5. Economic Outlook

Global growth is forecast to remain well below its historical average over the next two years. Real incomes have declined as the cost of living has escalated, in part due to Europe's energy crisis. The highly synchronised global monetary policy tightening is also expected to weigh on demand. While the central forecast for growth in Australia's major trading partners is unchanged, the balance of risks has improved (with plausible scenarios for higher or lower inflation and growth over the next few years). In particular, the Chinese authorities' decision in December to lift most COVID-19 restrictions sooner than had been expected, inflation showing clearer signs of peaking and lower global gas prices have reduced some of the downside risks to the global outlook (see chapter on 'The International Environment').

Economic growth in Australia is forecast to slow this year as rising interest rates, the higher cost of living and declining real wealth weigh on growth. The outlook for GDP growth is little changed from three months ago (Table 5.1). While the incoming data on domestic demand for the second half of 2022 was a little weaker than expected, the overall implications for the growth outlook have been broadly offset by stronger population growth, which is being driven by higher net overseas arrivals. GDP growth is expected to have been 2¾ per cent over 2022 and to be 1½ per cent over both 2023 and 2024. Domestic activity is forecast to pick up a little from late 2024 onwards as the drag on growth from the earlier monetary policy tightening starts to wane and inflation moderates. The labour market is very tight; the recent pick-up in net arrivals following the reopening of the international border has supported robust growth in employment and is helping to alleviate shortages in some areas. The unemployment rate is forecast to remain around 3½ per cent until mid-2023, before rising as growth in output slows.

Headline consumer price inflation was 7.8 per cent over 2022. Inflation is forecast to decline to around the top of the 2–3 per cent target band over coming years. The easing in global price pressures already underway is expected to flow through to domestic prices over time. In addition, slower growth in domestic demand and a moderation in labour market conditions are expected to reduce domestic inflationary pressures. Inflation could turn out to be higher than expected if the high inflation environment leads to greater feedback between wages and prices than has been typical in the inflation targeting era. On the other hand, inflation could be lower than expected if the easing in goods inflation is faster or more widespread than anticipated.

A key source of uncertainty for the domestic activity outlook relates to the competing forces affecting household spending. Aggregate household incomes have been sustained by strong labour demand, which has supported employment and hours worked and has led to stronger wages growth. Household balance sheets – in aggregate – are in good shape, underpinned by a high level of savings in recent years, although some households (especially those with limited spare income, high debt and low savings) are finding it hard to adjust to higher interest rates and higher inflation. High inflation and rising interest rates are also weighing on aggregate household disposable income and spending in real terms. Household consumption will also be dampened by wealth effects due to the decline in housing prices.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market pricing, with an assumed peak in the cash rate of around 3¾ per cent in the second half of 2023 before declining to around 3 per cent by mid-2025. The exchange rate is assumed to be unchanged at its current level, which has appreciated a little over the past three months. Petrol prices are assumed to be broadly unchanged around their recent level. Population growth projections have been revised higher following a stronger-than-expected pick-up in net overseas arrivals; annual population growth over coming years is assumed to be around 1½ per cent, broadly in line with its pre-pandemic average.

Inflation in Australia is expected to have peaked

Consumer price inflation in Australia remains high and broadly based. Global factors – including pandemic-related disruptions to supply chains and Russia's invasion of Ukraine – have accounted for much of the increase in inflation over the past year. That said, strong domestic demand, a tight labour market, flood-related disruptions and capacity constraints in some sectors have also contributed to the upward pressure on prices. Headline consumer price inflation was 7.8 per cent over 2022; this is expected to be the peak in the current cycle (Graph 5.1).

Energy prices are expected to add significantly to inflationary pressures over coming years. Retail prices for electricity and gas have increased by 10–15 per cent since mid-2022, with most of the effects of the increase in electricity prices on the CPI occurring in the December quarter because of the timing of state government subsidies. Recent announcements from major energy retailers suggest that gas price increases in early 2023 will be larger than expected a few months ago. Later in the forecast period, energy price increases are likely to be smaller than previously assumed, reflecting the expected impact of the Australian Government's Energy Price Relief Plan.

Goods price inflation is forecast to moderate in the period ahead, consistent with (but a little later than) the experience overseas. Information from liaison and business surveys indicates that upstream cost pressures are easing, reflecting the ongoing resolution of the global imbalance between supply and demand for goods and lower commodity prices. Inflation has eased materially for new dwellings and this is expected to broaden to other goods over time. Grocery price inflation remains high, but information from liaison indicates that firms expect the pace of price increases to moderate over the coming year.

Services inflation is forecast to remain high. Domestic labour cost growth is expected to pick up strongly over the coming year and remain high over the forecast period, adding to cost pressures for labour-intensive market services. Rental price inflation has picked up and is expected to increase further over coming quarters as the impact of low vacancy rates on higher advertised rents over the past year or so works its way through the stock of outstanding rental agreements.

The near-term outlook for underlying inflation has been revised higher as a result of the stronger-than-expected December quarter underlying inflation outcome and an upward revision to labour costs (discussed below) (Graph 5.2). Later in the forecast period, the outlook for underlying inflation has been revised

Table 5.1: Output Growth and Inflation Forecasts(a)

Per cent

	Year-ended					
	Dec 2022	June 2023	Dec 2023	June 2024	Dec 2024	June 2025
GDP growth	2¾	2¼	1½	1½	1½	1¾
(previous)	(3)	(2)	(1½)	(1½)	(1½)	(n/a)
Unemployment rate(b)	3.5	3½	3¾	4	4¼	4½
(previous)	(3½)	(3½)	(3¾)	(4)	(4¼)	(n/a)
CPI inflation	7.8	6¾	4¾	3½	3¼	3
(previous)	(8)	(6¼)	(4¾)	(4¼)	(3¼)	(n/a)
Trimmed mean inflation	6.9	6¼	4¼	3¼	3	3
(previous)	(6½)	(5½)	(3¾)	(3½)	(3¼)	(n/a)
	Year-average					
	2022	**2022/23**	**2023**	**2023/24**	**2024**	**2024/25**
GDP growth	3¾	3½	2¼	1½	1½	1¾
(previous)	(4)	(3½)	(2)	(1½)	(1½)	(n/a)

(a) Forecasts finalised 8 February. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing. Other forecast assumptions (assumptions as of November *Statement* in parenthesis): TWI at 62 (62); A$ at US$0.69 (US$0.64); Brent crude oil price at US$82bbl (US$89bbl). The rate of population growth is assumed to be in line with its pre-pandemic average. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter.

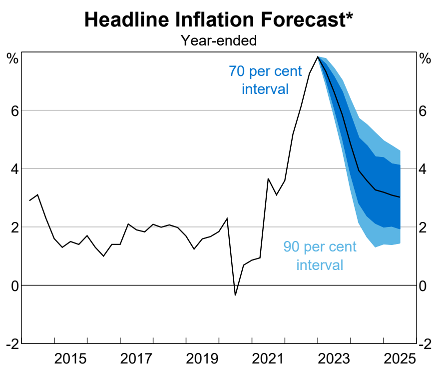
Sources: ABS; RBA

down slightly, reflecting downward revisions to energy price increases in 2023/24.

Underlying inflation is forecast to decline significantly over coming years to be around the top of the inflation target range by mid-2025.

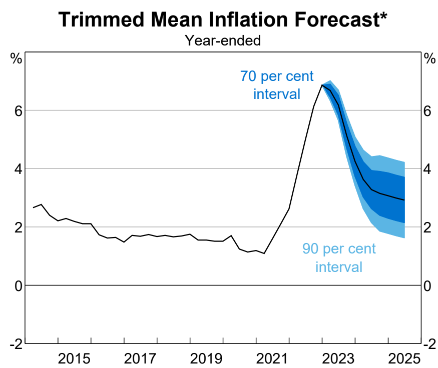
There is a high degree of uncertainty around the speed and extent of downward pressure on inflation from goods prices (which could come through sooner and swifter than expected) and domestic price pressures (which may be

Graph 5.1



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

Graph 5.2



* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

stronger than anticipated); these risks are discussed further below in the section on 'Key domestic uncertainties'.

Economic growth is expected to slow this year

GDP growth is expected to have slowed during 2022 to be around 2¾ per cent over the year – a little slower than expected three months ago – as the initial bounce-back from pandemic-related restrictions has mostly run its course (Graph 5.3). Economic growth is forecast to slow further this year, with recent declines in household real wealth and real disposable income expected to weigh on consumption growth over 2023. Export volumes are forecast to grow strongly, driven by the ongoing rebound in tourism and education-related travel, including from the resumption of visitors from China following the removal of the requirement to quarantine on return. GDP growth is forecast to slow to 1½ per cent over 2023, and to remain around that rate before picking up slightly towards the end of the forecast period in mid-2025.

Consumption growth is expected to slow due to rising prices and higher interest rates

Consumption growth is expected to slow over 2023 (Graph 5.4). While strong labour market outcomes and population growth are forecast to continue to support aggregate household income over this period, higher consumer prices and net interest expenses will weigh on spending. Lower household net wealth, driven by lower housing prices, is also expected to weigh on consumption. Further out, consumption growth is forecast to increase gradually towards its pre-pandemic average owing to the waning effects of earlier interest rate rises, the recovery of household wealth and tax cuts supporting disposable incomes.

The household saving ratio is forecast to continue to decline over the next year, before increasing to around its pre-pandemic average.

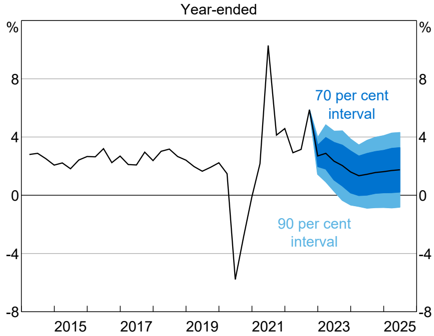
The outlook for business investment remains positive

The outlook for investment remains positive. A large pipeline of projects is expected to support activity over 2023. While the recent flow of data and information from liaison indicates that materials shortages and related supply chain issues have eased a little, labour shortages remain a constraint on activity and are limiting

Graph 5.3

GDP Growth Forecast*

Year-ended



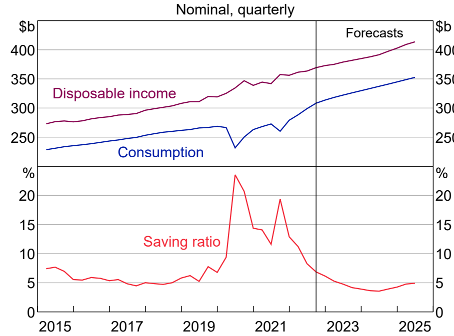
* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

Graph 5.4

Household Consumption and Income

Nominal, quarterly



Sources: ABS; RBA

the pace at which the pipeline of work can be worked through.

New dwelling investment is forecast to decline once the backlog of dwelling construction is worked through, consistent with the weak demand for new detached dwellings observed in the December quarter. Information from liaison with developers suggests that investor demand for higher density dwelling investment has also decreased, even though unit rental yields have risen since the start of 2022. Stronger immigration is forecast to boost rental demand in the medium term, but this is expected to be partially mitigated by an increase in average household size from current low levels. Higher density housing supply is expected to respond to these pressures with a lag due to the long planning and construction lead times; after gaining planning approvals and pre-sales to commence a project, the average apartment building takes more than two years to build.

Non-mining machinery and equipment investment is expected to increase over the forecast period, aided in the near term by the easing of supply chain pressures. Information from the ABS Capital Expenditure Survey suggests that firms' nominal investment intentions remain at or above average levels, though this partly reflects the higher cost of undertaking a given volume of investment.

Mining investment is forecast to be broadly unchanged over coming years. While expansionary iron ore and LNG projects are expected to go ahead over 2023, the vast majority of mining investment is intended to replace ageing structures and equipment.

Public demand is forecast to remain at a high level

A decline in pandemic-related spending is forecast to weigh on public consumption throughout most of 2023. Public investment is forecast to grow over coming years. The existing pipeline of public engineering work is anticipated to support a high level of public capital expenditure for several years. The speed of the rollout will continue to be affected by capacity constraints in the construction sector, particularly in the near term.

The ongoing recovery in travel will support services exports and imports

Export volumes are forecast to grow strongly over the next year, driven by services exports, as travel recovers to be back around pre-pandemic norms by 2024. Travel services are expected to recover a little faster than previously forecast, following the removal of the requirement for travellers from China to quarantine upon their return.

Coal and iron ore exports increased in late 2022, based on partial indicators, and resource exports are expected to remain broadly flat over 2023. Resource exports are already close to capacity and so any effects from the brighter outlook for China will mostly come through prices. Additional iron ore production capacity is due for completion in 2024, which will support a modest increase in export volumes.

Rural export volumes increased strongly over 2022 and are expected to remain elevated in the near term. Following three successive La Niña events and above-average rainfall – which has supported record crop production – long-range climate forecasts suggest rainfall and growing conditions will return to neutral levels in the first half of 2023.

Import volumes are forecast to increase a little faster than domestic demand over the next year as Australians increase overseas travel.

The terms of trade are expected to increase in the March quarter due to higher bulk commodity prices after declining slightly in the December quarter of 2022 (Graph 5.5). The terms of trade are expected to remain at a historically high level, but decline over the remainder of the forecast period, as commodity export prices decline from elevated levels.

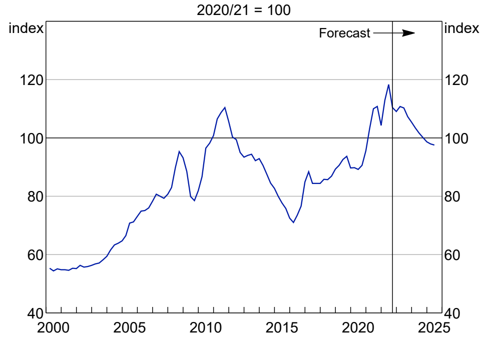
The unemployment rate is forecast to increase as economic growth slows

A broad range of measures suggest that the labour market is very tight. The unemployment rate is forecast to remain around 3½ per cent until mid-2023 (Graph 5.6); broader measures of labour underutilisation are also anticipated to remain around their lowest levels in decades as firms have increased the hours of workers in response to strong demand. With subdued economic growth expected through 2023 and 2024, the unemployment rate is forecast to gradually increase and reach 4½ per cent by mid-2025.

Graph 5.5

Terms of Trade

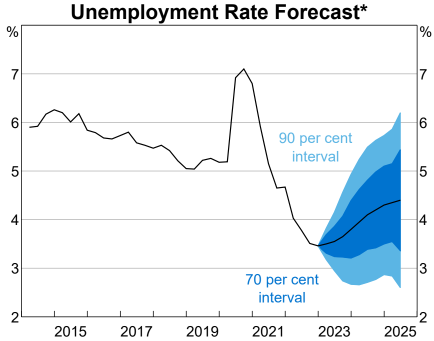
2020/21 = 100



Sources: ABS; RBA

Graph 5.6

Unemployment Rate Forecast*



* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

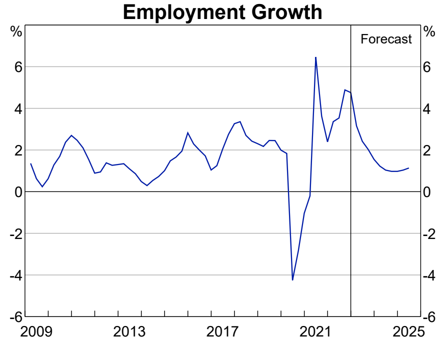
Demand for labour moderated over the second half of 2022 but remains strong. The pick-up in net arrivals since the reopening of the international border has supported employment growth. This should help to alleviate labour shortages in some industries over time, while also adding to aggregate demand in the economy. Growth in employment is forecast to ease over 2023 alongside slower growth in activity (Graph 5.7). Participation in the labour force is expected to be sustained around historically high levels over the next couple of years. Structural trends – such as higher female and older worker participation – are expected to be offset by the cyclical slowing in the labour market in the second half of the forecast period.

Wages growth is expected to pick up further

Aggregate wages growth picked up in late 2022 and is expected to strengthen further in the period ahead. Firms in the Bank's liaison program report this has largely been driven by strong labour demand in a tight labour market, elevated staff turnover, higher inflation outcomes and pass-through to wages from the Fair Work Commission's decision announced in June. Consistent with the multi-year duration of agreements, wages growth in public and private enterprise agreements is forecast to be below

Graph 5.7

Employment Growth



Sources: ABS; RBA

outcomes for other bargaining streams, and so weigh on near-term aggregate wages growth.

Growth in the Wage Price Index (WPI) – a measure of changes in base wage rates for a given quantity and quality of labour – is forecast to reach 4¼ per cent in late 2023 before declining to 3¾ per cent in mid-2025 (Graph 5.8). The near term outlook is higher than a few months ago, reflecting the stronger-than-expected September quarter WPI outcome and ongoing strength in timely indicators of wages growth. WPI growth is expected to ease in the second half of the forecast period as the unemployment rate rises and labour market capacity constraints become less binding. However, the expected easing in wages growth remains relatively modest, reflecting inertia in the wage-setting process, ongoing cost-of-living pressures and a still relatively tight labour market. The effect of high inflation and cost-of-living pressures on price- and wage-setting behaviour is a material risk to the outlook (see 'Key domestic uncertainties' below).

Broader measures of labour income growth are expected to increase at a faster rate than the WPI over the forecast period as employers use bonus payments to retain or attract staff, more hours are worked at overtime rates and job turnover rates remain high. These broader measures imply less of a decline in real incomes than suggested by the WPI measure (Graph 5.9).

Key domestic uncertainties

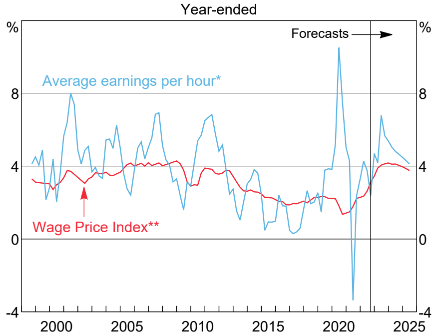
The outlook for household consumption is clouded by competing forces

Momentum in household consumption growth could be sustained for longer than expected. The effect of the recent falls in housing wealth on consumption may be cushioned by the substantial equity built by most homeowners as a result of the large run up in housing prices over the past few years. Also, many households built savings buffers during the pandemic. If households are more willing to spend from these liquid savings than from other forms of wealth, spending could be stronger than anticipated for a time. This would be reflected in a larger fall in the household savings ratio, as has occurred in the United States. Mortgage holders continued to add to savings buffers in offset and redraw facilities in the second half of 2022 despite higher interest rates, which could also suggest the recent growth in household spending could be sustained for longer than anticipated. Stronger-than-expected growth in domestic demand would see domestic inflationary pressures build further.

Graph 5.8

Wages and Earnings Growth

Year-ended



* Non-farm; includes social contributions.

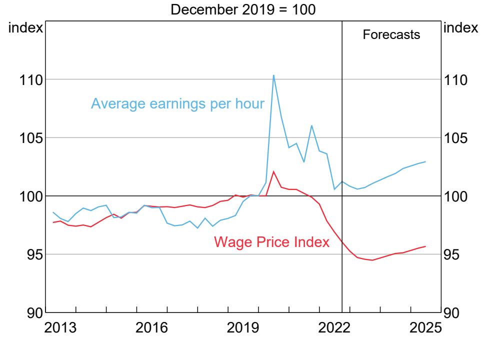
** Excluding bonuses and commissions.

Sources: ABS; RBA

Graph 5.9

Real Labour Income*

December 2019 = 100



* Deflated using the headline Consumer Price Index.

Sources: ABS; RBA

On the other hand, a significant further decline in real disposable incomes for the average household could weigh on consumption growth by more than expected, particularly in combination with declining household wealth. Higher prices are putting pressure on household budgets and could weigh on consumption by more than expected, particularly for low-income households that typically have lower savings buffers. Many households are well placed to absorb higher interest rate costs without significant spending cuts. However, interest rates have risen quickly and some households with low savings buffers and high debt relative to incomes will have to adjust their spending sharply. Consumption growth could also be weaker than anticipated in response to larger-than-expected falls in housing prices or other asset prices, or because of larger-than-expected spending responses to those declines.

A high-inflation environment could shift wage- and price-setting behaviour and raise inflation expectations

Inflation in Australia and internationally is high and expected to continue weighing on real incomes. The composition of inflation in Australia is also expected to shift, with higher inflation expected in more persistent and non-discretionary items, such as rents, in coming years. Information from liaison indicates that higher inflation outcomes are a factor in current wage negotiations; this is likely to contribute to a pick-up in wages growth in the period ahead.

Beyond this expected response, inflationary pressures can change how businesses and households behave. People tend to pay closer attention to changes in costs and prices in a high-inflation environment, which can increase the pass-through of inflation to wages and vice versa. A tight labour market and resilient demand conditions would support this feedback. The forecast for wages growth seeks to centralise some of this risk to the wages outlook, but it is possible that feedback could be even stronger than expected. Stronger feedback between wages and prices would result in persistently higher inflation throughout the forecast period, which could lead to inflation expectations becoming de-anchored.

Goods prices could decline significantly and weigh on inflation outcomes

The inflation forecasts presented above assume that goods prices stabilise at a high level rather than decline over coming years. The global imbalance between the supply and demand for goods continues to improve. Shipping costs have largely retraced their pandemic increase and goods inflation has eased in most advanced economies – for example, prices have declined in recent months in the United States, with some private sector analysts predicting outright declines in goods consumer prices in 2023. Large or widespread declines in goods prices would moderate inflation outcomes by more than currently expected. One way this could occur is if the simultaneous tightening of monetary policy across many economies affects demand by more than the sum of individual-economy effects would imply. For example, if prices for consumer durables reversed one-third of the price increases recorded since the onset of the pandemic, year-ended headline inflation would be around ¾ percentage point lower than the current forecast.

Energy and other supply shocks could lead to different outcomes for inflation and growth

The risks from energy and other supply-side shocks that have affected the economy over recent years have diminished, but this could change quickly. Vaccine-resistant variants of COVID-19 remain a significant risk with serious consequences for health and economic activity. The end of China's 'dynamic clearing' approach to COVID-19 lowers the risk of further supply chain issues in the future; however, China's demand for energy commodities will increase as domestic demand strengthens. Some analysts believe this could lead to large increases in energy prices over coming months. The Australian Government's Energy Price Relief Plan should limit the extent to which further shocks in global energy prices transmit to domestic retail electricity and gas prices. However, it is possible that the declines in global energy prices and the effects of domestic policy have a smaller impact on domestic energy prices than currently expected, reflecting the complexities of the sector and the costs of and potential for complications in the transition to greater use of renewable energy.