Overview

Inflation continues to moderate but remains high.

Inflation continues to moderate and is expected to return to the target range of 2–3 per cent in 2025 and to reach the midpoint in 2026. Goods price inflation has declined but services price inflation remains high, supported by continued excess demand in the economy and strong domestic cost pressures, both for labour and non-labour inputs.

Higher interest rates are working to establish a more sustainable balance between demand in the economy and its overall capacity to supply goods and services. The staff's assessment is that the stance of monetary policy in Australia is currently restrictive, based on financial indicators and the ongoing easing in the growth of aggregate demand. Conditions in the labour market continue to ease gradually, although they remain tighter than is consistent with sustained full employment and inflation at target. A period of subdued demand growth and moderate employment growth over the coming year or two will bring about a better balance between supply and demand.

Cash rate target unchanged to support inflation returning to target.

High inflation hurts all Australians. It erodes purchasing power and the value of savings and makes it harder for businesses to plan and invest. It adversely affects all Australians, but particularly those on low incomes. Low and stable inflation, consistent with the inflation target, facilitates strong and sustainable growth in the economy over the longer term. The best contribution that monetary policy can make to the wellbeing of the Australian people is to ensure that inflation returns to target in a reasonable timeframe.

At its February 2024 meeting, the Reserve Bank Board decided to leave the cash rate target unchanged at 4.35 per cent. This decision supports progress of inflation to the midpoint of the 2–3 per cent target range within a reasonable timeframe and continued moderate growth in employment. The Board expects that it will be some time yet before inflation is sustainably in the target range, and the Board remains resolute to return inflation to target in a reasonable timeframe. The path of interest rates that will best ensure this will depend upon the data and the evolving assessment of risks, and a further increase in interest rates cannot be ruled out.

What is going on in the economy?

Global inflation remains high but there has been encouraging progress towards central banks' targets.

Much of the easing in inflation to date in advanced economies has been due to lower energy and goods price inflation. Services price inflation remains elevated, partly reflecting still tight labour markets. Economic growth has slowed to below trend in many advanced economies in response to restrictive monetary policy settings and is contributing to returning inflation to target. In the United States, economic growth has remained robust while inflation has continued to decline.

Monetary policy settings in advanced economies are restrictive, but broader measures of financial market conditions have eased over recent months. Amid better-than-expected global inflation data, market participants expect central banks to start easing their policy rates over coming quarters.

Government bond yields have fallen and spreads on riskier asset classes have declined. Many central banks expect inflation to gradually return to target on a sustained basis over the next year or two. However, they have indicated that rate cuts may not come as soon as market participants expect as they await more evidence that the moderation in inflation will be sustained. Overall, the Australian dollar has been little changed.

In Australia, growth in demand has slowed noticeably.

A large share of the increase in the cash rate since May 2022 has been passed on to borrowers. The most recent cash rate increase in November 2023 has been passed through to advertised rates, and most remaining low fixed-rate loans will roll off onto higher rates over 2024. The share of household incomes used to meet mortgage payments is high by recent historical standards and still rising. Housing credit growth has stabilised at a lower level than in 2022, although new lending has risen over the past year.

Tighter monetary policy has contributed to a noticeable slowing in the growth of demand over the past year. Household spending growth has been weak, and in per capita terms spending has declined. This has been only partly offset by strong growth in business investment, public sector spending and spending by international students and tourists.

High inflation as well as higher interest rates and tax payments have weighed on household disposable incomes. In aggregate, households have responded to these pressures by curbing their spending, particularly on discretionary items. Households are saving less and, in some cases, drawing down on their accumulated savings buffers. Timely indicators, including from the RBA's liaison program, suggest that growth in consumer spending has remained subdued this year so far.

Labour market conditions remain tight but have continued to ease over recent months.

Employment growth has gradually eased and average hours worked have declined in recent months. At the same time, the supply of labour has increased with strong population growth and record high labour force participation (although population growth also adds to aggregate demand). As a result, the unemployment rate and the underemployment rate have both increased by around ½ percentage point since mid-2023 but from very low levels.

Wages growth remains robust, although there are signs that it is slowing in some segments of the labour market. Firms expect wages growth to ease more broadly over the year ahead. Very weak productivity outcomes have contributed to a sharp increase in labour costs per unit of output over the past year.

Demand in the Australian economy has continued to exceed supply, but subdued demand growth is closing this gap.

The staff's overall assessment is that the aggregate level of demand has remained above the economy's capacity to supply goods and services, thereby putting pressure on inflation. The labour market has also remained tight relative to what would be consistent with sustained full employment and inflation at target. This assessment is discussed in more detail in Chapter 2: Economic Conditions and Chapter 4: In Depth – Full Employment.

Inflation has moderated but services price inflation remains high.

Recent data confirm that inflation in Australia continues to slow. Both headline and underlying inflation declined in the December quarter by slightly more than had been expected at the time of the November *Statement*. Goods price inflation was weaker than expected, a pattern also seen overseas.

Services price inflation, which largely reflects conditions in the domestic economy, remained high and was broadly in line with expectations.

How do we see the economy developing?

Economic growth is expected to slow both at home and abroad.

Economic growth in Australia's major trading partners is expected to slow in 2024 and remain well below its pre-pandemic average for some time. This outlook is largely unchanged from that in the November *Statement*. In China, growth is expected to slow over the next two years as the post-pandemic rebound in services consumption fades and the property sector remains weak.

In Australia, overall demand growth is expected to remain subdued in the near term as high inflation and earlier interest rate increases continue to weigh on consumption. The near-term outlook for GDP growth has been revised down modestly since November, primarily reflecting a weaker outlook for consumer spending. The decline in real incomes over the past couple of years is expected to continue to weigh on consumption, particularly in the first half of 2024. As inflation moderates and real incomes start to rise, consumption growth is expected to recover to its pre-pandemic average over the next couple of years.

Conditions in the labour market are expected to ease further in the next year or so to be broadly consistent with sustained full employment while inflation declines toward the target. Employment is expected to continue to grow moderately, but more slowly than the working-age population, and so the unemployment rate and the broader underutilisation rate are expected to increase further. Nominal wages growth is expected to remain robust in the near term, before moderating in response to easing in the labour market. The outlook for wages growth is consistent with the inflation target, on the assumption that productivity growth increases to around its long-run average.

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

Services inflation remains high and is expected to decline only gradually as demand for services moderates and growth in labour and non-labour costs eases. Goods price inflation is expected to be subdued over coming years, having already declined substantially over the past year as the resolution of earlier supply disruptions flowed through to prices paid by consumers.

These forecasts are conditioned on a path of the cash rate target based on expectations of market economists and financial market pricing. In this path, the cash rate is around its peak in the current cycle and will remain around this level until the middle of the year, before gradually declining over the remainder of the forecast period.

The outlook is still highly uncertain.

The full effect of policy tightening on household consumption is uncertain. The squeeze on household finances, including from the increases in interest rates to date, could result in household consumption remaining subdued for longer than expected. This would put more downward pressure on labour demand and wages and see an earlier return to the inflation target than forecast. This could also occur if economic growth among our trading partners is slower than forecast.

Developments in the economy could prolong the time it takes to get inflation to target. Household consumption could turn out to be stronger than forecast if households are more willing to maintain a low saving rate or even draw down on their savings to support their spending. Other things equal, poor productivity outcomes would underpin higher-than-expected costs for businesses and put upward pressure on the prices paid by consumers. Adverse shocks caused by weather-related or geopolitical events that disrupt supply could also put upward pressure on prices of energy and consumer goods and prolong the time spent away from target.

The longer it takes to return inflation to target, the greater the erosion of the purchasing power of Australian households, and the greater the risk that inflation and wage expectations drift higher than is consistent with inflation at target. History shows that, should this occur, it would require more monetary policy tightening and a costly period of higher unemployment to stabilise inflation expectations and return inflation to target.

What did the Board decide?

The Board decided to leave the cash rate target unchanged at 4.35 per cent. This decision balances the objectives of monetary policy by supporting the return of inflation to target in a reasonable timeframe with gradual easing in labour market conditions to levels consistent with full employment. The Board expects that it will be some time yet before inflation is sustainably in the target range. The path of interest rates that will best ensure that inflation returns to target in a reasonable timeframe will depend upon the data and the evolving assessment of risks, and a further increase in interest rates cannot be ruled out.

Table: Output Growth, Unemployment and Inflation Forecasts[(a)]

Per cent

	Year-ended					
	Dec 2023	June 2024	Dec 2024	June 2025	Dec 2025	June 2026
GDP growth	1.5	1.3	1.8	2.1	2.3	2.4
(previous)	(1.6)	(1.8)	(2.0)	(2.2)	(2.4)	–
Unemployment rate[(b)]	3.8	4.2	4.3	4.4	4.4	4.4
(previous)	(3.8)	(4.0)	(4.2)	(4.3)	(4.3)	–
CPI inflation	4.1	3.3	3.2	3.1	2.8	2.6
(previous)	(4.5)	(3.9)	(3.5)	(3.3)	(2.9)	–
Trimmed mean inflation	4.2	3.6	3.1	3.0	2.8	2.6
(previous)	(4.5)	(3.9)	(3.3)	(3.0)	(2.9)	–
	Year-average					
	2023	2023/24	2024	2024/25	2025	2025/26
GDP growth	2.0	1.6	1.5	1.9	2.2	2.3
(previous)	(2.0)	(1.7)	(1.8)	(2.0)	(2.2)	–

(a) Forecasts finalised 31 January. 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; the cash rate is assumed to remain around its current level of 4.35 per cent until the middle of 2024 before declining to around 3.2 per cent by the middle of 2026. Other forecast assumptions (assumptions as of November Statement in parenthesis): TWI at 62 (61); A$ at US$0.66 (US$0.64); Brent crude oil price at US$80bbl (US$84bbl). The rate of population growth is assumed to have peaked in the September quarter at 2.5 per cent. After which it is expected to decline back to its pre-pandemic average of around 1.4 per cent. Shading indicates historical data.

(b) Average rate in the quarter.

Sources: ABS; RBA.