Overview

Inflation in Australia continued to decline in the June quarter from its peak at the end of last year, but it remains too high. Headline and trimmed mean inflation were around 6 per cent in year-ended terms. Goods price inflation eased further in the quarter, and by more than had been expected, especially for consumer durables. An easing in global cost pressures and a slowing in domestic demand growth are flowing through to domestic goods price inflation. By contrast, services price inflation – especially for market services and rents – remained strong.

The outlook for inflation is little changed from three months ago. CPI Inflation is forecast to continue to decline, to be around 3¼ per cent at the end of 2024 and back within the 2–3 per cent target range in late 2025. Further easing in goods price inflation is expected to drive the decline in inflation over the year ahead. However, demand continuing to exceed supply in parts of the economy and domestic cost pressures, due to the associated ongoing tightness in the labour market and rising energy costs, are expected to see inflationary pressures persist for a while, especially for services. At the same time, rent inflation will remain high, particularly as high population growth in recent quarters has added demand to an already tight rental market.

The labour market is still tight, although conditions have eased a little. The unemployment rate has been close to 3½ per cent for the past year, and strong population growth has continued to support employment growth over recent months. However, a range of indicators of labour demand, such as job vacancies, have declined from their peaks and the underemployment rate has risen a little over recent months. Firms in the Bank's liaison program have also reported an improvement in labour availability, supported by the arrival of foreign workers.

In response to the tight labour market and high inflation, wages growth picked up to its highest rate in a decade. While more timely indicators suggest wages growth was steady in the June quarter at around 3½ to 4 per cent, wages growth is expected to strengthen in the second half of the year because of the ongoing tightness in the labour market, increases in award and minimum wages, and recent developments in public sector wage policies. The inflation forecasts assume labour productivity growth, which is currently very weak, will return to its pre-pandemic trend over the next year or so; this will be needed for the current rate of growth in nominal wages to be consistent with the inflation target.

Growth in economic activity has been subdued this year, contributing to a better balance between supply and demand. Consumer spending has slowed considerably over the past year as cost-of-living pressures, the rise in interest rates and the earlier decline in housing prices all weighed on demand. Despite slower growth, the level of economic activity in Australia is still around its pre-pandemic trend.

Growth in the economy is expected to remain subdued over the period ahead, reaching a trough of around 1 per cent at the end of 2023, before gradually picking up to around

2¼ per cent by the end of 2025. Employment is expected to continue to increase over the forecast period, but at a slower pace than the working-age population. In response, the unemployment rate is expected to start picking up gradually in the period ahead, to reach 4½ per cent by late 2024. These forecasts are broadly as they were three months ago. They embed a higher profile for the cash rate over the forecast period compared with the May *Statement*, including because of increases in the cash rate in May and June. But there are other forces working in the opposite direction, including from higher-than-expected population growth and an earlier-than-expected recovery in the established housing market.

The housing market has turned around earlier than anticipated because of the combined effects of stronger demand – buoyed partly by strong population growth – and limited supply. Housing prices have increased in recent months across most capital cities. Construction activity for new dwellings continues to be limited by capacity constraints because of labour shortages and a tightening in financial conditions. For developers, cash-flow constraints and an increase in insolvencies could create further delays in completions. The pipeline of existing work is expected to support construction activity as capacity constraints ease, despite relatively weak demand for new construction.

The outlook for the domestic economy is subject to a range of uncertainties. Household consumption remains a key source of uncertainty. Weakness in household consumption could persist for longer than expected if weak growth in aggregate real disposable income and a rising unemployment rate have larger-than-expected effects on spending, especially on households with high debt and low savings. Alternatively, it is possible that consumer spending could recover more quickly than currently forecast, particularly if the labour market is more resilient than expected, and as real incomes start to improve as inflation declines. Higher housing prices are expected to support household consumption, but the extent of the effect is uncertain and will be influenced by how housing turnover responds.

There are both upside and downside risks to the inflation outlook. Inflation could be more persistent than forecast if wages growth is stronger than expected, if productivity growth fails to recover or if profit margins widen as input costs decline, even as the economy slows. On the other hand, declines in global cost pressures could pass through more quickly to domestic prices than assumed, supported by weak consumer demand. Global disinflationary pressures could also be greater than assumed, particularly in the context of recent weaker-than-expected growth and low inflation in China.

Globally, headline inflation has declined further in most advanced economies, and by a little more than earlier expected in some cases. But core inflation remains well above central banks' targets and is proving to be persistent. Labour market conditions in advanced economies remain tight, which is supporting strong wages growth, particularly in Europe. Weak productivity growth also remains a concern for the inflation outlook in most of these economies.

Central banks in most advanced economies have increased policy rates further over recent months in response to concerns that inflation could be more persistent than expected. According to market expectations, policy rates for many central banks are close to their peaks, though a few are expected to raise rates a bit further. Concerns around US banking stresses have eased since earlier in the year, which has supported a narrowing in credit spreads. Even so, credit growth in the United States and Europe has continued to slow, consistent with the significant tightening in monetary policies.

In China, the pace of economic recovery has eased following an initial strong rebound after the lifting of COVID-19 restrictions at the end of last year. The outlook for the Chinese economy has been revised lower over recent months, but growth in China is still consistent with the authorities' target of around 5 per cent in 2023. The outlook will depend on how the recovery in household consumption continues to play out, and the scale and effectiveness of any policy support, particularly in the property sector, which has deteriorated further this year. Iron ore prices have been resilient reflecting the expectation of some further targeted stimulus for the property sector. By contrast, thermal coal prices have declined, partly because of weak industrial demand in China.

Overall, growth in Australia's major trading partners is expected to be around 3¼ per cent in 2023 and 3 per cent in 2024, which is well below pre-pandemic longer run averages and lower than forecast three months ago. The downward revision partly reflects recent slower growth in China. On the other hand, growth in major advanced economies has been revised up slightly for 2023, as the trough in growth in these economies is now expected to occur a little later than previously thought.

In Australia, monetary conditions have tightened further over recent months. Banks have increased both lending and deposit rates further, but the overall increase in this tightening phase has been less than the increase in the cash rate. Credit growth has stabilised recently, though at a noticeably lower level than late last year. While demand for new housing loans remains well below its early 2022 level, it has increased a little since earlier this year alongside increases in activity in the housing market and in housing prices. The Australian dollar is broadly around its levels in May on a trade-weighted basis.

Over the course of this year, the Reserve Bank Board has taken further steps to ensure inflation returns to the target range within a reasonable time. The Board raised interest rates by 25 basis points at the May and June meetings, to provide greater confidence that inflation would return to target over the forecast horizon. At that time, the flow of data had indicated that upside risks to inflation had increased, and the Board responded to the shift in risk by raising policy rates. This brought the cumulative increase to 400 basis points during the current tightening phase.

At the subsequent meetings in July and August, the Board decided to hold rates unchanged. It did this to provide time to assess the impact of the increases to date as well as the outlooks for inflation and the economy, and the associated risks.

At both the July and August meetings, the Board considered the option of raising rates further. The case to increase the cash rate further centred on the fact that inflation was still too high and that it was expected to remain above the target until mid-2025. Also, demand continues to exceed supply in some parts of the economy, and labour market conditions are still tight, which is conducive to above-average increases in prices and wages. At the same time, productivity growth remains weak, which is contributing to strong growth in costs. While goods inflation has slowed, services inflation remains strong. In some comparable economies, core inflation (especially for services) has proven to be stickier than anticipated and policy rates have been raised further in response. In these economies, policy rates are generally at a higher level than the cash rate in Australia, yet Australia's inflation rate is at least as high. These factors highlight the risk that inflation could be above the target range for an even longer period than currently forecast, which would increase the probability of higher inflation expectations becoming embedded. Tightening policy further could provide some further insurance against these upside risks to inflation.

Notwithstanding these arguments, the Board judged that the stronger case was to hold the cash rate steady in July and August. The Board is mindful that monetary policy has been tightened significantly in a relatively short period and that the level of the cash rate is restricting economic activity. Growth in the economy has slowed and policy is working to establish a better balance of supply and demand in the economy and thus to bring inflation down. The data in recent months have confirmed that inflation is moving in the right direction and are consistent with inflation returning to the 2–3 per cent target range over the forecast period.

The Board is also mindful that the typical lags of monetary policy mean that the full effects of the interest rate increases to date on demand, the labour market and inflation are yet to be seen. Many households are experiencing a painful squeeze on their budgets, reflecting the high cost of living but also the fast pace of the interest rate increases so far. The Board has also been conscious of the economic and social benefits of preserving as much of the gains in the labour market as possible. These considerations meant that the Board could take some more time to assess how the economy and risks to inflation and employment are evolving.

The Board's current assessment is that the risks around the inflation outlook are broadly balanced. But it recognises that the crystallisation of upside risks would increase the likelihood of inflation staying high for longer and a rise in medium-term inflation expectations. If inflation expectations were to rise, the result would be even higher interest rates, a more substantial slowing in the economy and a larger rise in unemployment to bring inflation back to target. So far, medium-term inflation expectations remain consistent with inflation returning to target and it is important that this remains the case.

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