Statement on Monetary Policy

FEBRUARY 2021

RESERVE BANK OF AUSTRALIA

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Contents

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Overview

The successful development of COVID-19 vaccines has improved the medium-term outlook for global growth. Vaccination programs are underway in a number of countries. As these are rolled out, health-related restrictions can be eased and many types of activity can return to something close to their pre-pandemic trends. In the near term, however, some momentum in the global economy has been lost, as infection rates have surged in a number of economies and lockdown measures have again become necessary. The recovery is likely to be bumpy and uneven, and dependent both on the health situation and ongoing fiscal and monetary policy support. Spare capacity will remain for some years, dampening inflationary pressures.

The domestic economic recovery has run faster than previously expected. This has been consistent with the pattern seen globally, of unexpectedly fast (but partial) recoveries after lockdown measures were lifted, as well as Australia's relatively better health outcomes. Fiscal policy has supported household and business cashflows, and the Victorian lockdown measures weighed less on economic activity than earlier assumed. Consumption has recovered faster, and dwelling and business investment have not been as weak as had been anticipated.

The Bank's forecasts have been revised to incorporate this stronger starting point. GDP is expected to have contracted by 2 per cent over 2020, a smaller decline than earlier anticipated. Growth of around 3½ per cent is expected over each of 2021 and 2022 as the recovery progresses.

In line with this recovery in activity, the labour market has also performed better than expected. Employment grew strongly over the latter part of 2020, and the unemployment rate declined to 6.6 per cent in December. Although underemployment remains high, the sharp increase during the height of the activity restrictions has mostly reversed. The participation rate has already returned to the historic highs seen just prior to the pandemic. But over 900,000 Australians remain unemployed, around 220,000 more than at the onset of the pandemic. Employment is likewise yet to recover completely – especially full-time employment – and some workers are still on reduced hours. This shortfall is particularly evident in the industries that have been most affected by health-related restrictions on activity and travel.

The outlook for the labour market has improved as a result of the better starting point and growth outlook. It now appears that the unemployment rate has already peaked. Although the end of the JobKeeper program in March creates some uncertainty for the near term, over the whole forecast period employment growth is expected to remain solid, consistent with the ongoing recovery in activity. The unemployment rate is expected to continue declining, but will still be around 6 per cent at the end of this year and 5½ per cent at the end of next year, reaching around 5¼ per cent by mid 2023.

Headline inflation has been volatile since the pandemic started. The introduction and subsequent reversal of various temporary policy support measures, such as free child care, have resulted in large price movements. Working in the opposite direction, prices of some retail items, especially household goods, were initially boosted in response to strong demand and supply disruptions. Most of these effects have now run their course. Housing-related inflation increased a little, as discounting of the prices of newly built homes eased in response to strong demand, and some temporary rent reductions expired.

Underlying inflation pressures remain subdued and are expected to be fairly muted in the period ahead. Spare capacity in the labour market remains elevated, and wages growth has eased further from already low rates. Many employers have responded to the economic challenges of the pandemic by delaying wage increases, imposing wage freezes and, in some cases, applying temporary wage cuts. Forward indicators suggest wages growth will remain soft this year.

Both underlying price inflation and wages growth are expected to remain below 2 per cent over the forecast period, out to mid 2023. Trimmed mean inflation is expected to be 1¼ per cent over 2021 and 1½ per cent over 2022. For inflation to be sustainably within the Bank's target range of 2–3 per cent, a period of labour market tightness that leads to faster wages growth is needed. However, even the latest, upgraded, forecasts for economic activity and employment still imply a degree of spare capacity and slow wages growth over coming years.

The bounce-back in the Australian economy would not have been possible without the successful public health outcomes. Even so, the speed of the recovery has also underlined the importance of timely and substantial policy support. The JobKeeper program preserved employment relationships and supported the incomes of both households and businesses. Increased social assistance payments, temporary rent relief and loan repayment deferrals have also assisted, as did the lower debt-servicing costs resulting from the monetary policy measures.

Unusually for a period of rising unemployment, both household income and business profits increased. This supported the sharp recovery in household consumption, after many types of spending were constrained by health-related restrictions in the June quarter. How spending responds to the tapering of some fiscal support measures remains a source of uncertainty for the outlook.

Policy support has also been instrumental in moderating the declines in housing and business investment. Demand for detached houses has been brought forward in response to various government incentives. Tax incentives have also encouraged business investment in machinery & equipment, though business investment has been soft for some time and is still expected to lag the broader economic recovery. The outlook for public investment has strengthened, with several states foreshadowing a considerable increase in expenditure in their recent budgets.

Experience overseas has also highlighted the role of fiscal and monetary policy support, both during upsurges in infection rates and once the health situation improves. Governments in several countries have announced additional fiscal support packages in recent months, in response to renewed virus outbreaks or to support the economic recovery. Several central banks have recently increased the size and/or extended the timeframe of their asset purchase programs. Some have also introduced or enhanced lending facilities to support the flow of credit to households and businesses.

The COVID-19 pandemic has induced considerable shifts in the pattern of demand, most notably away from services, which have been most affected by activity restrictions, towards goods. This has supported a rapid recovery in global trade and industrial production. The export sectors in China and some other Asian economies have therefore expanded strongly, particularly for producers of semiconductors and household goods. These economies have also benefited from relatively good control over the virus, so their domestic economic recoveries are also generally more advanced than elsewhere.

The strong rebound in industrial demand has supported an increase in commodity prices in recent months. Strong growth in Chinese steel production, both for industrial uses and domestic construction, has boosted iron ore prices and thus Australia's terms of trade. It has also put upward pressure on the value of the Australian dollar, which is in the upper end of the range of recent years.

As in previous *Statements*, the forecasts are presented in the form of 3 scenarios, this time representing different outcomes related to the spread of the virus and the rollout of vaccines. The degree of uncertainty on this dimension has narrowed as the Australian public health system has prevented several small outbreaks from spreading more widely. The baseline forecast assumes that no further large outbreaks of COVID-19 occur in Australia, though there could be a few small outbreaks on the scale seen over the past couple of months. Domestic activity restrictions are assumed to ease over the course of this year. Australia's international borders are assumed to remain closed until at least the end of the year.

In the downside scenario, further large outbreaks require broad activity restrictions to be reimposed, though not the extended lockdowns contemplated in previous downside scenarios. In this scenario, the unemployment rate remains just below 7 per cent for most of 2021 and declines only gradually thereafter.

The upside scenario assumes a sequence of positive health outcomes that enable a faster easing of restrictions on activity and boost confidence and thus spending. The unemployment rate would fall more quickly under this scenario, falling below 5 per cent by the end of next year. Inflation would also rise a little faster, but would still be below 2 per cent by end of the forecast period in mid 2023.

Monetary policy has helped support the economy by ensuring that financial conditions remain highly accommodative. The Bank announced another package of monetary policy measures in November. This included lower rates for the cash rate target, bond yield target, Term Funding Facility and remuneration on exchange settlement balances. It also included a program to purchase $100 billion of government bonds over a period of about 6 months.

Last year's monetary policy package is working broadly as expected and is supporting the economy. The changes have contributed to a further easing in financial conditions and helped ensure that the banking system is able to provide the credit that is needed for the recovery. Short-term interest rates have declined further to historical lows; together with the reduced interest rate on the Term Funding Facility, this has lowered bank funding costs and flowed through to even lower borrowing rates for households and businesses, and thus stronger cash flows. With 3 months' experience, the bond purchase program is working as intended, and government bond markets continue to function well. While the brighter global outlook has lifted long-dated bond yields globally, Australian long-term government bond yields are about 30 basis points lower because of the program than they otherwise would have been. The exchange rate is also lower than it otherwise would have been.

Accommodative financial conditions have supported balance sheets and lifted asset prices, including housing prices. New lending to owner-occupiers has picked up noticeably in recent months, and growth in housing credit to owner-occupiers has also increased. Growth in investor credit and business credit is weak. Firms have been raising additional funds in debt and equity markets, and some firms have benefited from higher cash flows and retained earnings.

At its February meeting, the Reserve Bank Board decided to maintain the targets of 10 basis points for the cash rate and the yield on 3-year Australian Government bonds, as well as the parameters of the Term Funding Facility. The Board remains committed to do what it can to support the economy through the recovery, by maintaining highly supportive monetary conditions until its goals are achieved, which is still some way off. In light of the outlook and the international context, the Board decided to purchase an additional $100 billion of bonds issued by the Australian Government and states and territories when the current bond purchase program is completed in mid April. These additional purchases will be at the current rate of $5 billion a week.

The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest.

1. The International Environment

Following a strong rebound in global activity in the September quarter, the economic recovery lost a little momentum late last year following a resurgence of COVID-19 infections and a significant tightening in activity restrictions in some economies. But in China and a small number of other economies where infection numbers have remained low, economic activity has rebounded strongly to pre-pandemic levels. The unprecedented fiscal and monetary policy response continues to support activity in many economies, including in Australia.

The approval of a number of effective vaccines in recent months raises the prospect of a more rapid improvement in health outcomes, but it will take some time for vaccines to be rolled out on a sufficient scale to contain the virus. While global growth forecasts for the coming year have increased a little relative to the November *Statement on Monetary Policy*, the significant disruption to the global economy from the pandemic, and consequent substantial spare productive capacity, is likely to keep inflation low for some time.

Monetary policy settings remain very accommodative globally and central banks have indicated that they will remain so for some time. Broader financial conditions continue to support economic growth. Credit risk premiums have narrowed, equity prices have rallied and investment flows to emerging markets have increased. These developments reflect positive sentiment around the ongoing rollout of vaccines, new fiscal stimulus measures, as well as expectations of ongoing monetary policy accommodation. Sovereign bond yields remain at historically low levels, although they have risen in a number of countries, reflecting expectations of further fiscal stimulus and the improvement in the outlook.

The resurgence in infections in late 2020 has slowed the global recovery, although the rollout of vaccinations is supporting the outlook

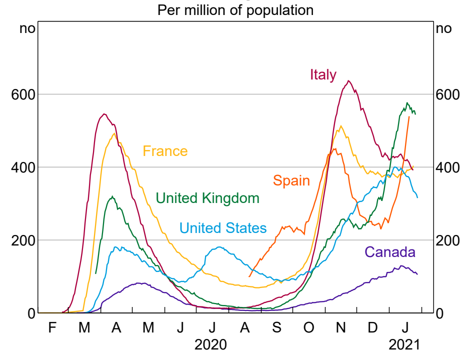
The resurgence in COVID-19 cases since late last year has affected many economies and a number have seen hospitalisations surpass their earlier peaks (Graph 1.1). Containment measures have been tightened and extended in many locations. In parts of Western Europe, lockdown measures have become almost as restrictive as they were during the initial wave of the pandemic and are likely to remain in place for much of the Northern Hemisphere winter. The rollout of vaccines should start to reduce the effects of the virus, but just how quickly this occurs will depend on the speed of production and distribution. Access to vaccines is currently very limited in most emerging market economies.

The resurgence in infections and the tightening of containment measures dampened economic activity around the turn of the year (Graph 1.2). Population mobility has remained well below pre-pandemic levels (Graph 1.3). Nevertheless, the economic impact of the resurgence of infections and associated lockdowns is expected to be smaller than during the initial outbreak. There are various reasons for this: current lockdowns are generally more targeted; businesses and households have adapted to carrying on economic activity during lockdown conditions; and personal protective equipment (PPE) is more readily available. Consumer spending will also be supported by ongoing fiscal and monetary policy measures and the prospect of the pandemic moving into a less disruptive phase as mass vaccinations roll out. To date, reported GDP outcomes for the December quarter have been stronger than expected in many economies.

Graph 1.1

COVID-19 Hospitalisations

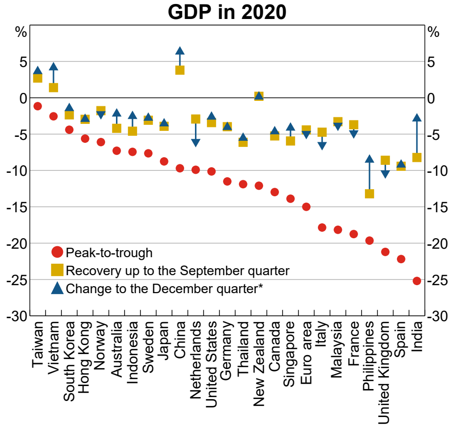
Per million of population



Source: Our World in Data

Graph 1.2

GDP in 2020



* Forecasts used where December quarter GDP has not yet been reported

Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

Global trade and production have continued to recover

The resilience in goods demand supported the recovery in global goods trade and industrial production during the second part of 2020 (Graph 1.4). This partly reflects consumers substituting towards goods as spending on consumer services has fallen. Demand for electronics has been especially strong, driven by remote working. This has boosted exports from China and other east Asian economies, as the region is a significant producer of semi-conductors and other electronics. A shortage of shipping capacity from Asia has lengthened supplier delivery times to other regions and the broader recovery in goods consumption has pushed up producer input prices globally.

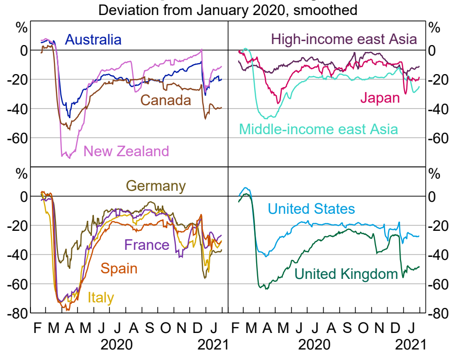
Global trade arrangements continue to evolve

Some of the political tensions of recent years that affected global trade are in a period of transition. The European Union and the United Kingdom reached a trade agreement in late December, which should limit large-scale disruptions to a key trading relationship following Brexit. Meanwhile, it is yet to be seen how the US–China trade relationship will evolve under the new US Administration following

Graph 1.3

Population Mobility

Deviation from January 2020, smoothed



Sources: Google LLC (2021), 'Google COVID-19 Community Mobility Reports', available at https://www.google.com/covid19/mobility/ viewed on 4 February 2021; RBA years of significant trade tensions. China appears unlikely to have met their purchase commitments under the 'Phase One' trade deal with the United States; as of November, China had only met a little over half of the 2020 target.

Demand for manufactured goods has supported east Asia's recovery …

The broad-based strength in east Asian goods exports has supported growth in the region (Graph 1.5). Demand from China has been resilient and exports to the major advanced economies surpassed pre-pandemic levels by November 2020. However, the recovery in domestic spending has been slowed by a resurgence in COVID-19 infections and tighter containment measures across the region. Population mobility associated with retail and entertainment activity has declined in most of these economies since late 2020 (Graph 1.6).

… while domestic activity has recovered to above pre-pandemic levels in China

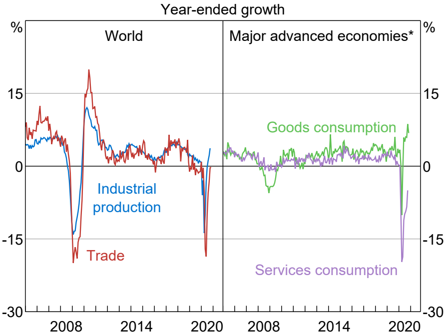
After contracting sharply in early 2020, the Chinese economy has largely recovered, growing by 6.5 per cent in 2020 in year-ended terms. Activity is now well above pre-pandemic levels in most parts of the economy. This economic resilience has stemmed from China's ability to avoid large-scale outbreaks of the virus since early 2020 and to effectively target economic policy support measures. The early stages of the recovery were driven by construction-related investment and production, partly because fiscal spending was largely directed towards infrastructure projects. Consistent with this, production of construction-related products, such as steel, rose notably over 2020 (Graph 1.7). Fixed asset investment also continued to recover in the December quarter, albeit moderating from the very high growth rates seen earlier in the year.

Consumption continued to recover in the December quarter and consumption patterns

Graph 1.4

Trade, Production and Consumption

Year-ended growth

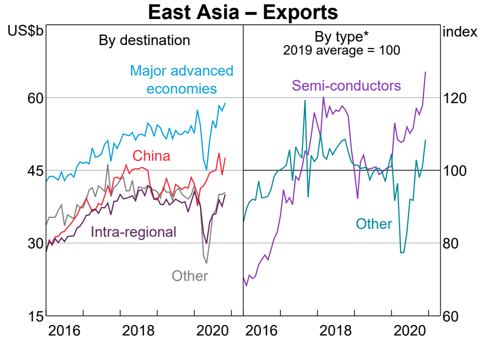


* Includes the United States, the United Kingdom and Japan

Sources: CEIC Data; RBA; Refinitiv

Graph 1.5

East Asia – Exports



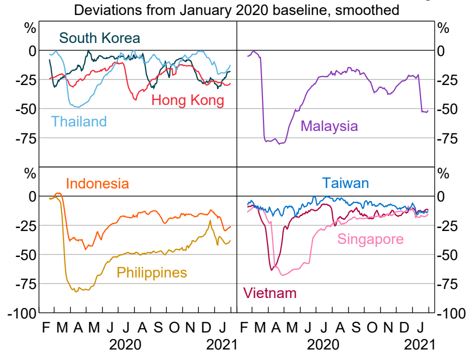
* Includes South Korea and Taiwan

Sources: CEIC Data; RBA; Refinitiv

Graph 1.6

East Asia – Retail and Recreation Mobility*

Deviations from January 2020 baseline, smoothed



* Based on GPS readings around retail & recreation locations

Sources: Google LLC (2021), 'Google COVID-19 Community Mobility Reports', available at https://www.google.com/covid19/mobility/ viewed on 4 February 2021; RBA have begun to normalise. Household consumption of essential items, such as food and rental services, remained relatively stable over 2020, while consumption of discretionary services, such as eating out and cultural & entertainment services, only reached pre-pandemic levels in the December quarter. Consumption of these services could decline again if restrictions are tightened materially in response to the small resurgence of COVID-19 cases in north-east China.

Chinese export growth picked up over 2020 and contributed significantly to overall growth (Graph 1.8). Among the drivers of this growth in exports has been strong global demand for goods and the swift rebound in industrial production in China. Earlier in 2020 demand was strongest for PPE, medical supplies and computers; more recently the growth has been more broad based. Imports also picked up in the second half of 2020, but by a smaller margin than exports.

Chinese financial conditions remain accommodative but authorities are alert to financial risks

Financial conditions in China continue to support growth and employment. The People's Bank of China (PBC) is maintaining a moderately accommodative monetary policy stance as it seeks to balance assistance for China's economic recovery with limiting the build-up of risks in the financial system.

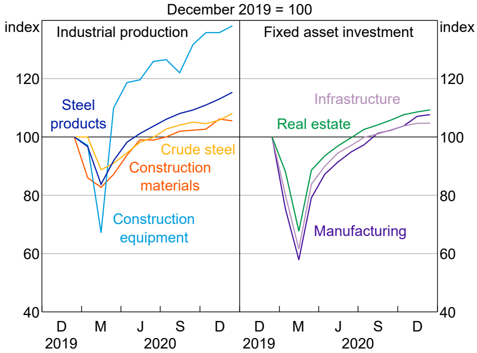
Chinese policymakers have overseen some tightening of conditions in financial markets alongside the economic recovery so far, while maintaining other stimulatory policies. In particular, bank lending rates and reserve requirement ratios (RRRs) remain low, and a raft of other measures aimed at encouraging the flow of credit to small and private businesses remain in place (Graph 1.9). These measures saw growth in total social financing (TSF) increase over 2020, consistent with the stated goal of authorities to support the recovery with notably higher credit growth (Graph 1.10). The faster pace of TSF growth over 2020 was also partly driven by strong issuance of government bonds, a high share of which was related to infrastructure activity. This was partly offset by a reduction in lending by the more opaque channels of the financial system, following actions by regulators.

Though corporate financing conditions remain accommodative in general, there was a tightening in the corporate bond market around the turn of the year. Corporate bond spreads rose and issuance became more difficult following defaults in November by several

Graph 1.7

China – Activity Indicators*

December 2019 = 100



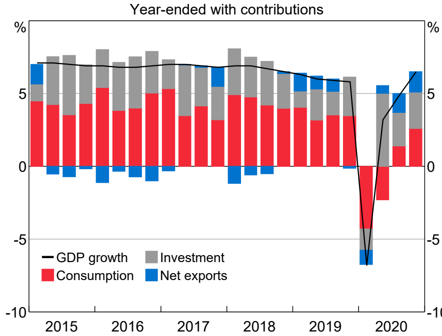
* Seasonally adjusted by the RBA

Sources: CEIC Data; RBA

Graph 1.8

China – GDP Growth

Year-ended with contributions



Sources: CEIC Data; RBA

enterprises owned by local governments, which have historically benefited from substantial government support (Graph 1.11). Authorities have warned that more defaults will occur in the future to help ensure that markets price risks appropriately.

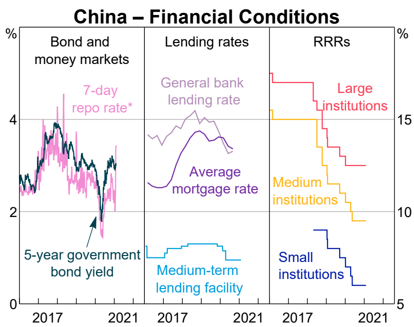
Authorities have affirmed that reducing risk in the financial system remains a key policy objective and that it will be necessary to tighten monetary conditions further at some point during the recovery. However, authorities have also emphasised that any reduction in policy accommodation will be gradual. In particular, policymakers have indicated that targeted measures supporting certain segments of the economy such as smaller firms are likely to stay in place for some time. TSF growth is expected to moderate over 2021 as authorities aim to keep overall debt levels in the economy stable relative to GDP.

The renminbi has appreciated further

The renminbi has appreciated since mid last year reflecting the recovery in Chinese economic activity and higher interest rates relative to those of advanced economies, which have encouraged bond and equity inflows. This has occurred alongside a broad-based depreciation in the US dollar, and the renminbi has appreciated by around 11 per cent against the US dollar to its highest level since 2018 (Graph 1.12).

Capital inflows have also been associated with China's inclusion in some global fixed income benchmarks last year and gradual improvements in foreign access to securities markets. Foreign holdings of renminbi-denominated assets have increased further, although foreign participation remains low by international standards (Graph 1.13). Since the beginning of the year, authorities have eased restrictions on Chinese cross-border lending and tightened restrictions for cross-border borrowing, while quotas for portfolio investment abroad have been increased. These adjustments

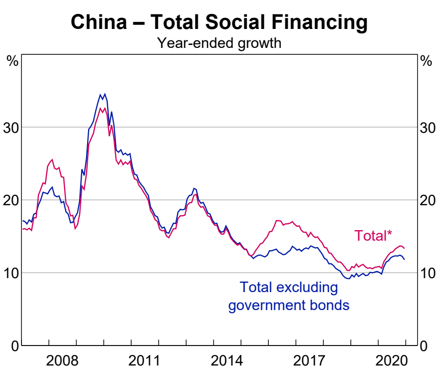
Graph 1.9



* 14-day average

Sources: Bloomberg; CEIC data; RBA

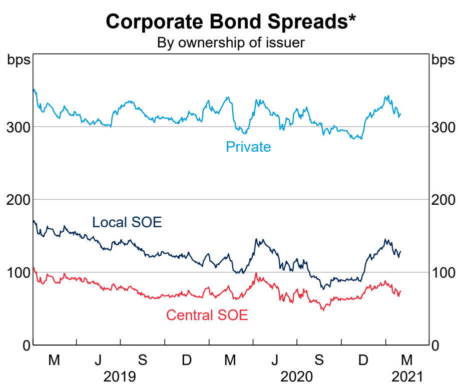
Graph 1.10



* Measure targeted by authorities; government bond issuance includes refinancing of debts previously included elsewhere in TSF; RBA estimates prior to 2016

Sources: CEIC Data; RBA

Graph 1.11



* Average spread across all maturities longer than 6 months

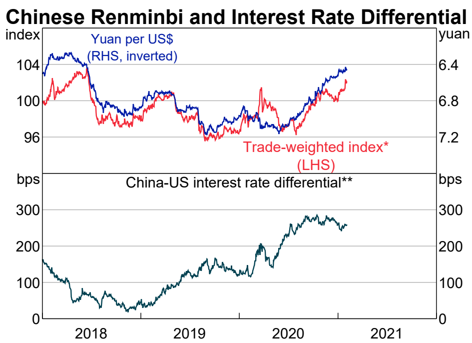
Sources: RBA; Wind Information

have been consistent with the stated goals of promoting a two-way opening of the capital account and having a more flexible, market-determined exchange rate.

India's economic recovery has gained momentum

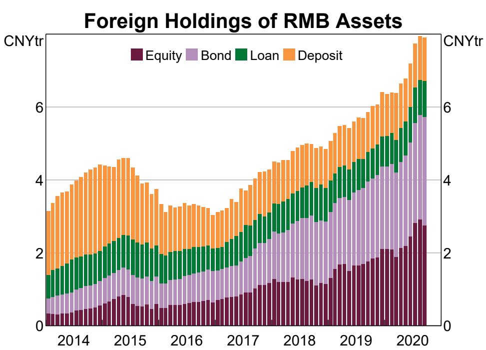
In India, the pace of economic recovery has strengthened alongside a decline in COVID-19 cases and a further relaxation of restrictions. Following severe disruptions during India's initial lockdown, industrial production has continued to recover and steel production is now around pre-pandemic levels. Steel demand is supporting an increase in demand for Australian coking coal exports to India (Graph 1.14; see 'Domestic Economic Conditions' chapter).

Graph 1.12



* Indexed to 1 January 2018=100
** 5-year government bond yields
Sources: Bloomberg; Chinese Foreign Exchange Trade System

Graph 1.13



Source: CEIC

Nonetheless, overall economic activity is still below pre-pandemic levels, particularly in parts of the services sector.

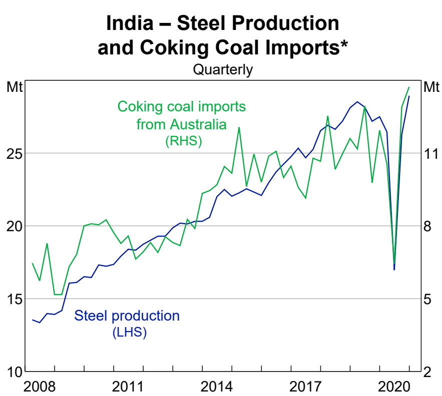
To date, concerns around fiscal space and high inflation have limited the amount of fiscal and monetary support provided by the Indian authorities. However, the recent Indian budget suggests fiscal expenditure will increase this year and further declines in headline inflation, as currently forecast, could provide scope for further monetary policy easing if required.

The recovery in industrial demand has led to a sharp increase in commodity prices

The ongoing recovery in industrial production in China and parts of Asia is supporting the price of commodities, including some key exports for Australia. Iron ore, coal and oil-related commodity prices have all increased sharply over the past 3 months, and most other commodity prices are also higher. That said, momentum in some commodity prices has moderated more recently.

The benchmark iron ore price has increased by around 30 per cent since the previous *Statement* (Table 1.1). Although the price has eased a little since late January, it remains around its highest level since 2013 (Graph 1.15). This has reflected

Graph 1.14



* Seasonally adjusted by the RBA
Sources: ABS; CEIC Data; RBA

Table 1.1: Commodity Price Changes[(a)]

Per cent

	Since previous *Statement*	Over the past year
Bulk commodities	36	58
– Iron ore	31	83
– Coking coal	45	1
– Thermal coal	58	35
Rural	9	10
Base metals	6	18
Gold	–7	12
Brent crude oil[(b)]	46	7
RBA ICP	16	20
– Using spot prices for bulk commodities	23	27

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices

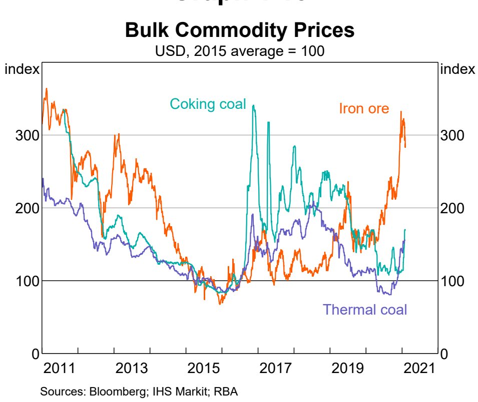
(b) In US dollars

Sources: Bloomberg; IHS Markit; RBA

ongoing strength in Chinese steel production and supply issues, including a weaker outlook for Brazilian production and, to a lesser extent, scheduled maintenance and weather-related disruptions in Australian supply. The surge in prices in December prompted China's Dalian Commodity Exchange to tighten limits on trading, reportedly to address speculative activity in the iron ore futures market.

The Newcastle thermal coal spot price has increased sharply since late 2020 because of

Graph 1.15



stronger demand outside China and previous disruptions to Australian supply arising from weather-related damage to port infrastructure. Coking coal prices have also increased sharply in recent weeks but remain at a significant discount relative to domestic Chinese prices, partly reflecting uncertainty surrounding Chinese demand for Australian coal. Higher demand for coking coal elsewhere, particularly from India, has provided support to prices.

The price of Brent crude oil has increased by around 45 per cent since the previous *Statement* and is now back around levels observed prior to the onset of the pandemic (Graph 1.16). The price received by Australian Liquefied Natural Gas (LNG) exporters is linked to oil prices with a lag and will therefore increase over the next couple of quarters. The Asian LNG spot price spiked to a record level in mid January following strong Northern Hemisphere winter demand and concerns of a global supply shortfall. The price has since decreased, amid an easing in peak demand and greater availability of spot cargoes.

There is significant spare capacity in advanced economies, keeping inflation low

Economic activity at the end of 2020 remained below pre-pandemic levels across advanced economies. Significant spare capacity remains in labour markets in advanced economies despite the rebound in global activity in the September quarter. The extent of this shortfall has varied across economies, depending on health outcomes and the stringency of restrictions, the size of the services sector (which has faced significant headwinds throughout the pandemic) and the scale of fiscal and monetary support.

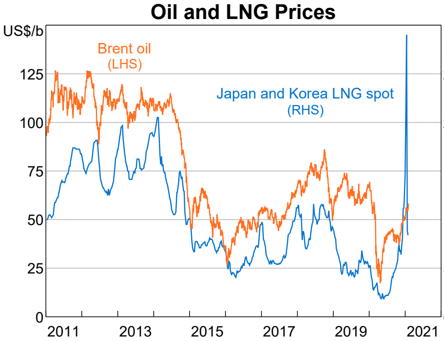
Wage subsidy programs have operated in many advanced economies throughout the pandemic, with the United States a key exception. These subsidies have supported the retention of workers and kept many businesses afloat. In line with the intent of these programs, the labour market adjustment in these economies has occurred largely through a reduction in average hours worked rather than a fall in employment (Graph 1.17). This has resulted in a smaller increase in unemployment rates than otherwise. The number of workers supported by wage subsidies had significantly fallen by mid last year, but reliance on these programs has increased again in some economies that have tightened containment measures.

Spare capacity in labour markets, evident in broad measures of underutilisation, will weigh on wages growth and underlying inflation for some time. While inflation in the prices of goods has picked up in most advanced economies since June, reflecting both supply disruptions and increased demand, this has been offset by disinflation in services prices; services inflation has been volatile due to policy changes to support spending in the sector, including temporary consumption tax reductions. In the case of headline inflation, the increase in oil prices since November will provide a boost, but the effects will be offset in part by the significant easing in food inflation as production disruptions have subsided.

Inflation remains low. It is expected to pick up towards central bank targets, but only very gradually as the global recovery gains traction and spare capacity in labour markets is eventually absorbed. Market-based and economists' inflation expectations have increased (Graph 1.18). Prospects of significantly more expansionary US fiscal policy in recent months and very accommodative monetary policy have also supported the increase in market-based inflation expectations.

Graph 1.16

Oil and LNG Prices

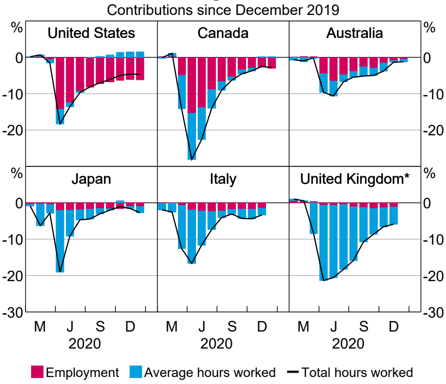


Sources: Bloomberg; RBA; Refinitiv

Graph 1.17

Cumulative Change in Hours Worked

Contributions since December 2019



* United Kingdom data are derived from the weekly Labour Force Survey

Sources: CEIC Data; Office for National Statistics; RBA; Refinitiv

Fiscal policy support has been extended

Fiscal policy has provided critical support to household and business incomes throughout the pandemic, particularly in advanced economies. This support is likely to be required for some time as a result of the latest upswing in COVID-19 infections, the recent period of intensive lockdowns and the significant amount of spare capacity remaining in many economies.

European governments have increased fiscal support measures, mainly through extended wage subsidies and business transfers. The US authorities approved a further large expansion of fiscal policy (4 per cent of GDP) in late 2020, which extended unemployment benefits, reintroduced forgivable loans to businesses that maintain employment levels and provided another round of direct transfers to households (Graph 1.19). The prospects of a further fiscal expansion have increased significantly after the Democrats secured a majority in both chambers of the United States Congress. Many advanced economies have announced substantial funding for their mass vaccination programs. And some economies, including Japan, the European Union and Canada, have announced very sizeable fiscal policy measures for the recovery phase that emphasise 'green' and digital investment.

Central banks in advanced economies continue to provide significant monetary policy support

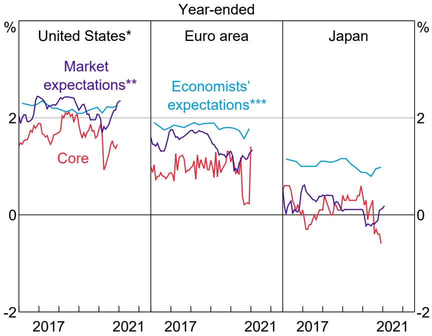
Monetary policy settings in advanced economies remain highly accommodative and are expected to remain so for some time given significant spare capacity and subdued outlooks for inflation. Indeed, in recent months, several central banks have extended the timeframe for which existing monetary stimulus will be in place. The European Central Bank (ECB), Bank of England (BoE), Bank of Japan (BoJ) and Swedish Riksbank recently expanded the size of their asset purchase programs and extended their horizon until the end of 2021 or later (Table 1.2). The Chair of the US Federal Reserve (Fed) indicated that, consistent with the Fed's updated forward guidance, any tapering of Fed asset purchases was unlikely in the near term, and would be gradual and signalled well ahead of time.

A number of central banks have also made changes to their lending facilities, or launched new facilities, to encourage the flow of credit to the real economy (Graph 1.20). The ECB extended by a year the period during which banks will receive a discounted interest rate on borrowings under its term funding scheme and

Graph 1.18

Inflation and Inflation Expectations

Year-ended



* Personal consumption expenditure inflation

** Implied from 5-year, 5-year forward inflation swaps

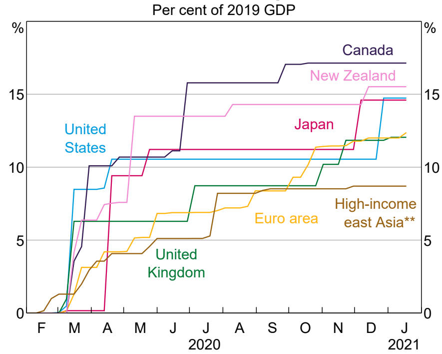
*** Consensus; average of 4- and 5-years ahead

Sources: Bloomberg; Consensus Economics; RBA; Refinitiv

Graph 1.19

Direct Fiscal Response*

Per cent of 2019 GDP



* Includes state government stimulus for Canada and Germany; excludes loan guarantees and unallocated funds; based on published estimates

** GDP-weighted average of Hong Kong, Singapore, South Korea and Taiwan

Sources: IMF; national sources; RBA; Refinitiv; Reuters

Table 1.2: Central Bank Government Bond Purchase Programs[a]

Programs announced since 3 March 2020

	End date	Purchase target	Purchases to date	
			Nominal	Per cent of GDP
Fed	Open-ended	Unlimited	US$2.3tn	11
ECB	March 2022	€1850bn[b]	€982.7bn	8
BoJ	Open-ended	Unlimited (yield curve control)	¥44.3tn	8
BoE	End 2021	£440bn	£313.8bn	15
BoC	Open-ended	Unlimited	C$294.2bn	13
RBNZ	June 2022	NZ$100bn	NZ$45.8bn	13
Riksbank	End 2021	SEK700bn[b]	SEK123.3bn	3
RBA	Open-ended	Unlimited (3-year yield target)	A$72.3bn	4
	April 2021	A$100bn	A$55bn	3
	September 2021	A$100bn	A$0bn	0

(a) Includes state and local government debt. Includes purchases to alleviate market dysfunction and purchases made as part of pre-announced bond purchase programs; RBA purchases to alleviate market dysfunction are included in 3-year yield target purchases

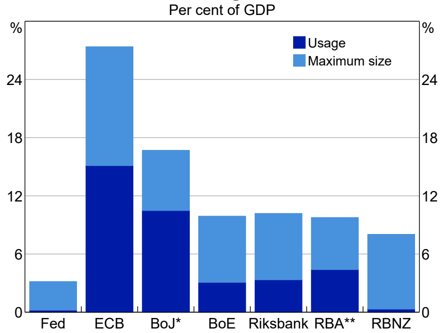
(b) Includes private sector asset purchases

increased the borrowing limit. The BoE extended the duration of its term funding scheme by 6 months to October 2021, while the BoJ extended the duration of its lending facilities and removed the upper limit on loans provided to each bank for some facilities. Also, the Reserve Bank of New Zealand (RBNZ) introduced a Funding for Lending Programme (FLP). The FLP will provide funding for 3-year terms at a floating interest rate equal to the prevailing policy rate, with the borrowing limit tied to a bank's volume of lending to the non-financial private sector.

While broad-based stimulus is expected to continue for some time, central banks have continued to scale back measures aimed at alleviating dysfunction or supporting the flow of credit in particular markets as conditions in these markets have improved. A number of Fed emergency lending facilities were closed in December (Graph 1.21). The ECB reduced its holdings of commercial paper and has lowered the pace of private sector asset purchases. The Bank of Canada (BoC) discontinued its purchases of provincial money market securities, and reduced its primary market purchases of Treasury Bills.

Central banks continue to signal that policy rates will remain at very low levels until there is sustained progress towards employment and inflation goals. In the United States, most members of the Federal Open Market Committee (FOMC) expect the policy rate to remain unchanged until at least 2023, consistent with forward guidance that the policy rate will

Graph 1.20



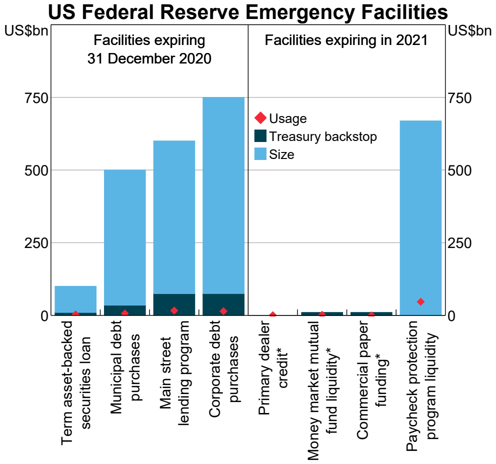
* Total usage and size of two lending facilities introduced in 2020
** Total size includes current initial and additional allowances
Sources: Central banks; RBA; Refinitiv

not be increased until the labour market has reached maximum employment and inflation has risen to 2 per cent and is on track to moderately exceed 2 per cent for some time. In Europe and Japan, rates are expected to remain at current or lower levels for the foreseeable future. In the United Kingdom market pricing suggests that the BoE will lower the policy rate by 10 basis points to zero per cent by end 2021 (Graph 1.22). In New Zealand, market participants expect the policy rate to remain unchanged in 2021.

Some central banks will undertake or announce the results of reviews of monetary policy frameworks and tools in the coming year. An independent review of the BoE's approach to quantitative easing (QE) found that the programs had been delivered effectively, but recommended more work to improve technical understanding and build public understanding and trust in QE as a monetary policy tool. Meanwhile, the BoJ is reviewing the sustainability of its policy measures given that it has accumulated a large share of equity exchange traded funds and government bonds on issue. The ECB expects to conclude its monetary policy strategy review in the second half of the year.

Graph 1.21

US Federal Reserve Emergency Facilities



* No upper limit

Sources: Refinitiv; US Federal Reserve

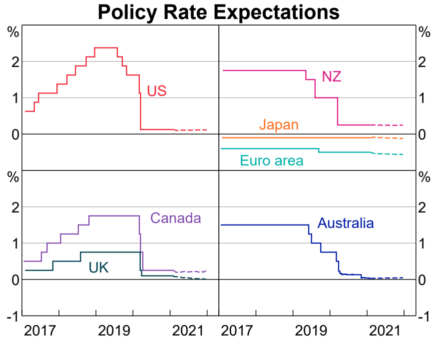
Government bond yields have increased, but remain low

Long-term government bond yields have increased in most advanced economies since the end of November (Graph 1.23). This is partly because the economic outlook has improved, related to the rollout of COVID-19 vaccines, although this has been tempered by rising COVID-19 cases and new containment measures in some economies. Expectations of new fiscal stimulus measures, particularly in the United States, have also contributed to higher government bond yields.

The recent rise in government bond yields has mostly been reflected in an increase in inflation

Graph 1.22

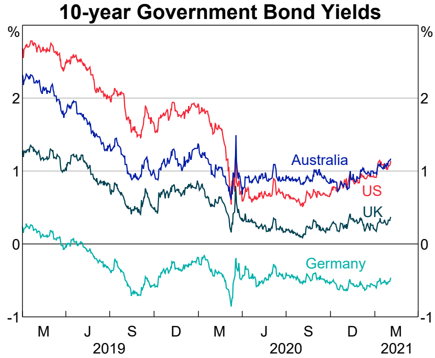
Policy Rate Expectations



Sources: Bloomberg; RBA

Graph 1.23

10-year Government Bond Yields



Source: Bloomberg

compensation, whereas real yields have declined or remained stable at low levels (Graph 1.24). This is consistent with expectations that policy rates will not be raised until there is a substantial and sustained increase in inflation, in line with strong forward guidance from central banks, most notably the Fed.

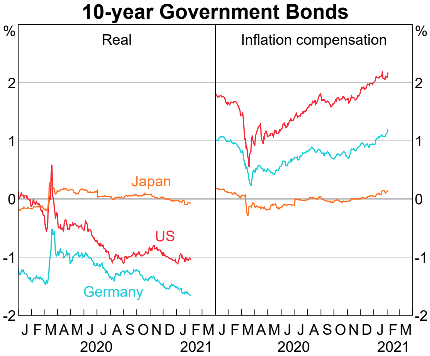
Sovereign debt issuance is expected to remain elevated to fund ongoing fiscal deficits. Most major central banks have purchased (in secondary markets) the equivalent of more than half of net government debt issuance since the start of the pandemic, which has contributed to keeping bond yields low and stable (Graph 1.25; Graph 1.26). In most cases, central banks have indicated that they expect to continue purchasing at around the same pace until at least the end of 2021, which is likely to comprise a significant share of new issuance this year.

Corporate funding conditions in advanced economies are highly accommodative

Corporate funding conditions have been supported by expectations that widespread vaccination will allow economic activity to normalise in the second half of 2021, alongside ongoing fiscal and monetary support. Conditions have improved further despite the recent resurgence in infections and

Graph 1.24

10-year Government Bonds



Sources: Bloomberg; RBA

containment measures in a number of major economies.

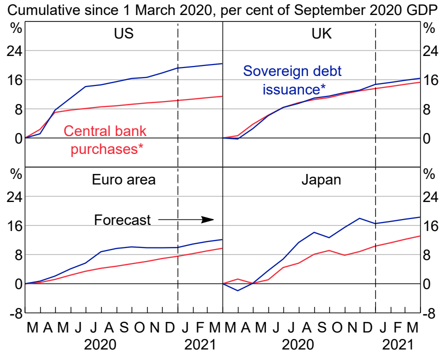
Corporate bond yields and credit spreads have declined further in recent months (Graph 1.27). Borrowing costs are currently around record lows in the United States and Europe, and issuance conditions remain favourable for both investment grade and sub-investment grade borrowers.

Equity prices have increased significantly over recent months. Bank share prices have outperformed other sectors, especially in the

Graph 1.25

Sovereign Debt Issuance and Central Bank Purchases

Cumulative since 1 March 2020, per cent of September 2020 GDP



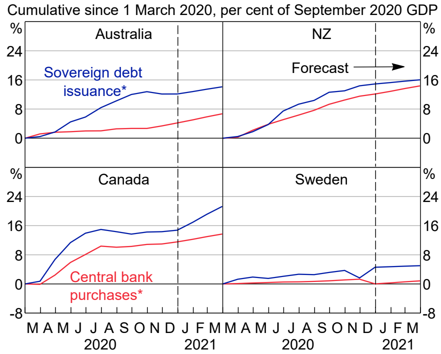
* Net of maturities

Sources: BoE; BoJ; ECB; Fed; National Debt Management Entities; Refinitiv; UBS

Graph 1.26

Sovereign Debt Issuance and Central Bank Purchases

Cumulative since 1 March 2020, per cent of September 2020 GDP



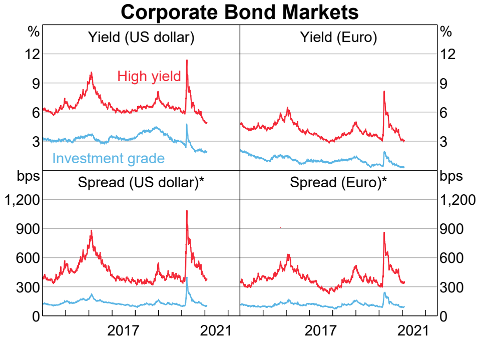
* Net of maturities

Sources: BoC; National Debt Management Entities; RBA; RBNZ; Refinitiv; Riksbank

United States, amid a substantial recovery in profits for the December quarter (Graph 1.28). The improved economic outlook is expected to support bank profits via lower loan losses (and loss provisioning), a steeper yield curve and potentially greater lending activity. Bank share prices have also benefited from an easing in restrictions on share buybacks in a number of countries. In the United States, shares in a number of small companies experienced sizeable swings in prices in early 2021 alongside heightened retail investor activity. As a result of this volatility, brokers faced significantly higher margin requirements to clear equity trades in certain companies; in response, some online brokers restricted purchases of these shares to reduce their own exposures.

Graph 1.27

Corporate Bond Markets



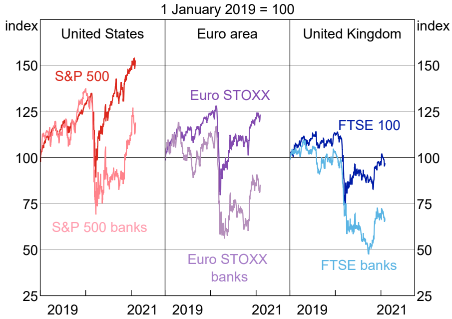
* Spread to equivalent maturity government bond yield

Source: ICE Data is used with permission

Graph 1.28

Equity Prices

1 January 2019 = 100



Source: Bloomberg

Conditions in short-term US dollar funding markets remain accommodative. The cost of borrowing US dollars in foreign exchange swap markets increased towards the end of 2020, although year-end funding pressures were less acute than in some previous years. These funding pressures can emerge because regulatory factors discourage large banks in the United States and Europe from intermediating activity over the year-end period. In contrast, unsecured borrowing rates in US onshore markets remained low and stable over this period (Graph 1.29).

The US dollar has depreciated significantly

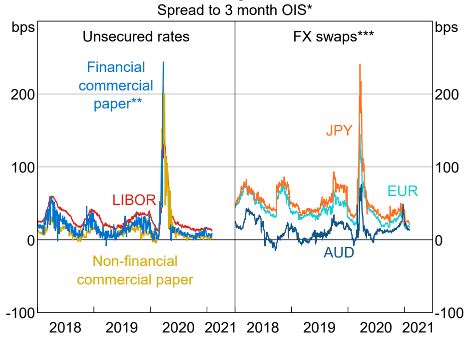
The US dollar has depreciated further on a trade-weighted (TWI) basis since early November and is around 11 per cent lower than its peak in March 2020 (Graph 1.30). Since early November, the depreciation of the US dollar has been consistent with expectations of a stronger recovery in global growth and a general improvement in risk sentiment.

The euro has been little changed over recent months, while the UK pound appreciated in the lead-up to the post-Brexit trade deal that was reached in December; even so the UK pound

Graph 1.29

US Dollar Money Market Rates

Spread to 3 month OIS*



* Overnight indexed swaps

** Data unavailable from 27 March to 6 May and 4 June to 12 June due to insufficient trading volumes

*** 3 month LIBOR minus 3 month FX swap basis

Sources: Bloomberg; RBA; Refinitiv

remains well below its level prior to the Brexit referendum in 2016. The currencies of most other advanced economies, including Australia, have also appreciated over recent months (see 'Domestic Financial Conditions' chapter for recent developments in the Australian dollar).

Financial conditions in emerging markets have improved

Financial conditions in emerging market economies (EMEs) have improved in recent months. Policy rates for most EMEs have been little changed at low levels and a number of EME central banks have indicated that the scope for further policy easing is limited. Yields on bonds denominated in local currency remain around record lows for most EMEs, despite recent increases in Latin America. Equity prices have risen further, there have been large investment inflows and currencies have generally appreciated against the US dollar. Spreads on government and corporate bonds denominated in US dollars have continued to narrow but remain above their pre-pandemic levels.

Financial conditions in emerging Asia have generally been more favourable than in other regions over the past year (Graph 1.31). That is because the region has benefited from the recovery in global trade and production as well as having entered the crisis with stronger fundamentals than other regions, including stronger economic growth and more fiscal space.

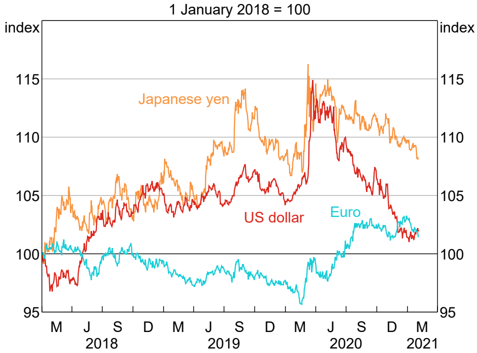
Some EMEs remain vulnerable to changing conditions related to the health and economic crisis. While there has been a general improvement in financial conditions since the onset of the pandemic, they remain tighter for more vulnerable EMEs, most notably South Africa and Turkey. Developments over the past year in these 2 countries have exacerbated pre-existing vulnerabilities such as weak economic growth, large fiscal deficits and reliance on external financing.

The International Monetary Fund (IMF) has continued to expand its provision of financial assistance. In general, IMF lending is beginning to transition from emergency support to longer-term, reform-based programs. In recognition of the particular challenges faced by low-income countries, G20 members agreed upon a common framework to guide the restructuring of official sector debt in those countries facing debt distress.

Graph 1.30

Trade-weighted Exchange Rates

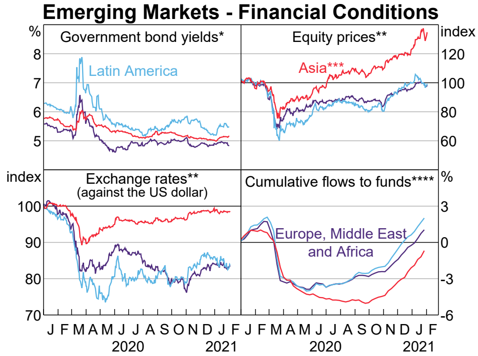
1 January 2018 = 100



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System

Graph 1.31

Emerging Markets - Financial Conditions



* Local currency bonds, weighted by market value
** 1 Jan 2020 = 100
*** Excluding China
**** Per cent of assets under management; includes flows to bond and equity funds

Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Ongoing policy support and mass vaccinations should enable a durable economic recovery

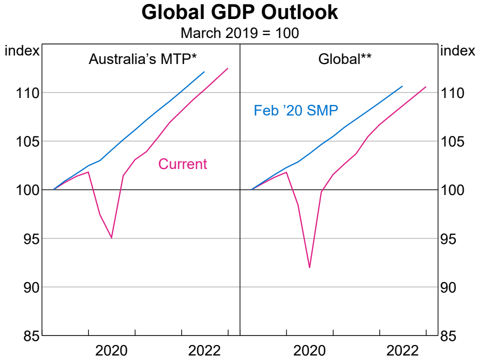
A successful rollout of mass vaccinations globally should allow a durable unwinding of social distancing measures and an increase in economic activity over the course of 2021. Even still, the level of global economic activity is expected to remain below its pre-pandemic trajectory which will keep inflationary pressures low and mean that fiscal and monetary policy support will be required for some time.

Australia's major trading partners' GDP is expected to grow by 7 per cent in 2021 and by 4½ per cent in 2022 in year-average terms (Graph 1.32). The outlook is a little stronger than at the time of the November *Statement*. Part of this upgrade stems from a better starting point: activity was generally stronger than expected in the September quarter and recent virus outbreaks do not appear to have fully offset this. Further out, improved prospects for the mass rollout of vaccines have also contributed to a stronger outlook.

However, the outlook remains highly uncertain due to near-term pandemic developments, the effectiveness of the rollout of vaccinations and uncertainty around the path and traction of future policy support:

Graph 1.32

Global GDP Outlook



* Australia's major trading partner GDP; weighted by Australia's export shares

** Weighted by purchasing power parity GDP

Sources: ABS; CEIC Data; Consensus Economics; IMF; RBA; Refinitiv

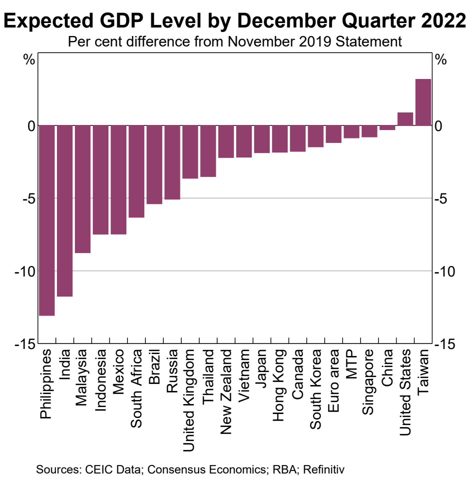
- Some economies may have to tighten containment measures further or keep them in place for longer, which raises near-term downside risks. Challenges posed by virus mutations are increasing, as more contagious variants of the virus are spreading globally and the high level of infections increases the possibility that further new mutations may emerge.
- Further out, the outlook assumes that vulnerability to the virus in advanced economies will have fallen significantly by the second half of 2021 owing to the rollout of vaccinations. Achieving this time frame will require significant mobilisation of resources.
- Fiscal policy could be significantly more expansionary than expected, especially in the United States, which should boost growth but may also put upward pressure on bond yields and tighten financial conditions. Conversely, a premature winding-down of policy support could precipitate a downturn before the recovery was complete.

The economic recovery is likely to be faster than typical but still incomplete

Overall, global economic activity is expected to recover faster than in a typical recession because much of the weakness has been the result of mandated constraints rather than weak demand. Also, in many advanced economies the scarring effects on the labour market are likely to have been more limited than usual because of proactive fiscal and monetary policy responses. Support for private incomes, constrained consumption opportunities and precautionary motives have led to a considerable build-up in savings, which could significantly boost consumption when the pandemic recedes.

Despite the more positive outlook, the sheer scale of the economic contraction in the first half of 2020 will mean that global activity and labour markets will take considerable time to recover. The global recovery will also remain uneven. In a small number of economies, including China and the United States, the level of GDP is expected to have recovered to around its pre-pandemic trajectory by the end of 2022. But for many others, the pandemic is expected to have a longer lasting effect on activity. This is particularly the case for some emerging market economies that have had less policy flexibility in responding to the crisis and/or that face significant challenges in administering large scale vaccine programs (Graph 1.33). ✠

Graph 1.33



2. Domestic Economic Conditions

The recovery in the Australian economy is well underway. The lifting of restrictions in Victoria has contributed to a further improvement across a range of indicators of economic activity. Employment has recovered faster than previously expected and has supported growth in household spending. Extraordinary policy measures have continued to support household and business cash flow and balance sheet positions.

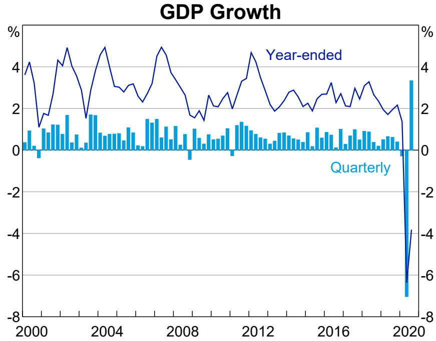
Nevertheless, conditions in parts of the private economy remain weak. Firms' reported investment intentions across most industries are sharply lower than before the pandemic. While some businesses have been able to adapt their activities, those in a number of industries such as the arts, hospitality and tourism continue to be significantly affected by the disruptions induced by the pandemic. The recovery in New South Wales and Victoria has been more restrained than elsewhere, due to mobility restrictions and the larger effect on these states of international border closures. Full-time employment is still well below pre-pandemic levels and the unemployment rate remains much higher than a year ago. As set out in the 'Economic Outlook' chapter, the recovery will depend on health outcomes and the ability of households and businesses to adjust through a period where some temporary support measures are unwound.

Economic activity rebounded over the second half of 2020 at a faster pace than expected

The Australian economy rebounded by 3 per cent in the September quarter, following a 7 per cent contraction in the June quarter (Graph 2.1). The main contributor to growth in the September quarter was household consumption, which increased by 8 per cent, supported by growth in household income, the lifting of restrictions and a reduction in precautionary behaviour. Public investment and dwelling investment increased but business investment declined in the quarter. Indicators of economic activity have, for the most part, picked up since September, and GDP growth is expected to have been solid in the December quarter, underpinned by the continued recovery in household consumption.

Graph 2.1

GDP Growth



Source: ABS

Employment has recovered to near pre-pandemic levels

Employment increased by 280,000 people in the December quarter to be a little below its February 2020 level. Much of the increase in recent months has been in Victoria, where employment rebounded as restrictions in that state eased, while employment in other states has continued to recover at a more moderate pace (Graph 2.2). Nationally, total hours worked remain a little below their pre-pandemic level, both because the number of people in employment is yet to fully recover and some workers are yet to see their weekly hours return to previous levels (Graph 2.3). The large increase in the number of employed people working zero hours for economic reasons in the initial phase of the pandemic has mostly unwound as activity has picked up. Improved economic conditions have also supported a recovery in average hours worked, to be near pre-pandemic levels.

The number of people employed part time has returned to its pre-pandemic level, but full-time employment has only partially recovered; there were around 125,000 fewer full-time workers in December 2020 compared with February (Graph 2.4). The recovery in part-time work has been fairly widespread across industries, with the level of part-time employment in most industries back to, or above, pre-pandemic levels; the accommodation & food services industry is a notable exception (Graph 2.5). The fall and subsequent recovery in part-time employment was unusually large compared to the experience of previous labour market slowdowns, reflecting the larger share of part-time workers in industries most affected by activity restrictions. Employment is yet to fully recover in industries that were most affected by restrictions on activity, whether directly (such as many household services industries) or indirectly as suppliers. For example, although manufacturing was less directly constrained by activity restrictions, employment in this industry in November was well below its level in February; around two-thirds of these employment losses were in food product manufacturing, where around 40 per cent of industry output is supplied to domestic hospitality services or is exported.

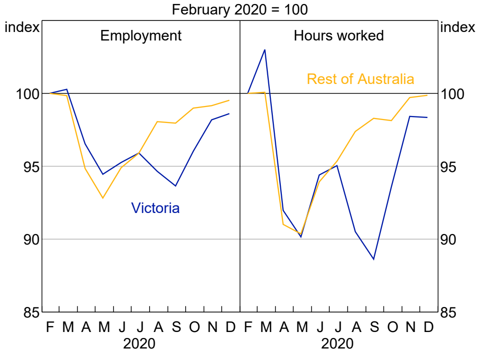
Unemployment has declined but remains high

The unemployment rate was 6.6 per cent in December, down from its peak of 7.5 per cent in July 2020 (Graph 2.6). The decline in the unemployment rate has been faster than expected at the time of the previous *Statement on Monetary Policy*, reflecting a stronger-than-

Graph 2.2

Employment and Hours Worked

February 2020 = 100

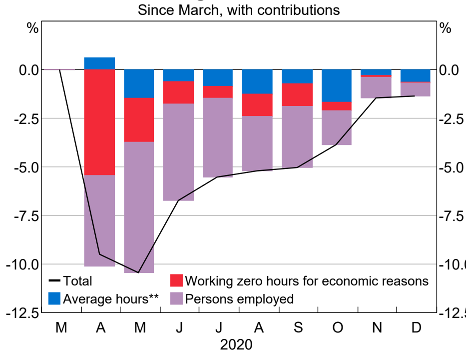


Sources: ABS; RBA

Graph 2.3

Cumulative Change in Total Hours Worked*

Since March, with contributions



* Total hours worked each week; seasonally adjusted

** Excluding people working zero hours for economic reasons

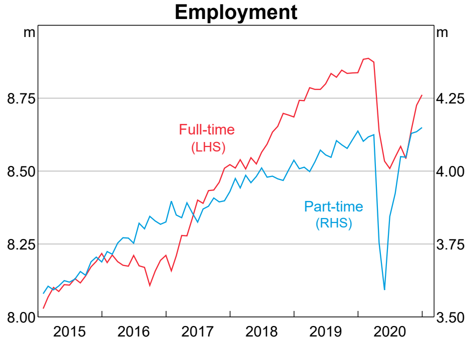
Sources: ABS; RBA

anticipated recovery in activity and employment in the December quarter. Growth in employment was greater than the increase in labour market participation, which has been boosted by the return of individuals who had temporarily exited the labour force in the first phase of the pandemic. The participation rate in December reached a historic high of 66.2 per cent; it was near or above pre-pandemic levels in all states.

Despite improving labour market conditions, there were still over 900,000 people unemployed in December, around 220,000 more than in February 2020. Broader indicators of spare capacity in the labour market have reversed much of the increases recorded in mid 2020, but remain elevated. The heads-based underemployment rate – which measures the share of full-time workers working reduced hours for economic reasons and part-time workers willing and available to work more hours – was 8.5 per cent in December, around its pre-pandemic level. The rate of labour market underutilisation – which adds together unemployed and underemployed people – was around 15 per cent in December, still well above pre-pandemic levels.

Graph 2.4

Employment

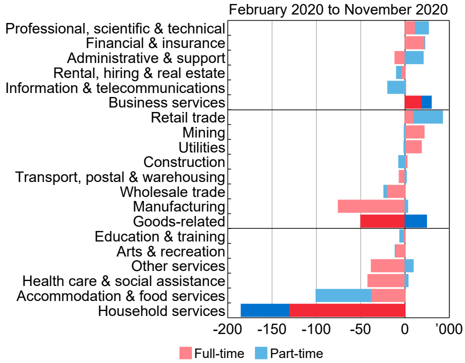


Source: ABS

Graph 2.5

Cumulative Change in Employment by Industry*

February 2020 to November 2020



* Darker colours indicate cumulative change in employment by sector

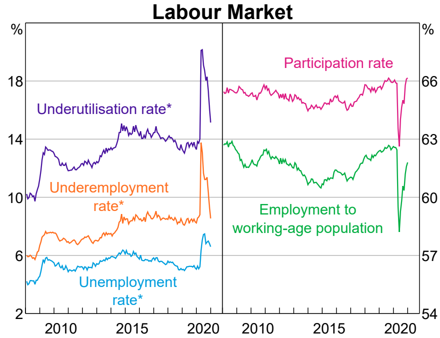
Sources: ABS; RBA

Leading indicators of labour market demand continue to recover

Forward-looking indicators of employment such as job advertisements and vacancies have continued to improve in recent months. Job advertisements remain below peaks seen in recent years, while vacancies are now above pre-pandemic levels (Graph 2.7). Survey indicators of employment intentions have picked up strongly since mid 2020. Information from business liaison also suggests improved employment expectations, although the outlook is mixed across industries. Some firms in restriction-affected industries, such as tourism and education, still expect to reduce employment over the year ahead. In the construction sector, near-term employment intentions in apartment and non-residential construction are also subdued, but employment in detached home

Graph 2.6

Labour Market



* Heads-based measure

Sources: ABS; RBA

construction has been strong, especially in Western Australia. The outlook for employment in infrastructure-related businesses is picking up as projects get underway.

Liaison information suggests that firms that are no longer eligible for JobKeeper payments are generally finding demand has recovered sufficiently to maintain or increase staffing levels. Firms that expect to remain eligible for JobKeeper have typically experienced a fall in revenue due to the restrictions in Victoria in the second half of 2020, or are in industries that are more affected by domestic and international travel restrictions.

Containment measures introduced over late December had a limited effect on activity

Several states experienced community outbreaks of COVID-19 over recent months stemming from returned overseas travellers. A rapid and targeted response by state authorities brought these outbreaks under control without affecting activity materially. A mix of short localised lockdowns, mandated use of masks, reductions in gathering sizes, intensive contract tracing by health authorities and restrictions on movement across state and territory borders were implemented. While indicators of mobility declined, particularly in Sydney, part of this was probably seasonal and movement of people remained higher nationally relative to the earlier outbreaks in 2020. Surveyed measures of consumer and business confidence also held broadly steady and remain around long-run averages (Graph 2.8).

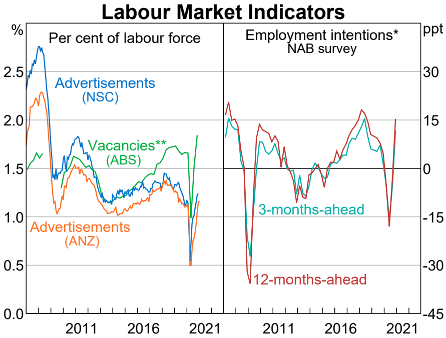
Household spending increased

Household consumption recovered strongly over the second half of 2020, but remained below its pre-pandemic level. Timely indicators suggest household spending increased in the December quarter, supported by favourable health outcomes, an improvement in labour market conditions, a return of consumer sentiment to around pre-pandemic levels and policy measures that have boosted household cash flow. The categories of spending that were most constrained by activity restrictions earlier in the year rebounded quickly as social distancing restrictions were eased, such as cafes & restaurants and clothing & footwear (Graph 2.9). Sales of household goods remain elevated, having benefited from the substitution from services where consumption possibilities are still constrained.

Information from liaison suggests that the recent domestic COVID-19 outbreaks had only a

Graph 2.7

Labour Market Indicators



* Net balance for the following period; deviation from average; 12-months-ahead measure seasonally adjusted by the RBA

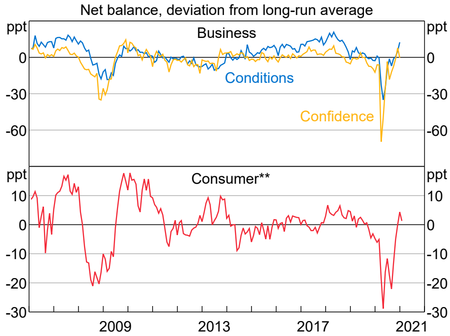
** Survey was suspended between May 2008 and November 2009

Sources: ABS; ANZ; NAB; National Skills Commission (NSC); RBA

Graph 2.8

Business and Consumer Sentiment*

Net balance, deviation from long-run average



* Latest observations are December 2020 for business confidence and conditions and January 2021 for consumer confidence

** Average of Westpac–Melbourne Institute and ANZ–Roy Morgan surveys

Sources: ANZ–Roy Morgan; NAB; RBA; Westpac–Melbourne Institute modest effect on overall household spending. Consumption patterns are likely to have shifted a bit in those states that recently imposed tighter mobility restrictions. For example, spending on discretionary services and travel declined a little, while sales of household goods and food increased, consistent with households spending more time at home.

Temporary policies have boosted household cash flow but support is moderating

Nominal household disposable income increased by 3½ per cent in the September quarter, to be 8 per cent higher in year-ended terms; this is the strongest growth in nearly a decade (Graph 2.10). The JobKeeper program continued to support household cash flow, as did the recovery in economic activity and the labour market. Social assistance payments remained elevated. Towards the end of the year, tighter eligibility requirements for several policies took effect and the early superannuation withdrawal scheme concluded. Partly offsetting this, tax cuts brought forward in the Australian Government Budget took effect from October and pensioners and some other households have begun to receive two further Economic Support Payments, each valued at $250.

The household saving rate rose sharply early on in the pandemic because income increased and consumption declined. The household sector is estimated to have accumulated buffers of around $200 billion over the June and September quarters, or around 15 per cent of pre-pandemic annual income. The saving rate edged a bit lower but remained very high at close to 20 per cent in the September quarter (Graph 2.11). The pattern of consumption over recent quarters suggests restrictions on activity and strong health incentives to avoid some types of consumption have been primary drivers of the increase in household saving. Income uncertainty has also contributed to some extent, especially for those households whose income was most affected by the pandemic.

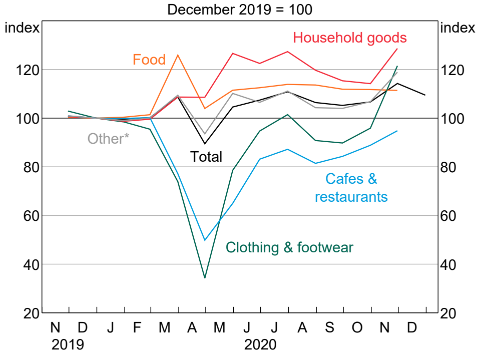
Conditions in the established housing market have strengthened …

Housing prices nationally increased by 3 per cent over the past year (Table 2.1). This was despite Sydney and Melbourne recording price declines following the onset of the pandemic. In recent months, housing prices have increased in all capital cities, although prices remain below their previous peaks in several cities (Graph 2.12).

Graph 2.9

Retail Sales Values

December 2019 = 100



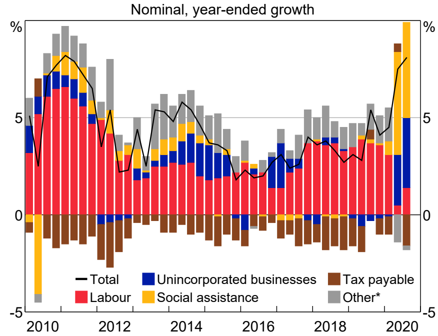
* Includes department stores and other retailing

Sources: ABS; RBA

Graph 2.10

Household Disposable Income

Nominal, year-ended growth



* Includes financial income, interest payable and other smaller components

Sources: ABS; RBA

Table 2.1: Growth in Housing Prices

Percentage change, seasonally adjusted

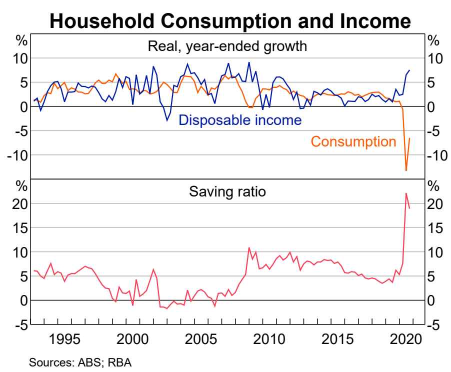
	January	December	November	October	Year-ended	Past five years
Sydney	0.3	0.6	0.4	0.0	2.0	11
Melbourne	0.4	0.6	0.3	–0.6	–2.1	15
Brisbane	0.8	0.9	0.3	0.3	4.0	9
Adelaide	0.8	0.8	0.9	0.9	6.5	14
Perth	1.3	1.0	0.9	0.6	3.4	–13
Darwin	2.0	2.1	1.8	0.9	11.4	–17
Canberra	1.2	0.8	1.1	0.9	8.5	28
Hobart	1.1	0.7	1.0	0.6	6.8	48
Capital cities	0.5	0.8	0.5	0.0	1.7	10
Regional	1.3	1.4	1.2	0.8	7.9	17
Australia	0.8	0.9	0.6	0.1	3.0	11

Sources: CoreLogic, RBA

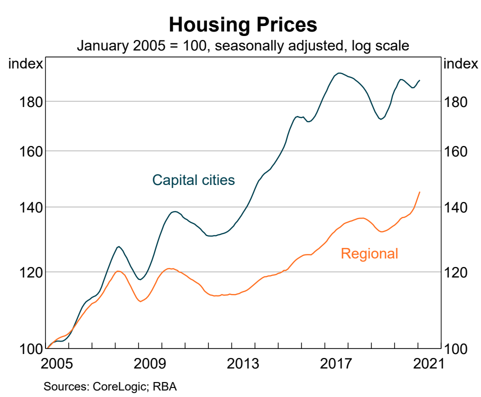
Housing price increases in regional Australia outpaced growth in the capital cities over the second half of 2020. Prices for houses have also increased by more than prices for units in recent months. Non-price indicators, including housing turnover, increased further towards the end of the year. Auction clearance rates increased in December in Sydney and Melbourne and auction volumes also increased. Lending data indicated that owner-occupiers accounted for a large proportion of recent housing purchases, supported by very low interest rates and policies to support first home buyers (see 'Domestic Financial Conditions' chapter).

Rental market conditions for owners of apartments in Sydney and Melbourne are weak, but conditions for houses have generally strengthened across most cities and regional areas. Advertised rents for units in Sydney and Melbourne have continued to decline over the past 6 months, while rents for houses in both cities increased a little (Graph 2.13). In December the rental vacancy rate declined noticeably in Sydney and edged down in Melbourne, though

Graph 2.11



Graph 2.12



they remained elevated in both cities (Graph 2.14). By contrast, vacancy rates in Perth declined to near-record lows and rents increased strongly, partly reflecting the limited supply of new rental stock. Some rental markets outside the capital cities remained tight. Advertised rents grew more strongly in regional New South Wales, Queensland and Victoria than in the capital cities of these states, in part driven by strong demand from households relocating from the capital cities.

… and detached housing construction activity has increased

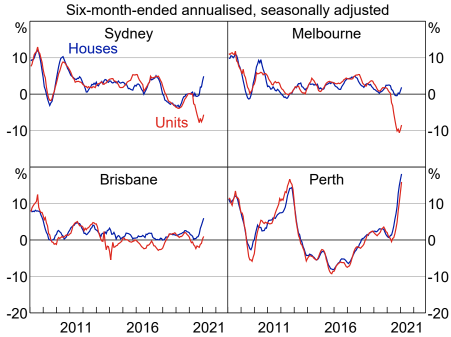
Building approvals for detached dwellings increased strongly over the second half of 2020 to be around their highest level on record (Graph 2.15). Approvals for alterations & additions also increased sharply in New South Wales and Queensland. Strong demand from owner-occupiers, particularly first home buyers, has been encouraged by policy support, including low interest rates and the Australian Government's HomeBuilder scheme. Sales of new homes increased sharply in December as buyers sought to secure the full $25,000 HomeBuilder Grant by signing contracts before the end of the month. Greenfield land sales remained elevated in the December quarter, driven by a surge in sales in Melbourne, while sales in other capital cities eased a little. Almost all detached home builders in the Bank's liaison program report that their construction pipelines are 'full' well into 2021, with activity expected to peak in the middle of 2021; extensions to deadlines for construction commencement for government grants has helped to extend the order book for builders.

Approvals for higher-density dwellings have remained very low nationally. Developers in the liaison program report that sales of off-the-plan apartments remain weak, citing buyer preferences for established or recently completed properties, rental income uncertainty weighing on investor demand and an absence of foreign buyers. Some developers reported that they had delayed commencements of planned projects, and they expect demand for

Graph 2.13

Advertised Rents Growth

Six-month-ended annualised, seasonally adjusted

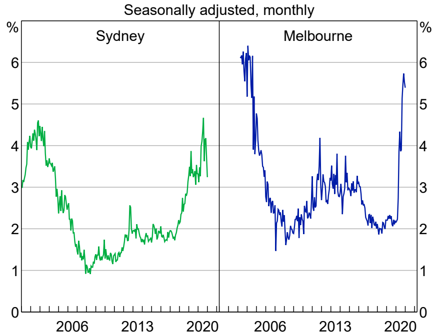


Sources: CoreLogic; RBA

Graph 2.14

Rental Vacancy Rates

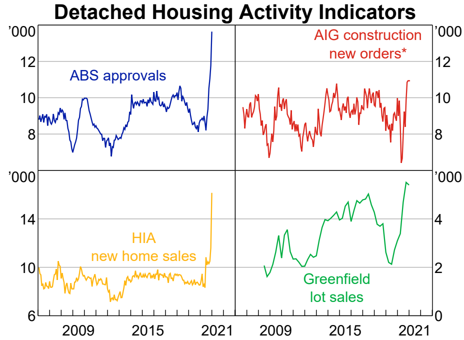
Seasonally adjusted, monthly



Sources: RBA; REINSW; REIV

Graph 2.15

Detached Housing Activity Indicators



* Rescaled to have the same mean and variance as ABS approvals

Sources: ABS; AIG; HIA; RBA; Research4

higher-density apartments to remain low for the foreseeable future. This is consistent with the sharp reduction in net overseas migration, contributing to the slowest rate of population growth in a century, and a shift in buyer preferences towards detached housing.

State budgets imply a strong increase in public investment

Health and other pandemic management spending over recent quarters contributed to a 6 per cent increase in public demand over the year to the September quarter. Public investment was unchanged over the year, although most states released budgets since the previous *Statement* that foreshadow a large increase in investment spending over the next few years. Projects flagged by state government budgets included large and small infrastructure projects and the construction of social housing.

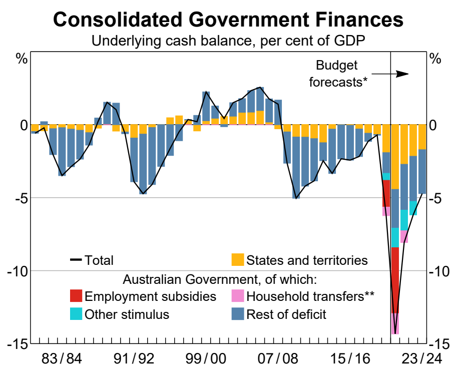
The consolidated deficit of the Australian and state governments is expected to peak at just under 15 per cent of GDP in 2020/21 (Graph 2.16). Improved economic conditions over the second half of 2020 contributed to a revision to the expected Australian Government Budget deficit, from around 11 to 10 per cent of GDP, in the mid-year budget update. Projections from the Australian and state treasuries suggest that the consolidated deficit will decline sharply after 2020/21, reflecting the expiry of income support measures such as JobKeeper and improved economic conditions.

Business investment has declined further

Private non-mining business investment declined by a further 4 per cent in the September quarter, to be 13 per cent lower over the year (Graph 2.17). Heightened restrictions in Victoria constrained non-residential construction activity in the quarter, but by less than anticipated. Machinery & equipment investment fell further, to be its lowest level since 2006. The decline in machinery & equipment investment was significant but smaller than had been expected, leading to a more moderate fall in non-mining investment overall.

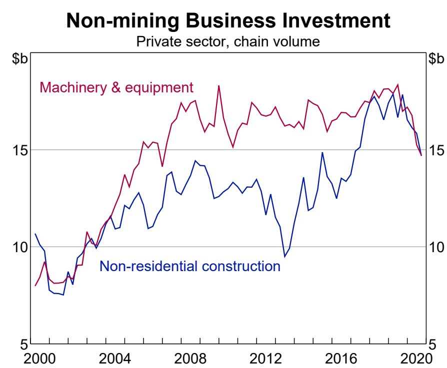
Firms' expectations for investment increased off a very low base in the most recent ABS Capital Expenditure (Capex) survey (Graph 2.18). In particular, non-mining firms anticipate a more moderate decline in machinery & equipment investment this financial year than had previously been expected. The Capex survey, conducted in October and November, was the first since the announcement of expanded tax incentives for investment by the Australian Government. The increase in business profits over recent quarters will also help to support the

Graph 2.16



* Forecasts from latest budgets or budget updates
** Includes household income tax changes from 2020/21 budget
Sources: ABS; Australian Treasury; RBA; state and territory budgets

Graph 2.17



Sources: ABS; RBA

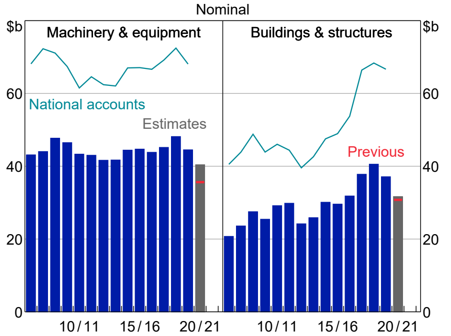
outlook for investment as activity continues to recover. Expectations for non-residential construction by non-mining firms remain weak, consistent with the low level of building approvals in the second half of 2020.

Mining investment declined by 5 per cent in the September quarter, but was moderately higher over the year. Information from liaison and company reports continue to suggest that investment will be supported by work on iron ore and coal projects this financial year. However, spending will likely be more modest than was previously anticipated, with the Capex survey indicating that some firms have scaled back their investment intentions (Graph 2.19).

Graph 2.18

Non-mining Capital Expenditure*

Nominal



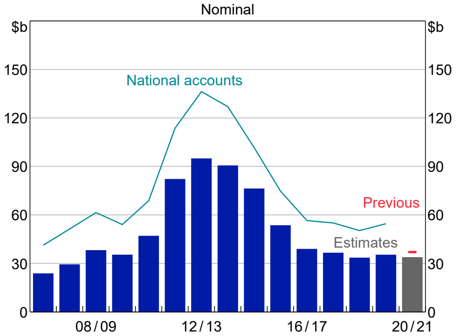
* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending

Sources: ABS; RBA

Graph 2.19

Mining Capital Expenditure*

Nominal



* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending

Sources: ABS; RBA

Trade in goods has picked up in recent months

The trade surplus narrowed significantly in the September quarter (Graph 2.20). Import volumes increased strongly, driven by imports of capital and consumer goods, consistent with the ongoing recovery in domestic spending. At the same time export volumes declined by around 3 per cent in the quarter, led by lower resource exports. Trade in services remained constrained by ongoing restrictions on international travel.

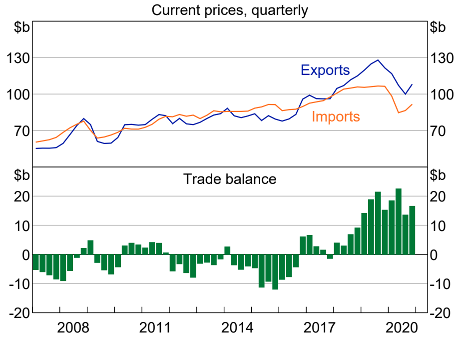
The trade surplus widened a little in the December quarter. Partial data suggest that trade in goods picked up over the period. Increased exports of machinery & equipment have supported growth in manufactured exports as global demand has improved. Rural exports have also increased, led by cereals after the drought broke in parts of Australia last year. The outlook for the rural sector remains favourable, with record crop production forecast by the Australian Bureau of Agricultural and Resource Economics (ABARES) as a result of good growing conditions associated with the La Niña event underway (Graph 2.21).

Resource export volumes also appear to have increased in the December quarter, although coal exports remained at low levels (Graph 2.22). Domestic coal production had been cut back in response to lower prices since the onset of the

Graph 2.20

Trade in Goods and Services*

Current prices, quarterly



* Based on monthly data; seasonally adjusted by the RBA

Sources: ABS; RBA

pandemic. Prices have since recovered because a cold Northern Hemisphere winter has increased demand for thermal coal, and Indian steel production has recovered to pre-pandemic levels. But coal exports to China have fallen in recent months and could remain weak for some time because of ongoing uncertainty surrounding Chinese coal import policies and the bilateral trading relationship; any increase in coal exports will likely involve diverting these exports elsewhere.

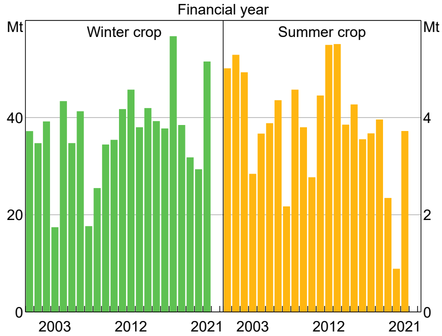
Partial trade data suggest that iron ore export volumes were little changed in the December quarter, as exports from Western Australia were affected by maintenance and weather-related port disruptions. Iron ore exports are expected to remain close to capacity as producers respond to high iron ore prices, which have been underpinned by strong Chinese steel production and constrained global supply. LNG exports look to have risen owing to increased energy demand from the cold Northern Hemisphere winter.

Goods imports have continued to increase in recent months in line with the recovery in domestic spending. Imports of consumption goods are well above their pre-pandemic level. Imports of passenger motor vehicles have driven the rebound, having increased in each of the last 6 months. Despite the strength in consumer goods imports, many retailers in the business liaison program report that inventories remain lower than ideal. Capital goods imports have also increased over recent months, especially imports of industrial transport equipment. ✠

Graph 2.21

Australian Crop Production*

Financial year



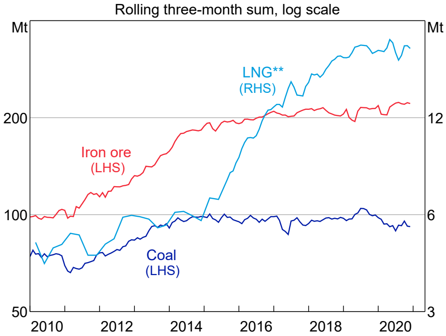
* Includes ABARES forecast for 2020/21

Source: ABARES

Graph 2.22

Resource Exports*

Rolling three-month sum, log scale



* Seasonally adjusted by the RBA

** Quarterly prior to September 2015

Sources: ABS; Department of Industry, Science, Energy and Resources; RBA

3. Domestic Financial Conditions

The Reserve Bank's policy measures announced in 2020 – including the reduction in the cash rate, the target for the yield on the 3-year Australian Government bond, the $100 billion bond purchase program, and the Term Funding Facility (TFF) – have lowered funding costs across the private and public sectors and are supporting balance sheets and asset prices. Interest rates on housing and business loans are at historic lows and the Reserve Bank's measures have also supported the availability of credit to households and businesses. On average, lending rates have declined broadly in line with banks' funding costs, although the extent of reductions in interest rates has varied across different types of housing and business loans. Demand for housing finance picked up in the second half of 2020, but demand for new business loans remains subdued. In February the Reserve Bank announced that it would purchase an additional $100 billion of bonds when the current bond purchase program is completed in mid April.

By lowering the structure of interest rates across the economy, the Reserve Bank's policy measures have contributed to a lower exchange rate than otherwise. Nevertheless, against the backdrop of a general improvement in expectations for a recovery in global growth, which has seen commodity prices rise markedly, the Australian dollar has appreciated since November. Australian equity prices have increased over recent months, but are slightly below the levels seen a year ago.

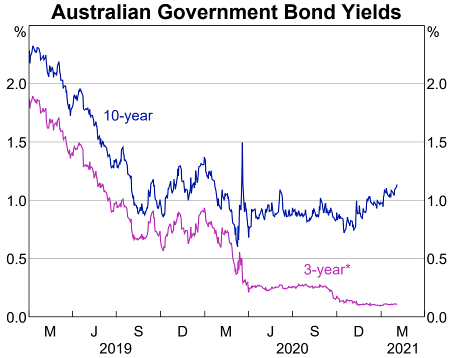
The 3-year government bond yield has remained at the target, and the bond purchase program has put downward pressure on long-end yields

The yield on the 3-year Australian Government Security (AGS) declined following the package of further policy measures announced in early November, and has remained consistent with the new target of around 10 basis points, supported by $9 billion of Bank purchases of the April 2023 and April 2024 bonds in the secondary market in November and early December (Graph 3.1).

Since the commencement of the $100 billion bond purchase program in early November, the Bank has purchased $55 billion of longer-term bonds under this program. Of these, as planned, 80 per cent has been allocated to AGS and 20 per cent to bonds issued by the state and territory borrowing authorities (known as semi-government securities, or semis). The effect of

Graph 3.1

Australian Government Bond Yields



* 3-year yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond thereafter

Sources: RBA; Yieldbroker

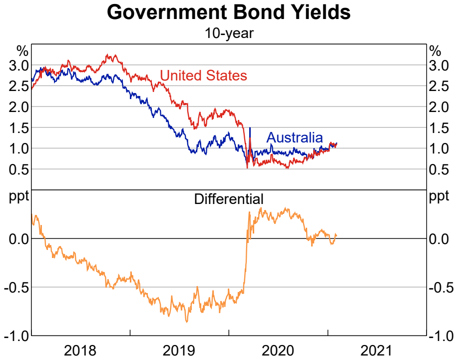
the program can be estimated by examining the cumulative response of bond yields to key news about the program. This suggests that the program has contributed to a decline of roughly 30 basis points in 10-year AGS yields and a narrowing of around 5–10 basis points in semis spreads to AGS. Also, the spread between the 10-year AGS yield and the equivalent US Treasury yield has narrowed by around 30 basis points when compared with the months before the market was anticipating a bond purchase program by the Bank (Graph 3.2). However, other factors also influence AGS yields, including economic developments domestically and offshore. As a result, the level of the 10-year AGS yield has risen over recent months, alongside a similar rise in US Treasury yields and global yields more broadly. This rise in global long-end yields has been driven in part by progress in the development and deployment of COVID-19 vaccines, and prospects for further US fiscal stimulus following the US election results. The $100 billion extension to the bond purchase program, announced on 2 February, was to a large extent anticipated by market participants and so it led to a very modest reduction in longer-term yields and spreads when announced.

Government bond markets are functioning well

AGS and semis markets have continued to function smoothly over recent months, with bid-offer spreads remaining around their average levels of recent years. These are well below the elevated levels seen during the period of market dislocation in March and April last year, which the Bank helped to alleviate with purchases of bonds and provision of liquidity through open market operations (OMO). Spreads between the yields on semis and AGS remain near historical lows (Graph 3.3). In November, the ASX launched a new 5-year AGS futures contract, which should support the liquidity of bonds of that maturity.

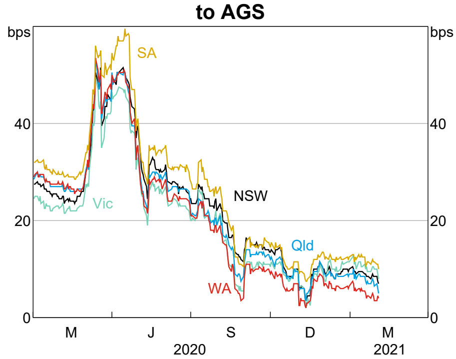
Funding conditions remained favourable for the Australian and the state and territory governments. Government bond yields remain near historical lows and markets have absorbed large volumes of issuance. The Australian Office of Financial Management (AOFM) has issued $160 billion of Treasury Bonds and $69 billion of Treasury Notes since the start of July 2020 (Graph 3.4). This pace of issuance is well above that of recent years, although issuance slowed over the fourth quarter of 2020 with the AOFM well ahead of schedule based on its expected funding requirements. Accordingly, following

Graph 3.2



Sources: Bloomberg; RBA; Yieldbroker

Graph 3.3



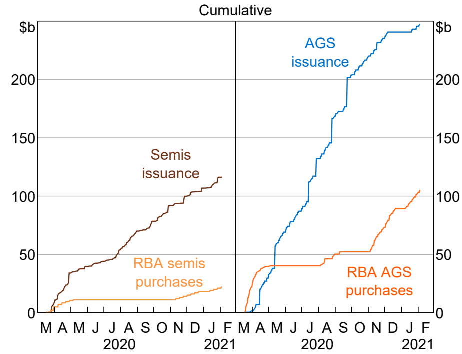
Sources: RBA; Yieldbroker

the update of the 2020/21 federal budget in mid December, the AOFM announced weekly bond issuance will remain around $2–3 billion per week, which is well below the $4–5 billion per week seen earlier in the financial year. Demand at AOFM tenders has been consistently strong, including for the $6 billion syndicated tap in November 2020 of the existing 2041 bond line. While the projected increase in government debt for 2020/21 and the associated stock of debt outstanding are the largest as a share of GDP in a number of decades, they are not unprecedented (Graph 3.5). Moreover, the stock of debt as a share of GDP remains low compared with other advanced countries.

Graph 3.4

Government Issuance and RBA Purchases

Cumulative

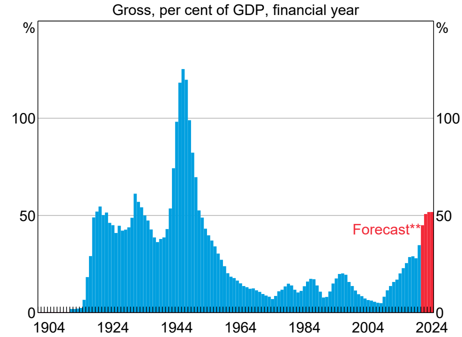


Sources: Bloomberg; RBA; Yieldbroker

Graph 3.5

Australian Government Debt*

Gross, per cent of GDP, financial year



* Historical series contain structural breaks and adjustments

** 2020/21 Budget

Sources: ABS; Australian Treasury; Barnard (1986); Butlin (1985)

The TFF continues to provide low-cost term funding to the banking sector

The TFF is providing low-cost term funding to authorised deposit-taking institutions (ADIs) and an incentive for ADIs to increase lending to businesses, particularly small- and medium-sized enterprises (SMEs).[1] In November 2020, the interest rate on new TFF drawings was reduced from 0.25 per cent to 0.1 per cent, in line with the reduction in other policy rates.

The total funding allowance available under the TFF is around $185 billion as of February 2021, which is about 7 per cent of outstanding credit. This includes: drawings under the initial allowance; funding available under the additional allowance (linked to ADIs' new lending to businesses); and the supplementary allowance (added to the facility effective from October 2020).

In aggregate, ADIs have drawn around $86 billion in TFF funding to date. TFF drawdowns slowed after the window to access the initial allowance closed on 30 September, and drawdowns of the remaining (supplementary and additional) allowances have remained modest (Graph 3.6). This reflects the fact that ADIs remain well funded and the deadline for accessing these allowances is not until 30 June 2021. Many ADIs have indicated in liaison that they plan to take up most or all of their supplementary allowances, although some ADIs have indicated that they have access to sufficient private funding for their needs and will not draw all of their remaining allowances. The TFF is continuing to help keep funding costs and lending rates at historic lows.

Liquidity in the banking system and the size of the Bank's balance sheet have increased further

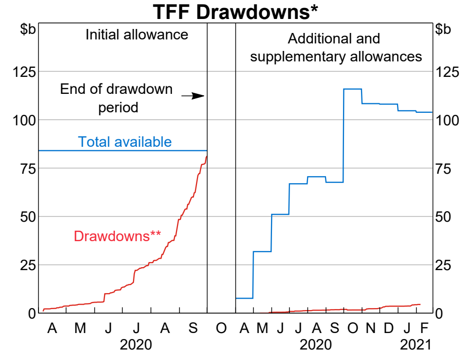
Liquidity in the banking system – as measured by exchange settlement (ES) balances held at the Reserve Bank – has increased further in recent months (Graph 3.7). Since November, this has mainly reflected the effect of the Bank's purchases of government bonds (Graph 3.8). Government flows have also recently added to system liquidity because net government spending (which increases system liquidity) has exceeded net government issuance (which reduces system liquidity), following a period in which the reverse was true.[2]

Since the onset of the pandemic, ES balances have risen by around $130 billion, reflecting the Reserve Bank's government bond purchases as well as lending under the TFF. These large liquidity injections have reduced the demand by banks for funding in the Bank's OMO; as a result, the amount of liquidity provided via OMO has declined to its lowest level since 2013. Since the start of the pandemic, government flows have tended to reduce system liquidity, as net issuance of Australian Government bonds has exceeded net spending by the Australian Government over this period.

These developments are reflected in the Reserve Bank's balance sheet, which has almost doubled in size since the start of the pandemic and currently stands at around $335 billion. Growth in the Bank's assets has been driven by an increase in holdings of long-dated government bonds – as a result of the Bank's bond purchases – and an increase in securities held as collateral under the TFF (Graph 3.9). This has been partly offset by a decline in securities provided as collateral in OMO. On the liabilities side, ES balances have risen significantly (as discussed above). Deposits held by the Australian Government at the Reserve Bank have also grown substantially since the pandemic began, again because funds raised via government bond issuance have, to date, exceeded net spending by the Australian Government (Graph 3.10).

Graph 3.6

TFF Drawdowns*



* Until 30 September 2020, repos were applied against initial allowance until fully drawn, then against additional allowance. From 1 October 2020, repos applied against additional and supplementary allowances

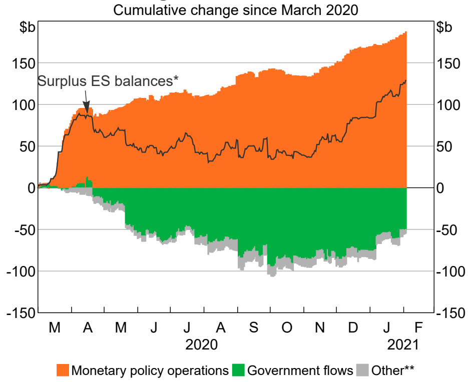
** Includes all settled, contracted and pre-processed repos to date

Sources: APRA; RBA

Graph 3.7

Exchange Settlement Balances

Cumulative change since March 2020



* Total ES balances net of contracted open repo positions

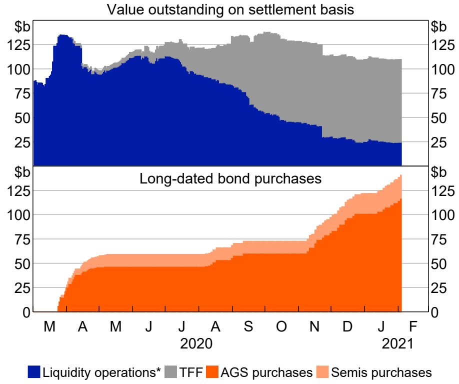
** Includes net banknote issuance and other RBA client flows

Source: RBA

Graph 3.8

Monetary Policy Operations

Value outstanding on settlement basis



* Liquidity injections net of drains and maturities; contracted in OMOs, FX swaps and short-dated bond purchases

Source: RBA

The cash rate declined further

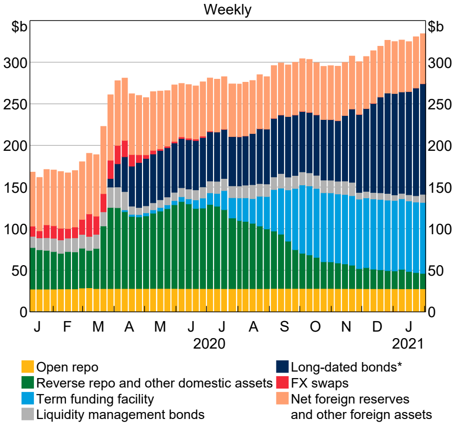
Following the reduction of the cash rate target to 10 basis points at the Reserve Bank Board meeting in early November, the cash rate declined and is currently 3 basis points (Graph 3.11). Financial market prices imply that investors expect the cash rate to remain close to this level for a considerable period. The cash rate remains a little above the rate of remuneration on ES balances, which was reduced to zero in early November. This difference reflects the compensation required by the banks that lend excess balances in the overnight cash market to cover the associated transaction costs and credit risks. The cash rate has been trading below the cash rate target since March 2020. This was expected and is consistent with the experience of other countries that have significantly increased cash reserves in the banking system.

Activity in the overnight cash market has also remained subdued, consistent with very high ES balances (Graph 3.12). Indeed, since November transaction volumes in the overnight cash market have been below the thresholds required to calculate the cash rate based on actual transactions almost half the time. In these instances, the published cash rate has been determined on the basis of the robust fall-back arrangements built into the cash rate procedures. Under these arrangements, the cash rate was published based on the last published cash rate on all but 2 instances. In these cases, the published cash rate was set at a different rate that, in the expert judgement of the Bank as the cash rate administrator, better reflected current market conditions.[3]

Graph 3.9

Reserve Bank Assets

Weekly



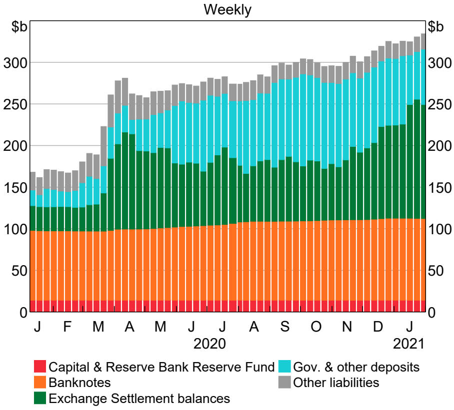
* Purchased under programs announced in March and November 2020

Source: RBA

Graph 3.10

Reserve Bank Liabilities

Weekly



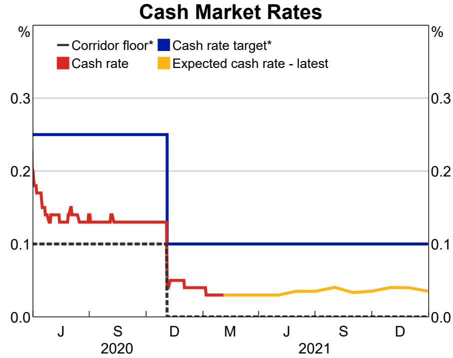
Source: RBA

Money market rates remain very low

Short-term money market rates are at historically low levels owing to the low level of the cash rate and the large amount of liquidity in the banking system (Graph 3.13). The rates on 3-month bank

Graph 3.11

Cash Market Rates



* Assumes unchanged future policy settings

Sources: Bloomberg; RBA

bills (BBSW) have edged lower to be around 1 basis point, slightly below the overnight indexed swap (OIS) rate. Following the reduction in the cash rate target and the remuneration on ES balances in November, repo rates at the Bank's daily market operations declined from 18 basis points to 10 basis points. Repo rates in the private interbank market also moved lower. The implied cost of borrowing Australian dollars via the foreign exchange swap market declined significantly into negative territory towards the end of the calendar year as liquidity in the foreign exchange swap market deteriorated. The implied cost has since retraced to be closer to zero. The temporary decline reflected abundant Australian dollar liquidity in the domestic money market and the propensity for offshore financial institutions to reduce the supply of US dollars towards the end of the calendar year to reduce the size of their balance sheets (see 'The International Environment' chapter); the reduced need by domestic financial institutions to swap US dollars into Australian dollars given lower offshore bond issuance also contributed.

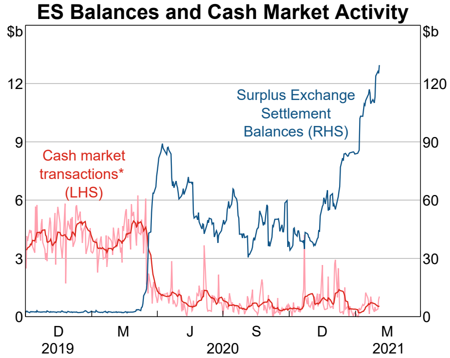
RMBS issuance was primarily by non-ADIs in 2020

Issuance of asset-backed securities (ABS) in 2020 was lower than in recent years, owing to the low level of issuance by banks. ABS issuance by non-ADIs increased in 2020, particularly in the second half of the year. As of September 2020, around half of the stock of Australian ABS outstanding had been issued by non-ADIs (Graph 3.14). Spreads relative to benchmark rates on residential mortgage-backed securities (RMBS) issued by non-ADIs declined over the year, but remained elevated relative to pre-COVID levels. Nonetheless, benchmark rates also declined significantly over 2020, causing yields on RMBS to decline to historically low levels. Spreads on ADI RMBS fell below the levels observed at the beginning of 2020, consistent with the decline in RMBS issuance by ADIs.

Since the March announcement of the Structured Finance Support Fund (SFSF), the Australian Office of Finance Management (AOFM) has provided funding to securitisation warehouses and has invested directly in ABS in the primary and secondary markets. These measures supported the improvement of conditions in the ABS market since then. The AOFM has not intervened in primary or secondary markets since July, but continues to support the warehouse market and provide support via its forbearance special purpose vehicle.

Graph 3.12

ES Balances and Cash Market Activity

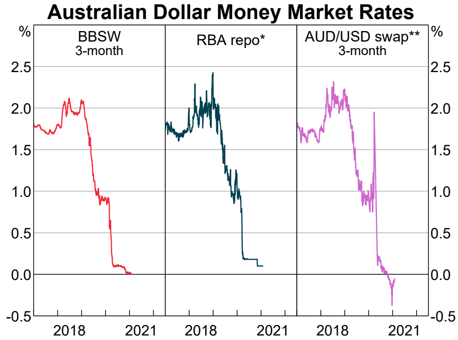


* 10-business-day moving average; pink line shows actual transaction volumes

Source: RBA

Graph 3.13

Australian Dollar Money Market Rates



* Weighted average rate for morning open market operation repos

** Implied AUD cost via commercial paper issuance and a cross-currency swap

Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve

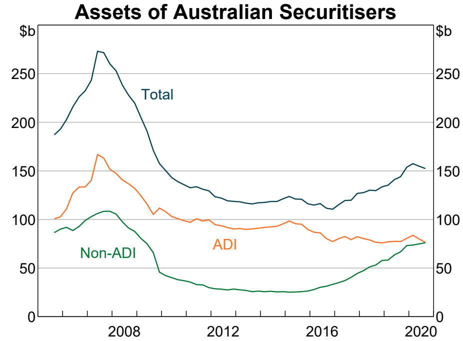
Banks' issuance of senior bonds was low, although the major banks continued to issue hybrid securities

Australian banks' issuance of senior unsecured bonds was very low in 2020 (Graph 3.15). The low level of bond issuance reflected the availability of low-cost funding from the TFF, strong deposit growth and the moderate pace of overall asset growth.

Banks continued to issue Tier 2 hybrid securities in 2020, raising $20 billion in this form. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements, which will increase in January 2024. Spreads on these Tier 2 hybrid issues were similar to those in 2019.

Graph 3.14

Assets of Australian Securitisers

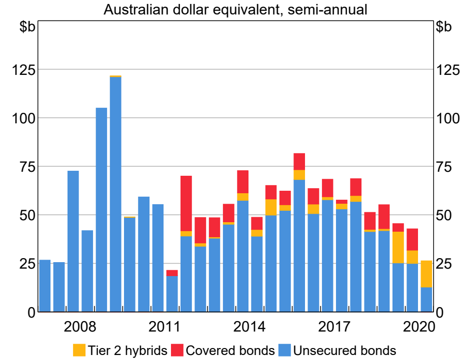


Sources: ABS; RBA

Graph 3.15

Australian Banks' Bond and Hybrid Issuance

Australian dollar equivalent, semi-annual



Sources: Bloomberg; RBA

Deposit rates declined further

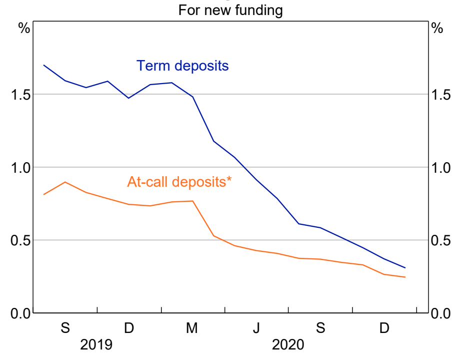
Banks have continued to respond to the plentiful supply of funding at low rates by reducing deposit rates, including following the November Board meeting. Rates for new retail and wholesale deposits have declined by 10 basis points since the end of September (Graph 3.16).

Over the past year or so, interest rates for new term deposits have declined by around 125 basis points, while rates for at-call deposits declined by around 50 basis points. The decline in the spread between interest rates on term deposits and other deposit rates is encouraging a shift by customers from term to at-call deposits. These changes have led to a rise in the share of bank deposits paying low interest rates (of between zero and 25 basis points). A little over one quarter of the debt funding of the major banks was estimated to be in the form of deposits paying interest of 25 basis points or less in the September quarter last year. This compares with around 15 per cent in late 2019. However, by value the majority of banks' deposits are still paying rates above 25 basis points, reflecting a sizeable share of deposits paying interest rates greater than 100 basis points.

Graph 3.16

Banks' Deposit Rates

For new funding



* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits

Sources: APRA; RBA

Banks' overall funding costs declined to historically low levels

The Reserve Bank's policy measures have lowered banks' funding costs to historically low levels (Graph 3.17). Banks' non-equity funding costs are estimated to have declined by a similar amount to the cash rate since the end of February 2020. Much of the banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which have declined by around 80 basis points since the end of February 2020. Low-cost funding from the TFF and deposit inflows have reduced banks' need for new wholesale funding; while the cost of new 3-year bank bonds has declined, it remains higher than the rate on TFF borrowing. The additional policy measures announced by the Reserve Bank since late last year are expected to lower banks' funding costs a little further over the period ahead. This reflects the continued flow-through of the decline in BBSW rates to debt funding costs, ongoing reductions in banks' deposit rates and expected future drawdowns of the low-cost funding from the TFF.

The deposit share of banks' total funding (including equity) has increased by around 4 percentage points since the end of February 2020 (Graph 3.18). Government bond purchases by the Reserve Bank and the banking sector have contributed to deposit growth, for example as payments for bonds purchased from the private (non-bank) sector are credited to the deposit accounts of those selling these bonds.[4] The rising shares of low-cost funding from the TFF and deposits are in line with the reduction in the share of wholesale debt funding.

Interest rates on business loans declined to historical lows

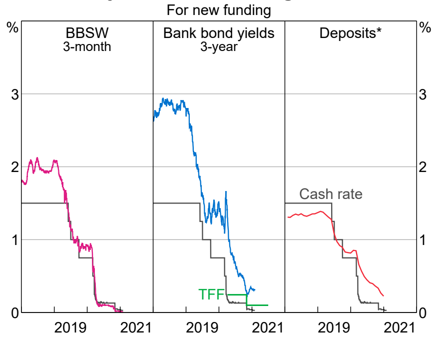
Following the Reserve Bank's decision to ease monetary policy further in November, a number of banks announced reductions in interest rates of between 30 and 75 basis points for new loans under the Government's SME loan guarantee scheme. A few banks announced reductions for some new loans to small businesses that are outside of the guarantee scheme.

More generally, since monetary policy was first eased in response to the pandemic, interest rates on outstanding business loans have declined to historical lows (Graph 3.19). Interest rates on variable-rate loans to large businesses have declined by 85 basis points since the end of February 2020. Interest rates on variable-rate loans to small and medium-sized businesses have declined by around 80 basis points over the same period. Most of the reductions

Graph 3.17

Major Banks' Funding Costs

For new funding



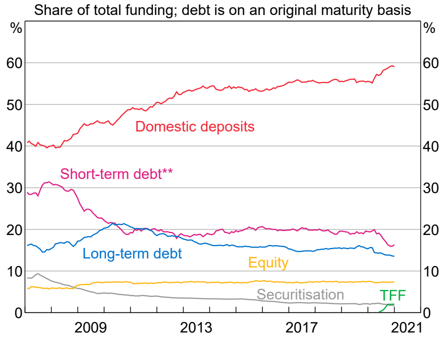
* RBA estimates; excludes deposits in housing loan offset accounts

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

Graph 3.18

Banks' Funding Composition*

Share of total funding; debt is on an original maturity basis



* Adjusted for movements in foreign exchange rates

** Includes deposits and intragroup funding from non-residents

Sources: ABS; APRA; Bloomberg; RBA; Refinitiv occurred between March and July 2020, although interest rates have drifted lower since then.

Interest rates on housing loans also declined

A number of lenders reduced their housing lending rates following the package of monetary policy measures announced in early November last year. While some small lenders passed on the 15 basis point reduction in the cash rate target to their standard variable rates (SVRs) in full, the majority of lenders, including the major banks, did not reduce their variable housing rates (Graph 3.20). Instead, interest rate cuts of late have predominantly been for fixed-rate housing loans (Graph 3.21). The major banks, along with some other lenders, announced reductions in advertised fixed home-loan rates of between 10 and 110 basis points following the November Board meeting. Although most fixed-rate loans are for 2- or 3-year terms, the largest reductions in advertised rates of up to 110 basis points were for loans with 4-year terms. Some new fixed-rate loans are being advertised with interest rates of below 2 per cent.

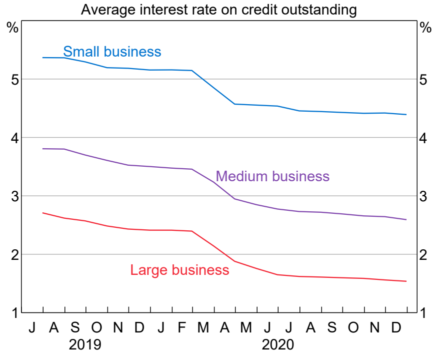
Over the past year or so, the interest rates paid by borrowers on housing loans have declined alongside the decline in banks' funding costs. Interest rates on outstanding variable-rate mortgages have declined by around 45 basis points since the end of February 2020 (Table 3.1). Much of that decline occurred in March and April last year, following the Reserve Bank's initial package of policy measures, as lenders reduced their SVRs by close to 30 basis points, on average. Outstanding variable rates have continued to drift down since then, reflecting ongoing competition for new high-quality borrowers and the associated effect of the elevated level of borrower refinancing.

The rates paid by borrowers on new fixed-rate loans have declined by around 85 basis points since the end of last February, to be around 55–75 basis points below new variable interest rates at the end of December. This has encouraged new borrowers to take out fixed-rate loans and existing borrowers to refinance their loans at very low fixed interest rates. The proportion of new loans funded at fixed interest rates remains high by historical standards, and the stock of fixed-rate housing loans has risen by about 5 percentage points since the start of 2020 to account for around 25 per cent of housing credit outstanding.

Graph 3.19

Business – Variable Lending Rates*

Average interest rate on credit outstanding

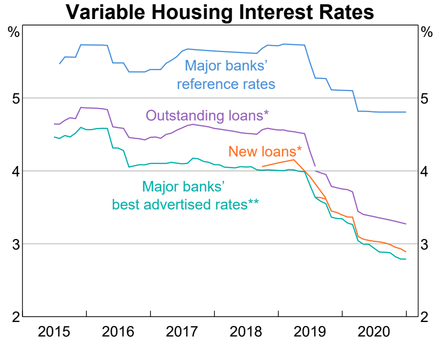


* Data cover financial institutions with $2 billion or more in business credit

Sources: APRA; RBA

Graph 3.20

Variable Housing Interest Rates



* Series break in July 2019; thereafter, data based on EFS collection

** Including low-cost brands

Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Table 3.1: Average Outstanding Housing Rates

December 2020

	Interest rate Per cent	Change since February 2020 Basis points
Variable-rate loans		
– Owner-occupier	3.15	–43
– Investor	3.51	–46
All variable-rate loans	3.27	–44
Fixed-rate loans		
– Owner-occupier	2.76	–96
– Investor	3.16	–85
By repayment type[(a)]		
– Principal-and-interest	3.08	–54
– Interest-only	3.70	–53

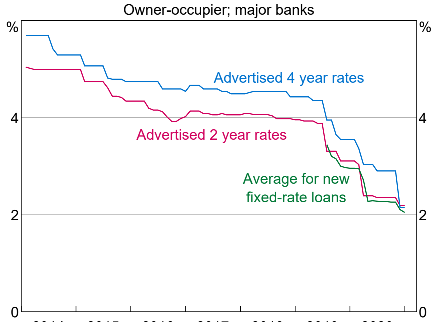
(a) Weighted average across fixed- and variable-rate loans

Growth in total credit has eased back to pre-pandemic levels

Total credit growth declined following the sharp rise in the early part of the pandemic (Graph 3.22; Table 3.2). This decline has mostly been driven by businesses repaying lines of credit that were initially drawn down over March and April to shore up liquidity positions during that especially uncertain period. Demand for business credit has been subdued since then (discussed further below). Meanwhile, growth in housing credit picked up a little in late 2020. This followed the easing of restrictions put in place to contain the virus, and has been supported by lower interest rates, government measures targeted at first home buyers and the HomeBuilder program.

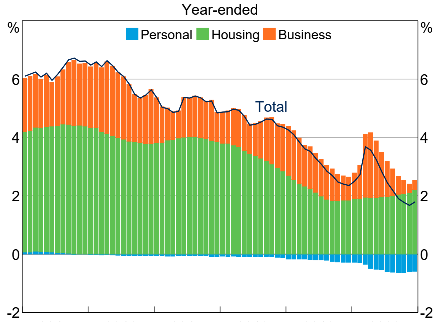
The stock of personal credit outstanding fell even more noticeably during the pandemic. Around half of the decline in personal credit between March and September was due to the decline in outstanding credit card debt, reflecting lower credit card spending by households and borrowers repaying this debt. Borrowers' capacity to repay debt was boosted by superannuation withdrawals and govern-

Graph 3.21



Sources: APRA; banks' websites; RBA

Graph 3.22



* Seasonally adjusted and break-adjusted

Sources: APRA; RBA

Table 3.2: Growth in Financial Aggregates

Percentage change[(a)(b)]

		Three-month annualised		Six-month annualised
	Sep 2020	Dec 2020	Jun 2020	Dec 2020
Total credit	–0.5	1.9	2.9	0.7
– Household	2.0	3.4	1.7	2.7
– Housing	3.4	4.3	3.2	3.8
– Owner-occupier	5.1	6.1	5.5	5.6
– Investor	0.2	0.9	–0.6	0.6
– Personal	–14.0	–5.4	–14.7	–9.8
– Business	–5.3	–1.2	5.4	–3.3
Broad money	10.7	8.7	15.7	9.7

(a) Seasonally-adjusted and break-adjusted

(b) Sources: ABS; APRA; RBA

ment assistance payments. More recently, spending on credit cards has increased a little as movement restrictions to contain the virus have been eased.

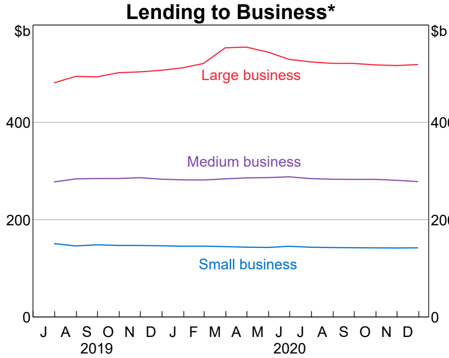
Business lending has been consistent with businesses' precautionary behaviour

Lending to businesses decreased over 2020, despite the sharp increase seen over March and April (Graph 3.23). Large businesses have, overall, gradually repaid the lines of credit that were initially drawn down as a precaution to shore up liquidity positions, and have taken out fewer loans for other purposes than in the period prior to the pandemic. Even so, the size of credit facilities available has increased significantly since the pandemic, suggesting that businesses are continuing to take a cautious approach to managing their access to liquidity. The volume of lending to SMEs has remained little changed over this time, with a pick-up in lending to the agriculture sector in 2020 offset by a decline in lending to other services (Graph 3.24).

Demand for new loans is subdued despite historically low interest rates. Commitments for new business loans have declined since April to levels well below those seen before the pandemic, although they have stabilised somewhat in recent months (Graph 3.25). Survey data and liaison with businesses and banks suggest that businesses have been reluctant to take on debt given the uncertainty about the economic outlook. Businesses have also made use of a range of temporary government and loan payment deferral initiatives, which have helped to build up liquidity buffers and lessened the need for new loans. Around 65 per cent of large businesses surveyed by the Australian

Graph 3.23

Lending to Business*



* Data cover financial institutions with $2 billion or more in business credit

Sources: APRA; RBA

Bureau of Statistics in October reported that they had enough cash to cover their expenses for at least the next 6 months, up from 50 per cent in June. In both June and October, over 35 per cent of the smaller businesses surveyed reported that they had sufficient cash for at least the next 6 months. Prior to the pandemic, around half of businesses had less than a month's worth of cash on hand to meet expenses.

Within overall business loan commitments, however, those for new SME loans have increased a little of late, and are currently around the average level observed over the six months preceding the pandemic (Graph 3.26). Loan commitments for the purchase of property and for plant and equipment have contributed the most to the recent increase. Lending activity for plant and equipment has been supported by the Australian Government's enhancements to the instant asset tax write-off scheme announced in the 2020/21 budget.

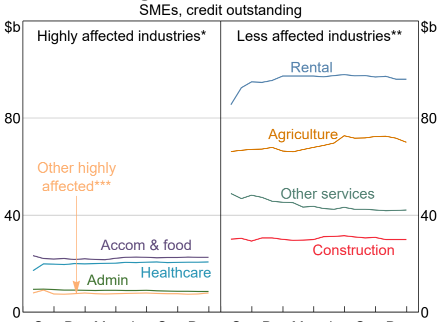
Take-up of the Australian Government's $40 billion SME loan guarantee scheme, which was put in place in late March 2020, has been low to date. About $3 billion of loan commitments have been made to around 30,000 businesses under the scheme. In October 2020, the scheme was made more generous to prospective borrowers in terms of how much could be borrowed, the use of collateral to secure the loan, and the repayment terms. The availability of funding at low cost through the scheme will help to support new lending should the demand from businesses pick up.

Most loan repayment deferral arrangements on SME loans that were offered by banks in 2020 have now expired. The vast majority of SME borrowers that had a deferral in place have resumed repayments. As of the end of December 2020, just over 1 per cent of all small business loans by number still had a loan

Graph 3.24

Lending to Selected Industries

SMEs, credit outstanding



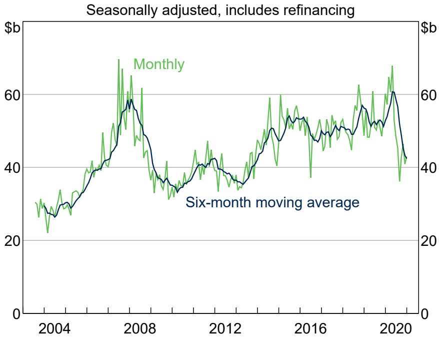
* Industries with the highest share of businesses reporting a fall in revenue of greater than 50 per cent in June ABS survey
** Top four industries by value of SME lending
*** Education and training; arts and recreation services; information media and telecommunications

Sources: APRA; RBA

Graph 3.25

Business Loan Commitments*

Seasonally adjusted, includes refinancing



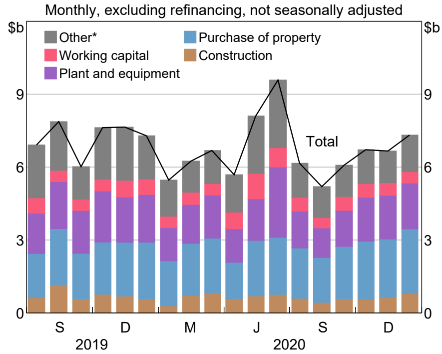
* Adjusted for series break prior to September 2019

Sources: APRA; RBA

Graph 3.26

SME Fixed-term Loan Commitments

Monthly, excluding refinancing, not seasonally adjusted



* Wholesale finance, acquisitions and general business purposes

Sources: APRA; RBA

repayment deferral in place, down from a peak of around 13 per cent in June 2020.

The supply of business credit tightened in response to the pandemic

The availability of credit to businesses tightened in 2020, mostly for those business that have been more affected by the pandemic. Banks have reported in liaison that much of the tightening has reflected the application of existing lending standards in a weaker economic environment. In addition, banks have required a greater degree of verification of borrowers' information to better understand whether it is reasonable to extend a loan, given uncertainty about the economic outlook. Some banks continue to be cautious about lending to particular sectors – such as tourism, retail and commercial property – and to customers that are new to the bank.

Surveys of small businesses indicate that access to finance became less difficult in the latter months of 2020 (Graph 3.27). However, at the same time, fewer businesses report that they have tried to access finance, consistent with subdued demand for credit. In late September, the Australian Government announced changes to responsible lending obligations intended to simplify the loan application process and reduce the extent of verification procedures. Enabling legislation was introduced to parliament in late 2020 and is currently under consideration. At the same time, ASIC has reiterated that consumer lending laws do not apply to small business lending.

Corporate bond issuance increased in 2020

Bond issuance by non-financial corporations increased in 2020, driven by a pick-up in issuance from non-resource firms. Issuance in the domestic market was above average, and a much larger-than-usual share of bonds had a tenor of 10 years or longer (Graph 3.28). Liaison indicates that the low level of interest rates has increased demand for long-term bonds as investors have sought higher yields. Following a sharp increase early in 2020, corporate bond spreads declined over the second half of the year, to be around levels seen before the COVID-19 outbreak.

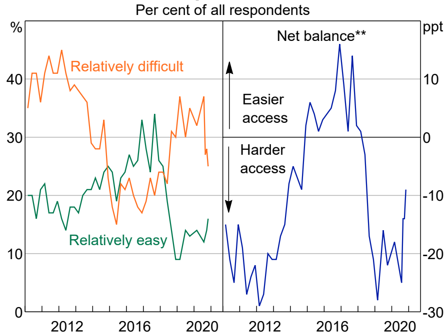
Demand for housing loans picked up as restrictions to contain the virus were eased

Housing credit growth picked up towards the end of 2020, returning to around the same pace of growth experienced prior to the pandemic

Graph 3.27

Small Business Perception of Access to Finance*

Per cent of all respondents



* Survey has asked about perceptions of changes in access to finance relative to a previous period since July 2019; before that the survey asked for point-in-time assessments

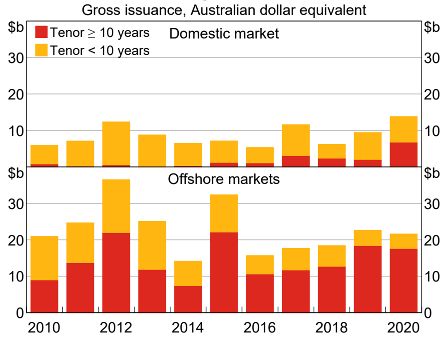
** Net balance is the difference between the percentage of firms indicating access is relatively easy and the percentage of firms indicating access is relatively difficult

Sources: RBA; Sensis

Graph 3.28

Non-financial Corporate Bond Issuance

Gross issuance, Australian dollar equivalent



Sources: Bloomberg; Private Placement Monitor; RBA

(3¾ per cent on a 6-month-ended annualised basis). Loans to owner-occupiers have mostly driven the increase in late 2020, but investor housing credit also increased a little over the same period having declined over much of the year (Graph 3.29).

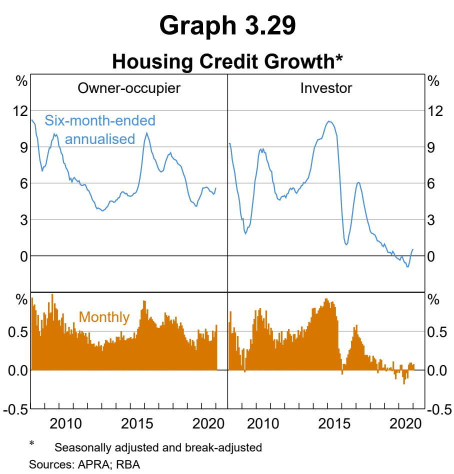
Commitments for new housing loans rebounded sharply over the second half of the year to be 30 per cent above the levels seen in March 2020 (Graph 3.30). Lower interest rates, government measures targeted at first home buyers and the HomeBuilder program have all supported demand for housing finance. The increase is also consistent with an improvement in some housing market activity indicators such as auction clearance rates and turnover (see 'Domestic Economic Conditions' chapter). Banks have indicated in liaison that the increase in housing market activity over the second half of 2020 in part reflects pent-up demand; borrowers who found it difficult to purchase a property when restrictions were in place have since been able to do so. In Victoria, commitments for new loans have also increased over recent months following a gradual easing of the restrictions that were put in place to contain an outbreak of the virus between July and September.

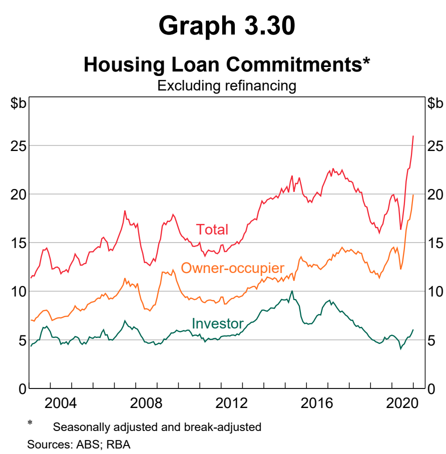
The availability of housing credit had tightened a little in response to the pandemic. However, in recent months, banks have begun to ease some requirements regarding additional information and have reduced the extent to which they have discounted highly variable sources of income (such as bonuses and commissions) when assessing a borrower's capacity to service a loan. Banks have also indicated more appetite for loans with higher loan-to-valuation ratios (LVRs).

Overall, the major banks' market share of housing lending has decreased since 2017, while the shares of both other ADIs and non-ADI lenders have increased (Graph 3.31). Since the middle of last year, non-ADI lenders' share of housing credit has decreased slightly, although even within this group there has been considerable variation, with some non-ADI lenders increasing their share of housing credit.

Payments into housing loan offset and redraw accounts were elevated throughout 2020

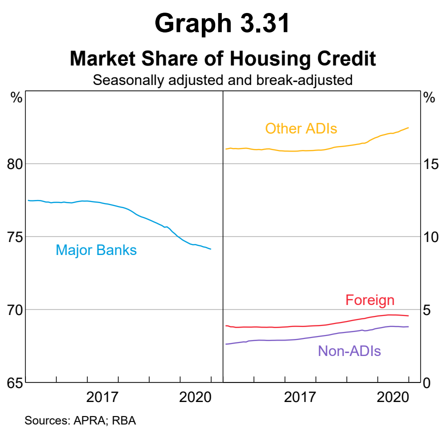
Mortgage borrowers have made substantial payments into offset and redraw accounts since March, amounting to 4 per cent of disposable income (around $40 billion) (Graph 3.32). The bulk of these funds have been placed into offset accounts (a type of deposit account linked to mortgages) and so do not reduce the measure of credit outstanding. Payments into redraw accounts, which do reduce the measure of





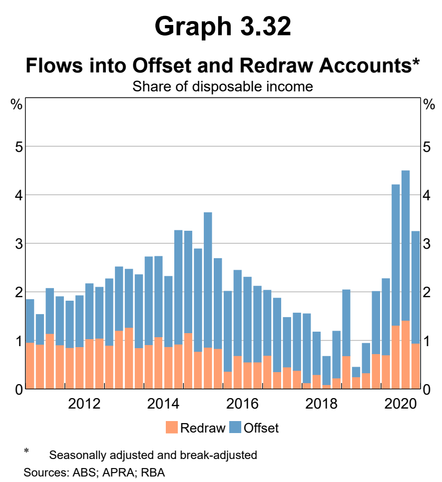
credit outstanding, have also increased noticeably. The increase in payments is likely to reflect a combination of reduced opportunities for spending, mortgage holders saving for precautionary reasons, and some borrowers depositing cash received from early release superannuation and fiscal payments into these accounts.

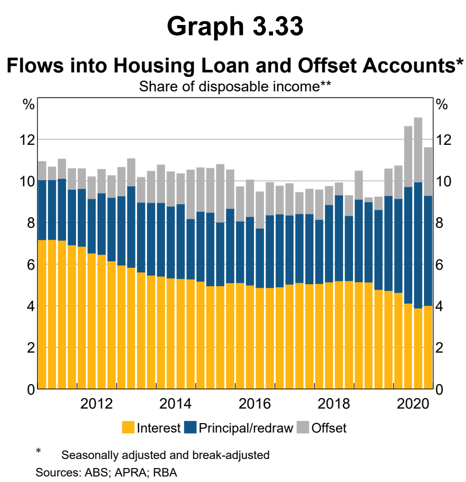
Net payments into redraw and offset accounts remain high but have eased a little over recent months, consistent with a tapering in fiscal payments, and a decline in the number of households that have accessed early release superannuation. The easing of restrictions in Victoria – allowing for more spending opportunities – may also have contributed.



Over 2020, reductions in housing loan interest rates flowed through to borrowers in the form of lower interest payments (Graph 3.33). Since March, interest payments have declined by around ½ percentage point as a share of disposable income. This reflects the pass-through of the Bank's policy easing and borrowers refinancing to lower interest rates, as well as the strong growth in disposable income since that time.

The share of mortgage holders with a repayment deferral arrangement in place declined to 2 per cent at the end of December 2020, from a peak of 8 per cent at the end of June. Banks announced 6-month loan payment deferrals in March 2020 to provide support for borrowers impacted by the pandemic, most of which were due to expire between September and October. Since September, around 85 per cent of borrowers that have exited their deferral arrangement have agreed to resume full payments. The remaining share are mostly made up of borrowers who have had their deferrals extended, and a small share have had hardship arrangements put in place (2 per cent of those exiting deferral arrangements).





Australian equity prices have risen but remain slightly lower than one year ago

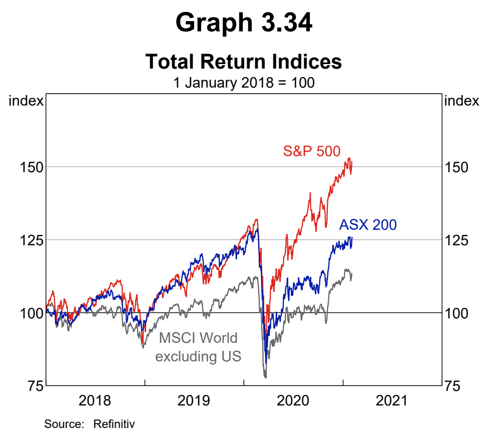
The ASX 200 has increased further over recent months to be around 2 per cent below its February 2020 peak on a total return basis, which takes dividends into account. The rebound in global equity prices since March last year reflects the recovery in the global economy and the related monetary and fiscal stimulus, along with an improvement in sentiment as effective COVID-19 vaccines have been developed (Graph 3.34). On a total return basis, the ASX 200 has performed broadly in line with other overseas equity markets. The stronger growth of the S&P 500 over the past year partly reflects the strength of technology stocks, which have a much larger weight in the US index.

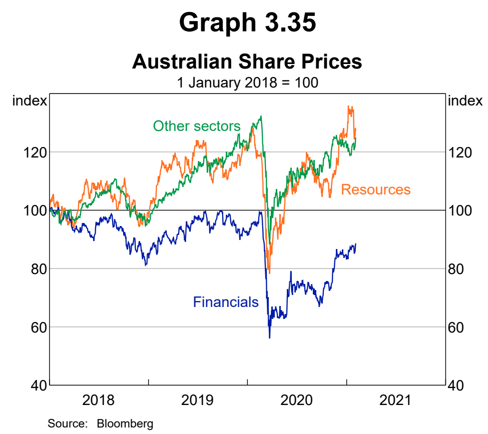
Equity prices in the resources sector are almost back to their previous peak in early 2020 and have contributed much of the rise in the ASX 200 since March (Graph 3.35). In recent months, major miners performed strongly on the back of higher iron ore prices, amid tighter than expected supply and increased demand for iron ore from China. Equity prices of oil companies increased alongside supply cuts from the Organization of the Petroleum Exporting Countries. The financial sector underperformed the ASX 200 index in recent months, consistent with developments in other advanced economies. It remains around 12 per cent below its February 2020 peak, in part reflecting substantial loan loss provisions. Equity prices for companies outside the financial and resources sectors are around 5 per cent below their peak in early 2020. The information technology sector has performed strongly over the past year, as companies have benefited from the shift to working from home and the pick-up in growth of online sales.

Listed companies issued over $65 billion of new equity in 2020, the most since 2009, as companies shored up their balance sheets again at a time of great uncertainty (Graph 3.36). Companies that were most affected by the pandemic, such as travel and industrial companies, raised significantly more capital than their historical average. More recently, some firms have raised capital for mergers and acquisitions. The value of pending mergers and acquisitions increased sharply in the December quarter, as firms seek to acquire competitors that have lower values of market capitalisation than before the outbreak of COVID-19.

The Australian dollar has appreciated since November

The Australian dollar has appreciated by around 5 per cent on a trade-weighted (TWI) basis since early November, and is higher than its level prior



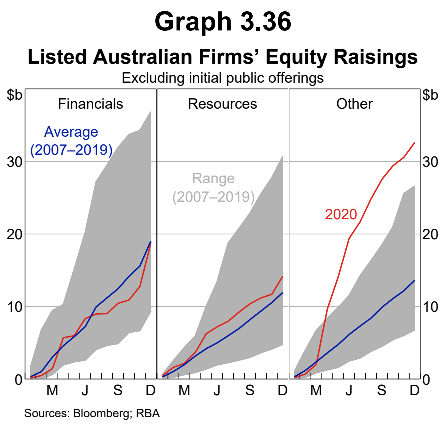


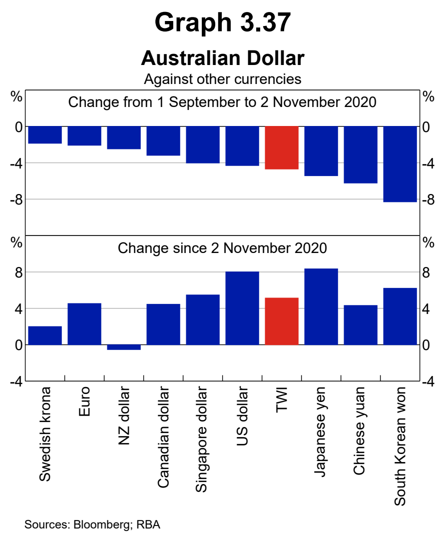
to the onset of the pandemic. The appreciation since November has been noticeable against the US dollar (Graph 3.37). This has occurred against the backdrop of the general improvement in expectations for the recovery in global growth, which has seen the US dollar depreciate and many commodity prices increase markedly (Graph 3.38). In particular, the price of iron ore has increased by around 30 per cent since early November and is around its highest level since 2013 (see 'The International Environment' chapter).

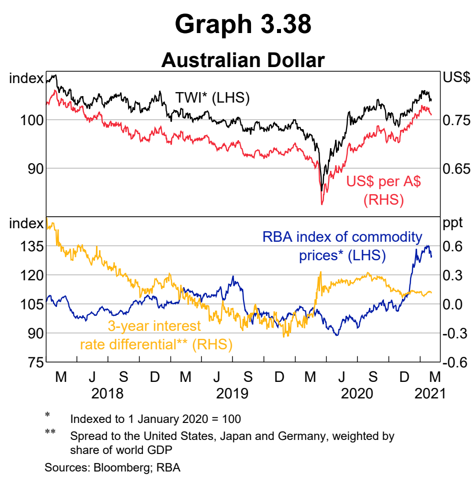
Interest rates on government bonds in Australia have been little changed relative to those in other major advanced economies since the previous *Statement*. However, Australian interest rates did decline relative to those abroad in the months leading up to the introduction of the Reserve Bank's package of policy measures introduced in November. Following the recent announcement of the extension to the bond purchase program, the Australian dollar has been little changed. However, given the lower structure of interest rates in the domestic economy associated with the Bank's policy measures over the past year, the exchange rate is lower than otherwise.

Australia has continued to experience net capital outflows

Australia continued to be a net lender of capital in the September quarter with capital outflows exceeding capital inflows (Graph 3.39). This is in line with Australia recording a current account surplus (see 'Domestic Economic Conditions' chapter). Outflows were related to a decline in the outstanding stock of debt issued abroad by Australian banks, consistent with their access to low-cost funding domestically from the TFF and the moderate pace of growth in their assets. Outflows also reflected superannuation and investment funds purchasing foreign equities. Partly offsetting this was inflows of capital to







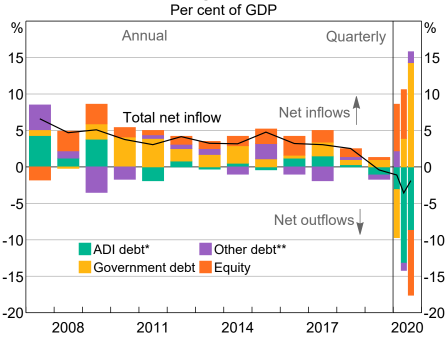
Australia from foreign purchases of Australian Government debt.

Despite a small increase in the September quarter, Australia's net foreign liability position remains around its lowest level as a per cent of GDP since the 1990s. The decline in the net foreign liability position over the past 4 years reflects the increase in the net foreign equity asset position that has occurred over this period as superannuation funds have increased their allocations to foreign equity (Graph 3.40).

Graph 3.39

Net Capital Flows

Per cent of GDP



* Adjusted for the US dollar swap facility in 2008-09 & 2020

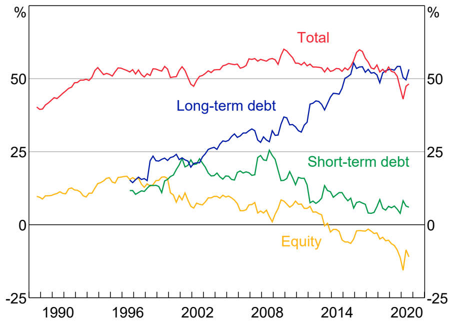
** Includes public corporations and private sector

Sources: ABS; RBA

Graph 3.40

Net Foreign Liability Position

Per cent of GDP



Sources: ABS; RBA

Endnotes

[1] See Alston M, S Black, B Jackman and C Schwartz (2020), 'The Term Funding Facility', RBA *Bulletin*, December, viewed 28 January 2021. Available at <https://www.rba.gov.au/publications/bulletin/2020/dec/the-term-funding-facility.html>

[2] For more information on the effect of government flows on system liquidity, see Robertson B (2017) 'Structural Liquidity and Domestic Market Operations', RBA *Bulletin*, September, viewed 28 January 2021. Available at <https://www.rba.gov.au/publications/bulletin/2017/sep/5.html>.

[3] Kent C (2020), 'The Reserve Bank's Operations – Liquidity, Market Function and Funding', speech to KangaNews, Sydney 27 July. Available at <https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>

[4] For more information, see RBA (2020), 'Box D: Recent Growth in the Money Supply and Deposits', RBA Statement on Monetary Policy, August, pp 75–77, viewed 28 January 2021. Available at: <https://www.rba.gov.au/publications/smp/2020/aug/box-d-recent-growth-in-the-money-supply-and-deposits.html>.

4. Inflation

Consumer price movements in 2020 were dominated by the impact of responses to the COVID-19 pandemic, as well as large swings in average fuel prices earlier in the year. This introduced more volatility than usual in headline inflation readings. Looking through this volatility, underlying inflation pressures are low.

Over the second half of the year, the unwinding of government support measures such as free child care boosted inflation significantly. Housing inflation also picked up a little in the December quarter on the back of increased demand for detached houses, supported by government grants, while some temporary rent reductions reversed. Offsetting this has been a moderation in retail price inflation; although price movements are still being shaped by increased expenditure on household goods relative to services, the effect of this is easing, as is the effect of earlier global supply chain pressures. There were also some methodological challenges that affected CPI outcomes throughout the year – most notably the need to impute prices for items that were unavailable due to activity restrictions – but these factors were largely resolved by the end of the year.

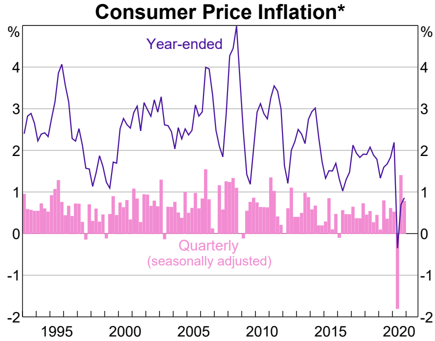
Wages growth has slowed further recently, as employers have responded to the economic challenges of the pandemic by delaying wage increases, imposing freezes and, in some cases, applying temporary wage cuts. Recent lower award wage decisions have also weighed on wage outcomes. While many of these measures are temporary, and will provide some near-term boost to wages as they unwind, forward indicators suggest wages growth will remain soft this year. National accounts measures of wages growth have been temporarily boosted by the JobKeeper wage subsidy, as well as by large compositional effects due to greater employment losses in lower-paid jobs.

CPI inflation moderated in the December quarter

Headline inflation was 0.8 per cent (seasonally adjusted) in the December quarter (Table 4.1; Graph 4.1). Much of this increase was driven by the further unwinding of government support measures such as free child care, as well as the annual increase in the tobacco excise rate. In year-ended terms, headline inflation was 0.9 per cent. This was slightly higher than expected at the time of the November *Statement on Monetary Policy*, mainly because prices of some components that have been affected by pandemic-related policies rose more than expected.

Graph 4.1

Consumer Price Inflation*



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly[a]		Year-ended[b]	
	December quarter 2020	September quarter 2020	December quarter 2020	September quarter 2020
Consumer Price Index	0.9	1.6	0.9	0.7
Seasonally adjusted CPI	0.8	1.4	–	–
– Tradables	–0.2	1.0	–0.6	0.0
– Tradables (excl volatile items)[c]	0.0	0.4	1.4	1.1
– Non-tradables	1.2	1.6	1.5	1.0
Selected underlying measures				
Trimmed mean	0.4	0.3	1.2	1.2
Weighted median	0.5	0.2	1.4	1.2
CPI excl volatile items[c]	0.9	1.3	1.5	0.9

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median

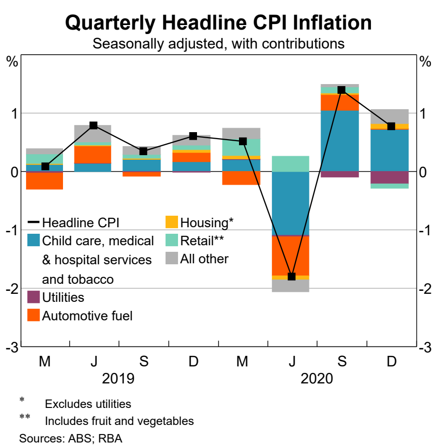
(c) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

The main drivers of the increase in the headline CPI in the December quarter were the return to full-price child care for the entire quarter and price rises for tobacco and medical & hospital services (Graph 4.2). Together, these price increases contributed 0.8 percentage points to CPI inflation in the quarter. Housing-related prices also increased in aggregate; new dwelling prices rose, driven by strong demand as purchasers sought to utilise the various government incentives on offer, while rents were broadly steady. These increases were offset by price falls for utilities due to government rebates. Prices for retail items also declined modestly as global supply disruptions eased and discounting resumed for food and some consumer durables.

Measures of underlying inflation over 2020 were affected by some unusually large component-level price movements and the imputation approach adopted by the Australian Bureau of Statistics (ABS) for missing prices. However, these issues had largely abated by the December quarter, providing a clearer signal of the low underlying inflationary pressures in the economy. Trimmed mean inflation was subdued at 0.4 per cent in the December quarter and 1.2 per cent over the year (Graph 4.3). Spare capacity in the economy and associated low wages growth have contributed to muted

Graph 4.2



underlying inflationary pressures for a number of years.

The ABS updates expenditure weights every year in December to ensure that the weights are reflective of spending by Australian households. Due to the COVID-19 pandemic, the changes in the weights were unusually large for some components (see 'Box A: Consumption Patterns and Consumer Price Index Weights'). The new weights were applied to the December quarter 2020 CPI, but they did not affect reported inflation outcomes much.

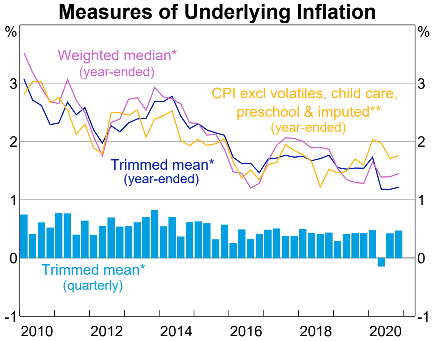
Government policies continued to drive movements in some administered prices

Administered prices, which comprise around 15 per cent of the consumption basket, rebounded further in the December quarter following a sharp decline earlier in the pandemic. Australian Government subsidies for child care services substantially reduced the price of child care in the June quarter and early September quarter (Graph 4.4). The return to full-price child care in early July, alongside broad-based price increases by providers in October, boosted quarter-average CPI child care prices in both the September and December quarters. This resulted in child care prices ending the year a touch above their pre-pandemic levels. The end of the free child care program (which had also covered before- and after-school care services) also boosted preschool & primary education prices. Together, these increases contributed 0.4 percentage points to headline inflation in the December quarter. However, prices for preschool & primary education are likely to remain below their pre-COVID-19 levels for some time as free preschool programs in New South Wales and Victoria have been extended until end 2021.

Other administered prices (excluding utilities) rose a little in the December quarter (Graph 4.5). Medical & hospital services inflation was unusually strong, reflected in the average increase in private health insurance premiums of 2.9 per cent (Graph 4.6). This contributed 0.2 percentage points to headline inflation in the quarter. Premiums typically increase in April each year, but insurers agreed to defer the 2020 increase until October in order to ease pressure on customers during the initial phase of the pandemic. Urban transport fares also increased as discounted off-peak transport prices ended in Sydney. Administered price inflation has trended lower over many years, and

Graph 4.3

Measures of Underlying Inflation



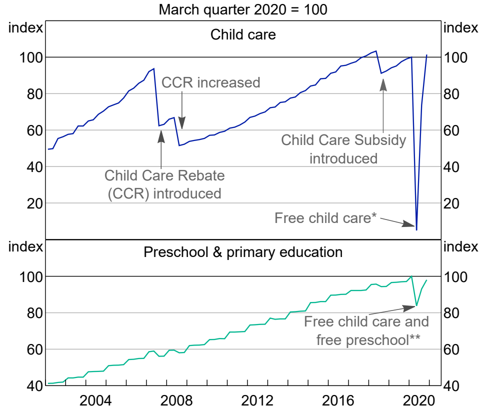
* Seasonally adjusted
** Not seasonally adjusted; excludes fruit, vegetables, automotive fuel, child care, preschool & primary education and items that were imputed using headline CPI for all capital cities in the June or September quarter 2020

Sources: ABS; RBA

Graph 4.4

Early Education Prices

March quarter 2020 = 100



* Nationwide from 5 April to 12 July 2020
** Nationwide from 5 April to 12 July 2020 for child care; term 2 in Queensland and terms 2 to 4 in New South Wales and Victoria for preschool

Sources: ABS; RBA

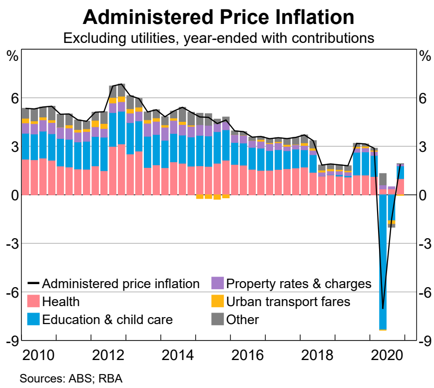
this trend is expected to persist for some time partly because of ongoing administered price freezes in a number of states and territories.

Utilities prices decreased further in the quarter

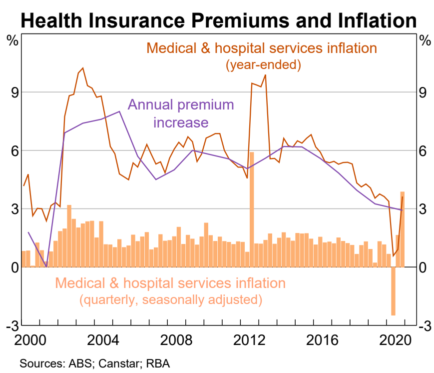
Prices for utilities, which account for around 5 per cent of the consumption basket, declined further by 4.4 per cent in the December quarter, in large part because of special rebates introduced in some states (Graph 4.7). The Western Australian Government provided households with a one-off credit of $600 to reduce their electricity bills from 1 November, which led to a large temporary decline in WA electricity prices in the quarter. The rebate was applied to quarterly electricity bills from November onward and will continue to weigh on prices in early 2021 as additional customers receive the rebate; this will be partly offset by price increases as customers that have already received the rebates return to normal billing over the coming months. The Queensland Government also provided additional rebates that were applied to households' electricity bills in the September and December quarters. Gas prices were generally unchanged across most capital cities in the quarter.

Utilities inflation has been subdued for the past 2 years and is likely to remain low for some time. Domestic wholesale gas prices have fallen in recent months. Lower wholesale gas prices and increased electricity supply from renewables continue to put downward pressure on utilities prices. Retail utilities prices in Canberra, Darwin, Hobart and Perth are expected to remain broadly unchanged until the second half of 2021 due to state and territory government price freezes.

Graph 4.5



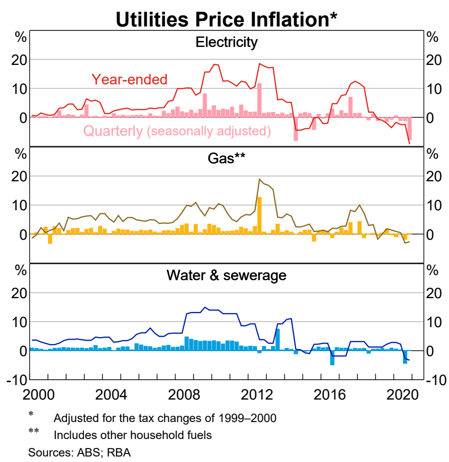
Graph 4.6



Housing inflation picked up as new dwelling inflation remained relatively strong and rent deflation eased

The 2 largest components of the CPI basket are new dwelling purchases by owner-occupiers

Graph 4.7



and rents; together these account for around one-sixth of the CPI basket. Housing-related inflation rose a little in the December quarter, after slowing sharply in the first half of 2020.

Prices for newly constructed dwellings increased by 0.7 per cent in the quarter and were 1.7 per cent higher over the year, reflecting stronger demand in the detached housing sector (Graph 4.8). This demand has been boosted by the Australian Government's HomeBuilder program and some state government grants. In particular, demand for new detached dwellings surged in the December quarter as purchasers finalised contracts before the scheduled reduction in the value of the HomeBuilder grant on 1 January 2021. Although these grants are reflected as measured price declines in the CPI, increased demand for new housing encouraged some builders to increase base prices or offer fewer discounts to buyers, more than offsetting this effect. Price inflation for new dwellings has been particularly strong in Perth over the past few quarters following a prolonged period of weakness. Despite the recent pick up in new dwelling prices in Sydney and Melbourne, new dwelling inflation there remains low relative to history.

Rents were broadly steady in the December quarter but were 1.3 per cent lower over the year (Graph 4.9). Declines in rental prices over the middle of 2020 in part reflected elevated supply of rental properties and weaker demand because of travel restrictions and lower population growth. Rent reductions for existing tenants continued to weigh on rent inflation in the December quarter, but this decline was offset by renters who had previously negotiated temporary discounts returning to their usual payments. Rents increased notably in Perth in the quarter, partly reflecting tighter rental market conditions following several years of subdued growth in dwelling investment. In contrast, rents were fairly flat in Sydney and Melbourne.

Automotive fuel prices remain below their pre-COVID-19 levels

Fuel prices were fairly steady over the September and December quarters, after falling sharply and only partially recovering over the first half of 2020 (Graph 4.10). There was a notable rise in fuel prices in the month of January – at current levels, automotive fuel is expected to contribute around ¼ percentage point to headline CPI in the March quarter.

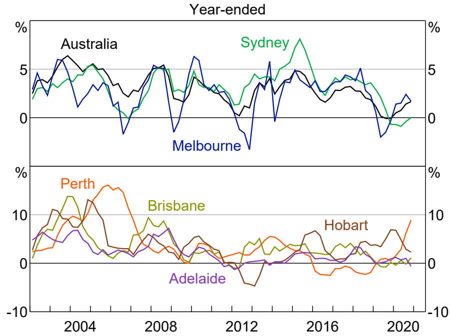
Tobacco prices rose due to a scheduled increase in the tobacco excise

Higher tobacco prices contributed 0.2 percentage points to headline CPI in the

Graph 4.8

New Dwelling Inflation

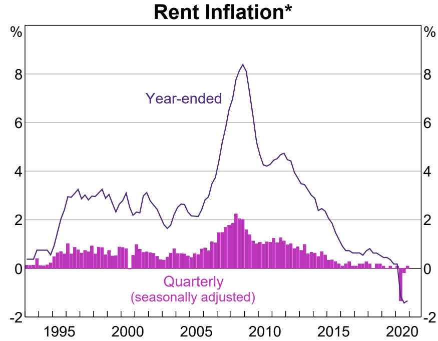
Year-ended



Source: ABS

Graph 4.9

Rent Inflation*



* Adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

December quarter (Graph 4.11). In addition to regular indexation, since 2013 tobacco prices have incorporated excise increases of 12½ per cent in September each year. The boost to headline inflation from these increases is expected to subside in 2021 as the tobacco excise returns to regular indexation.

Retail inflation moderated in the quarter as inventory-related price pressures eased

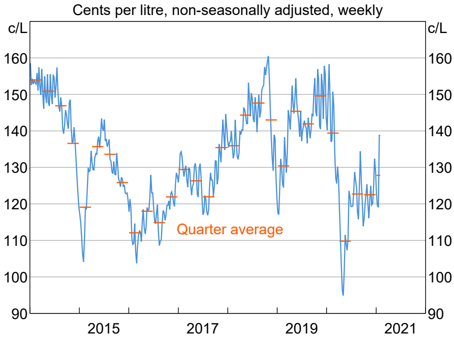
Retail prices, which comprise just over a quarter of the CPI, declined a little in the December quarter, but remained higher than they were a year ago. During 2020, sustained demand for many consumer durable items had driven retail prices higher as a large share of people spent more time at home during the initial COVID-19 outbreak. Reduced stock availability owing to global supply chain pressures also put upward pressure on prices for some retail items. As these pressures started easing, price increases slowed in the December quarter, particularly for furniture & household appliances (Graph 4.12). Part of this reflected the resumption of discounting by some retailers, as well as increased retailer participation in Black Friday sales events. Prices for clothing & footwear fell alongside subdued demand and increased discounting during sales periods in November and December. In contrast, motor vehicle price inflation remains elevated due to continued price pressures from strong demand and reduced domestic inventory.

Grocery prices (excluding fruit & vegetables) increased a little in the December quarter (Graph 4.13). Liaison reports suggest that supermarket discounting behaviour has returned to pre-pandemic patterns, following a reduction in discounting as demand increased strongly during the early stages of the pandemic. Price increases were notable for beef & veal, as better seasonal conditions have led some farmers to rebuild herds, reducing the supply of meat.

Graph 4.10

Unleaded Petrol Prices

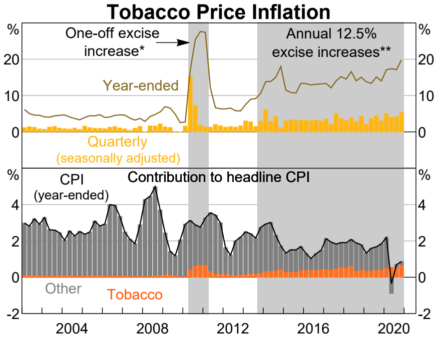
Cents per litre, non-seasonally adjusted, weekly



Sources: Australian Institute of Petroleum; RBA

Graph 4.11

Tobacco Price Inflation



* In 2010, the Commonwealth Government increased the excise and excise-equivalent customs duty rate applying to tobacco products by 25 per cent

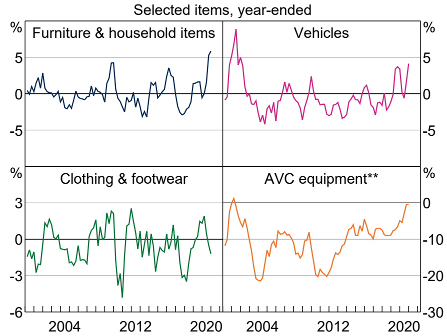
** In 2013, a new regime came into force that saw the tobacco excise increase by 12.5 per cent annually in addition to regular indexation; the regime ended in 2020

Sources: ABS; RBA

Graph 4.12

Consumer Durables Price Inflation*

Selected items, year-ended



* Adjusted for the tax changes of 1999–2000

** Audio, visual & computing equipment

Sources: ABS; RBA

Prices for fruit & vegetables, which can be volatile, declined in the December quarter. Despite recent reports of labour shortages for some produce harvesting, potential supply disruptions do not appear to have led to widespread price pressures.

Market services inflation picked up in the quarter but remains subdued

Inflation remains low for market services, which includes hairdressing, financial services, meals out & takeaway and domestic travel, and comprises a little under one-quarter of the consumption basket (Graph 4.14). The ABS has been able to return to normal price collection for domestic travel, which recorded a 3.8 per cent price increase in the December quarter. The only item that was still imputed (using headline CPI) in the quarter was international holiday travel & accommodation. Price inflation for household services slowed in the quarter, as demand moderated a little from the high levels seen immediately after restrictions were eased in many parts of the country in the previous quarter. In contrast, prices increased for meals out & takeaway.

Survey-based measures of inflation expectations remain low

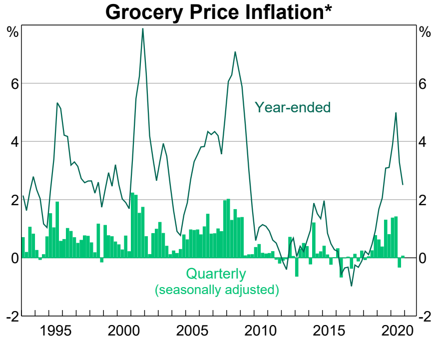
Price- and wage-setting behaviour can be affected by expectations about the future rate of inflation. Market economists' year-ahead inflation expectations have remained broadly steady following some volatility over the second half of 2020. In part this is because recent large anticipated changes in some price components (such as the effects of oil prices and child care subsidies) are no longer influencing year-ahead expectations (Graph 4.15). Unions' inflation expectations remain relatively subdued. Consensus and market economists' long-term inflation expectations are around 2–2½ per cent and remain consistent with the Bank's medium-term inflation target.

Wages growth declined further in the September quarter

Growth in the Wage Price Index (WPI) slowed to 0.1 per cent in the September quarter, to be 1.4 per cent in year-ended terms. This is the lowest reading since this series began 2 decades ago. Private sector wages growth remained at 0.1 per cent in the quarter, as many employers responded to the pandemic by delaying financial year-end wage reviews and enterprise bargaining agreement (EBA) increases

Graph 4.13

Grocery Price Inflation*

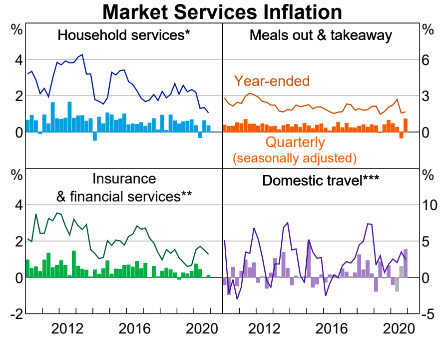


* Excludes alcoholic beverages, fruit, vegetables and meals out & takeaway

Sources: ABS; RBA

Graph 4.14

Market Services Inflation



* Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services

** Excludes deposit & loans to June quarter 2011

*** Imputed using headline CPI in the June and September quarters 2020

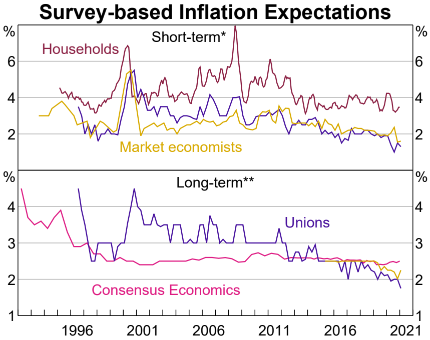
Sources: ABS; RBA

(Graph 4.16). Public sector wages growth declined to 0.2 per cent, reflecting deferred wage increases for Commonwealth employees, delays in negotiating the Victorian public service EBA and delays and reductions in wage increases for New South Wales state government employees.

Wages growth has been weakest in industries most reliant on award wage increases, including accommodation & food services and retail trade. Annual increases in award wages usually occur in the September quarter, but the Fair Work Commission decided in June to delay effective increases for most awards to November or February. These delayed awards are expected to provide some support to wages growth in affected industries in coming quarters, although the increase in award wages will be smaller than it has been in recent years in light of the current economic environment.

Graph 4.15

Survey-based Inflation Expectations



* Over the year ahead

** Average over the next 5 to 10 years for market economists and unions; average over 6 to 10 years in the future for Consensus

Sources: Australian Council of Trade Unions; Consensus Economics; RBA; Workplace Research Centre

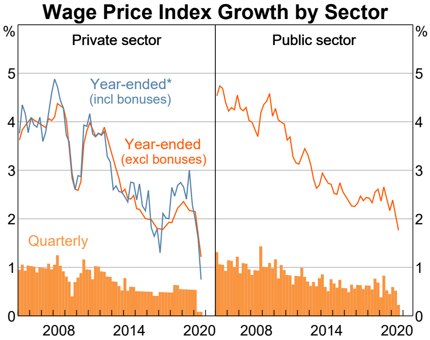
Other measures of earnings continued to be supported by JobKeeper

The national accounts measure of average earnings per hour declined a little in the September quarter, as hours worked in lower-paid jobs rebounded, bringing the composition of hours worked closer to its pre-pandemic mix (Graph 4.17). The JobKeeper wage subsidy continued to affect this measure of earnings; employees' average hourly earnings are boosted above their ordinary earnings in cases where employees would otherwise have earned less per fortnight than the minimum JobKeeper payment (which was $1,500 throughout most of the September quarter).

The further recovery in activity and changes to JobKeeper eligibility requirements in the December quarter are expected to have reduced the number of employers using the program, although payments to firms in industries most impacted by pandemic-related restrictions are likely to have remained elevated. With JobKeeper due to expire at the end of March, some further declines in measured

Graph 4.16

Wage Price Index Growth by Sector

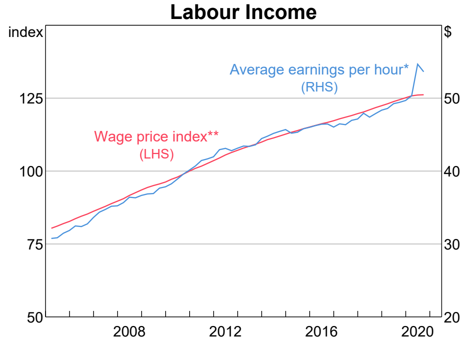


* Non-seasonally adjusted; bonuses include commissions

Source: ABS

Graph 4.17

Labour Income



* Non-farm

** Excluding bonuses and commissions; December 2010 = 100

Source: ABS

average earnings are expected in coming quarters.

Wage freezes will continue weighing on wages growth this year

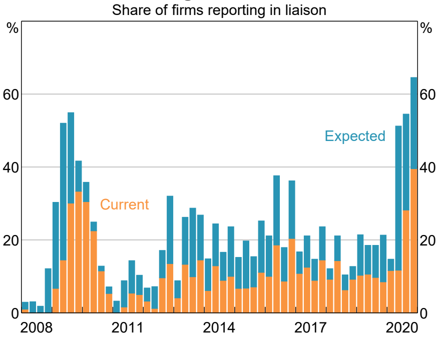
Liaison reports suggest that wages growth will remain weak for some time. The proportion of firms reporting they had wage freezes in place or intended to implement wage freezes this year increased further in the December quarter (Graph 4.18). Some firms also reported that bonuses would be reduced or withheld in coming quarters. However, in most cases these measures are expected to be temporary, with some unwinding of freezes and delays expected over the course of 2021.

Government wage policies announced in recent months have softened the outlook for public sector wages. The Australian Government has announced a wages policy that ties wage adjustments in future EBAs for Commonwealth public servants to private sector WPI outcomes. Some state governments have also announced measures to delay wage increases or cap wages growth at lower rates than had applied in recent years.

Graph 4.18

Wage Freezes

Share of firms reporting in liaison



Source: RBA

Box A

Consumption Patterns and Consumer Price Index Weights

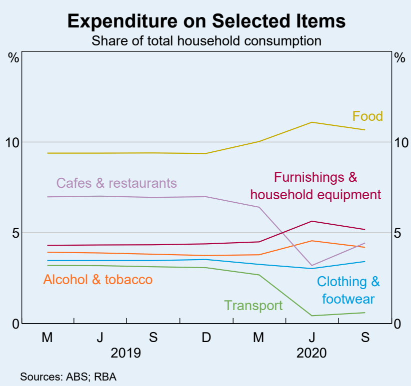
Restrictions on activity and discretionary decisions by households in response to the COVID-19 pandemic have led to changes in consumer spending patterns. These changes have in turn been reflected in the way the ABS calculates the Consumer Price Index (CPI). As household expenditure patterns continue to adjust to the pandemic and policy measures evolve, further larger-than-usual changes to CPI weights could occur over the next couple of years to ensure the index still provides an accurate and relevant measure of prices faced by households.

The pandemic has changed household consumption patterns …

Household spending patterns shifted considerably in response to the COVID-19 pandemic and associated activity restrictions. For example, during the initial phase of the pandemic in March and April 2020, spending at cafes & restaurants fell markedly as people avoided public gatherings and restrictions on eating out were imposed (Graph A.1). This was largely offset by increased spending on groceries for consumption at home. There was also a very strong increase in spending on many types of household durables, including home entertainment and computer equipment, appliances, recreational goods, furniture and home renovation goods. In contrast, spending on new motor vehicles, clothing & footwear and a range of other household services declined.

As restrictions eased across most of Australia, expenditure patterns began returning towards pre-pandemic shares for some items, such as clothing & footwear and alcohol consumed at venues. However, some changes to consumption patterns of other categories of goods and services have persisted. Purchases of food and drink for consumption at home remained elevated in the September quarter 2020, while spending at cafes & restaurants remained much lower than prior to the pandemic. A particularly large change was spending on international travel for holidays and education; this had accounted for around 5 per cent of household consumption in recent years, but fell to very low levels due to international border restrictions (Graph A.2).

Graph A.1



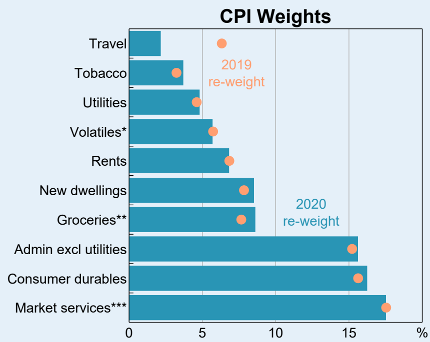
… that have been reflected in the calculation of the CPI

The ABS has captured these larger-than-usual shifts in household consumption patterns in the CPI by adjusting the relative weights of the various expenditure categories. Re-weighting ensures the CPI remains an accurate measure of household price inflation. In recent years, the ABS had been updating the weights in the CPI annually to reflect the consumption shares observed in the previous year's Household Final Consumption Expenditure (HFCE) estimates. Because of the unusually large changes in spending patterns since the outbreak of COVID-19, for the 2020 re-weighting the ABS has supplemented the HFCE estimates with a range of more timely data sources, such as supermarket scanner data.[1] Expenditure weights for around one-fifth of the CPI basket have been estimated using timelier data sources, including for grocery food, alcohol, electricity and domestic and international travel.

Consistent with the very large fall in expenditure on both international and domestic airfares, the weight applied to travel prices fell substantially (Graph A.3). International holiday travel, which made up around 3 per cent of the CPI basket as at the end 2019, now comprises less than 0.1 per cent of the CPI. The decline in the weight assigned to international travel has meant that the share of tradable items in the consumption basket has continued its long-run decline, to be now less than one-third of the CPI (Graph A.4). The largest increases in expenditure weights over the past year were for groceries, consumer durables and new dwellings, with market services retaining the largest weight in the CPI.

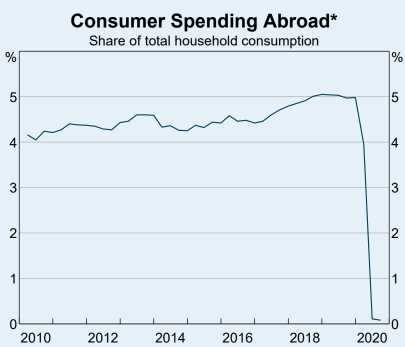
Although some of these changes represent unusually large annual adjustments, in

Graph A.3



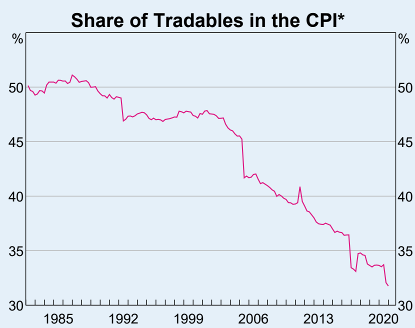
* Includes fruit, vegetables and automotive fuel
** Excludes alcoholic beverages, fruit, vegetables and meals out & takeaway
*** Excludes domestic travel and telecommunications
Sources: ABS; RBA

Graph A.2



* Includes personal travel and passenger transport services
Sources: ABS; RBA

Graph A.4



* Tradables include goods and services that are frequently exported or imported such as imported manufactured goods, some food items and services such as international travel
Sources: ABS; RBA

absolute terms the changes to individual expenditure weights are still only around 1–2 percentage points. Accordingly, these weight changes have not affected our overall assessment of current and future inflation (see 'Economic Outlook' chapter). Where a larger weight applies to an expenditure category with a faster (or slower) rate of inflation, this will increase (or decrease) aggregate inflation measures by a small amount. There could also be larger-than-usual updates to CPI weights over the next couple of years as household expenditure patterns continue to adjust to the pandemic and related policy measures. The ABS has indicated it will continue to monitor spending patterns using timely data in order to ensure that the CPI reflects the actual composition of household consumption. These weight adjustments may add some volatility to CPI outcomes over the next couple of years, but these effects are likely to be small relative to other factors shaping the inflation outlook.

Endnotes

[1] This approach aligns with guidance from international bodies and has been used by other statistical agencies, including Stats NZ and Eurostat. For more information, see ABS (2020), 'The 2020 Annual Re-weight of the Australian Consumer Price Index', available at <abs.gov.au/statistics/research/2020-annual-re-weight-australian-consumer-price-index>.

5. Economic Outlook

The outlook for the global economy has improved since the November *Statement on Monetary Policy*. While the global recovery lost a little momentum late last year after a resurgence of COVID-19 infections in some economies, a number of vaccines have been approved and vaccinations have begun. Fiscal and monetary policy also remain very expansionary and, in some economies, fiscal support may increase further in the period ahead. The pace of the recovery will continue to vary across economies and, in many, the recovery will remain incomplete over the forecast period. Underlying inflationary pressures are likely to remain subdued globally for some time given considerable spare capacity.

Growth in Australia's major trading partners is expected to be a little stronger than at the time of the November *Statement* (see 'The International Environment' chapter). Part of this upgrade stems from a better starting point: activity in Australia's major trading partners was generally stronger than expected in the September quarter and recent virus outbreaks do not appear to have fully offset this. The outlook for Australia's major trading partners is a little stronger than for the rest of the world because some large trading partners – China and a few advanced east Asian economies – have been successful in suppressing infections and are benefiting from a strong recovery in their merchandise exports.

The recovery in the domestic economy has been sustained over recent months, supported by better health outcomes and a further expansion in monetary and fiscal policy in the second half of last year. In the baseline scenario, forecasts for GDP and employment growth have been upgraded relative to the November *Statement*, largely reflecting a stronger starting point for the forecasts. As a result, GDP and employment are expected to reach their pre-pandemic levels over the course of 2021, around 6–12 months earlier than previously expected. The unemployment rate is likely to have already peaked and is now expected to decline steadily to around 5¼ per cent by mid 2023.

Although these are materially better outcomes than previously expected, the level of GDP is still expected to remain below that forecast at the time of the February 2020 *Statement*. This partly reflects a smaller population; in per capita terms, the shortfall in GDP is less pronounced but still material. Spare capacity in the labour market is expected to remain elevated over the forecast period, and both wages growth and underlying inflation are expected to remain below 2 per cent.

The economy is now transitioning beyond the initial 'snapback' phase, which was underpinned by favourable health outcomes, the faster-than-expected lifting of activity restrictions and very substantial policy support. The nature and speed of the next phase of the domestic recovery remains uncertain and is expected to be uneven for some time yet. Beyond the risks associated with the virus, a key uncertainty is how Australian households and businesses respond and adapt to the tapering of some fiscal and other temporary support measures in coming quarters following the extraordinary boost to cash flows they received last year.

The baseline scenario assumes that no further large outbreaks of COVID-19 and accompanying hard lockdowns occur within Australia and that restrictions, when imposed, are brief. The domestic vaccination program is assumed to proceed in line with government guidance, and the international border is assumed to remain closed until the end of 2021. Under this scenario, GDP is expected to have contracted by around 2 per cent over the year to December 2020, but then grow by around 3½ per cent over both 2021 and 2022. Inflation is expected to pick up a little alongside the gradual decline in the unemployment rate, to be 1¾ per cent by mid 2023.

Given the high degree of uncertainty around the outlook, 2 alternative scenarios (upside and downside) are considered to assess the potential economic impact of different health outcomes. In summary:

- A stronger economic recovery than the one outlined in the baseline scenario is possible if ongoing low case numbers in Australia and a sustained run of positive health outcomes enable a faster easing of domestic restrictions. These outcomes would boost consumer and business confidence and reduce uncertainty, leading to a stronger recovery in private consumption and investment. In this scenario, a stronger rebound in activity would see the unemployment rate decline at a faster pace, falling to around 4¾ per cent by the end of 2022.
- Alternatively, a plausible downside scenario is that Australia experiences further large outbreaks of the virus. It is assumed that this would require broad activity restrictions to be reimposed, though not the extended lockdowns assumed in previous downside scenarios. In this scenario, consumer and business confidence would be weaker and the recovery in household consumption and business investment would be slower than in the baseline scenario. As a result the unemployment rate would peak in this scenario at around 6¾ per cent in mid 2021 and decline only slowly in 2022.

The recovery in domestic activity is well under way, but substantial spare capacity remains

The stronger-than-expected recovery in the second half of last year is primarily responsible for lifting the forecast level of GDP by around 1½ per cent across the forecast period. GDP is now expected to return to pre-pandemic levels by the middle of this year. The faster-than-expected removal of social distancing restrictions and recent policy measures are assessed to have pulled forward GDP growth from 2021 into the latter part of 2020, although GDP growth in 2022 is still broadly unchanged (at a higher level) relative to the November *Statement* (Table 5.1; Graph 5.1).

The recovery in household spending and an increase in public demand led the initial rebound in activity and are expected to be the main contributors to GDP growth over coming quarters. A pick-up in business investment is anticipated to lag the recovery in other components of private demand. Many firms are expected to fully utilise their existing capacity

Graph 5.1

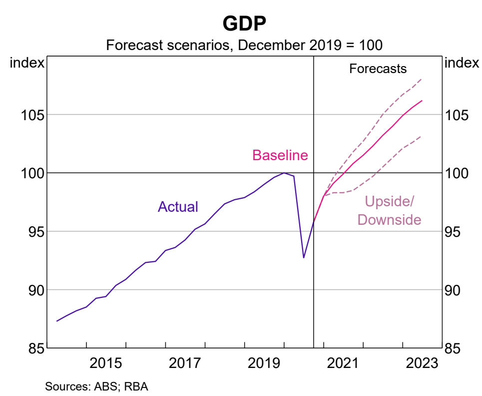


Table 5.1: Output Growth and Inflation Forecasts[(a)(b)]

Per cent

	Year-ended					
	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
GDP growth	−2	8	3½	3½	3½	3
(previous)	(−4½)	(6)	(4½)	(3½)	(3½)	(n/a)
Unemployment rate[(c)]	6.8	6½	6	5½	5½	5¼
(previous)	(7¾)	(7¼)	(6¾)	(6½)	(6¼)	(n/a)
CPI inflation	0.9	3	1½	1½	1½	1¾
(previous)	(½)	(2¼)	1	(1¼)	(1½)	(n/a)
Trimmed mean inflation	1.2	1¼	1¼	1½	1½	1¾
(previous)	(1)	(1¼)	(1)	(1¼)	(1½)	(n/a)
	Year-average					
	2020	**2020/21**	**2021**	**2021/22**	**2022**	**2022/23**
GDP growth	−2½	0	4	4	3½	3
(previous)	(−3½)	(−2)	(3)	(4½)	(3½)	(n/a)

(a) Forecasts finalised on 3 February. Forecast assumptions (November Statement in parenthesis): TWI at 63 (60), A$ at US$0.76 (US$0.70), Brent crude oil price at US$56/bbl (US$42/bbl); the cash rate remains around its current level and other elements of the Bank's monetary stimulus package are in line with the announcements made following the February 2021 Board meeting.

(b) Rounding varies: GDP growth to the nearest half point; unemployment rate and inflation rate to the nearest quarter point. Shaded regions are published historical data and are shown to one decimal place. Figures in parentheses show the corresponding baseline scenario forecasts in the November 2020 Statement.

(c) Average rate in the quarter.

Sources: ABS; RBA

before embarking on large scale investments during a period of unusually high uncertainty.

Labour market

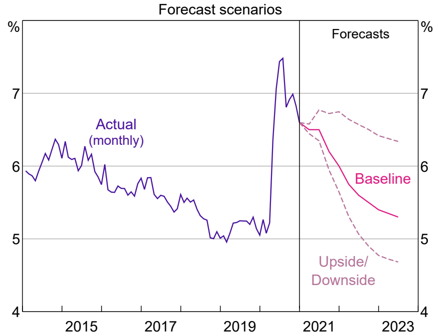
Labour market outcomes in the December quarter were much stronger than expected at the time of the November *Statement*. Employment and labour force participation have recovered more quickly than anticipated, and the unemployment rate declined further to 6.6 per cent in December. These outcomes suggest the peak in the unemployment rate has already occurred, and at a much lower level than expected earlier in the pandemic (Graph 5.2).

The improved near-term outlook means the expected recovery in employment and total hours has been front-loaded, with both of these aggregates returning to their pre-pandemic levels by late 2021 (Graph 5.3). The key driver of the faster recovery in the labour market has been the stronger-than-expected rebound in activity over the second half of 2020. The return to employment of people who had temporarily exited the workforce has also occurred more rapidly than expected; industries most affected

Graph 5.2

Unemployment Rate

Forecast scenarios



Sources: ABS; RBA

by activity restrictions were those with typically higher turnover rates, meaning rehiring could happen faster. The quick rebound in participation suggests that there has been less labour market scarring and fewer search frictions than is typically seen in labour market downturns and recoveries. It also implies that there are fewer workers still out of the labour force waiting to rejoin, which reduces the likelihood of a material increase in the unemployment rate being driven by people returning to the labour force.

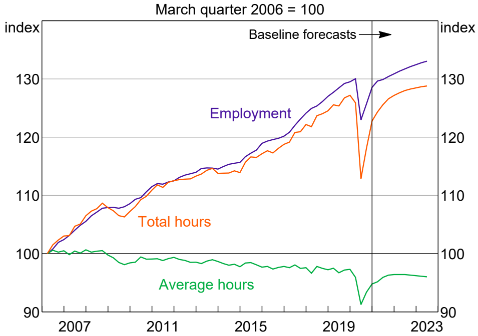
The JobKeeper program winds down at the end of March, which creates some uncertainty for the overall pace of employment growth in the first part of the year. Employment is then expected to continue growing over the forecast period, underpinned by the ongoing expansion, but at a slower pace than previously anticipated given much of the expected recovery has already occurred.

The decline in the unemployment rate is expected to slow in the next quarter or two as JobKeeper finishes. From mid 2021, and consistent with the outlook for employment growth, the unemployment rate continues to move gradually lower to reach around 5¼ per cent by the end of the forecast period in mid 2023. While the outlook for unemployment is materially better than expected a few months ago, this still represents a significant amount of spare capacity in the economy, with the unemployment and underemployment rates expected to remain elevated across the forecast period. Although average hours worked have rebounded quickly to date, there are still some workers (particularly full-time) who remain on reduced or zero hours.

Graph 5.3

Employment and Hours Worked

March quarter 2006 = 100



Sources: ABS; RBA

Labour force participation has returned to historically high levels, as a large number of people who had temporarily left the workforce had already returned by December. Some further modest increase in participation is expected in the next few quarters, as the recent strength in employment encourages some people currently outside the workforce to enter or return. Further out, the participation rate is expected to ease back a little as the recovery matures, but longer-run structural drivers of increased participation (such as incremental increases in the pension eligibility age and better health outcomes for older people) are expected to remain in place.

Public demand

Public demand is expected to make a larger contribution to domestic final demand growth over the year to June 2021 than was anticipated at the time of the November *Statement*. The upgrade reflects capital spending plans in state budgets that were released over recent months, which foreshadowed a larger and more rapid increase in public investment than previously indicated. Aggregate public investment is forecast to increase by around 25 per cent over the year to June 2021, a boost that is roughly comparable to the increase in public investment after the global financial crisis. Public consumption is expected to grow modestly over coming quarters and then decline a little as direct spending related to management of the pandemic is reduced.

Household consumption, income and saving

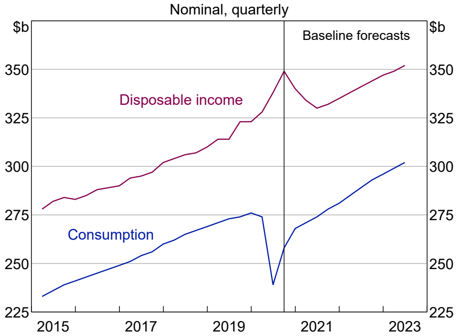
Consumption is expected to recover to pre-pandemic levels around the end of 2021 (Graph 5.4). The ongoing recovery in consumption is expected to be underpinned by the recovery in labour income, net household wealth and a gradual decline in uncertainty related to health and economic outcomes. Over recent months, the recovery in household spending was a little faster than expected at the time of the previous *Statement*, led by households in Victoria. The improvement in labour market conditions has supported household income and partly offset an expected decline in non-labour income as tighter eligibility requirements for income support measures have come into effect. Households who were affected by the tightening of containment measures over the summer are expected to have reduced their spending only modestly and for a short period.

The household saving rate is expected to decline from around 20 per cent in the September quarter 2020 to 5 per cent by the end of the forecast period, broadly in line with pre-pandemic levels. Household disposable income is expected to decline through the first half of 2021 as social assistance payments decline and the JobKeeper program is phased out, before income resumes a steady uptrend in line with the expected economic recovery. Consumption possibilities are expected to continue to broaden as restrictions ease further, which should be conducive to households spending a larger share of income received.

Graph 5.4

Household Consumption and Income

Nominal, quarterly



Sources: ABS; RBA

Dwelling investment

Dwelling investment is forecast to return to its pre-pandemic level by mid 2021. Building approvals for detached houses and alterations & additions increased sharply in the second half of 2020, indicating that a strong pick-up in lower-density residential construction is underway. A large share of the dwelling investment expected to occur over the coming year is assumed to be activity pulled forward by the HomeBuilder scheme (and to a lesser extent, some state-based support measures). Investment in higher-density residential construction is expected to remain weak, consistent with low levels of building approvals.

Business investment

Non-mining business investment is forecast to increase gradually off a very low base over the first half of 2021 and return to pre-pandemic levels by the end of 2022. Investment in machinery & equipment is expected to lead the moderate recovery over the forecast period, after declining by less than previously anticipated over 2020. The rebound in domestic activity, expanded tax incentives for investment announced in the Australian Government Budget in October and increased business profits over recent quarters should all help to support investment, particularly in goods-related industries where business conditions are well above average.

By contrast, non-residential construction is still expected to fall sharply in the near term as the pipeline of existing projects is worked through and recent weakness in building approvals suggests that few new projects will commence. Non-residential construction activity is not expected to pick up until late 2021, in part because of the long lags in the approval and planning of projects. More broadly, these projections occur against a backdrop where non-mining business investment in a number of advanced economies, including Australia, was subdued for a long period prior to the pandemic, in part reflecting uncertainty about future demand conditions. Firms are likely to be faced with high uncertainty for some time.

Mining investment is now expected to be little changed in the near term compared with expectations of modest growth at the time of the November *Statement*. Recent survey data suggest some firms have scaled back their investment intentions, despite increases in some commodities prices towards the end of 2020. Further out, maintenance and sustaining projects are expected to support mining investment at around its current level. As yet, there have been no indications by major miners of plans to expand investment in response to recent high iron ore prices. Iron ore projects take a number of years to deliver and market participants expect prices to ease as Brazilian supply recovers.[1] While higher iron ore prices may not have much direct effect on near-term mining investment, higher prices will support state and federal government revenues through increased mining royalties and company income tax receipts.

External sector

The outlook for exports is broadly similar to that in the November *Statement*, with exports gradually recovering and reaching pre-pandemic levels by the end of 2022. The forecast has been downgraded a little in the near term as recent weakness in coal exports is expected to persist, outweighing higher iron ore exports. Lower overseas student enrolments will also reduce education exports. That said, exports are expected to grow a little faster over 2022 as the availability of vaccines supports a quicker recovery in tourism and education once international travel restrictions ease. As in the November *Statement*, this easing is assumed to happen around the end of 2021.

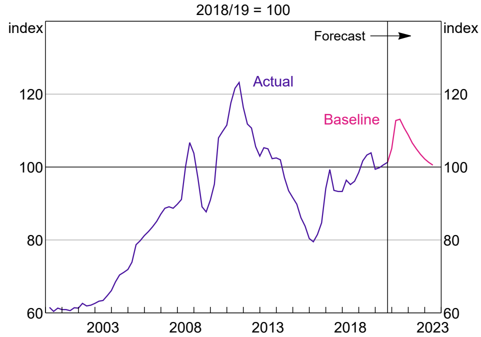
Forecast import growth has been revised up due to stronger domestic demand and the appreciation of the exchange rate, even though the appreciation of the Australian dollar is assumed to affect trade by less than usual, because of the restrictions on international travel. Imports are expected to exceed their pre-pandemic level at the start of 2022.

The trade surplus is expected to be significantly wider than was anticipated in the November *Statement* as a near 15 per cent increase in the terms of trade across the forecast period more than outweighs higher import volumes. The terms of trade is boosted by higher profiles for iron ore, coal and LNG prices and a lower profile for import prices. As in the November *Statement*, iron ore prices are expected to decline over the forecast period, albeit from a significantly higher starting point that is near decade highs. As a result, the terms of trade are expected to decline over the second half of the forecast period but from a much higher level than previously anticipated (Graph 5.5).

Graph 5.5

Terms of Trade

2018/19 = 100



Sources: ABS; RBA

Wages and inflation

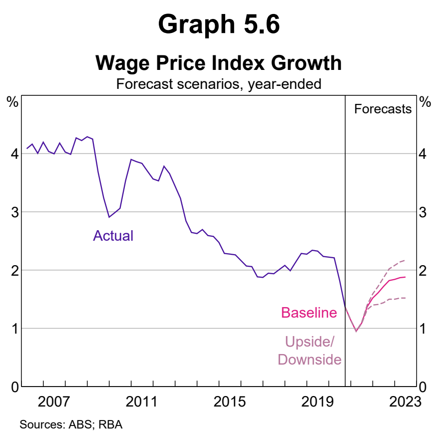
The outlook for wages growth is a little stronger than the baseline scenario in the November *Statement*, as absorption of spare capacity occurs at a slightly faster rate given the upgraded labour market outlook. However, even by mid 2023, the unemployment rate is still likely to be higher than is consistent with a tight labour market and a strong pick-up in wages growth. Year-ended growth in the Wage Price Index (WPI) is expected to remain below 2 per cent over the next few years, even slower than the low rates recorded prior to the pandemic (Graph 5.6).

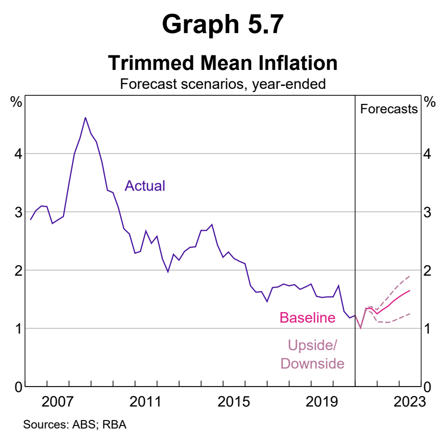
Despite the economic recovery getting underway in the September quarter, wages growth was weaker than in the June quarter, with the WPI increasing at its slowest rate since the series began 2 decades ago. Based on liaison reports, wages growth in the December quarter is expected to be weak again as private sector wage freezes remain widespread. As these wage freezes unwind, this will provide modest support to private sector wages growth over the year ahead, as will the strengthening labour market. Public sector wages will also pick up as some wage freezes and caps start to unwind. However, the broader outlook for public sector wages (which account for around one-quarter of the WPI) has been revised down slightly, as some state governments have announced measures to cap wage growth at lower rates than in recent years.

In line with the more positive outlook for the labour market, the outlook for underlying inflation has been revised up a little relative to the November *Statement*. Nonetheless, inflation is still expected to be subdued throughout the forecast period, consistent with some spare capacity remaining in the economy and wages growth remaining below 2 per cent in the baseline scenario (Graph 5.7).

Movements in headline inflation will continue to be choppy this year, reflecting the unwinding of rent reductions and various government support measures such as free child care and utilities rebates. Headline inflation is expected to increase to around 3 per cent over the year to June 2021, before dropping back to around 1½ per cent by the end of the year. Underlying inflation is expected to increase only gradually over the forecast period, reaching around 1¾ per cent by mid 2023.

At a compositional level, there are a number of cross-currents expected to affect inflation outcomes in the near term. Strong demand for detached housing construction is expected to boost new dwelling inflation. While rents are very weak at present, they are likely to pick up a little over the year ahead as negotiated rent





reductions unwind. Prices for consumer durables could increase further on the back of recent strong demand for cars and household items. Global supply chain disruptions had previously depleted inventories and generated some price pressures, but liaison reports suggest that this has now largely dissipated. Prices in other expenditure categories are expected to remain subdued; some government subsidies and rebates will remain in place for some time yet and a number of administered prices have been frozen. Utilities prices are also expected to continue to fall for some time, driven by low wholesale gas prices and increased electricity supply from renewables.

Risks and uncertainties

The momentum in activity and labour markets, the additional boost to the economy from state and Australian government budgets and the successful health response to the latest set of localised outbreaks have combined to reduce near-term downside risks. Internationally, a number of vaccines have been approved and vaccinations have begun, which reduces some of the downside risk to the global recovery.

Nevertheless, a higher-than-usual degree of uncertainty continues to surround the economic outlook. In recognition of this, plausible upside and downside scenarios for the domestic economy (based on different health assumptions) are outlined below, followed by a discussion of other risks and uncertainties.

Upside scenario: faster recovery

A stronger domestic recovery than the one set out in the baseline scenario is possible if a sustained run of positive health outcomes enables the remaining restrictions on activity to be eased more quickly. This would be expected to lead to a stronger rebound in consumer and business confidence, as well increased opportunities for services consumption, including interstate travel. A less uncertain environment would boost consumption in this scenario by households drawing down on savings accumulated over the past year; the scenario assumes that over the next year and a half, households consume around 40 per cent of the unplanned savings accumulated over the June and September quarters of 2020. In this scenario, higher confidence and increased activity also contributes to a faster rebound in business investment than in the baseline forecast.

The scenario also assumes faster-than-expected progress on overseas vaccination programs and more rapid control of virus outbreaks internationally. This underpins a faster recovery of tourism exports when international borders reopen, although the effect on GDP is almost entirely offset by stronger tourism imports in the scenario. Stronger activity and reduced uncertainty about the outlook support stronger labour demand and employment growth, which leads to a faster decline in the unemployment rate than in the baseline scenario; the unemployment rate declines to around 4¾ by the end of 2022 in this scenario. Better labour market outcomes lead to a stronger pick-up in wages growth and a slightly faster increase in inflation over the next couple of years.

Downside scenario: slower recovery

A plausible downside scenario would involve further large outbreaks that require broad activity restrictions to be reimposed. While these would be less severe than the extended lockdowns assumed in previous downside scenarios, an upswing in domestic case numbers would see activity restrictions tightened. This would negatively affect confidence and weigh on private consumption and investment. In this scenario, the combination of activity restrictions and weaker confidence induces households to consume less and add further to their stock of accumulated savings.

This scenario involves a longer and more damaging slowdown in activity than envisaged in the baseline scenario. Intermittent state border closures would be expected to prompt consumers to delay or reconsider interstate travel plans. Combined with temporary restrictions on activity and negative confidence effects this would reduce consumer spending and business investment. In this scenario, GDP increases more gradually over 2021, with growth only starting to pick up from early 2022. The slowing in activity and heightened uncertainty in this scenario would reduce momentum in the labour market recovery as firms put off hiring decisions and/or lay off extra workers. The unemployment rate peaks at a higher rate of 6¾ per cent in mid 2021 in this scenario, and declines only slowly thereafter. The larger degree of spare labour market capacity places further downward pressure on wages growth, which sees inflation trend lower until mid 2022.

Other risks and uncertainties

Beyond the uncertainty around health outcomes discussed in the scenarios above, there are other sources of risk and uncertainty clouding the domestic outlook, some of which have become more balanced in recent times.

One overarching issue will be how households and businesses respond to the tapering of fiscal and other temporary support measures following a period where household and business cash flows have been boosted by an extraordinary amount of policy support.

In the corporate sector, insolvencies could rise by more than expected as temporary support measures are withdrawn, reducing investment, slowing activity and placing upward pressure on the unemployment rate. There is also a risk that recent tax incentives that have supported business investment mostly pull forward demand, leading to a period of weak investment after the incentives expire. On the other hand, for some businesses that were able to build cash buffers and adapt their business models last year, stronger balance sheets and the opening of new opportunities as a result of the pandemic could provide a basis for a faster recovery. If elevated commodity prices persist longer than expected, it is also possible that this prompts mining firms to lift investment towards the end of the forecast period.

For the household sector, there are also risks to the baseline scenario forecasts in both directions. The expected decline in income through to mid year and a slowing in the recovery in labour markets could drag on the recovery in household consumption, as could a longer-lasting shift in risk preferences that results in the saving rate stabilising at a higher level. In the other direction, a stronger recovery in labour income, larger asset price gains and reduced economic uncertainty could prompt households to consume at a faster pace than currently envisaged in the baseline scenario, including by quickly drawing down on the large saving buffers accumulated over 2020. Higher housing prices could also support detached dwelling investment (alongside consumption) by more than expected, even as fiscal support measures unwind.

Turning to public investment, governments have collectively announced a large increase in capital spending over the year to June 2021. It is assumed that this spending occurs in a way that is broadly consistent with historical patterns of investment realisation and that capacity constraints are minimal. A more rapid rollout of public investment presents an upside risk to the forecasts given the intent of governments to ensure the timely rollout of capital spending programs. At the same time, there is a risk that the high level of budgeted capital spending could be slower to materialise due to capacity constraints, although subdued conditions in private non-residential construction means this is less likely than in the recent past.

The unusual nature of this downturn and recovery makes it difficult to judge the extent of spare capacity in the economy; any scarring effects would tend to damage the supply side of the economy and lower the growth rate of potential output. Although the improved outlook for the labour market suggests spare capacity will be absorbed faster than had been previously forecast, underutilisation is still expected to remain high for several years, which might delay the gradual pick-up in wages growth and inflation over the forecast period. It is also possible that if the unemployment rate were to decline more rapidly than expected, it might not be accompanied by stronger wage or price pressures if spare capacity is underestimated and wage and price inflation expectations become anchored at low levels. Given the extent of private and public sector wage freezes, as well as the likelihood that wages growth and underlying inflation remain below 2 per cent for an extended period, low inflation expectations may persist.

On the other hand, higher prices for some consumption goods and services, in part as a result of supply side bottlenecks, could lead to a sharper-than-expected increase in retail price inflation. Some firms will be better placed than others in passing through price pressures to consumers. More broadly, the speed of the labour market recovery so far, and possible changes in labour demand (such as for particular skills or in specific locations) combined with some labour supply constraints (such as border restrictions affecting the availability of skilled labour sourced overseas), could mean pockets of faster wages growth emerge more quickly, spilling over into broader measures of wage and price expectations.

Endnotes

[1] See RBA (2019), 'Box B: The Recent Increase in Iron Ore Prices and Implications for the Australian Economy', *Statement on Monetary Policy*, August, pp 37–40. Available at <https://www.rba.gov.au/publications/smp/2019/aug/box-b-the-recent-increase-in-iron-ore-prices-and-implications-for-the-australian-economy.html>