3. Outlook

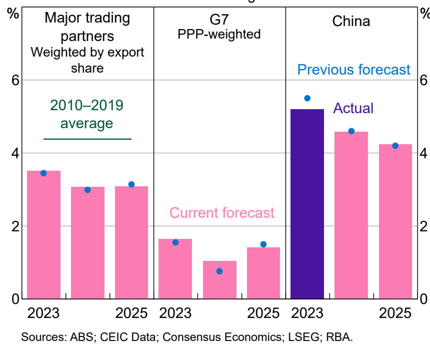
Summary

- **Most advanced economy central banks judge their policy rates to be restrictive and expect inflation to return to target over the next year or so.** Global growth is expected to be soft over the next two years, contributing to slower growth in demand for Australian goods and services.
- **Economic growth in Australia is expected to remain subdued in the near term as inflation and higher interest rates continue to weigh on demand.** The forecast for GDP growth is softer than three months ago, largely reflecting a weaker outlook for household consumption in the near term. From late 2024, growth is expected to pick up gradually as inflation declines and the pressures on household incomes ease.
- **Conditions in the labour market are expected to ease further to be broadly consistent with full employment in the next couple of years.** Nominal wages growth is expected to remain robust in the near term and then gradually ease.
- **Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and reach the midpoint in 2026.** The forecasts are based on the technical assumption that the cash rate will remain around the current level until the middle of 2024. Inflation is anticipated to decline a little quicker than previously thought, because goods price inflation has declined more than expected and domestic demand is also a little softer than previously anticipated. But, services inflation remains high and is still expected to decline only gradually as demand moderates and growth in labour and non-labour costs ease.
- **The risks to the domestic outlook are broadly balanced, though the costs associated with these risks differ.** The key risks are: (i) demand could be softer than expected, leading to costs to our full employment objective, though inflation would decline faster than expected in this case; and (ii) inflation could take longer to return to target than anticipated, which would be costly (in terms of both the employment and inflation objectives) if this led to inflation expectations drifting upwards.

3.1 Global outlook

Global growth is expected to be below average and inflation to decline to be consistent with central bank targets in many economies.

Year-average GDP growth in Australia's major trading partners is expected to ease in 2024, contributing to weaker growth in demand for Australian goods and services. This overall outlook is little changed from three months ago, with stronger forecast growth in the United States and high-income economies in east Asia offset by weaker growth in some other advanced economies (Graph 3.1).



Central banks are generally forecasting that inflation in advanced economies will decline to be consistent with central bank targets over the next year or so, though flag upside risks. This expectation of a decline in inflation is alongside expectations of softer economic growth and a moderate easing in labour markets. Reflecting this, market expectations are that policy rates have peaked (see Chapter 1: Financial Conditions). In particular, GDP growth in advanced economies is forecast to slow substantially this year, partly reflecting the effects of tighter monetary policy on demand. In most G7 economies, private sector economists' forecasts of growth for 2024 are well below the average growth of the decade prior to the pandemic, although US growth is expected to slow only moderately. Overall G7 economic growth is forecast to pick up moderately from the latter half of 2024 and is expected to be supported by less restrictive monetary policy settings in a number of economies.

Growth in China is expected to slow over the next two years as the rebound in services consumption fades and the property sector remains weak. Weakness in these sectors is expected to be partly offset by continued strength in manufacturing investment and further policy support for infrastructure investment.

Risks to the outlook for global economic growth are tilted to the downside.

- **Key risk #1: Inflation may not decline as quickly as expected, even as demand slows further, leading to more restrictive monetary policy and softer global economic growth than anticipated.** Recent progress towards inflation targets has been faster than expected in some economies, but services inflation – which remains a key focus of many central banks – has eased only gradually and may remain stubbornly high. Recent disruptions to global shipping routes pose an additional modest upside risk to global inflation and downside risk to growth; this risk could become more material in the event of a significant escalation of the conflict in the Middle East.
- **Key risk #2: It remains uncertain how much further the earlier tightening in monetary policy will weigh on economic activity.** Recent further progress towards central bank inflation targets has reduced the likelihood that additional monetary policy tightening will be required in major advanced economies. However, lags in monetary policy transmission mean uncertainties remain (in both directions)

about the full impact on economic activity of the tightening that has occurred to date.

- **Key risk #3: Economic growth in China could slow more than forecast due to continued weakness in the property sector and weaker-than-anticipated household consumption.** Demand for housing in China remains weak despite further policy measures to support the sector. A deeper and more prolonged contraction in the property sector could weigh more heavily on household consumption, particularly if consumer confidence remains subdued and further policy support is limited. If weakness in Chinese demand were to compound the effects of soft demand from advanced economies, this could weigh on exports (and so economic growth) of other trade-exposed economies in east Asia.

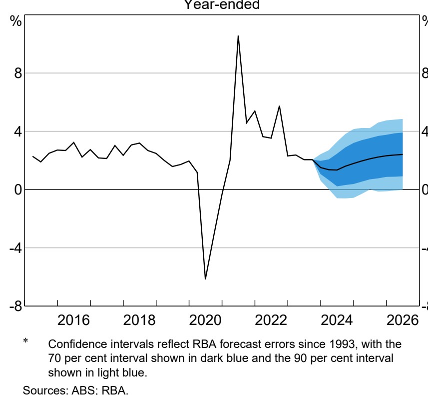
3.2 The domestic outlook

Economic growth is expected to remain subdued in the near term as inflation and earlier interest rate increases weigh on demand.

The near-term outlook for GDP growth has been revised down modestly from three months ago, reflecting a weaker outlook for consumer spending. The soft outlook for GDP growth in the near term reflects subdued domestic final demand growth (Graph 3.2). The pressure on household budgets from declines in real incomes over the past couple of years is expected to weigh on consumption, particularly in the first half of 2024. High construction costs and ongoing capacity constraints – reflecting shortages for skilled trades – are forecast to continue weighing on new building approvals and dwelling investment. Growth in non-mining business investment and public investment is forecast to soften from the high rates seen over the past year. However, the level of investment is expected to remain high, as firms continue to work through the large pipeline of construction work. Strong population growth – driven by growth in international students – and the continued recovery in inbound tourism is expected to support domestic activity in the near term and provide some offset to weak spending by Australian residents.

While *growth* in demand has slowed, the *level* of demand is still robust and is assessed to be above the economy's capacity to supply goods and services, thereby creating inflationary pressures (discussed further below). The forecast period of subdued growth relative to trend is expected to help bring demand and supply in the economy back into balance.

Graph 3.2



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

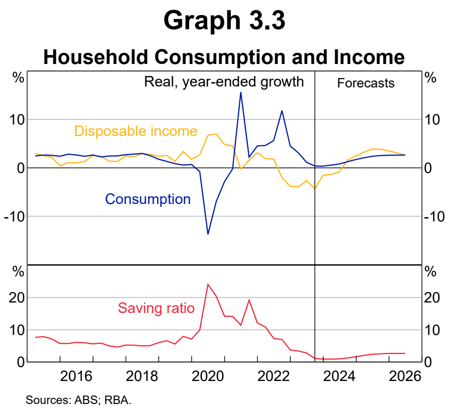
Sources: ABS; RBA.

The forecasts are based on the technical assumption that the cash rate is around its peak in the current cycle and will remain around this level until the middle of 2024; the cash rate path is based on financial market pricing and a survey of market economists (see Table 3.1: Detailed Forecast Table for more information). While high inflation affects all households and businesses, monetary policy tightening affects the cash flows of groups of households in different ways. Our assessment is that most of the two-fifths of households that have a mortgage are well placed to manage mortgage rates around their

current levels, by continuing to curtail spending, saving less or drawing down on savings buffers.[1] But, around 5 per cent of borrowers are currently estimated to have insufficient income to meet their most essential expenses and mortgage payments, and so are drawing down on savings or finding other ways to increase their income or reduce expenditure. Some of these borrowers are at risk of depleting their buffers within six months, which would see them fall behind on mortgage payments. Conversely, households that are net savers are benefiting from higher interest earned. The other channels of monetary policy are also working to slow the growth of demand and contributing to the decline in inflation, such as by increasing incentives to save and by supporting the value of the Australian dollar.

GDP growth is forecast to pick up gradually from later this year, largely reflecting stronger growth in household consumption and public demand. Household consumption growth is forecast to pick up to around its pre-pandemic average over the next year or so, supported by a recovery in real income growth as inflation continues to moderate (Graph 3.3). The household saving ratio is expected to decline further in the near term before increasing gradually from mid-2024 as real income growth turns positive. Dwelling investment is forecast to increase from 2025 onwards as earlier strong population growth and higher prices for established housing lead to a pick-up in demand for new housing. The forecasts for GDP growth beyond the near term are broadly similar to three months ago.

Graph 3.3



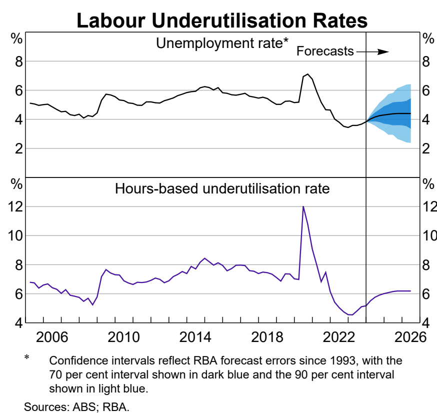
Labour market conditions are expected to ease further to be broadly consistent with full employment in the next couple of years …

Employment is expected to increase further, but at a slower pace than last year. Much of the labour market adjustment to subdued growth in economic activity is expected to occur through a decline in average hours worked. But employment growth is also forecast to slow and to be below growth in the working-age population for a time. The rate of participation in the labour force is expected to decline a little over the forecast period as conditions soften, but it is expected to remain at a high level. (Changes in the assumption for growth in the working-age population have been small relative to the large upward revisions that occurred last year because of stronger-than-expected net overseas migration.)

Labour underutilisation rates are expected to rise as employment growth moderates and average hours worked decline. Both the broader hours-based underutilisation rate (i.e. people working fewer hours than they want) and the unemployment rate have increased since late 2022 when labour market conditions were very tight, and a further increase is expected over coming quarters in response to slower economic growth (Graph 3.4). That said, the underutilisation rates forecast over the next few years are well below the typical rates of the past five decades.

The labour market forecasts are broadly consistent with a return to full employment conditions that can be sustained over time without adding to inflationary pressures. It appears that the economy will be able to sustain lower levels of labour underutilisation than were typically seen over the past five decades. The assessment of the labour market relative to full employment is based on a broad range of indicators, models and judgement (see Chapter 4: In Depth – Full Employment for more detail).

Graph 3.4



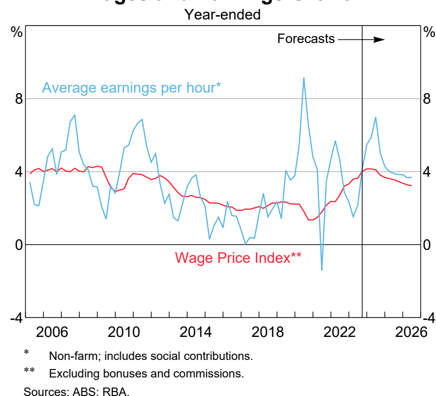
* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

… leading to a gradual easing in nominal wages growth.

Nominal wages growth is expected to remain robust in the near term, and then decline gradually in line with the easing in the labour market. Wages growth has already begun to moderate in some parts of the private sector and the moderation is expected to deepen and broaden out over the coming year (Graph 3.5).

Graph 3.5



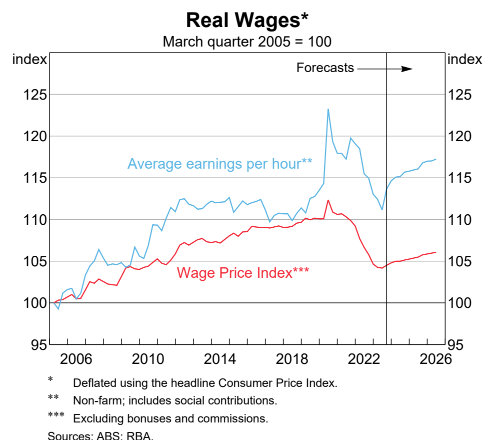
* Non-farm; includes social contributions.

** Excluding bonuses and commissions.

Sources: ABS; RBA.

The recent increase in real wages is expected to continue over the next couple of years; nominal wages are expected to increase at a faster pace than inflation (Graph 3.6).

Graph 3.6



* Deflated using the headline Consumer Price Index.

** Non-farm; includes social contributions.

*** Excluding bonuses and commissions.

Sources: ABS; RBA.

Growth in broad measures of labour costs is high because recent labour productivity outcomes have been weak. Recent growth in nominal unit labour costs – the measure of labour costs that matters most for inflation – has been at the highest rate since 1990 (excluding pandemic-impacted outcomes in 2020). Growth in unit labour costs is expected to slow gradually over the next few years.

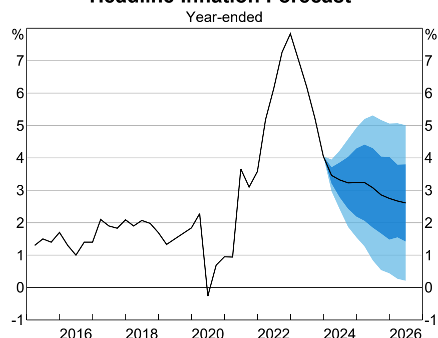
The forecasts for nominal wages growth remain consistent with the inflation target, provided labour productivity growth returns to around long-run averages; this assumption is embedded in the forecasts. While productivity growth is difficult to forecast and there are risks that productivity will be weaker than anticipated (see 3.3 Key risks to the domestic outlook), much of the recent weakness in productivity has been a by-product of the pandemic and the economic cycle and will likely unwind over the next few years. For example:

- The strong labour market has drawn in new workers and allowed others to change jobs more easily. This boost to employment is a good social and economic outcome, but it requires a transition period as people are trained in a new role. In time, job mobility can boost productivity through the benefits of better matching of people's skills with jobs.
- Some industries that faced capacity challenges in recent years, partly related to the pandemic and weather disruptions, could see an improvement in productivity as these challenges dissipate. For example, activity in the construction industry has been hampered by shortages that have led to delays in the way work is completed. But the improvement in the availability of materials and skilled labour is gradually reducing delays. In some industries – such as tourism– capacity has been insufficient to meet demand given the lags for firms (such as tourism operators) to re-establish infrastructure and resources, after a period of low demand.
- In recent years, the increase in hours worked has outpaced the growth in the capital stock; less capital per worker has been a key driver of the weakness in productivity. For example, high demand for wholesale trade services has contributed to a strong rise in hours worked, but the capital stock in that industry has yet to catch up. This is broadly expected to rebalance over the next few years, contributing to a pick-up in productivity.

Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and reach the midpoint in 2026.

Inflation is expected to be within the target range in 2025 (Graph 3.7; Graph 3.8). The decline in inflation is based on the expectations that in the next couple of years the labour market will be around levels consistent with full employment and that subdued economic growth will balance demand and supply of goods and services. Inflation expectations are assumed to remain consistent with achieving the inflation target in this timeframe.

Graph 3.7

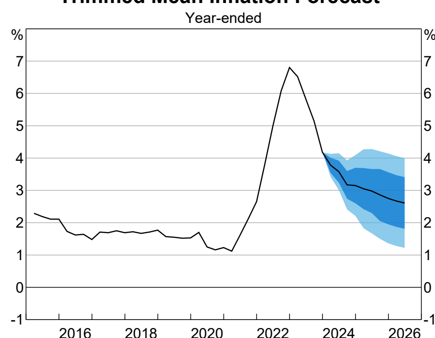


* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

Graph 3.8

Trimmed Mean Inflation Forecast*



* Confidence intervals reflect RBA forecast errors since 1993, with the 70 per cent interval shown in dark blue and the 90 per cent interval shown in light blue.

Sources: ABS; RBA.

Inflation is expected to decline a little quicker than previously thought. Goods price inflation has declined more quickly than expected three months ago, as the earlier easing in global upstream costs was passed through to consumer-facing prices; domestic demand is also a little softer than previously anticipated. The recent decline in fuel prices will lower headline inflation in the March quarter this year; together with the scheduled expiry of government electricity rebates in 2024, this creates some volatility in the progress of headline inflation to target.

But, services inflation remains high and is expected to decline only gradually as domestic inflationary pressures moderate. A further decline in services inflation is required for the inflation target to be achieved over time. Recent high inflation outcomes reflect the still-strong level of demand for services as well as strong growth in domestic costs. These costs include labour (partly because of poor productivity outcomes) and non-labour business inputs such as insurance and administrative services. There was a moderation in services inflation in the December quarter and a further easing is expected over the forecast period as cost growth eases, and as the demand for services moderates. Services inflation is expected to be slower to decline than goods inflation, consistent with the experience of other countries.

Goods price inflation is expected to be subdued over coming years. Recent inflation outcomes for many categories of goods have now returned to around pre-pandemic averages. Firms in the RBA's liaison program have reported a sustained improvement in supply chains and an easing in imported goods inflation. Domestic cost pressures remain a source of upward pressure in firms' pricing decisions, though these cost pressures are expected to ease over time.

Rent inflation is expected to remain high over the year ahead, before easing gradually. Growth in advertised rents remains strong. Housing supply has not kept pace with the increased demand for housing arising from robust nominal income growth and strong population growth in recent years, as well as the decrease in average household size since the beginning of the pandemic. This imbalance between supply and demand is contributing to very low vacancy rates and high rent inflation.

3.3 Key risks to the domestic outlook

The risks to the domestic outlook are assessed to be broadly balanced, though the costs associated with these risks differ. While some of the downside risks to the outlook would see a faster return to the inflation target, this would likely be accompanied by a cost to our employment objective. On the other hand, it would be costly (in terms of both our employment and inflation objectives) if a sustained period of high inflation led to inflation expectations drifting upwards.

Key risk #1 – If demand is weaker than expected, it could lead to spare capacity in the labour market and a faster decline in inflation.

With the labour market expected to be around the level consistent with full employment during the forecast period, materially weaker demand conditions would lead to spare capacity in the labour market. At the same time, weaker demand would also temper inflationary pressures, resulting in inflation returning to target earlier.

Some key channels through which demand could be weaker than expected include:

- **The recent weakness in household consumption could persist for longer than expected.** This could occur if the decline in real disposable incomes over the past couple of years has a larger or more persistent effect on consumption than anticipated. While many households with mortgages are well placed to absorb the increases in interest rates that have taken place, there is a risk that these households, especially those with low savings buffers and high debt relative to incomes, will adjust spending by more than expected. The increase in interest rates to date could also encourage all households to save more than expected, resulting in lower consumption growth; this has been evident across a number of peer economies.
- **International demand for Australian goods and services could be weaker than expected.** The outlook for global economic growth remains uncertain, with risks tilted to the downside. If services price inflation remains high despite further easing in demand growth, interest rates could be higher for longer than expected, and global economic growth could, in turn, slow by more than anticipated.

  The expected slowing in China's growth also continues to create uncertainty around the outlook for demand for commodities and, accordingly, the prices of Australia's key exports and terms of trade. Real estate investment has been a persistent drag on overall investment since 2021 and this is expected to continue for another year or so. The outlook for household consumption in China also remains weak, which could pose additional downside risks to Australia's education and tourism exports. While recent policy stimulus announcements have signalled further commitment by the Chinese authorities to support economic growth, constraints on local government finances could limit their ability to continue to do so. A prolonged cyclical downturn in China could further weigh on Australia's exports through its effect on output growth in Australia's major trading partners in the east Asian region, compounding the effects of slower growth in advanced economies.

Goods prices could decline significantly if domestic demand or international demand eases by more than anticipated. The inflation forecasts broadly assume that goods prices stabilise at a high level rather than decline over coming years. However, price declines have been recorded for some categories of goods in recent months. Larger or widespread declines in goods prices would moderate inflation outcomes by more than currently forecast. To provide a sense of the magnitude of this risk, 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 ½ percentage point lower than the current forecast. This would mean that headline inflation would be in the target range in 2024.

Key risk #2 – If inflation takes longer to return to target than anticipated, it could cause inflation expectations to drift upwards, which would impose costs for our employment objective.

Inflation is expected to be above the target range for around four years in total according to staff forecasts. If inflation expectations remain anchored – as assumed in the baseline forecasts – then inflation is expected to decline alongside an easing in the labour market. But, there is a risk that inflation will be above the target range for longer than this, which could result in inflation expectations drifting higher. A drift higher in inflation expectations would lock in a rate of inflation and nominal wages growth that is persistently higher, with no benefit to real wages. History suggests that it would require a sustained and costly period of spare capacity where labour is less than fully employed to reset expectations.

Some key channels through which inflation could be higher for longer than forecast include:

- **Supply shocks could boost inflation.** While the pandemic-related disruptions to supply chains have largely resolved, the risk of other supply shocks have increased. If there were an escalation of the recent disruptions to global shipping routes, goods price inflation could be higher than forecast for a time, which could further delay the return of inflation to target.
- **Inflation could be more persistent than expected if productivity growth does not pick up.** The baseline forecasts include an assumption that labour productivity growth increases to the rate recorded in the decades preceding the pandemic. Productivity growth could prove weaker than forecast if capital deepening does not eventuate (i.e. the rate of investment is insufficient relative to employment growth) or if the structural factors that were key drivers of the productivity growth slowdown since the mid-2000s persist (e.g. declining business dynamism and slowing technology adoption). If productivity is weaker than assumed, businesses could find themselves facing continued strong growth in labour costs, putting upward pressure on prices paid by consumers.
- **Demand could be stronger than expected and inflation could be higher for longer than anticipated as a result.** Household consumption could turn out to be stronger than forecast if households are more willing to maintain a low saving rate or draw down on their savings in order to support their spending. There is also a large amount of work in the construction pipeline that could be worked through more quickly than anticipated, increasing the competition for scarce labour and materials. These scenarios would result in inflation declining by less than anticipated and employment growth being stronger than forecast in the near term. In particular, there is a risk that services inflation could remain stubbornly higher than forecast; the evidence from other countries suggests that services inflation has moderated only gradually, despite progress on other aspects of inflation.

3.4 Detailed forecast information

The forecasts incorporate several technical assumptions:

- The cash rate is assumed to move broadly in line with expectations derived from surveys of professional economists and financial market pricing. Using this methodology, the cash rate remains around its current level of 4.35 per cent until mid-2024 before declining to around 3¼ per cent by the middle of 2026. This cash rate path is a little lower than at the November *Statement*.
- The exchange rate is assumed to be unchanged at its current level, which is 1.7 per cent higher than the November forecasts on a trade-weighted basis.
- Crude oil prices are assumed to be broadly unchanged around their current levels for the rest of the forecast period, which is around 4 per cent lower than at the November *Statement*.
- The assumed level of the population has been revised slightly higher. Recent net overseas migration has been stronger than expected while migration policy changes are expected to provide some offset over the forecast period; year-ended population growth is assumed to have peaked in the September quarter at around 2½ per cent, after which it is expected to decline back to its pre-pandemic average of around 1½ per cent.

Table 3.1 provides additional detail on forecasts of key macroeconomic variables (see Box B: Greater Transparency about Our Forecasts and Assumptions). The forecast table from current and previous *Statements* can be viewed, and data from these tables downloaded, via the Statement on Monetary Policy – Forecast Archive. ✠

Table 3.1: Detailed Forecast Table[a]

Percentage change through the four quarters to quarter shown, unless otherwise specified[b]

	Dec 2023	Jun 2024	Dec 2024	Jun 2025	Dec 2025	Jun 2026
Activity						
Gross domestic product	1.5	1.3	1.8	2.1	2.3	2.4
Household consumption	0.4	0.8	1.7	2.4	2.6	2.6
Dwelling investment	–0.2	–1.6	–1.5	0.3	2.0	3.5
Business investment	7.6	1.2	1.2	1.6	1.8	2.2
Public demand	4.0	2.2	1.1	2.1	2.8	3.0
Gross national expenditure	1.4	1.5	1.9	2.4	2.7	2.7
Major trading partner (export-weighted) GDP	3.5	3.1	3.1	3.1	3.0	3.0
Trade						
Imports	6.0	2.6	3.9	4.0	3.9	4.2
Exports	5.3	2.1	3.1	2.5	2.4	2.7
Terms of trade	–4.1	–1.1	–4.2	–5.0	–3.6	–2.5
Labour market						
Employment	3.0	2.0	1.2	1.2	1.4	1.5
Unemployment rate (quarterly, %)	3.8	4.2	4.3	4.4	4.4	4.4
Hours-based underutilisation rate (quarterly, %)	5.2	5.8	6	6.2	6.2	6.2
Income						
Wage Price Index	4.1	4.1	3.7	3.6	3.4	3.2
Nominal average earnings per hour (non-farm)	5.5	7.0	4.3	3.9	3.8	3.7
Real household disposable income	–1.5	–0.8	2.5	3.9	3.5	2.7
Inflation						
Consumer Price Index	4.1	3.3	3.2	3.1	2.8	2.6
Trimmed mean inflation	4.2	3.6	3.1	3.0	2.8	2.6
Assumptions						
Cash rate (%)[c]	4.2	4.3	3.9	3.6	3.4	3.2
Trade-weighted index (index)[d]	60.9	61.6	61.6	61.6	61.6	61.6
Brent crude oil price (US$/bbl)[e]	83.2	80.4	80.4	80.4	80.4	80.4
Estimated resident population[f]	2.4	2.0	1.6	1.4	1.4	1.4
Memo items						
Labour productivity[g]	–0.5	3.0	1.4	1.1	1.2	1.1
Household savings rate (%)[h]	0.9	1.0	1.7	2.4	2.7	2.7
Real Wage Price Index[i]	0.1	0.8	0.4	0.5	0.6	0.6
Real average earnings per hour (non-farm)[i]	1.4	3.5	1.0	0.8	1.0	1.1

(a) Forecasts finalised on 31 January.

(b) Forecasts are rounded to the first decimal point. Shading indicates historical data.

(c) The cash rate is assumed to move broadly in line with expectations derived from surveys of professional economists and financial market pricing.

(d) The daily exchange rate (TWI) is assumed to be unchanged at its current level going forward.

(e) Oil prices are assumed to remain constant at the current price over the current quarter. For the rest of the forecast period oil prices are expected to remain around the price implied by the six-month-forward rate.

(f) The population assumption draws on a range of sources, including partial indicators from the Australian Bureau of Statistics, migration policies, and estimates made by the Australian Government.

(g) GDP per hour worked (non-farm).

(h) Household savings rate refers to the ratio of household saving (disposable income minus consumption) to household disposable income, net of depreciation.

(i) Real Wage Price Index and non-farm average earnings per hour worked are both deflated by Consumer Price Index.

Sources: ABS; Bloomberg; CEIC Data; Consensus Economics; LSEG; RBA.

Endnote

[1] See RBA (2023), Financial Stability Review, October.