Overview

Inflation is high globally and has risen further in recent months. Strong demand, supported by monetary and fiscal stimulus, has come up against global supply capacity that continues to be impaired by the COVID-19 pandemic. In addition, some energy and food prices are higher as a result of Russia's invasion of Ukraine. Inflation has already reached 7–10 per cent in many economies and is expected to peak later and higher than previously thought. Unemployment rates remain around generational lows in most advanced economies.

The rapid increase in the cost of living is reducing real incomes. High inflation has also led central banks to increase interest rates quite quickly. Together, these developments are weighing on the outlook for global growth. The slowing in growth is expected to be driven by an easing in household consumption growth. Lower asset prices could also contribute to the downward pressure on consumption. Consumer confidence has fallen sharply in many countries and some timely indicators of growth in activity have begun to soften.

Inflation has been boosted by high energy prices, following Russia's invasion of Ukraine. Further shocks to energy prices are possible, given the tensions ensuing from the invasion; Europe is particularly exposed to the possibility that gas supplies will be further disrupted. As the global growth outlook has been revised lower, many non-energy commodity prices have reversed the increases that occurred in the wake of the invasion and are now back around their levels at the beginning of the year.

In Australia, inflation is now the highest it has been since the early 1990s and is expected to peak at a higher rate than earlier envisaged. Global factors have contributed significantly to this outcome, but domestic pressures are also playing a role. Headline inflation was 1.7 per cent (seasonally adjusted) in the June quarter and 6.1 per cent over the year. Higher prices for petrol again added to overall inflation, and the prices of fruit and vegetables rose because of flooding on the east coast. Inflation pressures are broadly based; trimmed mean inflation remained high in the quarter at 1.5 per cent, taking the year-ended rate to 4.9 per cent. Input cost pressures have lifted inflation for new dwelling construction, consumer durables, groceries and some services. A large share of the goods and services in the Consumer Price Index basket are seeing annualised inflation above 3 per cent at present.

Inflation in Australia is expected to increase further over the course of this year, reaching around 7¾ per cent in headline terms around the end of the year. Domestic retail gas and electricity prices are expected to increase by 10–15 per cent over the second half of 2022, given the high global price of energy and recent disruptions in the domestic electricity market. Trimmed mean inflation is also expected to peak around year-end, at about 6 per cent, as firms continue to pass transport and other non-labour cost pressures through to their own prices. As supply constraints continue to ease, inflation is expected to decline over coming years, to be back around the top of the 2 to 3 per cent target range by the end of 2024. One uncertainty affecting the outlook for inflation is the possibility that inflation expectations and the general inflation psychology shift, and lead to the higher inflation being more persistent.

The domestic labour market is the tightest it has been in many years. Employment growth has been strong and the unemployment rate has declined faster than earlier expected, to be 3.5 per cent in June – its lowest level in almost 50 years. Underemployment has also declined and the employment-to-population ratio and participation rate are both at record highs. Leading indicators of demand for labour remain strong. Job vacancies and advertisements are at exceptionally high levels. Many employers have reported in liaison and business surveys that they plan to increase headcount further but are finding it harder to do so. The unemployment rate is expected to decline a little further still, to 3¼ per cent in late 2022, which is lower than was previously forecast. It is then expected to increase gradually as economic growth slows.

The tight labour market is expected to result in stronger wages growth over the period ahead, but growth in labour costs is expected to be below the rate of inflation for a time. An increasing share of firms in liaison and business surveys have reported that they are paying larger wage increases this year, including because of the recent decision by the Fair Work Commission on minimum and award rates of pay. Recent high inflation outcomes have also been a factor in some recent wage negotiations. Broader measures of labour income growth are expected to increase faster than the Wage Price Index over the forecast period, as workers switch jobs in pursuit of higher pay and employers use non-wage remuneration such as bonuses to attract and retain staff.

The Australian economy has been resilient to the disruptions caused by the Omicron outbreaks and floods on the east coast, and grew strongly over the first half of this year. GDP is forecast to grow by 3¼ per cent over 2022, supported by consumption spending and a recovery in services exports. GDP growth is then expected to slow to 1¾ per cent in each of the following two years; these forecasts are lower than three months ago. A higher cost of living, rising interest rates and declining housing prices are expected to weigh on growth in spending, at the same time as growth in public demand slows. Reflecting still-high commodity prices, Australia's terms of trade are expected to remain on a higher trajectory than previously forecast, even as they decline from a likely historical high in the June quarter.

The competing forces of a tight labour market (and so strong labour incomes) and cost-of-living pressures on household incomes make the outlook for consumption unusually uncertain. Employment growth could be stronger than expected, and strong household balance sheet positions could support household consumption by more than anticipated. Alternatively, a decline in real incomes for the average household could weigh on spending more than expected, particularly if household wealth is also declining. Many households should be well placed to absorb higher prices and interest costs without significantly curtailing consumption. However, there are some households that will be more budget constrained in the period ahead, particularly those with low savings buffers and high debt.

The slowing housing market represents a headwind for household consumption. Established housing prices have been declining for some months in Sydney and Melbourne, and more recently in a wider range of cities and regions. The resulting wealth effects are expected to dampen growth in household consumption; however, it is noteworthy that these falls follow a substantial run-up in prices over the preceding 18 months. New lending for housing has also eased in recent months but remains at high levels. Dwelling investment is likely to be supported for at least the next year by the large pipeline of detached house construction projects that are currently underway. Capacity constraints and weather-related disruptions have limited the pace at which this pipeline can be worked down, however. Further out, the outlook for dwelling investment is softer as a result of the combination of declining housing prices, higher interest rates and high construction costs.

The outlook for investment more broadly remains positive, although capacity constraints are evident in some areas. Survey measures of business conditions are strong and business credit is growing rapidly. The pipeline of non-residential construction projects has increased recently, and surveys and liaison information about non-mining firms' investment intentions imply that machinery and equipment investment will grow over the period ahead. Public investment is expected to increase over the forecast period, but as for private-sector construction activity, it is likely to face capacity constraints. Public consumption is likely to grow more slowly than the rest of the economy, as pandemic-related spending unwinds.

Financial conditions globally have tightened noticeably from their unusually accommodative levels at the start of the year. Many advanced economy central banks have increased policy interest rates by more than earlier anticipated. These moves have been motivated by the need to reduce the risk that high inflation becomes entrenched, which would require a larger and more costly tightening in policy later on. Emerging market central banks have also continued to tighten policy, with a number in Asia starting to raise rates over recent months. In line with the weaker outlook for global growth, equity prices have fallen over the course of this year and credit spreads have widened. Longer-term government bond yields have also reversed some of their earlier increases. Movements in Australian financial markets have been broadly consistent with global developments. The Australian dollar has appreciated of late, largely reversing the depreciation over preceding months.

The risks to the global outlook are skewed to the downside. Inflation is high in many economies and increasingly driven by domestic demand pressures. The longer high inflation persists and the more expectations adjust, the more monetary policy might need to be tightened. In doing so, central banks are having to weigh up the need to rein in inflation and contain inflation expectations against the weakening outlook for growth. The synchronised nature of the tightening in monetary policy globally could prove quite contractionary, and is occurring at a time when fiscal policy is offering less support. As in Australia, it is also unclear how firms and households will respond to real incomes declining at the same time that labour markets in most advanced economies remain tight.

On the supply side, further shocks to global energy supply could adversely affect both global growth and inflation. In addition, restrictions to control the spread of COVID-19 in China led to an unexpectedly large contraction there in the June quarter; further outbreaks could both weigh on growth in China and disrupt global supply chains. The Chinese economy is also contending with weak property market conditions and increasing levels of distress among developers.

Over the course of this year, inflation in Australia has been higher than was previously expected and the labour market has tightened faster than was thought likely, with the unemployment rate now standing at 3½ per cent. In this environment, there is a risk that expectations of high inflation might be built into price- and wage-setting behaviour, making the higher inflation more persistent. At the same time, the outlook for both the global and the Australian economies has been downgraded, as central banks raise interest rates and household budgets come under pressure because of higher inflation.

In light of these developments and risks, the Reserve Bank Board has continued the process begun in May of normalising monetary conditions in Australia. During the pandemic, the Board put in place very considerable monetary stimulus to help the Australian economy through a very difficult period and provide insurance against the worst outcomes. The strong recovery of the economy and the high inflation are requiring the withdrawal of monetary stimulus earlier, and faster, than previously expected. Accordingly, the Board followed up the initial increase in the cash rate target of 25 basis points in May with three increases each of 50 basis points in the following three months. These increases have taken the cash rate target to 1.85 per cent and the remuneration rate on Exchange Settlement balances to 1.75 per cent. The increases have been required to create a more sustainable balance of demand and supply in the Australian economy.

The Board is committed to do what is necessary to ensure that inflation in Australia returns to the 2 to 3 per cent target range over time. It is seeking to do this in a way that keeps the economy on an even keel. The path to achieve this balance is a narrow one and subject to considerable uncertainty. The Board expects to take further steps in the process of normalising monetary conditions over the months ahead, but it is not on a pre-set path. The size and timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market.