continue to indicate that some central banks will start raising rates at a gradual pace this year. Local-currency government bond yields in Asia have not risen markedly, and spreads between US dollar-denominated bonds and equivalent US Treasury bonds remain low. Net portfolio inflows have continued, reflecting strong inflows into equity funds. The currencies of most emerging Asian economies have depreciated slightly against the US dollar.

More generally, some emerging market economies remain vulnerable to a tightening of global financial conditions at a time when their economic recoveries are still tentative,

particularly as central banks in advanced economies progress with tapering their asset purchases and raising policy rates. A tightening in global financial conditions would be of particular concern for emerging market economies with large fiscal deficits, high levels of debt and/or a large share of external financing, such as Brazil, Turkey and South Africa.

In light of the ongoing challenges facing the global economy, the International Monetary Fund (IMF) allocated an additional US\$650 billion worth of Special Drawing Rights (SDRs; an international reserve asset created by the IMF) to its member countries in August. This marked the first allocation of SDRs since 2009 and was intended to help foster the resilience and stability of the global economy by addressing the long-term need for reserve assets. The allocation is particularly beneficial for those economies with vulnerable external positions, as countries can choose to sell part or all of their SDRs for freely useable currencies. To enhance the impact of the allocation on the global economy, some countries with strong external positions have also discussed the possibility of using a share of their new allocation to support more vulnerable countries. A few countries have already made formal commitments to do this, including Australia. 🇦🇺



Endnotes

[1] China's cities are commonly (although not officially) grouped in 'tiers' according to size, ranging from the largest 'Tier 1' cities (such as Beijing and Shanghai) to medium-size 'Tier 2' cities (the capital cities of China's provinces) and smaller 'Tier 3' and below cities (which typically are less developed and have smaller populations).

[2] See RBA (2021), 'Box A: Central Bank Purchases of Government Bonds', *Statement on Monetary Policy*, August. Available at <<https://www.rba.gov.au/publications/smp/2021/aug/box-a-central-bank-purchases-of-government-bonds.html>>

Box A

Stress in the Chinese Property Development Sector

Financial conditions for the Chinese property sector have been stressed in recent months as the financial health of a number of highly leveraged property developers has deteriorated. Chinese authorities have prioritised deleveraging the property sector in recent years. In late 2020, they introduced the ‘three red lines’ policy, which requires developers to remain within limits on leverage, gearing and liquidity or be subject to tighter limits on their ability to take on new debt. Following this, concerns were initially centred around China Evergrande Group, a large and highly leveraged developer; however, these concerns have now spread to several other sizeable property developers. Spillovers to other sectors have been limited to date.

The financial position of Evergrande, a highly leveraged property developer, has deteriorated significantly

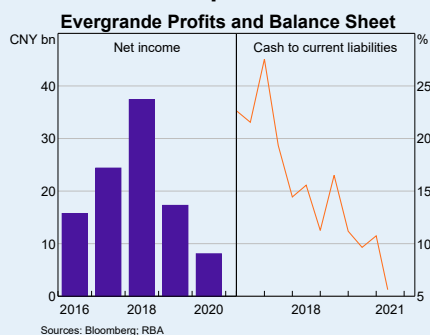
Evergrande, one of China’s largest and most leveraged property developers, has been facing significant stress as investors have become increasingly concerned about the company’s ability to meet its debt obligations. Evergrande’s liabilities are large in absolute terms, although they are small relative to lending in the Chinese financial system. While Evergrande’s total liabilities of around CNY2 trillion (around A\$420 billion) are equivalent to around 2 per cent of China’s GDP, its financial market liabilities (bank and trust loans, and onshore and offshore bonds)

represent much less than 2 per cent of total liabilities in each of those markets.

In recent years, Evergrande’s profitability has deteriorated at the same time as its core business has expanded rapidly (Graph A.1). This expansion has been underpinned by high and rising leverage, with much of their liabilities due to be repaid at short terms. It has also made sizeable investments in a wide range of businesses outside real estate development. Ongoing efforts by the Chinese authorities to reduce leverage in the real estate sector have contributed to Evergrande’s inability to secure debt funding and maintain adequate liquidity. Pre-sales of apartments by Evergrande, which represent a key source of funds, have also declined sharply.

In recent months, given its low levels of liquidity and inability to raise new debt, Evergrande has found it difficult to meet a range of its obligations as they have fallen due. These obligations have included coupon payments, particularly on its offshore bonds.

Graph A.1



Evergrande has delayed payments to its suppliers, which are the largest component of its reported liabilities (Graph A.2). Evergrande has also attempted to sell some of its assets – some at a steep discount – to raise additional cash and improve its liquidity position, but has so far been unable to complete these deals.

Since late September, Evergrande has missed several coupon payments on US dollar bonds, although it has repaid the earliest two of those payments within a 30-day grace period. Beyond coupon payments due in 2021, Evergrande has a significant amount of onshore and offshore bonds maturing in 2022, as well as onshore bonds for which investors have the right to demand early repayment in 2022. Evergrande has missed repayments of funds maturing in September owed to some customers of its wealth management products (these are often marketed as savings vehicles to retail investors); it has begun returning some of these funds in instalments. Evergrande has also failed to discharge guarantee obligations on some wealth management products issued by third parties. In addition, it has a number of off-balance sheet liabilities.

Bond markets are now pricing a high probability that Evergrande will default on both its US dollar- and renminbi-denominated bonds (Graph A.3). US dollar bond prices suggest that creditors expect to be able to recover only 25 cents on the dollar. The company requested a trading suspension for its onshore bonds in mid September, after which these bonds have only traded via negotiated transactions.

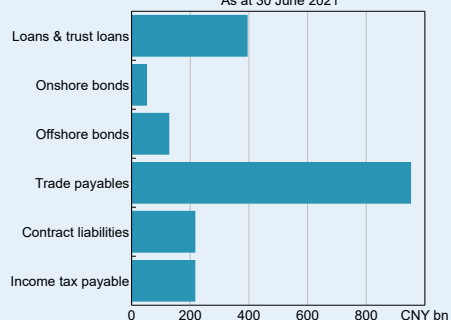
Concerns have spilled over to other developers facing similar pressures and banks with direct exposure to Evergrande

Developments around Evergrande have precipitated a sharp fall in bond and equity prices for other developers with low levels of liquid assets relative to their short-term liabilities. Bond markets are pricing in a significant probability of default for several medium-sized property developers that are not state owned, such as Kaisa Group and Yuzhou Group (Graph A.4). Adverse news about the financial health of several much smaller developers – including Modern Land, Fantasia Holdings and Sinic – have also weighed on market sentiment. Bond market prices recovered somewhat after Chinese central bank officials suggested that risks

Graph A.2

Evergrande Liabilities

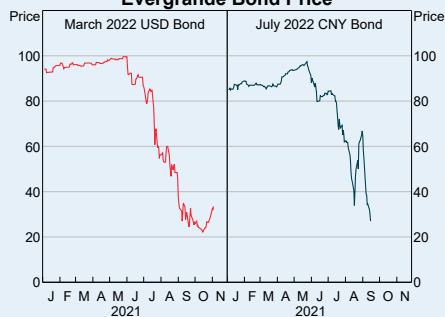
As at 30 June 2021



Source: Company report

Graph A.3

Evergrande Bond Price



Sources: Bloomberg; RBA

from Evergrande are controllable, and that banks may roll over maturing funding even for highly indebted developers. Other large developers have been relatively unaffected, with the exception of the highly leveraged Sunac and Greenland Holdings.

Equity prices have fallen for some Chinese banks, particularly for joint-stock banks with considerable direct exposure to Evergrande and other property developers (Graph A.5). By contrast, bank bond prices have not declined materially, suggesting that markets are not concerned that the stresses facing developers will affect the risk of default by any of the larger banking institutions that issue bonds. Likewise, yields have remained relatively stable for investment-grade corporate bonds, even though yields on high-yield offshore bonds – around two-thirds of which are developer bonds – have risen significantly (Graph A.6). Yields on bonds issued by local government financing vehicles, for which land holdings are an important asset, have also remained stable. Equity prices for listed companies that are known suppliers to Evergrande have declined. But broader equity prices, particularly for those listed on the mainland,

have remained fairly stable as other sectors have remained broadly unaffected by Evergrande’s issues.

Financial market developments more broadly suggest that spillovers from stress among Evergrande and other property developers to other parts of the Chinese financial system have so far been limited. That said, it is difficult to observe stress in less-transparent parts of the Chinese financial system, including among smaller banks. Moreover, the situation remains fluid, and further stress in the property sector could lead to a significant slowdown in the Chinese

Graph A.5

Chinese Equity Prices

4 Jan 2021 = 100

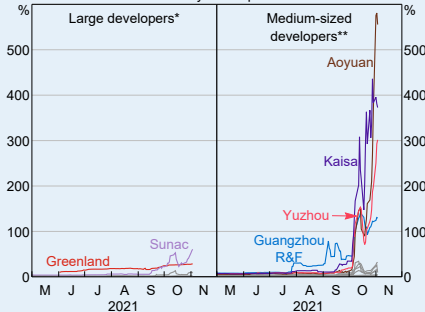


* Excluding Skshu Paint
 ** Excluding China Merchants Bank
 Sources: Bloomberg; Macquarie Research; RBA

Graph A.4

Chinese Developer Bond Yields

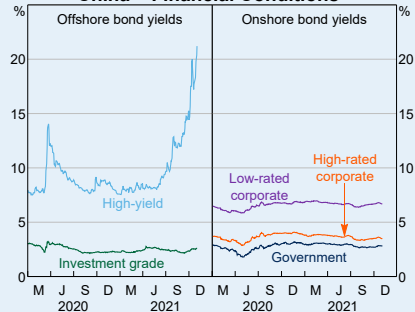
USD 2022 bonds by developer total liabilities



* Developers with liabilities more than CNY 500 billion
 ** Developers with liabilities of CNY 100-500 billion
 Sources: Bloomberg; RBA

Graph A.6

China – Financial Conditions*



* Onshore bond yields shown for five-year maturities, offshore bond yields are a weighted index with average maturity of six to seven years
 Sources: Bloomberg; CEIC; RBA

economy and broader stresses in the financial system. Policymakers in China face the challenge of avoiding further spillovers while also focusing on their longer-term

objective to reduce leverage in the property sector.^[1] 📄

Endnotes

- [1] For discussion on potential channels of contagion from Evergrande, see RBA (2021), Financial Stability Review, October. Available at <<https://www.rba.gov.au/publications/fsr/2021/oct/>>

2. Domestic Economic Conditions

Economic activity declined sharply in the September quarter due to the effect of health-related restrictions on private domestic demand in some states. GDP is forecast to have fallen by around 2½ per cent in the quarter, with a large decline in private consumption and investment partly offset by growth in public demand and a rebound in exports. Hours worked fell sharply in lockdown-affected states between June and September, but job attachment appears to have been maintained even as measured employment dropped.

Fiscal measures supported household and business income in areas affected by lockdowns, along with ongoing assistance from monetary policy. As restrictions ease, fiscal and monetary policy support will help to re-establish the momentum in the economy that was evident prior to the recent Delta outbreaks. Consistent with this, consumer and business sentiment has held up, as have forward-looking indicators of labour demand. Information from the Bank's liaison program suggests that many businesses have viewed the recent setback to activity as temporary and have maintained staff levels and investment plans.

Conditions vary considerably around the country and across industries. Economic activity has remained firm in states without major Delta outbreaks. Consumer spending was at a high level in Queensland, South Australia and Western Australia, and surveyed business conditions remained relatively strong in these states. Timely measures suggest that a rebound in activity is now well underway in the Australian Capital Territory, New South Wales and Victoria

as key vaccination rate thresholds have been met and restrictions on activity have been eased substantially. However, conditions remain subdued in parts of the economy more heavily affected by the pandemic, such as the tourism, transport, education and arts and recreation sectors, and their recovery is likely to take longer.

Domestic demand had strong underlying momentum prior to the recent outbreaks ...

The Australian economy grew by 0.7 per cent in the June quarter, led by a strong increase in domestic final demand. The major components of domestic demand had recovered to be close to, or above, their pre-pandemic level in the quarter (Graph 2.1). The external sector subtracted from growth, driven by a fall in resource export volumes because of temporary production disruptions. Imports of intermediate and capital goods grew strongly as firms continued to respond to tax incentives for investment. The strong underlying momentum in the domestic economy was maintained in the September quarter in states not affected by extended restrictions on activity.

... but restrictions in the September quarter weighed heavily on activity

A sharp rise in COVID-19 case numbers in New South Wales and Victoria led to stay-at-home orders being extended for longer than had been announced at the time of the previous *Statement*. Around half of the Australian population were under significant restrictions for most of the September quarter (Graph 2.2). GDP

is forecast to have fallen by around 2½ per cent in the quarter. The largest effects will, once again, have been on private consumption and investment, as observed in the June quarter of 2020 when national lockdowns were in effect.

In contrast to the lockdowns in 2020, measures of business and consumer sentiment have held up well in recent months. Information from the Bank’s liaison program suggests that businesses have viewed the recent setback as temporary and anticipate a strong recovery in activity. Further, population mobility – a timely measure

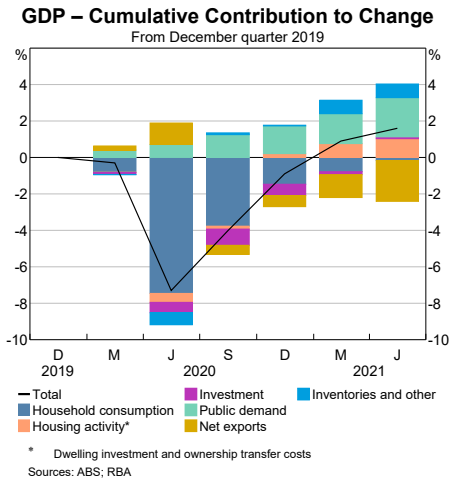
of economic activity – has increased strongly in New South Wales and Victoria (Graph 2.3).

Lockdowns temporarily interrupted further improvement in the labour market ...

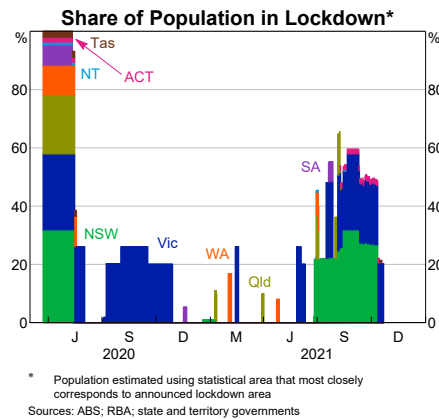
There were large disruptions to the labour market in recent months. A significant number of workers were on reduced hours or stood down in those parts of the economy most affected by lockdowns. Total hours worked fell by 3 per cent from June to September, and employment decreased by 2 per cent (around 280,000 people). Although a very large number of people have been affected, in aggregate these disruptions were not as severe as the sharp drops in total hours and employment that occurred in the initial phases of the pandemic in 2020 (Graph 2.4).

The effects on the labour market have been greatest in New South Wales and Victoria; elsewhere, the labour market has been more resilient. Similar to lockdowns in 2020, industries that recorded the largest declines in employment during recent months tended to be contact-intensive, such as accommodation & food and retail (Graph 2.5). Employment has been more resilient in industries in the business

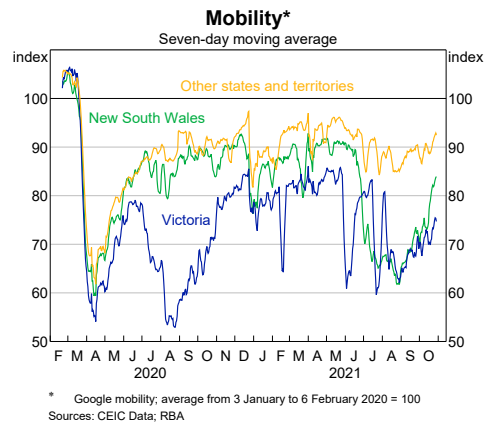
Graph 2.1



Graph 2.2



Graph 2.3



services sector, as well as manufacturing and healthcare.

There was a marked decline in the rate of labour market participation in recent months, from 66.2 per cent in June to 64.5 per cent in September. Although measured employment declined, many of the people recorded as ‘not employed’ maintained some degree of job attachment to their employers, and were not actively searching for a new job given they anticipated returning to their previous employment. For other people who were not employed, lockdowns reduced the availability of new employment opportunities; search requirements for JobSeeker eligibility were also suspended in COVID-19 hotspot areas. Lower

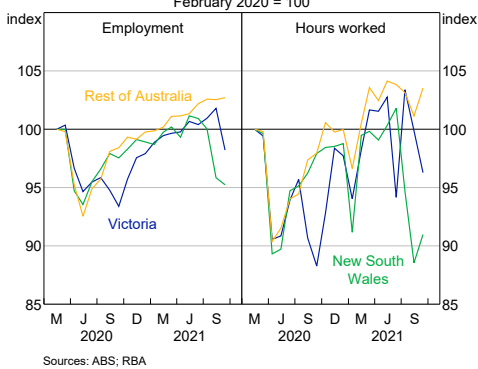
participation more than offset the effect of the fall in employment on the headline unemployment rate, which declined from 4.9 per cent in June to 4.6 per cent in September. An alternative measure of spare capacity that captures employed people working zero hours due to economic or ‘other’ reasons, as well as net flows out of the labour force, was 11 per cent in September (Graph 2.6).

... but underlying conditions in the labour market are strengthening again

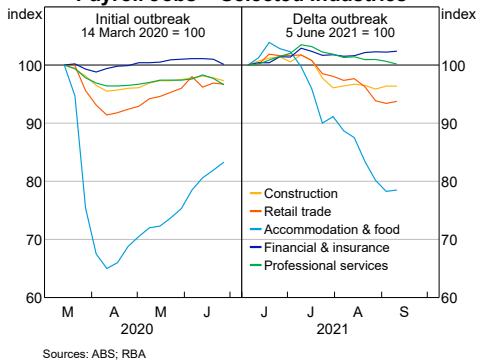
Forward-looking indicators of labour demand point to a strong recovery in the labour market over coming months (Graph 2.7). Timely data on job advertisements showed a strong increase in hiring intentions in New South Wales and Victoria from the latter half of September, ahead of the easing of lockdown restrictions. Hours worked also picked up in New South Wales in September. Liaison over recent months suggested that firms affected by lockdowns were reluctant to lay off staff given reported labour shortages and strong labour demand prior to the lockdowns.

Involuntary job turnover picked up sharply at the onset of the pandemic, and one in five people who left or lost their job over the year to February 2021 were retrenched (Graph 2.8). By

Graph 2.4
Employment and Hours Worked
February 2020 = 100

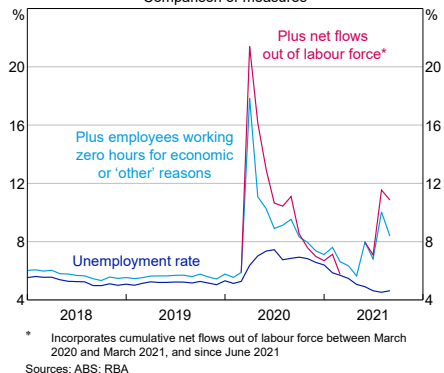


Graph 2.5
Payroll Jobs – Selected Industries
Initial outbreak 14 March 2020 = 100
Delta outbreak 5 June 2021 = 100



Graph 2.6

Unemployment Rate
Comparison of measures



contrast, the number of people leaving their jobs for voluntary reasons declined at the start of the pandemic, consistent with workers delaying job changes in the face of heightened uncertainty. Turnover has picked up in recent months; unlike last year, the recent increase in people leaving their jobs was driven by voluntary reasons, with the most common reason being to get a better job or because they wanted a change.

Strong underlying labour market conditions have also supported further increases in labour market participation over the past 18 months, notwithstanding the temporary effects of the recent lockdowns. Increases in participation by

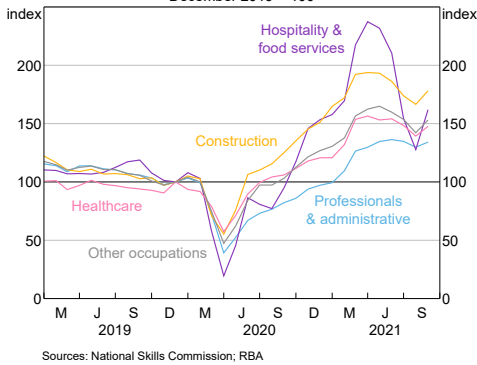
female workers reflects strength in industries that tend to have a higher share of female workers, such as health care (Graph 2.9). Labour force participation for older workers has also picked up from its level just prior to the pandemic, in contrast with the declines in participation observed in other advanced economies such as the United States.

Household consumption fell sharply in the September quarter, but is now recovering ...

Timely mobility and spending data, as well as information from the Bank's liaison program, suggest that household spending increased through September and October, following a large fall over the previous three months. There was a substantial decline in spending in New South Wales and Victoria in response to tighter restrictions on activity during the Delta outbreak (Graph 2.10). Spending remained elevated in states less affected by restrictions. The categories of spending that declined most sharply were, similar to last year, clothing & footwear and in contact-intensive industries, such as discretionary services (Graph 2.11). Conditions have been particularly challenging for smaller firms. Household expenditure on travel and holidays remained well below pre-pandemic levels, even in the states with relatively few

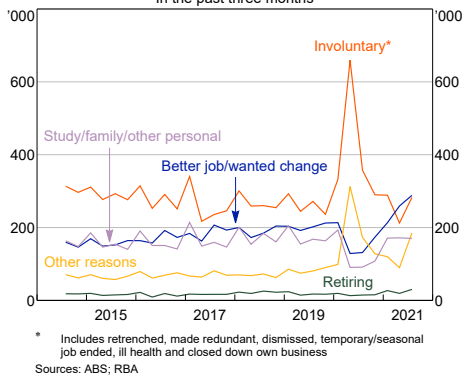
Graph 2.7

Job Advertisements by Occupation
December 2019 = 100



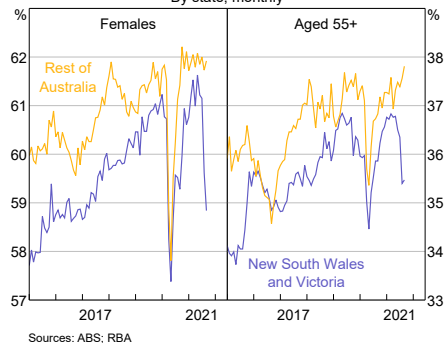
Graph 2.8

Reasons People Left/Lost Jobs
In the past three months



Graph 2.9

Participation Rates
By state, monthly



restrictions on activity, weighing heavily on the tourism sector.

... as fiscal measures have supported household and business incomes

Household disposable income is expected to have increased in the September quarter, after declining slightly in the June quarter. Labour income declined over this period, driven by a decline in employment and hours worked. But, in aggregate, this is likely to have been more than offset by higher social assistance income following the reintroduction of payments provided by the Australian Government and state and territory governments in response to

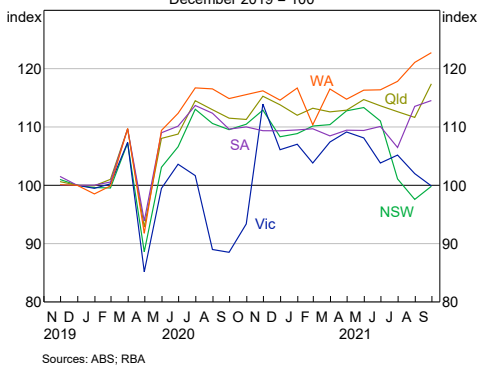
the lockdowns, similar to those provided in 2020. The household saving ratio is expected to have increased sharply in the September quarter as consumption opportunities were limited, particularly for discretionary services (Graph 2.12).

As well as disaster payments to support household income, government assistance packages included direct support to business through grants and payroll tax deferrals, which have supported the cash flow of businesses.

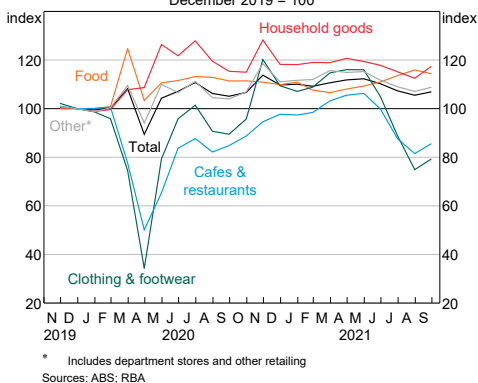
The Delta outbreak temporarily weighed on business investment

Non-mining business investment rose strongly prior to the 2021 lockdowns. Machinery & equipment investment increased to be well above its pre-pandemic level, supported by strong growth in profits throughout the pandemic, the rapid recovery in domestic activity and the Australian Government's tax incentives for investment (Graph 2.13). Non-mining non-residential construction activity had also turned around in the first half of the year, reflecting growth in investment in renewable energy projects and logistics buildings such as warehouses. Mining investment was little changed in June, as firms did not adjust capital

Graph 2.10
Retail Sales Values
December 2019 = 100

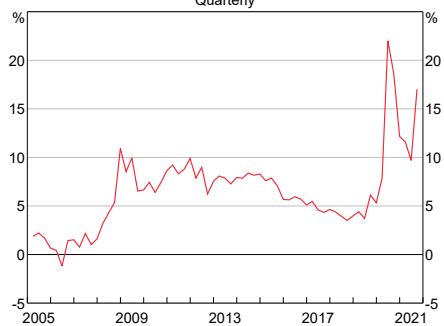


Graph 2.11
Retail Sales Values
December 2019 = 100



Graph 2.12

Household Saving Ratio*
Quarterly



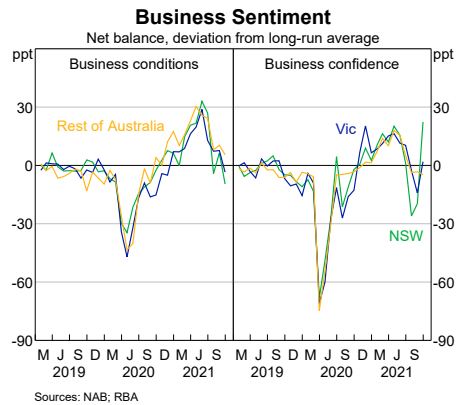
expenditure plans despite high commodity prices.

Investment activity, particularly construction, was disrupted during the September quarter as states with large outbreaks of the virus placed restrictions on construction site activity. As a result, business investment is expected to have contracted sharply in the September quarter. However, a range of partial indicators suggest that this will be a temporary setback, and that business investment will regain its positive momentum following the lifting of restrictions in states affected by outbreaks. Non-mining firms upgraded their investment expectations in the most recent ABS Capital Expenditure (Capex) survey, conducted in July and the first half of August. Many firms in the Bank's liaison program have remained optimistic about the outlook in recent months and have generally not cancelled capital expenditure plans. That said, the impact has been highly varied across firms of different sizes and operating in different industries. Firms in the construction sector have indicated there could be scope to catch up on missed non-residential construction work. Surveyed measures of business conditions declined from the very strong levels seen in the first half of the year, but remain broadly around average as business confidence rebounds, particularly in New South Wales (Graph 2.14).

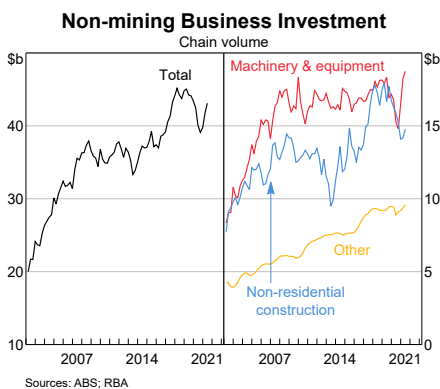
Public investment growth has increased and is supporting the domestic economy

The June quarter saw the fourth consecutive increase in public investment, supported by road and rail infrastructure construction. Growth has been particularly strong at the state and local government level, and that has been the main contributor to public investment growth in recent quarters (Graph 2.15). A very large pipeline of public capital expenditure works will support public investment for several years and is contributing to the demand for construction materials and labour.

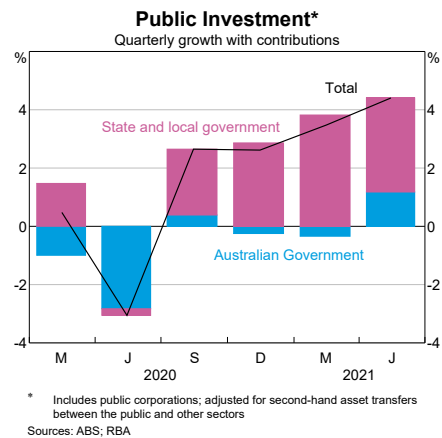
Graph 2.14



Graph 2.13



Graph 2.15



Public consumption remains elevated as share of GDP. Spending on government responses to the Delta outbreak and the accelerated rollout of COVID-19 vaccines will have contributed to public consumption growth at both the federal and state levels in the September quarter.

The outlook for residential construction activity remains strong but may be subject to capacity constraints

There is a large pipeline of almost 250,000 dwellings to be completed over coming years (Graph 2.16). Approvals for new detached housing have decreased since HomeBuilder program applications concluded in March 2021, but remain above pre-pandemic levels.

Approvals for alterations & additions have increased strongly over the past year. The increase in renovation activity has occurred as many households spend more time at home and have had reduced consumption options due to lockdowns and border restrictions. The construction of high-density dwellings continues to support investment as the pipeline of projects is worked through.

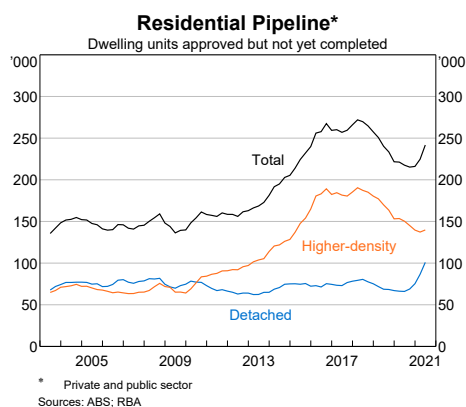
Capacity constraints have begun to slow the delivery of this large pipeline of approved dwellings. In the June quarter, dwelling investment grew modestly and the ratio of work completed to work yet to be done declined,

consistent with the impact of capacity constraints. Capacity utilisation for the construction sector in the June quarter was at a high level (Graph 2.17). The cost of building materials has also risen. In the September quarter, restrictions on workers attending construction sites in New South Wales and Victoria delayed work on dwelling investment projects. Information from the Bank’s liaison program suggests these disruptions have delayed building activity by a few months, with limited scope to make up for these delays because of capacity constraints.

Housing price growth remains strong in most markets

Housing prices have grown rapidly over 2021 across Australia (Table 2.1). Median housing prices have reached new highs in most capital cities (Graph 2.18). Demand for housing has been strong from owner-occupiers, including first home buyers, and investors (see chapter on ‘Domestic Financial Conditions’). Price growth has been strongest for detached dwellings and in regional areas over the past year. Restrictions introduced in response to the Delta outbreak, including on open inspections, temporarily weighed on housing market activity, particularly in Melbourne. However, new listings and auction market activity rebounded quickly

Graph 2.16



Graph 2.17

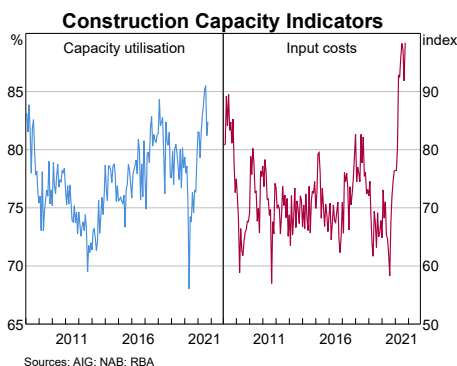


Table 2.1: Housing Price Growth

Percentage change, seasonally adjusted

	October	September	August	July	Year-ended	Past five years
Sydney	1.5	1.8	1.8	2.2	25.2	29
Melbourne	0.7	1.0	1.5	1.6	16.4	24
Brisbane	2.4	1.7	2.1	2.1	22.3	28
Adelaide	1.8	1.9	2.0	1.9	20.1	30
Perth	0.0	0.4	0.7	0.8	16.4	9
Darwin	0.4	0.2	0.5	1.4	19.3	0
Canberra	1.9	1.9	2.1	2.6	25.5	53
Hobart	1.9	2.4	2.4	2.2	28.1	72
Capital cities	1.3	1.5	1.7	1.9	20.8	25
Regional	1.8	1.8	2.0	1.9	24.3	36
Australia	1.5	1.6	1.7	1.9	21.6	27

Sources: CoreLogic; RBA

following the easing of restrictions in Sydney and Melbourne.

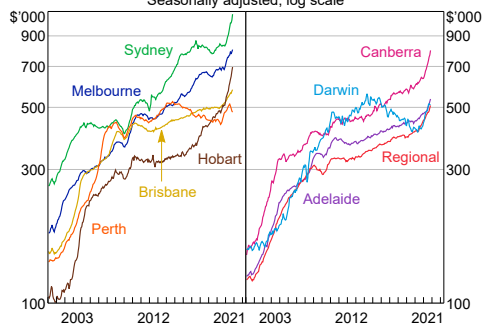
Advertised rents have increased strongly over the past year. The strongest increases were recorded in the smaller capital cities and regional areas, where changes in the pattern of internal migration during the pandemic have contributed to demand (Graph 2.19). The weakness in population growth resulting from the closure of the international border reduced rental demand in large capital cities, and advertised rents for units remain below their

pre-pandemic level in Melbourne and around their pre-pandemic level in Sydney. However, advertised rents for units in major capital cities have increased over recent months as vacancy rates have declined. Rental yields have fallen over the past year because advertised rents growth has been outpaced by housing price growth.

Graph 2.18

Median Housing Prices

Seasonally adjusted, log scale

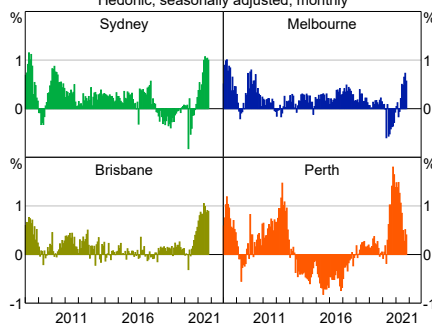


Sources: CoreLogic; RBA

Graph 2.19

Advertised Rents Growth


Hedonic, seasonally adjusted, monthly

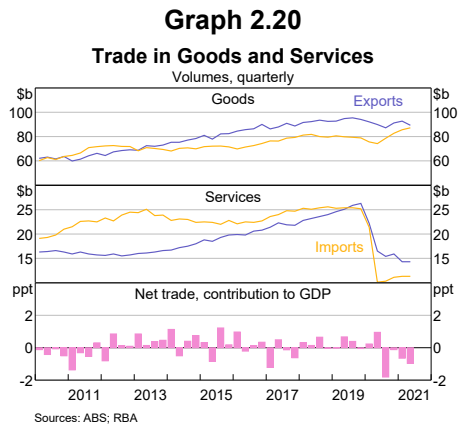


Sources: CoreLogic; RBA

Resource export volumes have begun to recover after temporary disruptions weighed on production

Partial data and information from the Bank’s liaison program indicate that resource export volumes began to recover in the September quarter, as maintenance and weather-related issues that affected June quarter exports were resolved (Graph 2.20). Rural exports have increased further over recent months. The near-term outlook for the rural sector remains favourable because of improved growing and pasture conditions, as well as strong global demand for grains, meat and wool. Trade in services remained low in the September quarter because of ongoing restrictions on international travel. The trade surplus reached a record level in

August supported by high prices for some key Australian export goods, notably coal and LNG. 



3. Domestic Financial Conditions

The policy measures implemented by the Reserve Bank since the onset of the pandemic have lowered 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 September, the Bank extended the bond purchase program, by buying \$4 billion per week until at least mid February.

From late September, Australian Government bond yields had risen markedly alongside increases in sovereign bond yields globally, to be around the levels reached earlier this year. This reflected rising inflation expectations both domestically and offshore and, related to this, expectations that central banks would begin to reduce stimulus earlier than previously expected. The rise also embodied an increase in risk premia as uncertainty about the inflation outlook and future interest rates increased. The rise in yields had been associated with a marked increase in volatility and a noticeable reduction in bond market liquidity, particularly for shorter-dated bonds. The yield on the April 2024 Australian Government bond had been close to zero for much of August and September but rose to over 75 basis points in October. Implied market expectations for the cash rate also rose alongside the broader move higher in yields, with the expected timing of the first cash rate increase now around mid 2022. At its November meeting, the Reserve Bank Board decided to discontinue the yield target of around 10 basis points for the April 2024 bond, after taking into account the upward revisions to

the staff's inflation forecasts and the associated shift in the distribution of possible cash rate outcomes under the Bank's forward guidance, as well as the reduced effectiveness of the yield target in assisting to hold down the general structure of interest rates in Australia as expectations of the future cash rate path shifted.

Banks' overall funding costs remain close to historic lows, notwithstanding the recent rise in yields, and overall lending rates continued to edge down over recent months, reaching new lows. Demand for housing finance remained high in the September quarter, while growth in business debt picked up to well above its average pace of recent years, driven by borrowing by larger firms. In response to the risks associated with rising household indebtedness, in October the Australian Prudential Regulation Authority (APRA) increased the serviceability assessment rate that it expects banks to use to assess prospective borrowers' loan applications. While this action will increase the resilience of borrowers, the effect on overall credit growth is expected to be modest. This is because most borrowers do not borrow at their maximum capacity, and the reduction in maximum loan sizes for affected borrowers will be small.

The Australian dollar has appreciated a little of late but remains below the levels seen earlier in the year. It reached year-to-date lows in mid August before retracing this move alongside the increase in yields on Australian Government bonds relative to those in the major advanced economies.

The bond purchase program has been extended, with purchases of \$4 billion per week until at least February 2022

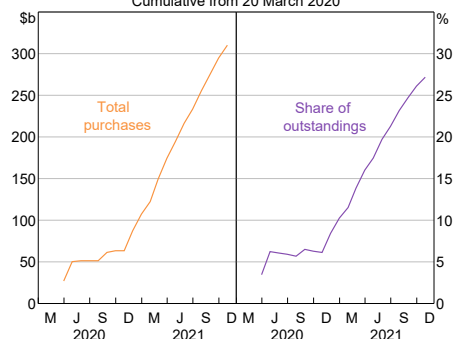
Following completion of the first two phases of the bond purchase program in early September, the Reserve Bank Board decided to extend government bond purchases at a pace of \$4 billion per week. This was a reduction from \$5 billion per week, as announced at the July Board meeting. At its September meeting, the Board also decided to purchase bonds at this pace until at least mid February 2022, in response to the delay in the economic recovery and the increased uncertainty associated with the Delta outbreak. Purchases announced for the period from September 2021 to February 2022 were broadly in line with market expectations and so government bond yields were little changed following the announcement. The Bank has purchased \$234 billion of longer-term government bonds since November 2020 under the bond purchase program, consisting of \$186 billion of Australian Government Securities (AGS) and \$48 billion of semi government securities (semis). Overall, since March 2020, the Bank has purchased around \$315 billion of government bonds under the bond purchase program and in support of the yield target and market functioning. The Bank currently holds 32 per cent of outstanding AGS and 16 per cent of outstanding semis (Graph 3.1). By mid February 2022, these shares are projected to increase to around 36 per cent and 18 per cent, respectively.

AGS yields have increased alongside global bond yields

Yields on long-term AGS increased by around 80 basis points since their lows in August, to be back around the levels seen earlier in the year (Graph 3.2). Shorter-dated AGS yields also increased significantly over the past month. These movements have occurred alongside similar moves in international markets, although

the moves in AGS yields have been larger than in US yields. In particular, 10-year AGS yields are now around 25 basis points above those of US Treasuries. The government bond market is less liquid in Australia than in the United States, which tends to result in larger moves in AGS yields during periods of volatility, as was also the case earlier this year. The increase in yields globally reflects rising inflation expectations in a number of major markets and, related to this, expectations that central banks will begin to reduce stimulus earlier than previously expected (see chapter on 'The International Environment'). Risk premia have also risen alongside a higher perceived risk of upside surprises to inflation and policy rates. Break-even inflation rates – which are measured as the difference between nominal and inflation-indexed bond yields and account for both inflation expectations and risk premia – have increased in Australia, although they remain lower than in a number of other major economies (Graph 3.3). While the Delta outbreak had weighed on the economic outlook and bond yields in preceding months, real yields in Australia have now increased substantially, supported by increasing vaccination rates and the easing of lockdowns.

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

The yield on the April 2024 bond also increased sharply and the yield target was discontinued

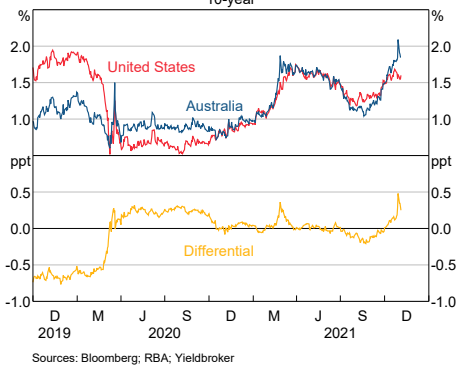
The yield on the April 2024 bond was close to zero in August and September, amid strong demand for short-term risk-free assets, but it increased sharply in October. The initial increase to almost 20 basis points occurred alongside the broader increase in yields globally, with selling of the April 2024 bond by investors who could achieve substantially higher returns by purchasing slightly longer-dated bonds. While there had been no demand to borrow the April 2024 bond from the Reserve Bank at that point, in mid October the Reserve Bank increased the fee it charges counterparties to borrow the April

2024 bond, making any short-selling of the bond more costly. The Reserve Bank also purchased \$1 billion of the bond at auction, after which the yield declined to be closer to the target of around 10 basis points. In late October, the yield on the April 2024 bond increased again following the release of the stronger-than-expected September quarter CPI. The yield then moved sharply higher with no further purchases of the April 2024 bond by the Reserve Bank (Graph 3.4).

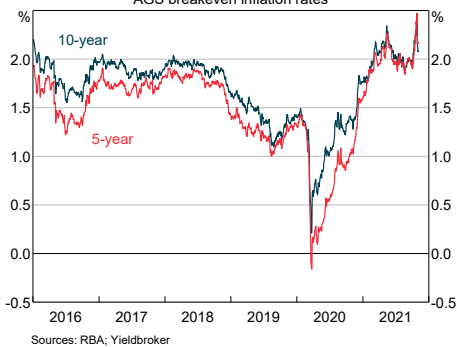
The Board decided to discontinue the target of 10 basis points for the yield on the April 2024 bond at the November meeting, taking into account upgraded staff forecasts (see chapter on ‘Economic Outlook’) and the associated shift in the distribution of possible cash rate outcomes, as well as the shift in market pricing reflected in other term interest rates in Australia. The April 2024 yield was little changed at around 70 basis points immediately following the Board announcement before falling to around 65 basis points over the following days, while longer term yields fell by around 10 basis points.

Swap rates around the three-year tenor had already moved noticeably above the April 2024 AGS yield earlier in 2021, but then rose sharply over October, alongside the broader

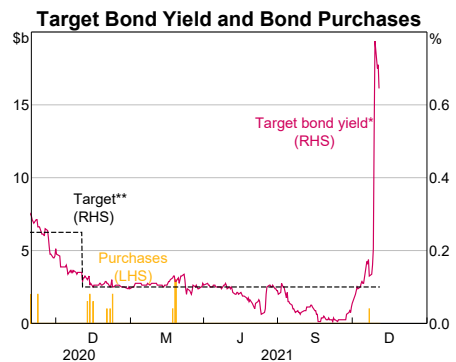
Graph 3.2
Government Bond Yields
10-year



Graph 3.3
Australian Inflation Expectations
AGS breakeven inflation rates



Graph 3.4



* Yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond until 2 November 2021

** Target was discontinued on 2 November 2021

increase in yields as the outlook for inflation and thus market expectations of future policy rates increased domestically and offshore (Graph 3.5). This meant that the yield target had become less effective in assisting to hold down the general structure of interest rates in Australia, with the higher swap rates flowing through to yields on bank and corporate bonds, which typically price off these swap rates.

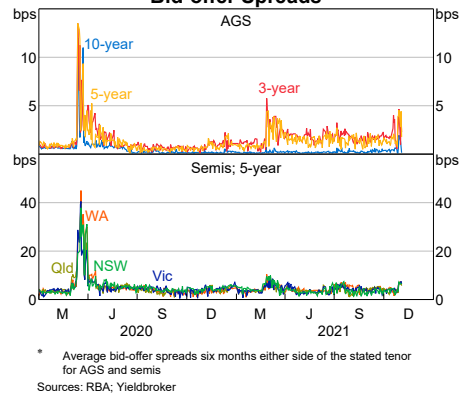
Market functioning was strained as bond yields rose

Similar to the situation in February and March of this year, bid-offer spreads across the yield curve widened alongside the significant increase in yields (Graph 3.6). This widening was most pronounced for shorter-dated AGS, where uncertainty around the outlook for inflation and the cash rate, as well as the yield target, led to a significant deterioration in market liquidity in the days leading up to the November Board meeting. The sharp movement in yields led to stop-loss selling by some leveraged investors, further contributing to market volatility, while turnover was relatively low in comparison to the earlier episode of strain in February and March. In the days following the November Board meeting, bid-offer spreads for shorter-dated AGS narrowed noticeably, although they remained higher than they were in the preceding months.

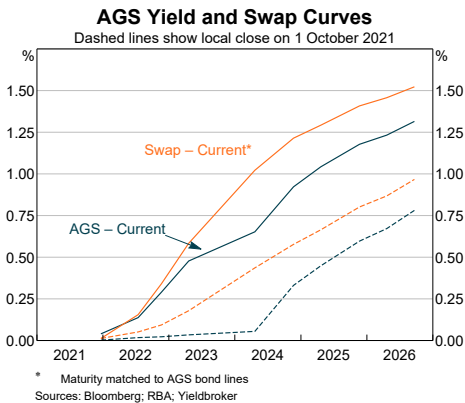
For longer-dated AGS, the increase in bid-offer spreads was more modest and short-lived.

Demand to borrow AGS and semis from the Bank increased in October and early November, particularly for bonds with residual maturity around three to seven years, although securities borrowing remained below the \$15 billion peak seen in June (Graph 3.7). By lending bonds back into the market for short periods the Bank supports the functioning of government bond markets.

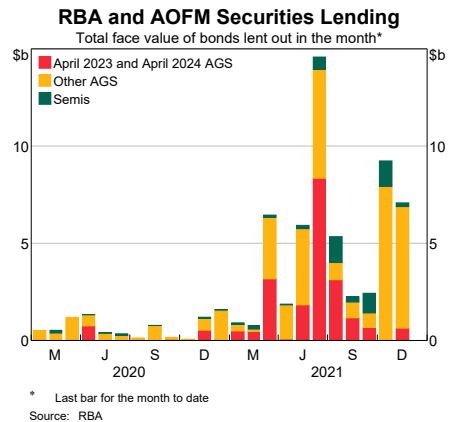
Graph 3.6
Bid-offer Spreads



Graph 3.5



Graph 3.7



The pace of government bond issuance has picked up

Bond issuance by the Australian Office of Financial Management (AOFM) has risen since late August (Graph 3.8). Nonetheless, AOFM issuance remains below the implied pace of issuance based on the AOFM's annual funding guidance for 2021/22. Issuance by the state and territory borrowing authorities has also increased over recent months, and some state authorities now appear to be ahead of their implied funding schedules. Demand has been strong at both AGS and semis auctions.

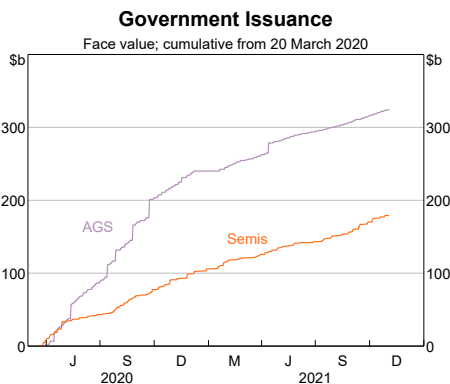
Spreads between the yields on semis and AGS narrowed over September and October to be around levels seen earlier in the year, with market liaison indicating robust demand for semis in both the primary and secondary markets, including from banks (Graph 3.9). In part, this reflected additional demand from banks for government bonds, in order to meet liquidity requirements following APRA's announcement in mid September that the Committed Liquidity Facility (CLF) will be phased out by the end of 2022.^[1] This change reflected the substantial increase in government debt and Exchange Settlement (ES) balances since the start of 2020, such that the value of these high-quality liquid assets available is sufficient for

banks to meet their liquidity requirements without relying on the CLF.^[2] Semis spreads to AGS widened a little in late October and early November, alongside the broader increase in yields and bond market volatility, although spreads remain historically low.

Market participants' expectations for the cash rate have risen

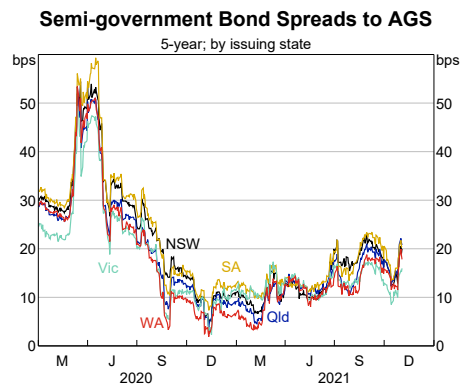
Activity in the cash market remains subdued due to the high level of system liquidity. The cash rate has remained at 3 basis points over the past three months. While expert judgement was used to determine the cash rate on all but three days over this period, on most days there were still transactions in the cash market, predominantly at 3 basis points. Market expectations for the cash rate have risen alongside the broader move higher in yields and the revised outlook for inflation. The expected timing of the first cash rate increase implied by market pricing is now around mid 2022. Prices for overnight indexed swap (OIS) contracts imply that market participants expect the cash rate to increase to around 1½ per cent by the end of 2023 (Graph 3.10).

Graph 3.8



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

Graph 3.9



Sources: RBA; Yieldbroker

Short-term money market rates remain at very low levels

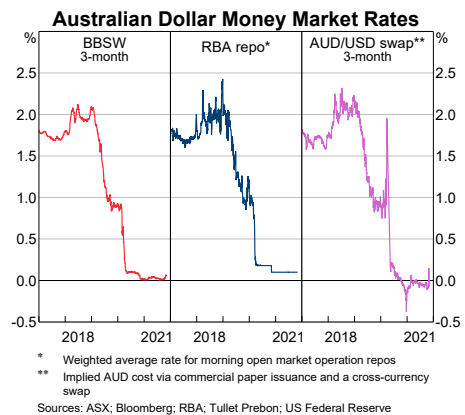
Short-term money market rates remain near historical lows given the low level of the cash rate and the high level of liquidity in the banking system (Graph 3.11). Bank bill swap rates (BBSW) and the cost of Australian dollar funding from offshore short-term issuance (via the foreign exchange swap market) moved a little higher over the past three months but remain very low. Repurchase agreement (repo) rates at the Bank’s regular open market liquidity operations (OMO) remain at 10 basis points. In October, the Bank changed the frequency of its liquidity operations from daily to weekly, reflecting limited use of the facility given the high level of liquidity currently in the financial system. Short-term liquidity obtained at OMO averaged around \$700 million per week through the quarter, well below the weekly average of around \$10 billion prior to the pandemic.

The Bank’s balance sheet and liquidity in the banking system have continued to increase

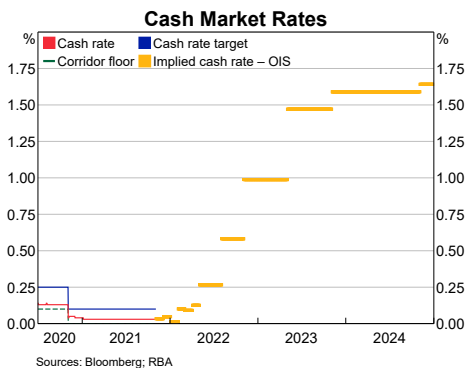
The Bank’s balance sheet has continued to grow over recent months, and currently stands at around \$590 billion – more than triple its size prior to the pandemic (Graph 3.12). Growth in the Bank’s assets since the middle of the year has reflected an ongoing increase in holdings of

AGS and semis, owing to the Bank’s bond purchases. This has been only partly offset in recent months by a continued decline in funds lent via OMO, given the high level of liquidity in the system, as well as a decline in open repos in September after the Bank removed the requirement for institutions to hold such repos with the Bank.^[3] Correspondingly, on the liabilities side, ES balances have continued to rise (Graph 3.13). Liquidity in the banking system – as measured by surplus ES balances – is currently around \$380 billion, compared with around \$2 billion–\$3 billion in the period before the pandemic.

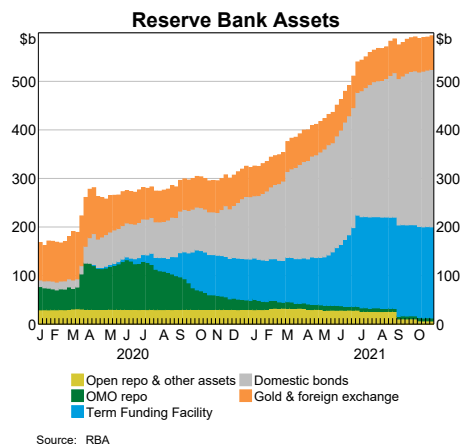
Graph 3.11



Graph 3.10



Graph 3.12



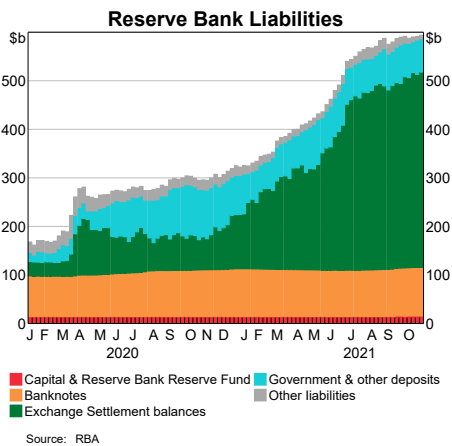
Bank bond issuance and yields have increased

Australian banks raised \$30 billion in bond markets in the three months to the end of October (Graph 3.14). This resulted in a rise in bank bonds outstanding (after taking account of bond maturities) since the end of August (Graph 3.15). The stock of bank bonds outstanding has been declining since mid 2018 – this was especially the case during the drawdown phase of the TFF, which provided banks with ready access to alternative low-cost term funding. Recent months also saw a return to notable volumes of covered bond issuance.

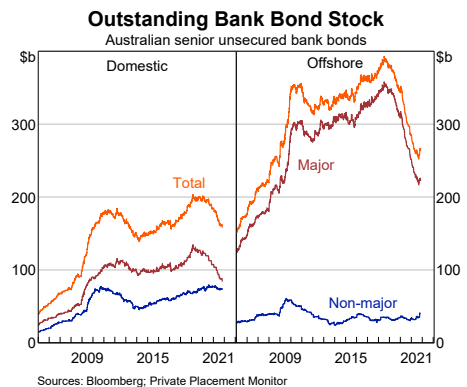
Bank bond issuance in 2021 has been at an average tenor of eight years. Banks are likely to be seeking funding at relatively long tenors to avoid additional maturities close to the periods when most TFF funding will need to be refinanced, as well as to take advantage of favourable pricing. Recent issuance has also been largely in offshore markets, which are typically deeper and more liquid for long-term funding.

Bank bond yields in secondary markets have increased recently, but remain low by historical standards (Graph 3.16). The rise is in line with the increase in three-year swap rates, though the spread to swap has also increased a little.

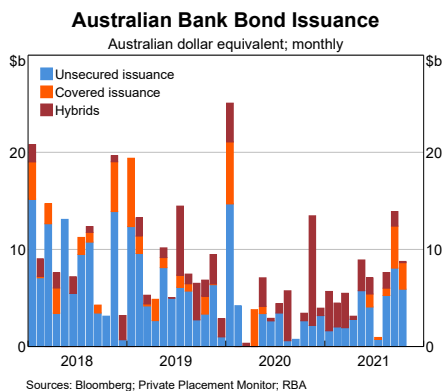
Graph 3.13



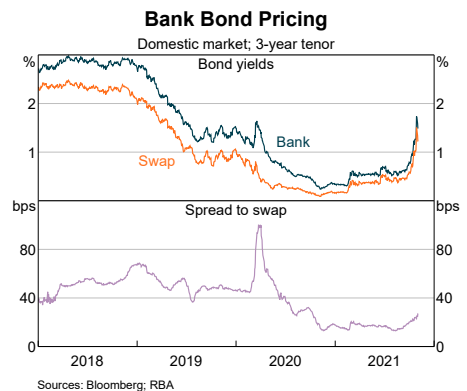
Graph 3.15



Graph 3.14



Graph 3.16



RMBS issuance is at a post-GFC high

The volume of residential mortgage backed securities (RMBS) issued in the September quarter increased to the highest level since the global financial crisis (GFC), reflecting a sharp pick-up in bank issuance, driven by the non-major banks (Graph 3.17). The first RMBS issuance by a major bank in over a year also occurred in the quarter. The pick-up in bank issuance follows the end of the TFF drawdown period. Issuance by non-banks also picked up further in the quarter, to a new high. Non-bank issuance volumes have been elevated during the pandemic, benefiting from strong demand as investors sought alternatives in the absence of much issuance by banks. Meanwhile, pricing on RMBS remains at the tightest levels seen in the post-GFC period.

The share of deposits paying low interest rates has increased further

Deposit rates for new funding have continued to edge lower, after declining sharply over 2020 (Graph 3.18). Interest rates paid on outstanding term deposits have decreased by around 5 basis points since the end of June 2021, as maturing higher-rate deposits are replaced with lower-rate new term deposits. The decline in the spread between interest rates on new term deposits and other deposit rates is continuing to

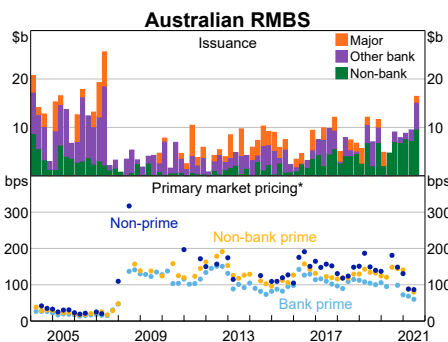
encourage a shift by customers from term to at-call deposits.

These developments have led to an increase in the share of deposits with the major banks that are paying low interest rates (between zero and 25 basis points). In the September quarter, nearly 40 per cent of the debt funding of major banks was in the form of deposits paying interest rates of 25 basis points or less (Graph 3.19). This compares with a little over one-third at the end of February 2021 and around 15 per cent in late 2019. Even so, some bonus savings accounts paying interest rates higher than 1 per cent (if certain conditions are met) are still on offer, particularly at non-major banks.

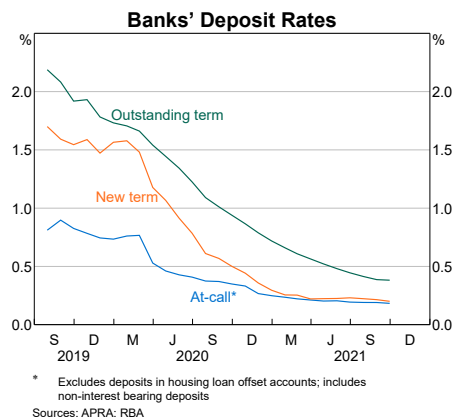
Banks' overall funding costs are around historical lows

Notwithstanding the recent rise in market yields, banks' non-equity funding costs have been around historical lows after declining a little following banks' final TFF drawdowns. The TFF has provided banks with low-cost funding for three years, and so will continue to support low funding costs until mid 2024. In addition, banks' funding costs have also benefited from the strong growth in low-rate deposits over the past year or so. Deposits now account for around

Graph 3.17



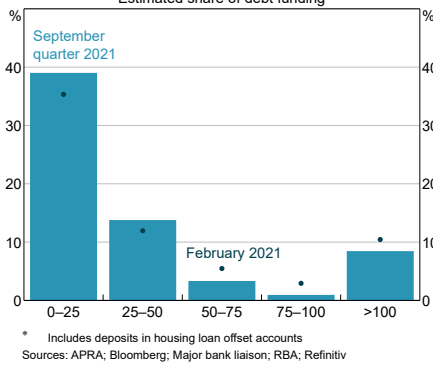
Graph 3.18



60 per cent of banks' total funding – around 5 percentage points higher than before the pandemic (Graph 3.20). This growth has been driven, in part, by the Reserve Bank's purchase of government bonds from non-banks, which then deposit the proceeds with banks. The purchases under the bond purchase program will continue to contribute to the growth of low cost funds for banks in the period ahead. In addition, because banks drew significantly on the TFF, they largely refrained from issuing new bonds during the TFF drawdown period, while outstanding bonds continued to mature. Funds from maturing bonds also contributed to deposit growth.

Graph 3.19

Major Bank Deposits by Interest Rate*
Estimated share of debt funding



Further declines in overall funding costs are expected to be limited. Bank bond yields have increased in recent months making it more costly to issue new debt (Graph 3.21). This will, in time, contribute to upward pressure on average funding costs. In the short term, banks' outstanding funding costs will tend to follow movements in BBSW, which has also increased slightly, as the cost of wholesale deposits and debt funding is linked directly or indirectly to it.

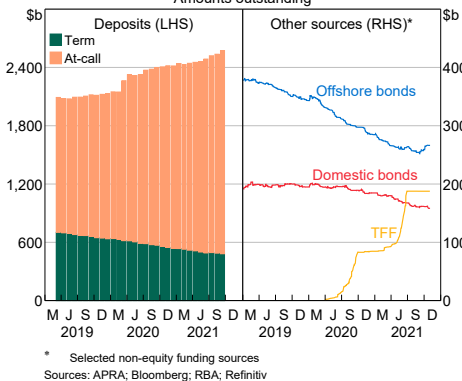
Interest rates on new housing loans are also around historical lows ...

Interest rates on new variable-rate loans have continued to edge down over recent months, and in September were 60 basis points lower than at the end of February 2020. Interest rates on new fixed-rate loans have been substantially lower than the interest rates on new variable-rate loans (by around 65–70 basis points) over the same period. As a result, the proportion of borrowers taking out fixed-rate loans has increased since the start of 2020, but variable-rate loans still account for two-thirds of the stock of total mortgages.

Pricing of short-term fixed-rate housing loans remains competitive. However, after a period of strong growth in fixed-rate loans, competition in housing loans may be shifting back towards

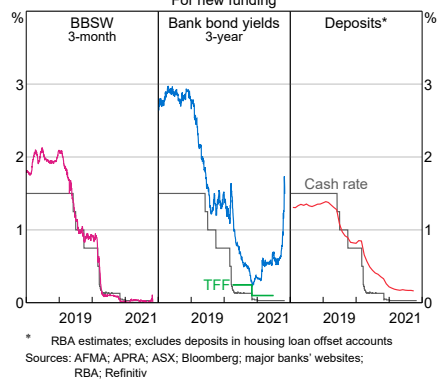
Graph 3.20

Banks' Funding Sources
Amounts outstanding



Graph 3.21

Major Banks' Funding Costs
For new funding



variable-rate loans. A number of banks have recently lowered rates on ‘basic’ variable-rate mortgages (which do not include features like offset accounts) to below 2 per cent. In contrast, banks have continued to increase rates on longer-term fixed-rate housing loans (loan terms of more than three years) in response to the rise in swap rates at those maturities (Graph 3.22). This has led to only a small rise in the average fixed rate paid on new loans because the share of new lending for longer-term fixed rate loans is relatively small and has been declining. Despite recent increases, interest rates on longer-term fixed-rate loans remain at low levels.

... and interest rates on outstanding housing loans have continued to decline

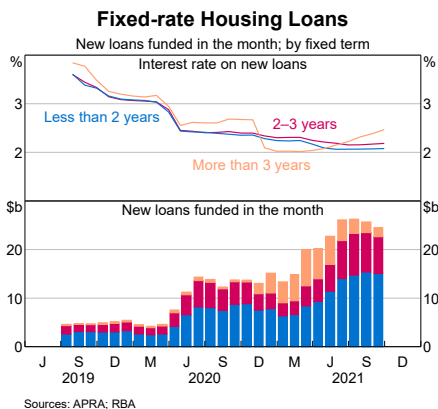
Interest rates on outstanding housing loans have continued to decline over recent months (Graph 3.23). Interest rates on outstanding variable-rate mortgages have declined by around 60 basis points since the end of February 2020, while interest rates on outstanding fixed-rate mortgages have declined by around 145 basis points (Table 3.1). Further declines are likely for a time, as the very low level of new lending rates encourages new housing borrowing and existing borrowers continue to refinance to lower loan rates. In particular,

borrowers reaching the end of their fixed-rate period have been able to obtain more favourable interest rates now on offer. Banks continue to compete for new customers by offering cashback deals of around \$2,000–\$3,000 for refinancing. Housing loan commitments for external refinancing are now at historical highs.

Interest rates on business loans also edged lower in recent months

Interest rates on outstanding business loans continued to drift lower in recent months (Graph 3.24). Since February 2020, interest rates on variable-rate loans have declined by around 100 basis points for small and medium-sized enterprises (SMEs) and 95 basis points for large enterprises. Over the same period, interest rates on fixed-rate loans have declined by around 90 basis points for SMEs and 60 basis points for large businesses. Liaison with banks suggests that increased competition in the business lending market has led to downward pressure on lending rates, particularly for loans to businesses that performed well throughout the lockdowns.

Graph 3.22



Graph 3.23

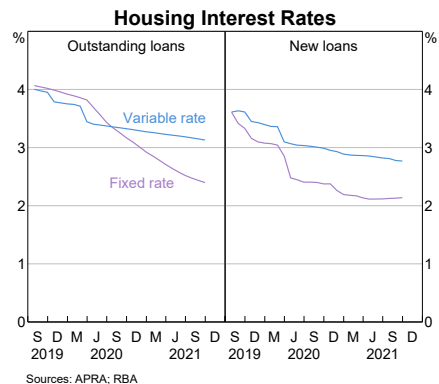


Table 3.1: Average Outstanding Housing Rates

September 2021

	Interest rate (per cent)	Change since February 2020 (basis points)
Variable-rate loans		
– Owner-occupier	3.02	–56
– Investor	3.34	–62
All variable-rate loans	3.13	–58
Fixed-rate loans		
– Owner-occupier	2.26	–147
– Investor	2.64	–137
All fixed-rate loans	2.40	–146
By repayment type ^(a)		
– Principal-and-interest	2.78	–84
– Interest-only	3.40	–82

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

Sources: APRA; RBA

Growth in total credit has picked up noticeably over 2021

Total credit growth has increased over 2021, to be around 7½ per cent in September on a six-month-ended annualised basis (Graph 3.25; Table 3.2). The pick-up in total credit growth has been driven by faster growth in both housing and business credit, while personal credit has continued to decline. In monthly terms, the rate of growth in total credit has slowed since June,

largely reflecting an easing in business credit growth, although it remains higher than earlier in the year.

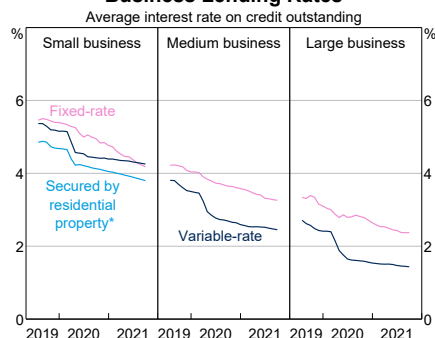
In six-month-ended annualised terms, owner-occupier housing credit growth increased to 10 per cent in September, while investor housing credit growth increased to 3¼ per cent. Demand for housing credit continues to be supported by low interest rates, strong activity in housing markets and government policy measures targeted at first home buyers. Lockdowns appear to have had some effect on demand for loans in New South Wales and Victoria, although these effects will unwind following the easing in restrictions in recent weeks.

Growth in business credit picked up strongly to 8¾ per cent in September on a six-month-ended-annualised basis. Demand for business loans also remained strong, particularly in industries that have been less affected by lockdowns.

Personal credit declined by 5½ per cent in September on a six-month-ended annualised

Graph 3.24

Business Lending Rates



* 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	
	June 21	Sept 21	Mar 21	Sept 21
Total credit	6.9	7.9	3.2	7.4
Household	6.9	6.7	4.4	6.8
– Housing	7.6	7.8	5.2	7.7
– Owner-occupier	10.0	10.2	7.3	10.1
– Investor	3.1	3.2	1.7	3.2
– Personal	–2.0	–8.7	–5.2	–5.4
Business	7.0	10.4	0.7	8.7
Broad money	8.9	10.5	6.1	9.7

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

Sources: ABS; APRA; RBA

basis. Much of the recent decline was driven by lower credit card debt, consistent with consumers having had reduced opportunities for spending during lockdowns at the same time that government payments were supporting incomes.

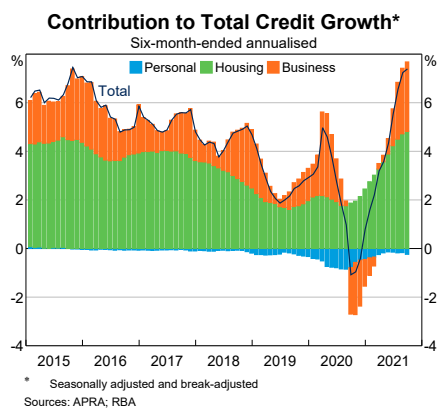
Demand for housing loans remained high

Housing credit growth picked up to be 7¾ per cent on a six-month-ended annualised basis in September. Growth has increased for both owner-occupiers and investors over 2021,

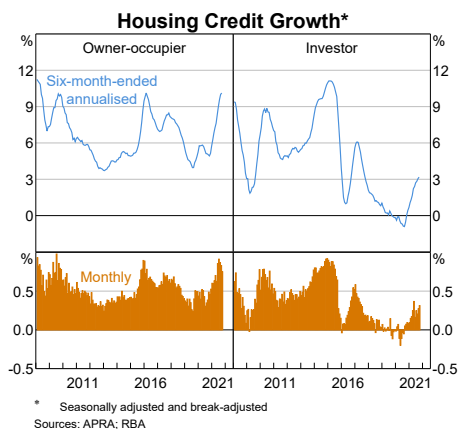
although owner-occupier credit growth has eased a little in monthly terms since the middle of the year (Graph 3.26).

Commitments for housing loans remain at high levels, but have declined somewhat since June, driven by reductions in commitments to owner-occupiers and first home buyers. The decline in commitments to first home buyers is consistent with the end of the HomeBuilder program in March and the increase in housing prices. Investor commitments have continued to increase, albeit at a slower pace than earlier in

Graph 3.25



Graph 3.26



the year (Graph 3.27). Owner-occupier commitments declined in New South Wales and Victoria recently, which may, in part, have reflected the effects of the lockdown on housing market turnover in those states.

In early October, in response to risks associated with high and rising household indebtedness, APRA increased the serviceability assessment rate that it expects lenders to use to assess prospective borrowers' loan applications.^[4] The serviceability rate was increased by 50 basis points, thereby reducing maximum loan sizes by around 5 per cent. In this way, it constrains the availability of credit to those borrowers that are seeking to borrow at, or very close to, their maximums. The effect on the flow of new housing credit is likely to be modest. This is because most borrowers do not borrow at their maximum capacity, and the reduction in maximum loan sizes for affected borrowers will be small.

Payments into housing loan offset and redraw accounts increased sharply

Payments into housing loan offset and redraw accounts increased sharply in the September quarter, to be around the peak level seen in mid 2020, after declining earlier in 2021. As in 2020, the recent rise in these payments is likely

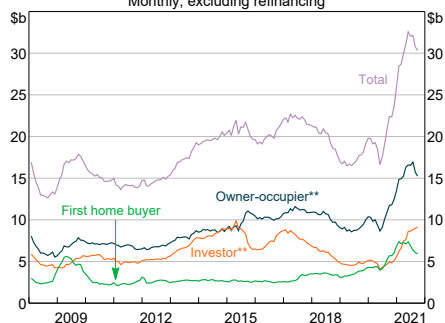
to reflect the effects of lockdowns – in particular, the reduced consumption opportunities alongside the government payments supporting incomes. Since the onset of the pandemic, mortgage borrowers' payments into offset and redraw accounts have been substantial, totalling about 3½ per cent of disposable income (around \$83 billion) (Graph 3.28).

Reductions in housing loan interest rates since March 2020 have flowed through to borrowers in the form of lower interest payments. As a result, interest payments have declined by around 1 percentage point as a share of disposable income, despite outstanding housing credit increasing over the same period. This reflects the combined effect of the pass-through of the Bank's policy easing, borrowers refinancing to lower interest rates and growth in disposable income.

In response to the recent COVID-19 outbreaks, many banks reintroduced a range of support measures, including payment deferrals for affected mortgagees. However, the share of mortgage holders with a repayment deferral in place at the end of the September quarter was less than 1 per cent of the stock of housing credit, compared with a peak of around 11 per cent in mid 2020.

Graph 3.27

Housing Loan Commitments*
Monthly; excluding refinancing



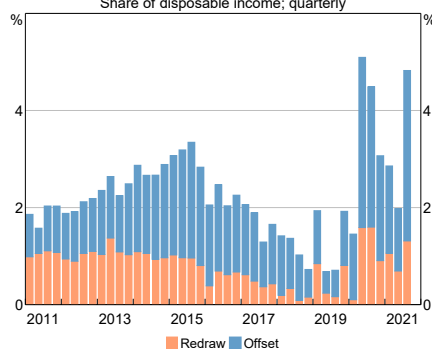
* Seasonally adjusted and break-adjusted

** Excluding first home buyers

Sources: ABS; RBA

Graph 3.28

Flows into Offset and Redraw Accounts*
Share of disposable income: quarterly



* Seasonally adjusted and break-adjusted.

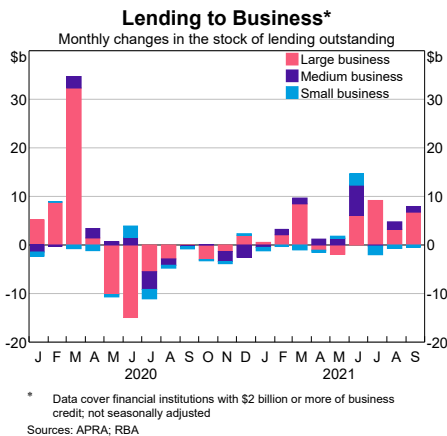
Sources: ABS; APRA; RBA

Lending to businesses has picked up

Business lending has picked up over recent months (Graph 3.29). The increase of late has been most pronounced for lending to large businesses, while the volume of lending to medium-sized firms increased slightly over the September quarter. Lending to small businesses was little changed. Commitments for new business loans have increased in six-month moving-average terms in the September quarter, to be around their average of the few years before the pandemic.

The increase in demand for business lending throughout the first half of 2021 was consistent with messages from bank liaison that there had been a little more appetite for business borrowing up to June, in response to the improved economic conditions. More recently, liaison suggests that demand for new loans remains strong from several industries that have been less impacted by lockdowns. Banks also expect demand for loans to pick up as restrictions ease, with firms positioning themselves for an expected recovery in spending. At the same time, some businesses still have little immediate need to borrow, in part because of the cash buffers they accumulated in 2020.

Graph 3.29



In April, the government introduced the SME Recovery Loan Scheme (an extension of the SME Guarantee Scheme), under which the government will partly guarantee certain SME loans. The SME Recovery Loan Scheme was initially open only 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 2021. From 1 October, the government expanded the scheme to all SMEs adversely affected by the pandemic. The new scheme offers more generous terms than the original scheme, including for interest rates. Nonetheless, take-up to September, the latest period for which data are available, remained low, in part reflecting subdued demand for financing from SMEs in the current environment.

In contrast to last year, the supply of credit to businesses does not appear to have tightened in response to recent lockdowns. Banks have indicated in liaison that they are seeking more opportunities to lend to businesses, and that competition between lenders has increased recently.

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 very low compared with last year, with around ½ per cent of the value of SME lending subject to deferrals as of September. Of these deferred loans, more than 90 per cent of borrowers were located in New South Wales or Victoria.

Growth in broader measures of business debt also increased

Growth in a broader measure of business debt has picked up strongly since March, to be well above its average pace over the past decade (Graph 3.30). In recent months, this growth has been broadly based across sources of debt. As well as the pick-up in growth in business credit, syndicated lending to large businesses (by

entities that do not report to APRA) has also increased, in part driven by loans for mergers and acquisitions (M&A). Growth in non-intermediated debt has also risen as corporate bond issuance remained high in the September quarter. Australian corporations raised around \$30 billion through the issuing of corporate bonds in the past six months (Graph 3.31); two-thirds of this funding was raised offshore.

Australian equity prices remain close to the recent peak

The ASX 200 decreased in September before partially retracing the move to be around 2 per cent below its mid August peak on a total return basis (which takes dividends into account) (Graph 3.32). The decline in September

occurred alongside declines in global equity prices, reflecting rising inflation expectations and, relatedly, a faster expected withdrawal of monetary policy stimulus, as well as concerns around growth in China. Overall, though, equity prices remain high and are well above pre-pandemic levels.

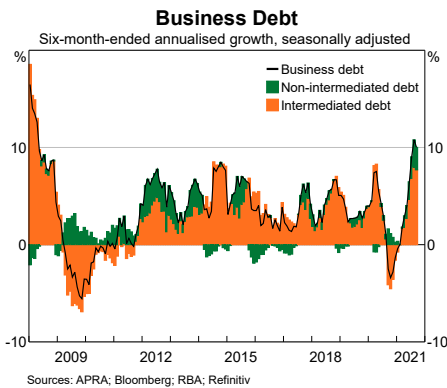
In Australia, stocks in the materials sector declined following sharp falls in the price of iron ore. By contrast, energy stocks have increased substantially as coal, oil and LNG prices have risen. The financials sector has outperformed the broader market in recent months as the economic outlook for Australia has improved due to the increase in local vaccination rates; travel-related stocks have also been supported by increasing vaccination rates and the lifting of lockdowns.

Capital markets activity is at a record level

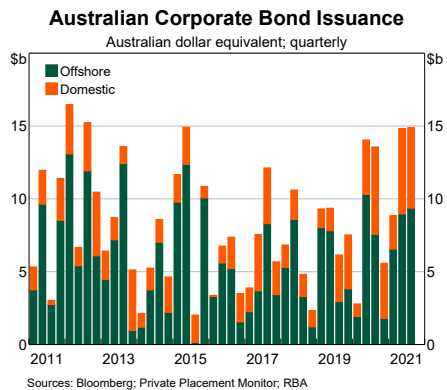
So far in 2021, there have been over 900 M&A deals announced, with a total deal value of around \$260 billion (Graph 3.33). While it is unclear whether all of these deals will be accepted, 2021 is likely to be a record year for M&A in the Australian market.

To the end of the September quarter in 2021, there were 137 initial public offerings (IPOs) for a total value raised of around \$6 billion

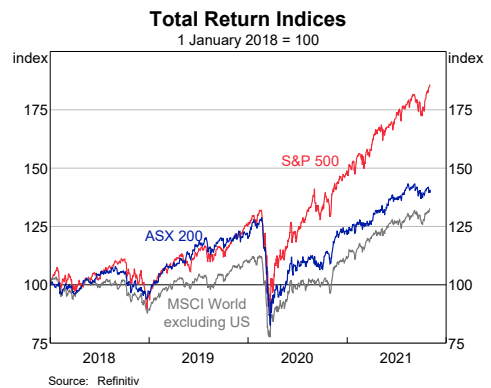
Graph 3.30



Graph 3.31



Graph 3.32



(Graph 3.34). This is significantly higher than the average over the past decade and is the highest level seen since 2014. In addition, Australian companies have raised around \$32 billion in secondary offerings, slightly above the average over the past decade.

Profits and dividends of Australian companies are at a record level

Aggregate underlying profits of ASX 200 companies increased to a record level in the first half of 2021. The increase in profits reflected a rebound from initial COVID-19 pandemic effects and strong earnings growth across a number of sectors. Most sectors returned to pre-

pandemic earnings levels over this period, with the materials sector posting its highest level of profits in history as a result of elevated commodity prices, most notably iron ore (Graph 3.35). A number of banks reported higher profits for the six months to June 2021, mainly reflecting decreased provisions for credit impairments and the writing back of earlier provisions, in line with the improved economic outlook. Owing to uncertainty surrounding lockdowns, many companies downgraded earnings guidance for the upcoming financial year and some removed guidance altogether.

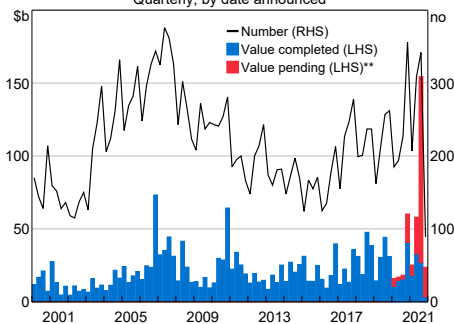
Overall dividends were at their highest level in history, helped by record dividends paid by some mining companies (Graph 3.36). Many companies have also announced share buybacks, although they remain low compared to dividends, as has been the case historically. Many of the announced buybacks were for banks, following restrained capital distributions over the recent past.

The Australian dollar has appreciated of late but remains lower than its levels earlier in the year

The Australian dollar reached year-to-date lows in mid August alongside concerns around slowing momentum in the Chinese economy, before appreciating more recently. This

Graph 3.33

M&A by Listed Australian Companies*
Quarterly, by date announced

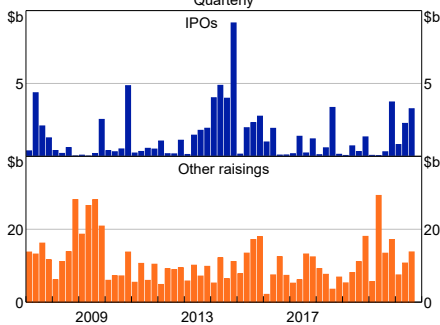


* Excludes the Telstra-NBN transaction and BHP Ltd's acquisition of BHP Plc; latest observation is quarter to date
** Includes transactions announced in the past two years but not completed

Sources: RBA; Refinitiv

Graph 3.34

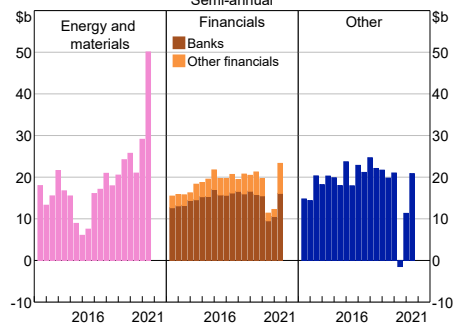
Australian Equity Raisings*
Quarterly



* All listed companies
Sources: ASX; RBA

Graph 3.35

ASX 200 Underlying Profits*
Semi-annual



* Underlying results adjust for one-off items such as asset revaluations.
Sources: Bloomberg; company reports; Morningstar; RBA

appreciation has been broadly consistent with an increase in yields on Australian Government bonds relative to those of the major advanced economies (Graph 3.37). The yield differential on Australian Government bonds had declined for a time, but this reversed noticeably over the past month or so. The RBA Index of Commodity Prices remains below its levels in the middle of the year.

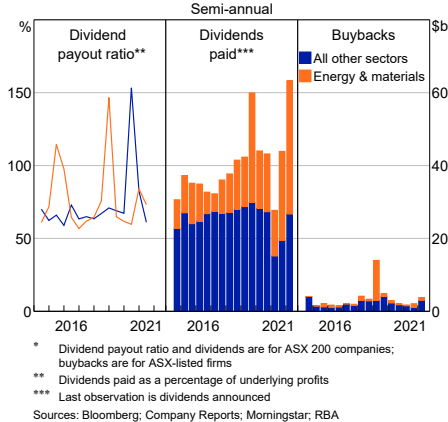
Australia continued to be a net lender of capital in the June quarter

Net capital outflows increased in the June quarter, consistent with the widening of Australia's current account surplus. Net outflows

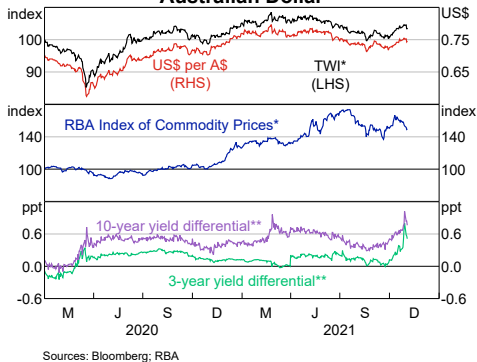
of capital over recent years have been the result of an increase in domestic savings relative to investment (Graph 3.38). Private savings have risen over the past couple of years, increasing notably during the pandemic. At the same time, investment has declined as a percentage of GDP over a number of years to levels that are similar to those in other advanced economies. This reflects a decline in private investment following the mining investment boom, during which capital inflows from overseas were used to help finance the expansion of capacity in the mining sector.^[5]

In the June quarter, net outflows continued to reflect portfolio investment as Australian investment funds (such as superannuation funds) increased their holdings of foreign equities (Graph 3.39). A decline in gross flows of foreign investment into Australia over recent years has also contributed to the net capital outflow. While net capital outflows have increased over recent years, Australia's stocks of gross foreign assets and liabilities remain large. This reflects flows of both foreign investment into Australia and Australian investment abroad. Australia's net foreign liability position remains around its lowest level in a number of decades as a percentage of GDP. 🇦🇺

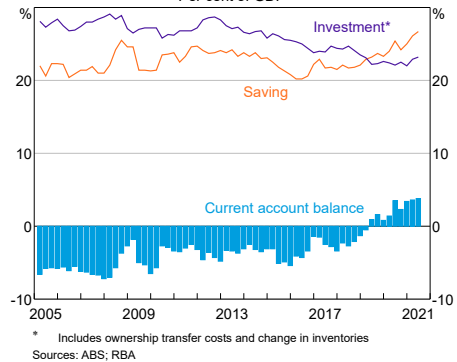
Graph 3.36
ASX Dividends and Buybacks*



Graph 3.37
Australian Dollar

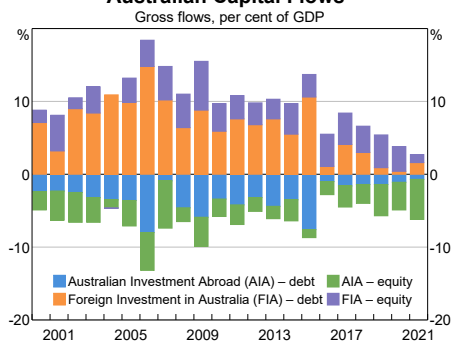


Graph 3.38
Saving and Investment



Graph 3.39

Australian Capital Flows*



* Excluding derivatives, 2021 value only includes March and June quarters

Sources: ABS; RBA

Endnotes

- [1] See APRA (2021), 'APRA Phases Out Reliance on Committed Liquidity Facility', Media Release, 10 September. Available at <[apra.gov.au/news-and-publications/apra-phases-out-reliance-on-committed-liquidity-facility](https://www.apra.gov.au/news-and-publications/apra-phases-out-reliance-on-committed-liquidity-facility)>.
- [2] APRA introduced the CLF in 2015 to enable banks to meet their liquidity requirements given the low level of government debt in Australia at the time. Under the CLF, the Reserve Bank provides a commitment (in exchange for a fee) to provide funds (against collateral) to banks in a period of liquidity stress. See RBA, 'Committed Liquidity Facility'. Available at <<https://www.rba.gov.au/mkt-operations/committed-liquidity-facility.html>>.
- [3] To ensure the smooth functioning of the payment system, financial institutions are required to hold sufficient ES balances to meet their after-hours payments needs. Given the high liquidity environment, in September 2021 the Bank removed the requirement for certain financial institutions to obtain this liquidity via open repos with the Bank.
- [4] See RBA (2021), 'Chapter 5: Mortgage Macroprudential Policies', *Financial Stability Review*, October. See also APRA (2021), 'APRA Increases Banks' Loan Serviceability Expectations to Counter Rising Risks in Home Lending', Media Release, 6 October. Available at <[apra.gov.au/news-and-publications/apra-increases-banks%E2%80%99-loan-serviceability-expectations-to-counter-rising](https://www.apra.gov.au/news-and-publications/apra-increases-banks%E2%80%99-loan-serviceability-expectations-to-counter-rising)>.
- [5] See Black S, B Chapman and C Windsor (2017), 'Australian Capital Flows', *RBA Bulletin*, June. Available at <<https://www.rba.gov.au/publications/bulletin/2017/jun/3.html>>

4. Inflation

Inflation was stronger than expected in the September quarter. Headline inflation was 0.8 per cent in the quarter and 3 per cent over the year. About two-thirds of the quarterly increase in the Consumer Price Index (CPI) was accounted for by sharp rises in two components: fuel prices and home-building costs. Growth in construction costs picked up noticeably in the quarter, reflecting both rising input costs globally and the Australia-specific effect of the strong demand induced by the HomeBuilder subsidy and similar state government grants. Although prices of some consumer durable goods picked up as import price pressures persisted and demand remained strong, inflation was fairly subdued in other expenditure components in the September quarter.

Underlying inflation was also the strongest for some time, at 0.7 per cent in the quarter and 2.1 per cent over the year.

Wages growth was moderate in the June quarter, with a return to more typical pre-pandemic patterns of growth in some parts of the private sector; this was somewhat offset by ongoing wage freezes elsewhere, as well as soft wages growth in the public sector. Wages growth was subdued in most industries, including those where there had been reports of labour shortages, such as construction, professional services and mining. Reports from the Bank's business liaison program suggest that recently firms have been using measures other than raising base wages in order to attract and retain staff, with wages only rising significantly for selected jobs in very high demand.

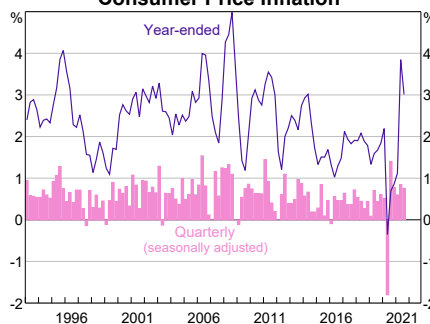
Headline inflation remained elevated and underlying inflation picked up in the September quarter

The CPI increased by 3 per cent over the year to the September quarter (Graph 4.1; Table 4.1). While the peak effect on price movements of earlier government policies (such as temporary subsidies for child care) has passed, their unwinding is still boosting year-ended inflation. The rebound in fuel prices since mid 2020 also continues to add to year-ended inflation. The combination of higher prices for automotive fuel and new dwelling purchase costs contributed about two-thirds of the 0.8 per cent (seasonally adjusted) increase in headline inflation in the September quarter (Graph 4.2).

Measures of underlying inflation attempt to remove the effect of irregular or temporary price changes in the CPI, such as the period of free child care in 2020. Both trimmed mean and weighted median inflation were 2.1 per cent in the year to the September quarter, up from

Graph 4.1

Consumer Price Inflation*



* Excludes interest charges prior to the September quarter 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)	
	September quarter 2021	June quarter 2021	September quarter 2021	June quarter 2021
Consumer Price Index	0.8	0.8	3.0	3.8
Seasonally adjusted CPI	0.8	0.8	–	–
– Tradables	0.7	1.4	3.1	3.6
– Tradables (excl volatile items) ^(c)	0.0	0.3	0.8	1.2
– Non-tradables	0.7	0.6	3.2	4.0
Selected underlying measures				
Trimmed mean	0.7	0.5	2.1	1.6
Weighted median	0.7	0.5	2.1	1.6
CPI excl volatile items ^(c)	0.5	0.6	2.5	3.1

(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

1.6 per cent in the year to the June quarter (Graph 4.3). This was the highest year-ended rate of inflation in these measures since 2015.

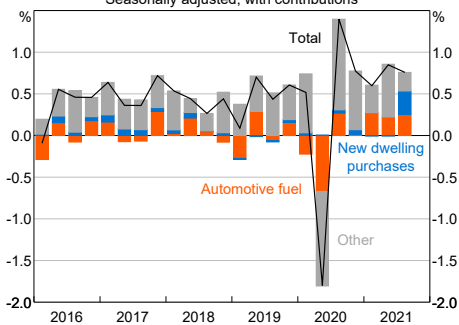
New dwelling inflation increased sharply in the quarter, driving much of the increase in aggregate inflation

Prices for new dwelling construction, which make up just under one-tenth of the CPI basket,

increased significantly – up by 3.3 per cent in the September quarter. This was driven by substantial increases in builders' base prices (exclusive of government subsidies) in most capital cities (Graph 4.4). Sustained strong demand for housing construction, in part boosted by the HomeBuilder subsidy and similar state government grants, enabled builders to

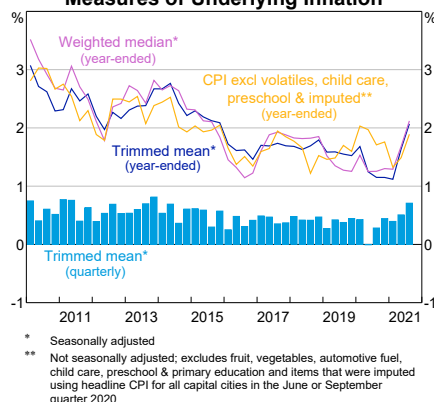
Graph 4.2

Quarterly CPI Inflation



Graph 4.3

Measures of Underlying Inflation



* Seasonally adjusted

** Not seasonally adjusted; excludes fruit, vegetables, automotive fuel, child care, preschool & primary education and items that were imputed using headline CPI for all capital cities in the June or September quarter 2020

pass through increased costs for domestic and imported building materials and labour. New dwelling inflation in the September quarter also lifted because fewer government grants were paid out than in the June quarter. Despite applications for HomeBuilder having closed earlier in the year, payments of grants are expected to continue for some time. This will dampen measured prices over that period, although the effect on inflation in a given quarter will vary depending on how many grants are paid out in that quarter.

A key driver of the pick-up in new dwelling inflation has been the strong rise in raw materials costs, which increased 4 per cent in the September quarter and 8 per cent over the year, the fastest pace since the 1980s (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 have been growing at their fastest pace since the early 2000s, and capacity utilisation in the construction industry has been high (see chapter on ‘Domestic Economic Conditions’).

Rents increased a little in aggregate, although there were large differences across cities

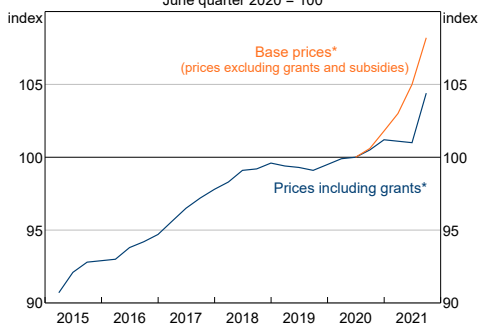
Rents, which account for around 7 per cent of the CPI basket, increased by 0.2 per cent in the September quarter. Although CPI rent inflation remains low relative to aggregate measures of inflation, it has picked up. Advertised rents suggest some further increases in the year ahead, although the pass-through of higher prices in newly rented dwellings to the CPI measure – which covers the entire stock of rental properties – is always gradual.

Rental conditions remain uneven across the country. Rents in Sydney and Melbourne fell further in the quarter due to subdued rental conditions, consistent with high vacancy rates; domestic and international border restrictions, and reduced numbers of short-term visitors and international students, contributed to these falls (Graph 4.6). This weakness somewhat offset continued strength in rents in the other capital cities experiencing low vacancy rates; recent high rent inflation in Perth partly reflects a shortage of rental stock following years of subdued dwelling investment.

Graph 4.4

New Dwelling Prices

June quarter 2020 = 100

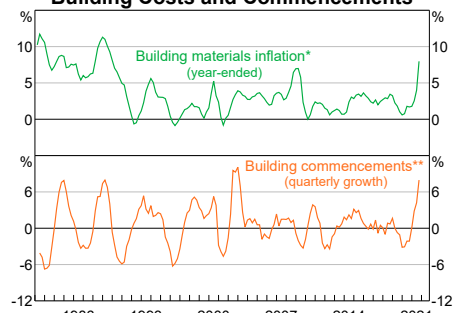


* Government housing construction grants include HomeBuilder and state government grants

Sources: ABS; RBA

Graph 4.5

Building Costs and Commencements



* Year-ended change in producer prices for inputs to house construction

** Volumes; six-quarter average lagged by one quarter; detached only prior to 2017; thereafter attached included with a 20 per cent weight

Sources: ABS; RBA

Retail inflation outcomes were mixed over the quarter

Retail prices, which comprise over a quarter of the CPI, were steady in the September quarter and 0.8 per cent higher than a year ago. However, the outcomes over the quarter varied across components. There were relatively strong price increases for some consumer durable items – including motor vehicles and some household goods – on the back of ongoing supply disruptions at overseas factories and sustained global and domestic demand (Graph 4.7). Liaison reports of input cost pressures among some non-food retailers have increased over recent months – partly because some overseas suppliers have increased prices in response to strong global demand and higher prices for raw materials, and partly because of the spike in shipping costs. By contrast, prices for clothing and footwear declined by 3.5 per cent in the quarter, as retailers increased discounting activity to move excess winter stocks because of weak demand during recent lockdowns.

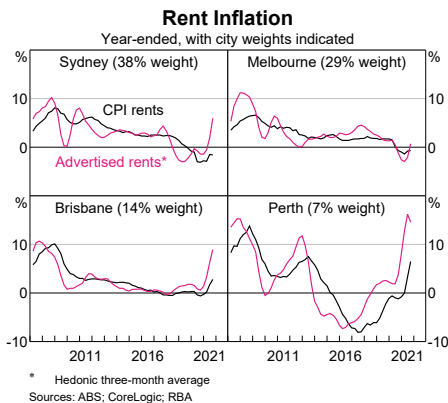
Liaison information suggests many firms have absorbed upstream cost pressures, supported by earlier hedging of foreign exchange exposures at a favourable rate and improved margins over the past year. However, some household appliances and furnishings retailers have recently started passing higher upstream

costs to consumers. Supply chain-related cost pressures and the extent of pass-through to consumers remain an upside risk to tradable goods inflation in the year ahead.

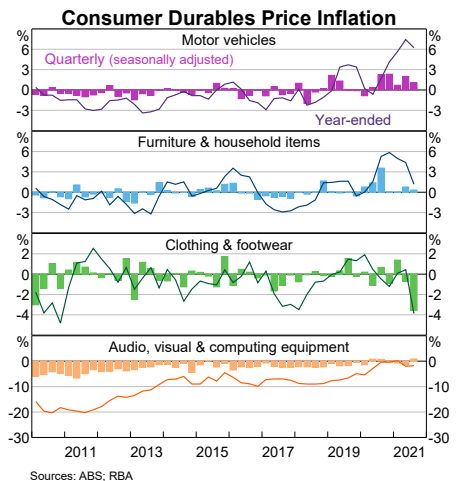
Grocery inflation has remained subdued in recent quarters (Graph 4.8). While lockdowns in 2020 and the sharp increase in ‘at home’ food consumption contributed to a marked rise in groceries inflation a year ago, prices did not respond similarly in the most recent lockdowns. Liaison information suggests that recent supermarket discounting behaviour has been in line with pre-pandemic patterns. Meat prices increased further as producers continued restocking following the end of the drought in eastern Australia; prices for other fresh food categories were little changed.

Prices of fruit & vegetables declined by 1.8 per cent in the quarter, subtracting a little from CPI inflation. Liaison suggests that favourable growing conditions have supported lower prices, and that concerns about labour shortages have not meaningfully affected fresh produce prices to date; fruit & vegetables prices are around 1 per cent lower than a year ago.

Graph 4.6



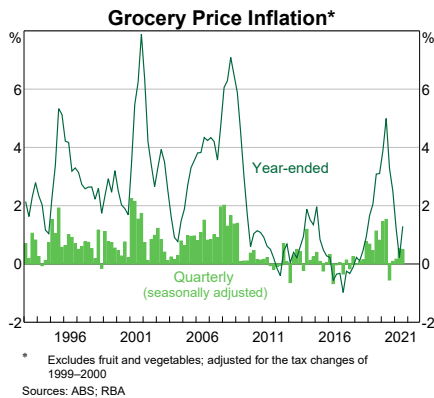
Graph 4.7



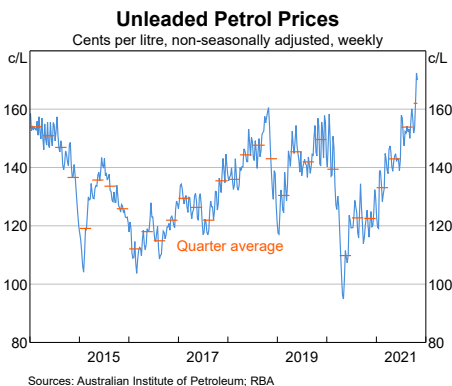
Fuel prices have increased strongly, making a large contribution to headline inflation

Fuel prices increased by just over 7 per cent in the September quarter, contributing 0.3 percentage points to headline inflation in the quarter (Graph 4.9). This lifted fuel prices in the CPI to their highest quarter average ever recorded (a little above prices in 2014). Fuel prices have increased even further since then, and at current levels would contribute $\frac{1}{3}$ percentage point to quarterly headline inflation in the December quarter.

Graph 4.8



Graph 4.9

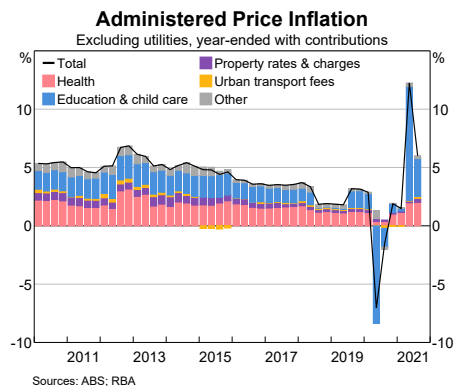


Administered prices increased only slightly as the effects of government policies faded further

Administered prices (excluding utilities) rose by 0.8 per cent in the September quarter. Growth was stronger over the year at 6 per cent, largely because of the effects of freezes and rebates that were in place this time last year (Graph 4.10). Child care prices increased by 1.4 per cent in the September quarter and look to be returning to their pre-pandemic trend, after a period of very large movements in 2020 due to the effect of temporary large subsidies. Most state and local government fees and charges also increased in the September quarter, after a range of freezes and discounts imposed over the past year were ended; in aggregate they increased by around $\frac{1}{2}$ per cent, primarily driven by a 1.2 per cent increase in property rates and charges.

Retail electricity prices declined slightly in the September quarter, and have been trending down for a number of years; prices are now 10 per cent lower than their recent peak at the end of 2018 (Graph 4.11). Retail gas prices increased only slightly in the quarter despite a spike in wholesale gas prices around the middle of the year, which was in part due to constrained supply.

Graph 4.10

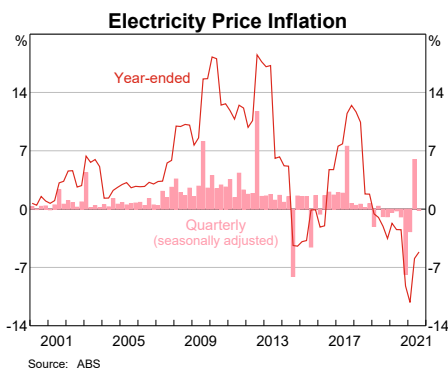


Restrictions in Sydney and Melbourne affected measured market services inflation in the quarter

Market services inflation, which accounts for a little over one-fifth of the CPI basket, was 0.8 per cent in the September quarter. However, price measurement was affected by recent lockdowns and state government vouchers. In particular, while the use of NSW 'Dine & Discover' vouchers in the June quarter had weighed on measured hospitality prices in that quarter, activity restrictions in the September quarter meant less use of vouchers and therefore measured prices increased. Since many of these vouchers are yet to be used, and additional similar vouchers have been announced by the NSW and some other state governments, this is expected to weigh on measured market services prices as they are used in future quarters.

Because of measurement difficulties caused by activity restrictions in a number of capital cities, prices for some market services as well as all domestic travel and accommodation services were imputed using headline inflation in the September quarter.

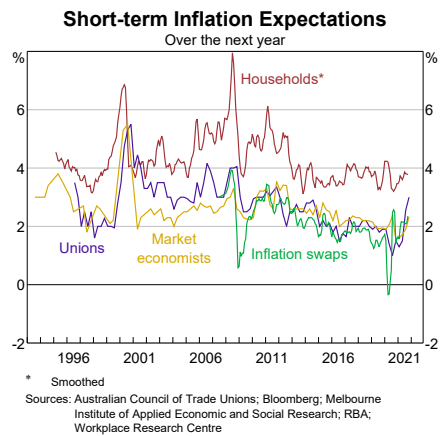
Graph 4.11



Inflation expectations have increased in recent months

Survey-based measures of short-term inflation expectations have increased over recent months, in particular for unions (Graph 4.12). Survey measures of long-term inflation expectations increased to around 2½ per cent, similar to levels seen in 2019 and consistent with the Bank's medium-term inflation target (Graph 4.13). Long-term market-based measures of inflation expectations also increased recently.

Graph 4.12



Graph 4.13



Wages growth was subdued across most industries in the June quarter

The Wage Price Index (WPI) grew by 0.4 per cent in the June quarter, and 1.7 per cent in year-ended terms (Graph 4.14). Private sector wages increased by 0.5 per cent, with soft growth across most industries. Public sector wages growth was more subdued, at 0.4 per cent, reflecting the prevalence of wage caps and freezes across the sector, as well as ongoing negotiations of new enterprise agreements, some of which were delayed due to the pandemic.

Disaggregated WPI data shows that the share of jobs subject to wage freezes remained elevated in the June quarter, and was particularly high for jobs where wages are set by individual agreement (Graph 4.15).

Based on job-level WPI data, most wage increases remained below 3 per cent over the year to the June quarter; the share of jobs experiencing wage increases above 3 per cent remains much lower than was seen in the 2000s (Graph 4.16). Information from the Bank's business liaison program suggests that – rather than raise base wages – many firms experiencing difficulties finding labour have been using other strategies to retain and attract employees. These strategies include paying targeted sign-on and retention bonuses, offering

increased workplace flexibility, providing more internal training and relying more on less-experienced staff. Liaison reports suggest that, recently, wages growth has been strong for specific jobs where labour shortages are acute (such as some types of IT professionals, tradespersons and chefs).

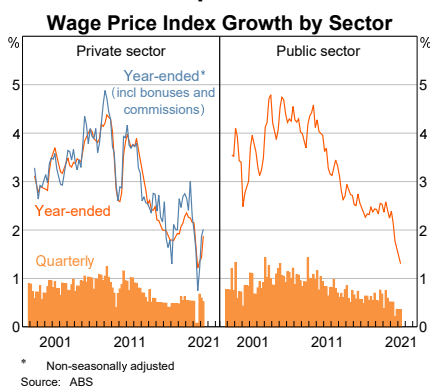
Leading indicators suggest wages growth is returning to pre-pandemic norms

Based on information from the Bank's liaison program, firms report that the prevalence of wage freezes declined in the September quarter and would decline further in the December

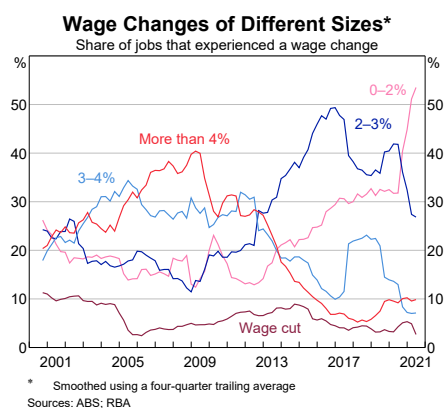
Graph 4.15



Graph 4.14

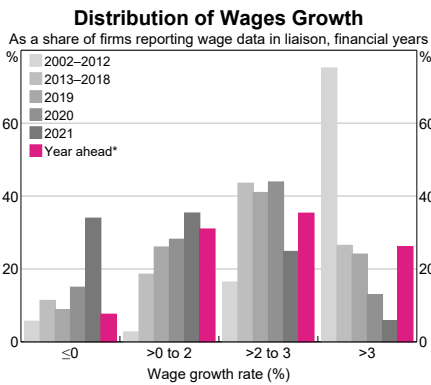


Graph 4.16



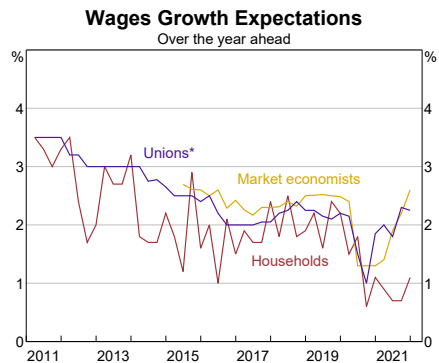
quarter. Firms are generally reporting an expected return to annual wage rises of 2–2½ per cent over the next year. The distribution of firms' wages growth expectations is broadly similar to the pre-pandemic pattern, with only around a quarter of firms expecting wages growth to be greater than 3 per cent (Graph 4.17). Other surveys of wages growth expectations are also consistent with wages growth picking up to around 2–2½ per cent over the year ahead (Graph 4.18). 🗨️

Graph 4.17



* Expectations for the year ahead for firms reporting in the September quarter of 2021
Source: RBA

Graph 4.18



* Union expectations are for the next calendar year
Sources: Australian Council of Trade Unions; Melbourne Institute of Applied Economic and Social Research; RBA; Workplace Research Centre

5. Economic Outlook

The ongoing rollout of vaccinations and significant policy stimulus has laid the groundwork for a sustained economic recovery. GDP is forecast to return to its pre-pandemic trend in many advanced economies over the next year. China's economy has already returned to its pre-pandemic path, though the outlook has become more uncertain. In several countries, consumer price inflation has increased to its highest rate in years and inflation expectations have picked up. The increase in global inflation has continued for longer than initially anticipated, and it is possible that inflationary pressures persist for some time yet due to strong global demand and ongoing capacity constraints. Nonetheless, central banks in advanced economies generally expect inflation to return to levels consistent with their targets next year, as bottlenecks in global goods markets ease and labour force participation picks up (see chapter on 'The International Environment').

Economic activity in Australia contracted sharply in the September quarter due to the lockdowns associated with outbreaks of the Delta variant of COVID-19. This setback has delayed but not derailed the economic recovery that was underway in the first half of the year. A rapid bounce back in domestic demand is forecast in the December and March quarters as restrictions are further eased. By mid 2022, the outlook is broadly in line with the pre-Delta recovery path. Under the central scenario, GDP is forecast to grow by around 3 per cent over 2021, 5½ per cent over 2022 and 2½ per cent over 2023 (Table 5.1).

The unemployment rate is expected to be a little below 5 per cent at the end of 2021, before declining to around 4 per cent by the end of 2023. Inflation was higher than anticipated in the September quarter, led by growth in new housing construction costs, as well as higher fuel prices. Underlying inflation is now forecast to be around 2¼ per cent for much of the forecast period, increasing to around 2½ per cent by the end of 2023. This inflation profile reflects a stronger outlook for housing cost inflation in coming quarters and a steady pick-up in wages growth further out.

In light of the considerable ongoing uncertainty around health outcomes and household consumption, two alternative scenarios are considered: an upside and a downside (as in recent *Statements*). 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.

A stronger economic trajectory than the one envisaged in the central scenario is possible if households increase spending by more than expected. This could be the result of positive news on the health front and high rates of vaccination leading to reduced uncertainty about the outlook and a boost in households' desire to consume out of their rising wealth. These conditions would also support stronger private investment. In this upside scenario, the unemployment rate declines more rapidly than in the central scenario, to be around 3¼ per cent, and the stronger labour market

Table 5.1: Output Growth and Inflation Forecasts^(a)

Per cent

	Year-ended					
	June 2021	Dec 2021	June 2022	Dec 2022	June 2023	Dec 2023
GDP growth	9.6	3	4	5½	3¼	2½
(previous)	(9½)	(4)	(4½)	(4¼)	(2¾)	(2½)
Unemployment rate ^(b)	5.1	4¾	4½	4¼	4	4
(previous)		(5)	(4½)	(4¼)	(4¼)	(4)
CPI inflation	3.8	3¼	2¾	2¼	2¼	2½
(previous)		(2½)	(1½)	(1¾)	(2)	(2¼)
Trimmed mean inflation	1.6	2¼	2¼	2¼	2¼	2½
(previous)		(1¾)	(1½)	(1¾)	(2)	(2¼)
Year-average						
	2020/21	2021	2021/22	2022	2022/23	2023
GDP growth	1.4	4¼	3¼	5	5	3
(previous)	(1¼)	(4¾)	(4½)	(5)	(4)	(2¾)

(a) Forecasts finalised on 3 November. The forecasts are conditioned on a path for the cash rate broadly in line with recent market pricing and assume other elements of the Bank's monetary stimulus are in line with the announcement made following the November 2021 Board meeting. Other forecast assumptions (August *Statement* in parenthesis): TWI at 62 (62), A\$ at US\$0.74 (US\$0.74), and Brent crude oil price at US\$80bbl (US\$70bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Budget. 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

sees underlying inflation increase to a little above 3 per cent by the end of 2023.

A weaker trajectory could eventuate due to lingering uncertainty about the outlook, which results in near-term precautionary saving, alongside a bad health outcome, such as the emergence of a new variant of the virus or waning efficacy of vaccines in the first half of 2022. The weaker economic environment would depress confidence, resulting in lower consumption and higher saving by households, and a slower recovery in private investment.

International travel would also resume more slowly, delaying the recovery in services trade. In this downside scenario, subdued activity pushes the unemployment rate to above pre-pandemic levels and drags on wages growth. This keeps underlying inflation below 2 per cent over most of the forecast period.

Domestic activity is forecast to recover strongly

The recovery in the Australian economy from the Delta outbreak is underway. A rapid recovery in household spending is expected in the near term, driven by the broadening of consumption opportunities and supported further out by growth in household income and wealth. Dwelling investment has started to bounce back from the health-related restrictions on construction activity and the recovery in business investment that was underway before the Delta outbreak is expected to resume. By mid 2022, the economy is forecast to be back on its pre-Delta path (Graph 5.1).

Consistent with the outlook for activity, employment is forecast to grow strongly over coming quarters, before moderating after mid 2022.

Participation in the labour force is also forecast to rebound, supported by the strength in labour market conditions. The unemployment rate is expected to decline to around 4 per cent by the end of 2023 (Graph 5.2).

The forecast profile for underlying inflation is higher in the near term, primarily because of larger-than-expected price increases for newly constructed housing. A steady pick-up in wages growth contributes to underlying inflation further out. Underlying inflation is forecast to be around 2¼ per cent for much of the forecast period, before picking up to around 2½ per cent by the end of 2023 (Graph 5.3).

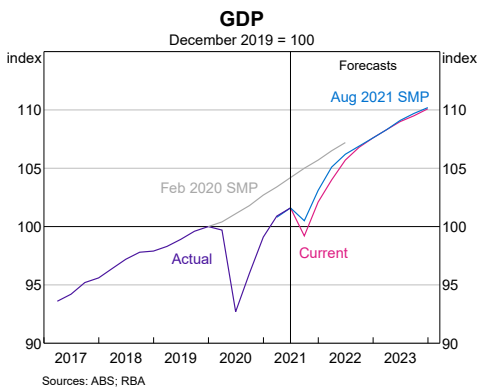
The forecasts are based on some technical assumptions. The cash rate is assumed to move

broadly in line with recent market pricing. The exchange rate and oil prices are assumed to remain around recent levels. The forecasts are based on state roadmaps for the relaxation of restrictions on activity, including domestic travel. The international border is assumed to gradually reopen to non-residents over the first half of 2022. The assumed rate of population growth is broadly in line with the profile set out in the Australian Government's 2021/22 Budget.

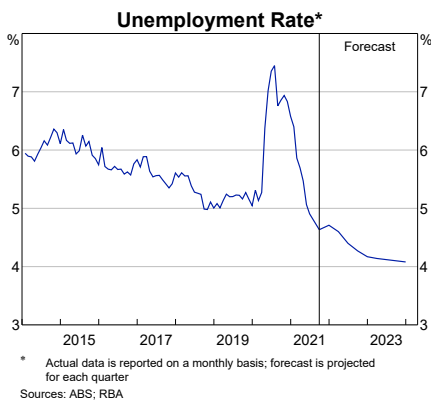
Household consumption, income and saving

Household consumption fell sharply in the September quarter in response to tighter activity restrictions in some states. However, consumption is forecast to rebound strongly across the December 2021 and March 2022 quarters as restrictions are eased and spending opportunities broaden (Graph 5.4). Consumption is projected to be back around its pre-Delta trajectory by mid 2022 and to grow steadily thereafter, supported by strong labour market outcomes, higher net household wealth and a decline in uncertainty related to health and economic outcomes. The strong labour market supports the outlook for household income via labour income, and offsets a decline in non-labour income as disaster payments and other income support measures conclude.

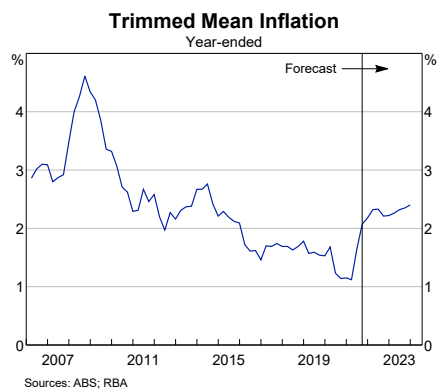
Graph 5.1



Graph 5.2



Graph 5.3



The household saving ratio increased sharply in the September quarter, reflecting reduced consumption opportunities and the delivery of social assistance payments to those who experienced job losses or worked reduced hours during the recent lockdowns. Further out, the saving ratio is forecast to decline to around its average level over the five years prior to the pandemic.

Investment

The outlook for investment remains positive with a large pipeline of public and private projects forecast to boost activity over coming years. While construction declined sharply in the September quarter due to restrictions on activity in some states, both residential and non-residential investment are expected to recover strongly over coming quarters before growth moderates later in the forecast period.

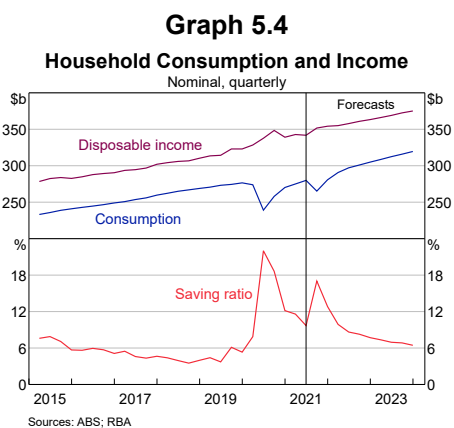
Residential construction increased to be well above its pre-pandemic level in the first half of the year, supported by fiscal stimulus and monetary easing over 2020 and 2021. There were a record number of commencements in the June quarter and work on these dwellings will sustain a high level of construction activity moving forward. Construction firms in the Bank's liaison program report that constraints on labour and the availability of materials are putting

pressure on input prices, and have created uncertainty around the pace at which this activity will be completed. While a large share of housing construction activity has been supported by fiscal subsidies such as HomeBuilder, there has also been strong underlying momentum from the effects of low interest rates and increases in housing prices and household income; the desire for more living space since the outbreak of the pandemic is also encouraging renovation activity. The elevated level of residential construction is anticipated to be maintained over coming years.

Following recent disruptions, a robust recovery in non-mining business investment is forecast over coming quarters. Machinery & equipment investment is forecast to contribute to growth over 2022, supported by tax incentives and as firms undertake some catch-up spending following the easing of restrictions. Information from the Bank's liaison program and recent business surveys indicate that firms remain optimistic about the outlook and have not scaled back capital expenditure plans. Private non-residential building approvals have trended higher over recent months, albeit from a low level. However, there is uncertainty over how binding capacity constraints may become and whether this will restrain growth in construction activity.

Mining investment is forecast to increase slightly over coming years, though this mainly reflects firms undertaking investment to sustain their level of production rather than to expand capacity. There have been few indications to date that recent large moves in commodity prices have affected the investment plans of the major miners.

Growth in public investment has strengthened over recent quarters and is expected to remain strong over the coming year. Some planned capital expenditure will have been further delayed by health-related restrictions on construction activity in the September quarter,



but these effects should be mostly temporary. The pipeline of public engineering work yet to be completed is very large and will support a high level of public capital expenditure for several years.

Public consumption

Public consumption is forecast to have increased sharply in the September quarter as governments across Australia responded to the Delta outbreak through additional spending on patient care, containment of the virus and accelerated vaccination programs. Public consumption is anticipated to remain elevated in the near term as spending programs announced in this year's federal and state government budgets are implemented. Further ahead, public consumption will be supported by the large government programs that led to a strong increase in public consumption as a share of GDP prior to the pandemic. This includes the National Disability Insurance Scheme and spending related to the aging of the Australian population.

External sector

Exports are expected to grow strongly over the forecast period. In the near term, this reflects a rebound in resource export volumes following recent weak outturns. Travel and education exports are forecast to grow at a faster pace over 2022 (compared to the previous *Statement*) as a result of the earlier-than-expected reopening of international borders. The recent strength in rural exports is expected to be sustained in the near term because of strong global demand, and as ongoing favourable weather conditions support a faster-than-expected herd rebuild and a lift in wool and crop production. Meanwhile, import volumes have been upgraded over the forecast period due to the earlier reopening of borders, though higher world export prices are likely to drag on import growth in the near term.

The terms of trade have been revised lower across the forecast period (Graph 5.5). While the sharp decline in the iron ore price in recent months has been broadly offset by the impact of higher coal and LNG prices, a projected decline in the terms of trade reflects expectations for lower iron ore and coal prices further out.

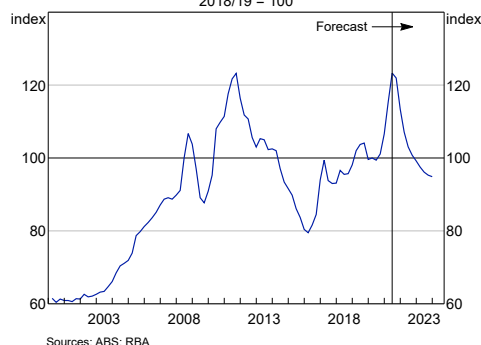
Labour market

The temporary effects of recent lockdowns on the labour market are already receding, and employment and participation are forecast to have fully recovered to their pre-Delta levels by the end of 2021 (Graph 5.6). The measured unemployment rate has been held down by the fall in labour market participation during the lockdowns more than offsetting declines in employment. At year-end the unemployment rate is expected to be a little below 5 per cent, but month-to-month outcomes for key labour market variables could remain volatile.

In line with the recovery in activity, the labour market is expected to strengthen further over the forecast period, albeit at a more moderate pace from mid 2022. Recent lockdowns do not appear to have had a lasting effect on underlying labour demand. The unemployment rate is expected to reach around 4¼ per cent by the end of 2022 and then decline a little further to be just above 4 per cent by the end of 2023.

Graph 5.5

Terms of Trade
2018/19 = 100



Employment growth is forecast to moderate as activity growth settles around its longer-run trend. A further lift in the participation rate is anticipated, supported by continued employment growth and longer-run structural drivers of higher labour force participation.

Wages and inflation

Wages growth should continue to pick up in the near term, as the remaining wage freezes and cuts implemented in 2020 are unwound and labour market conditions tighten. The medium-term outlook for private sector wages growth is stronger than at the time of the August *Statement*, reflecting the upgrade to labour market forecasts and the further absorption of spare capacity. Aggregate outcomes continue to be weighed down by more muted public sector wages growth, consistent with announced government wages policies.

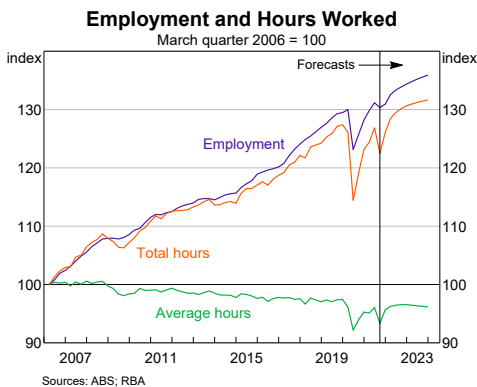
Growth in the Wage Price Index (WPI) is anticipated to pick up to above 2 per cent by the end of 2021, to be back in line with pre-pandemic wage growth norms of around 2–2½ per cent per annum (Graph 5.7). WPI growth is then forecast to strengthen further as the unemployment rate approaches 4 per cent, to be around 3 per cent by the end of 2023 – the fastest pace since 2013. Increases in the superannuation guarantee rate over coming

years are estimated to reduce WPI growth relative to average earnings by around a ¼ percentage point by the end of the forecast period; average earnings per hour is forecast to be growing above 3 per cent by 2023.

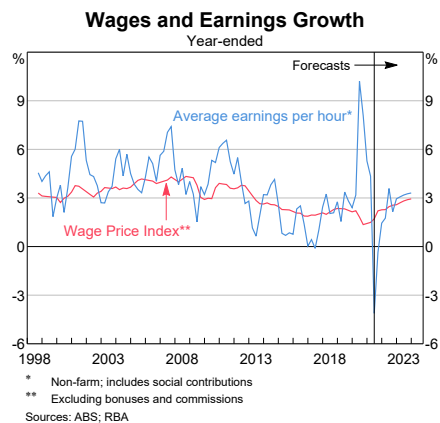
Near-term inflation outcomes are expected to be boosted by the effects of stronger new dwelling construction prices. Headline inflation is also being lifted by high fuel prices; however, it should converge back to underlying inflation as the effect of the recent run up in fuel prices wanes over the next year (Graph 5.8). Although some upstream price increases are expected to fade further out the forecast period, broader inflationary pressures are expected to continue building as spare capacity in the economy continues to be absorbed. Underlying inflation is forecast to be around 2¼ per cent for much of the forecast period, and then increase to be around 2½ per cent by the end of 2023. Similar to wages growth, this would represent a meaningful pick-up in underlying inflation relative to the experience of recent years.

Price pressures are expected to remain strong for new dwelling construction. Materials and labour costs have increased as demand has surged and supply chain constraints have become more binding. HomeBuilder and similar government grants will continue to have an important effect

Graph 5.6



Graph 5.7



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 aggregate inflation. The forecasts also allow for some risk of persistent price pressures for imported consumer durables goods. Liaison information suggests that, to date, cost increases have largely been absorbed into margins (including for firms where sales volumes have been strong) or mitigated by earlier forward orders of goods or hedging of the exchange rate. However, if cost pressures persist, further pass-through to consumer prices would be expected. Administered prices are anticipated to grow relatively slowly, and some ongoing government subsidy and rebate schemes will weigh on the inflation outlook. Utilities prices are also expected to remain subdued, reflecting reductions in regulated prices, low wholesale prices and increased electricity supply from renewables.

Scenarios

Upside scenario

A plausible upside scenario hinges on stronger consumption than in the central scenario, driven by stronger wealth effects and reduced uncertainty related to positive health outcomes

and high vaccination rates. These developments result in a greater desire on the part of households to consume out of the wealth that they have accumulated through saving as well as rising housing and equity prices. In this scenario, faster household spending has positive flow-on effects to private investment and activity more broadly, which reinforces the improvement in labour market conditions and boosts labour income (Graph 5.9).

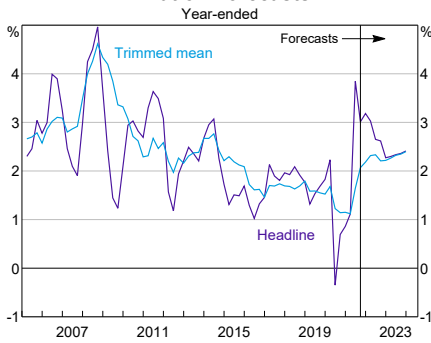
Consumption is around 4 per cent higher than in the central scenario by the end of 2023, and the saving ratio falls more sharply. A stronger pick-up in household consumption and business investment supports faster growth in employment. The resulting decline in the unemployment rate, to around 3¼ per cent, induces a strong recovery in wages growth and inflation over the next couple of years, with inflation rising to be above 3 per cent by the end of 2023 (Graph 5.10; Graph 5.11).

Downside scenario

A slower trajectory for the economy could materialise because of some combination of lingering uncertainty about the outlook alongside adverse health outcomes, such as the emergence of a new variant of the virus or declining efficacy of vaccines in the first half of 2022. In this scenario, the setback to the health

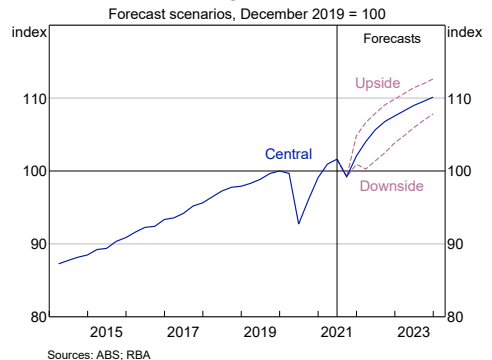
Graph 5.8

Inflation Forecasts



Graph 5.9

GDP



outlook leads to a temporary resumption of lockdowns and activity restrictions so that consumption slows sharply in early 2022 and international borders are unable to open fully until later in that year.

Weaker consumer and business confidence results in weaker household spending, higher saving and a delayed recovery in private investment. The slower return to international travel reduces opportunities for discretionary spending on services. Faced with a weaker outlook for activity, some firms reduce headcount while others forego or delay hiring decisions, which means the unemployment rate remains in the 4¾–5½ range for the entire forecast horizon. In this downside scenario, the lack of reduction in labour market spare capacity

weighs heavily on wages growth, with underlying inflation below 2 per cent for most of the forecast period.

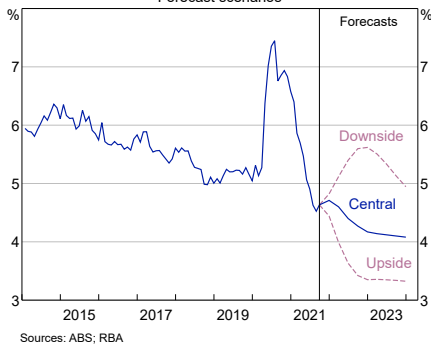
Other domestic risks and uncertainties

The upside and downside scenarios considered above illustrate two plausible alternative paths for the economy based on different underlying assumptions about health outcomes and household consumption. These include the extent of domestic lockdowns and activity restrictions, the consumption response out of wealth, and the speed with which international travel recovers. All of these factors have implications for the pace of improvement in the labour market. Beyond this, there are other sources of uncertainty.

An unexpected slowing in China’s economy – arising, for example, from a deeper-than-expected decline in construction activity or from increased uncertainty about economic policy more generally – would reduce demand for iron ore and other commodities. This would result in lower Australian resource export volumes and a decline in commodity prices, impacting Australia’s terms of trade, corporate profits and reducing government revenues from taxation and royalties. A slowdown in China or further restrictions on Australian exports would also delay the recovery in other parts of the Australian economy, possibly including the education and tourism sectors.

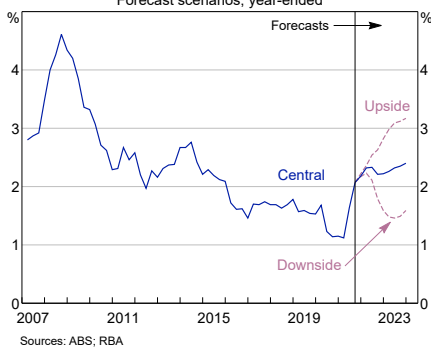
A key domestic uncertainty relates to the extent of labour market spare capacity and how wages and prices respond as this is absorbed over coming years. The central scenario assumes that acute labour shortages are limited to pockets of the economy, but these could become more widespread. Labour supply could also be constrained as activity picks up, especially if there is a lack of fully vaccinated staff in some sectors or because of isolation requirements due to outbreaks of the virus. On the other hand, the expected decline in the unemployment rate

Graph 5.10
Unemployment Rate
Forecast scenarios



Sources: ABS; RBA

Graph 5.11
Trimmed Mean Inflation
Forecast scenarios, year-ended



Sources: ABS; RBA

could occur more slowly than forecast if firms rely more on increases in employees' hours worked rather than headcount, or if labour market participation increases by more than forecast. Another consideration for the labour market outlook is the timing of the reopening of the domestic and international borders, and the resultant effects on labour supply across regions, industries and occupations.

In the central scenario, the unemployment rate is forecast to decline to around 4 per cent by the end of 2023, resulting in a steady pick-up in wages growth and inflation. In the past half century or so, this rate of unemployment has been experienced in Australia only briefly. As there is little recent historical experience to draw on, and the longer-term effects of the pandemic on potential growth and full employment are uncertain, it is possible that price pressures build more quickly or slowly than envisaged in the central scenario.

The outlook for inflation could also be influenced by a period of unexpectedly high inflation outcomes in the near term, including internationally, which results 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. Relatedly, if global price pressures from supply shortages persist for longer than expected, the extent of pass-through to domestic prices could be stronger

than envisaged and lead to higher inflation outcomes in Australia. However, it is also possible that global goods demand eases over the next year or so, around the same time that more goods supply comes online; this could see price pressures in global goods markets dissipate and feed through to lower imported price pressures in Australia.

There have been growing reports of labour and material shortages in construction. There is a risk that these capacity pressures could persist or worsen given the forecast increase in activity over coming years. In addition to resulting in more persistent price pressures, capacity constraints could lead to projects being rationed or delayed, resulting in lower output growth than otherwise.

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 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 and equity prices since late last year. But asset prices could be higher or lower over the forecast period as a result of changes to demand and supply, with consequent implications for consumption and activity. 📌

