5. Economic Outlook

Forecasts for global growth in 2022 and 2023 have been revised down since the May *Statement*, in response to the weaker outlook for real incomes and faster increases in policy rates. Growth in Australia's major trading partners is expected to fall well below the pre-pandemic average this year, in part because measures to suppress China's COVID-19 outbreak have weighed on activity there by much more than anticipated. One key uncertainty for the global growth outlook is how resilient consumer spending will be in response to a sharp slowing in real income growth and higher interest rates. It is also uncertain how persistent inflation will prove to be. A potential further tightening of supply in energy markets could impinge significantly on many economies, especially in Europe (see chapter on 'The International Environment').

The Australian economy is expected to grow strongly over 2022, before slowing next year. In the near term, GDP growth is expected to be supported by growth in household consumption and a recovery in services exports. Further ahead, higher consumer prices, rising interest rates and declining housing prices are expected to weigh on growth in private spending, at the same time as growth in public demand slows. Offsetting this to some extent, the elevated terms of trade will boost national income substantially. GDP is forecast to grow by 3¼ per cent over 2022, 1¾ per cent over 2023 and 1¾ per cent over 2024. These forecasts are lower than three months ago. Strong demand for labour is expected to see the unemployment rate decline to 3¼ per cent in late 2022, lower than the previous forecast. The unemployment rate is then expected to rise gradually, in line with slowing growth in activity, but to remain low by the standards of recent decades.

Inflation is now the highest it has been since the early 1990s and is forecast to increase further in the second half of this year. Consumer price inflation is expected to reach around 7¾ per cent around the end of the year before starting to decline in early 2023. Underlying inflation is expected to increase to 6 per cent in year-ended terms in the second half of 2022, largely reflecting further pass-through of upstream cost pressures in many sectors. Absent additional supply shocks, some cost pressures will wane over time. Further increases in labour costs in response to the tight labour market are expected to become the primary driver of inflation outcomes later in the forecast period. Headline and underlying inflation are expected to return to the top of the inflation target range by late 2024.

The effect of high inflation and cost-of-living pressures on wage- and price-setting behaviour is a material risk to the inflation outlook. Higher expectations of future inflation could result in inflation remaining elevated for longer than currently anticipated. Another source of uncertainty for the domestic growth outlook relates to the competing forces affecting household spending. At present, household incomes are being sustained by strong labour demand, which is feeding into strong growth in employment and hours worked, and will ultimately lead to stronger wages growth. Also household balance sheets are in generally good shape, underpinned by a high level of savings. Against those positive drivers of consumption, high inflation and rising interest rates are raising the cost of living and will weigh on households' spending. Household consumption could also be dampened by wealth effects as housing and other asset prices decline. How these competing forces net out is uncertain, and the balance could shift considerably over time. Other sources of uncertainty include the impact of supply shocks on price pressures and the persistence of disruptions from COVID-19.

Domestic activity

The Australian economy is expected to grow strongly over 2022 (albeit at a slower pace than previously expected), as household consumption is supported by strong labour income growth and education and travel services exports pick up. GDP growth is expected to slow in 2023 to below most estimates of potential output growth (Graph 5.1). The slowing is anticipated to be broadly based, with slower growth in household consumption, weaker dwelling investment as housing prices decline, a stabilisation of public demand at high levels after recent rapid growth, and slower growth in exports as the recovery in services exports nears completion.

Employment is forecast to grow strongly during 2022 before moderating as growth in activity slows. Since the start of this year, labour market outcomes have been robust and leading indicators of labour demand suggest this will continue in the near term. Participation in the labour force is expected to be sustained at historically high levels over the forecast period, supported by the cyclical strength in labour market conditions and the longer term trend toward increased participation among females and older Australians. The unemployment rate is forecast to decline to around 3¼ per cent in late 2022 before rising gradually thereafter, in line with slower growth in activity (Graph 5.2). Broader measures of labour underutilisation that include workers who are underemployed are also forecast to decline to their lowest level in many years as firms increase staff hours to meet demand. Following the reopening of the international border earlier this year, immigration could help to alleviate labour shortages in some industries over time, while also adding to demand in the economy.

Inflation is high and is expected to increase further in the second half of the year. The forecast for headline inflation has been revised up substantially compared with a few months ago, reflecting broad-based pricing pressures that are not expected to ease until early next year, as well as expectations of large increases in retail electricity and gas prices over the coming year. Headline inflation is expected to peak around 7¾ per cent in year-ended terms towards the end of 2022, before declining back to the top of the inflation target range by the end of 2024 (Graph 5.3).

The near-term outlook for underlying inflation has also been revised higher, with an expected peak at around 6 per cent in late 2022 (Graph 5.4). A significant share of firms in the Bank's liaison program have increased prices or expect to do so over coming months as a result of earlier increases in input costs. Some upstream cost pressures are showing signs of easing but it will take some time before this affects prices paid by consumers. Underlying inflation is expected to ease from early 2023 and to be back to the top of the inflation target range by the end of 2024. This moderation is expected to occur more slowly than previously assumed as higher energy costs partly offset declines in other input costs arising from the easing in supply chain pressures.

The forecasts are based on some technical assumptions. The path for the cash rate reflects expectations derived from surveys of professional economists and financial market

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

Per cent

	Year-ended					
	Jun 2022	Dec 2022	Jun 2023	Dec 2023	Jun 2024	Dec 2024
GDP growth	3½	3¼	2¼	1¾	1¾	1¾
(previous)	(3½)	(4¼)	(3)	(2)	(2)	(n/a)
Unemployment rate[(b)]	3.8	3¼	3½	3½	3¾	4
(previous)		(3¾)	(3½)	(3½)	(3½)	(n/a)
CPI inflation	6.1	7¾	6¼	4¼	3½	3
(previous)		(6)	(4¼)	(3¼)	(3)	(n/a)
Trimmed mean inflation	4.9	6	5	3¾	3¼	3
(previous)		(4¾)	(3½)	(3¼)	(3)	(n/a)
	Year-average					
	2021/22	2022	2022/23	2023	2023/24	2024
GDP growth	3¾	4	3½	2¼	1¾	1¾
(previous)	(3¾)	(4½)	(4½)	(2¾)	(2)	(n/a)

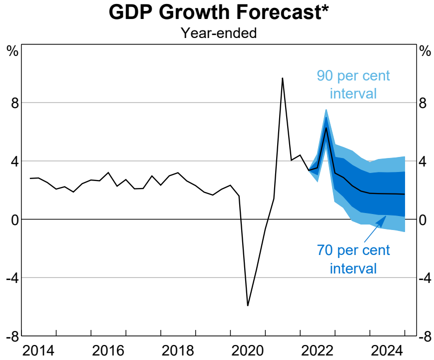
(a) Forecasts finalised on 3 August. The forecasts are conditioned on a path for the cash rate broadly in line with expectations derived from surveys of professional economists and financial market pricing. Other forecast assumptions (assumptions as of May *Statement* in parenthesis): TWI at 63 (63); A$ at US$0.69 (US$0.71); Brent crude oil price at US$94bbl (US$101bbl). The assumed rate of population growth is broadly in line with the profile set out in the Australian Government Budget 2022–23. Forecasts are rounded to the nearest quarter point. Shading indicates historical data, shown to the first decimal point.

(b) Average rate in the quarter.

Sources: ABS; RBA

pricing, with the cash rate assumed to increase to around 3 per cent by the end of 2022, and then decline a little by the end of 2024. The exchange rate is assumed to be unchanged at its current level. Wholesale petrol prices are assumed to be unchanged around their recent level, and the temporary discount in the fuel excise is assumed to be removed in line with government policy. Population growth projections are little changed from the May

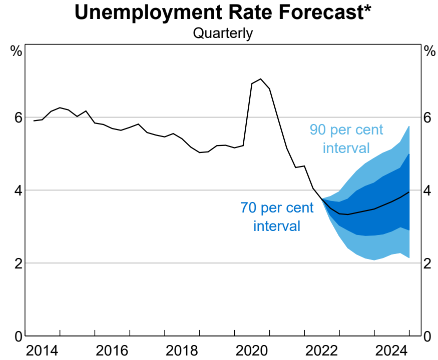
Graph 5.1



* Confidence intervals reflect RBA forecast errors since 1993.

Sources: ABS; RBA

Graph 5.2

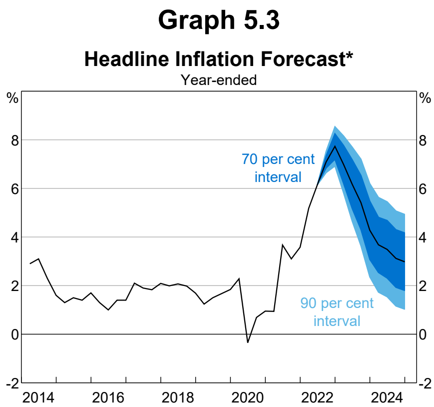


* Confidence intervals reflect RBA forecast errors since 1993.

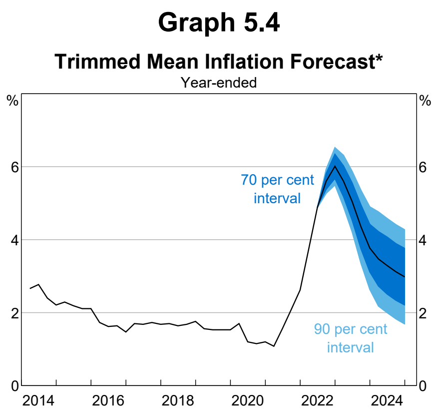
Sources: ABS; RBA

Statement and reflect assumptions used in the Australian Government Budget 2022–23.

The forecasts are also based on the assumption that any future waves of COVID-19 variants will mostly have a temporary impact on the economy, with limited restrictions on economic activity required and the labour market adjustment occurring mainly through a reduction in hours worked. The risk of more persistent disruptions from the virus is one of several uncertainties for the outlook (see 'Key domestic uncertainties', below).



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

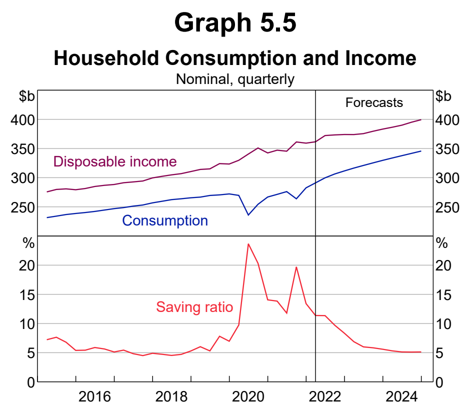


* Confidence intervals reflect RBA forecast errors since 1993.
Sources: ABS; RBA

Household consumption, income and saving

Household consumption grew solidly in the first half of 2022 as spending on discretionary goods and services, including hospitality and travel, continued to recover. The resilience in spending partly reflects strong growth in household disposable income. The near-term outlook for consumption continues to be supported by strong labour market outcomes, though growth is forecast to ease over the remainder of 2022 as households' budgets come under increased pressure from the rising cost of living (Graph 5.5). Higher prices, especially for food and fuel, are likely to impact low-income households in particular (which tend to spend a larger share of their income on these necessary items). While household balance sheets are generally strong and many households should be able to absorb these price increases, others have limited savings buffers and may have to reduce spending elsewhere. For some of these more vulnerable households, the impact of price rises will be mitigated to some extent by the indexation of social assistance payments twice per year, though price rises will reduce recipients' real incomes in the near term.

Further out, growth in consumption is forecast to slow as rising prices and higher net interest payments weigh on real disposable income growth, and declines in housing prices lower net



Sources: ABS; RBA

household wealth. The household saving ratio is expected to decline over the forecast period to just below its average level in the years prior to the pandemic.

Investment

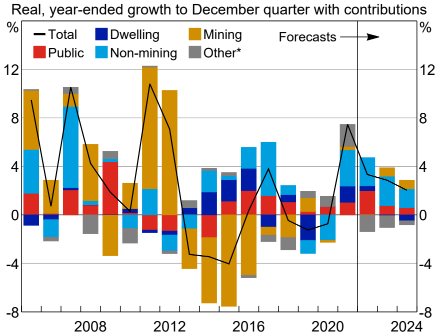
The outlook for investment remains positive (Graph 5.6). A large pipeline of residential and non-residential projects is expected to sustain construction activity for at least the next year. However, the recent flow of data and information from the Bank's liaison program indicate that capacity constraints have intensified in some sectors, which will limit the pace of growth in construction activity for some time.

The pipeline of private non-residential construction work yet to be done has increased recently, reflecting additional commercial projects. By contrast, the outlook for dwelling investment has been downgraded. Demand for new detached dwellings is expected to be soft as a further decline in established housing prices and high construction costs reduce the incentive to build new dwellings. Prospects for higher density residential projects are brighter, as rental vacancy rates in Sydney and Melbourne have declined and as population growth recovers following the reopening of the international border.

Graph 5.6

Investment

Real, year-ended growth to December quarter with contributions



* Includes ownership transfer costs, net purchases of second-hand assets, and other items.

Sources: ABS; RBA

Non-mining machinery and equipment investment is expected to grow over coming years, consistent with information from the ABS Capital Expenditure Survey and the Bank's liaison program. However, ongoing supply chain disruptions are anticipated to weigh on growth in the near term. Further, the effect of government tax incentives appears to be waning after earlier strong growth, as some firms brought forward investment.

Mining investment is forecast to increase a little over coming years. Shortages of skilled labour and some materials have become more binding, which is expected to weigh on growth in the near term. Elevated commodity prices and recent strong growth in profits for Australia's main commodity producers have not resulted in a material change of investment plans.

Public demand

Public consumption is forecast to have increased further in the June quarter from an already high level. Further ahead, public consumption is anticipated to decline as a share of nominal GDP as temporary spending measures introduced during the pandemic are unwound. Public investment is forecast to grow over the forecast period. The pipeline of public engineering work is anticipated to support a high level of public capital expenditure for several years, but the speed of the rollout will be constrained by labour and materials shortages for some time.

External sector

Exports are forecast to grow strongly over coming years. Travel and education exports have increased from very low levels following the full reopening of the international border and are expected to grow substantially in the period ahead, though the recovery has so far been slower than anticipated. Resource export volumes have declined in recent quarters due to maintenance and weather-related disruptions weighing on production. As these disruptions fade, resource exports are expected to pick up. Meanwhile, rural production has benefited from ongoing favourable weather conditions. Rural exports are forecast to remain elevated, reflecting strong global demand for grains and disruptions to global supply from Ukraine and Russia. Import volumes are expected to increase a little faster than domestic demand over the next year as tourism recovers following the reopening of the international border.

The near-term outlook for the terms of trade has been boosted by high global energy prices, particularly LNG and thermal coal, reflecting ongoing disruptions in energy markets due to Russia's invasion of Ukraine. The terms of trade are expected to reach a record high level in the June quarter (Graph 5.7). Commodity prices are projected to decline over the forecast period but to remain higher than previously anticipated, contributing to a higher level of the terms of trade compared with three months ago. The trade balance is expected to decline from its record level, in line with the projected decline in commodity prices.

Labour market

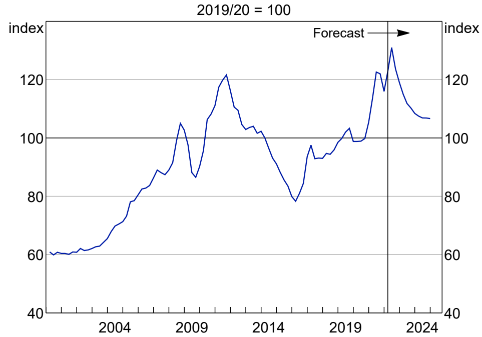
Labour market conditions tightened in the first half of 2022 and leading indicators suggest this will continue in the months ahead. The labour market adjustment to illness- and weather-related disruptions has occurred mostly through a decline in hours worked, with the disruptions caused by higher-than-usual levels of illness more persistent than expected a few months ago. Employment growth is forecast to remain strong in 2022 before moderating thereafter as activity slows (Graph 5.8). The participation rate is expected to increase further over 2022 and remain around this level until the end of 2024, supported by strong labour demand and longer run structural drivers, such as higher participation rates among females and older Australians.

A broad range of measures of labour market spare capacity suggest the labour market is the tightest it has been in decades. The unemployment rate is forecast to decline to around 3¼ per cent in late 2022 before rising modestly thereafter as a result of slower growth in activity. An increase in average hours worked, which remain below their pre-pandemic trend, is also expected to be a key margin of adjustment in response to strong labour demand. Average hours worked are expected to rise above the pre-pandemic level by late 2022, leading to

Graph 5.7

Terms of Trade

2019/20 = 100

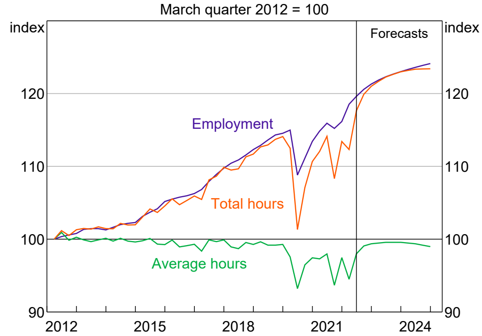


Sources: ABS; RBA

Graph 5.8

Employment and Hours Worked

March quarter 2012 = 100



Sources: ABS; RBA

further declines in broader measures of labour underutilisation.

Wages

Wages growth is expected to pick up further as labour market conditions continue to tighten. The share of firms in the Bank's liaison program reporting annual wages growth above 3 per cent has increased from around 25 per cent in late 2021 to 40 per cent in the June quarter. Around 60 per cent of firms expect that wages growth over the year ahead will be higher than current rates. The lift in expected wages growth reflects the response of firms to higher voluntary turnover, stronger inflation outcomes and the Fair Work Commission's decision on minimum and award wages. Business surveys also indicate that labour costs are picking up.

Aggregate wages growth outcomes are expected to continue to be restrained by wages growth in public and private enterprise agreements, particularly in the near term, consistent with the multi-year duration of agreements. In recent months, the New South Wales, Western Australian and Tasmanian governments announced increases in their wage caps for public sector workers, while the Queensland Government removed its wage cap. These changes will support a pick-up in wages growth as new agreements are negotiated, although the direct effect on aggregate wages growth is likely to be small.

Growth in the Wage Price Index (WPI) – a narrow measure of base wages designed to measure changes in wage rates for a given quantity and quality of labour – is expected to pick up to around 3½ per cent by mid-2023 and 3¾ per cent by the end of 2024; this would be the fastest pace since 2012 (Graph 5.9). Broader measures of labour income growth are expected to increase at a faster rate than the WPI over the forecast period as employers use bonus payments to retain or attract staff and provide temporary relief for the higher cost of living, as more hours are worked at overtime rates and as workers move jobs for higher pay. These broader measures imply less of a decline in real incomes than suggested by the narrower WPI measure (Graph 5.10).

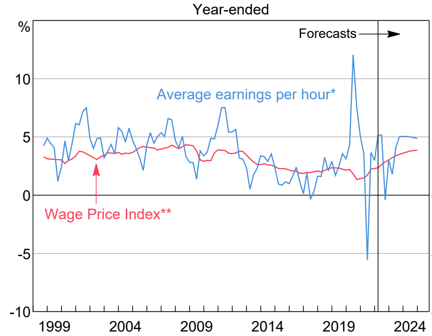
Inflation

The outlook for inflation has been revised higher from a few months ago. In the near term, headline inflation is expected to be boosted by higher utilities prices, reaching a peak of around 7¾ per cent by the end of 2022 (Graph 5.11). Wholesale electricity and gas prices have increased sharply in recent months, reflecting

Graph 5.9

Wages and Earnings Growth

Year-ended

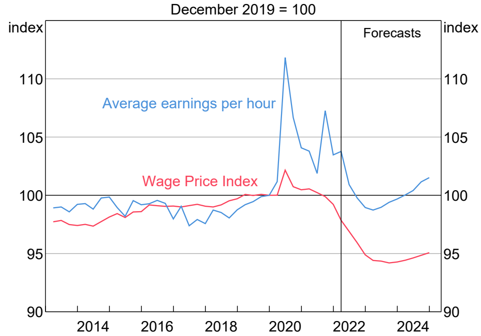


* Non-farm; includes social contributions.
** Excluding bonuses and commissions.
Sources: ABS; RBA

Graph 5.10

Real Labour Income*

December 2019 = 100



* Deflated using the headline Consumer Price Index.
Sources: ABS; RBA

domestic supply disruptions, strong demand and high international coal and gas prices. As a result, retail electricity and gas prices are expected to increase by 10–15 per cent in the September quarter of 2022, with announced increases by energy retailers being generally above the default market offer increases set by energy regulators, particularly among smaller providers. However, the introduction of rebates by some state governments are expected to delay most of the direct effect of higher utilities prices on headline inflation until the December quarter of 2022.

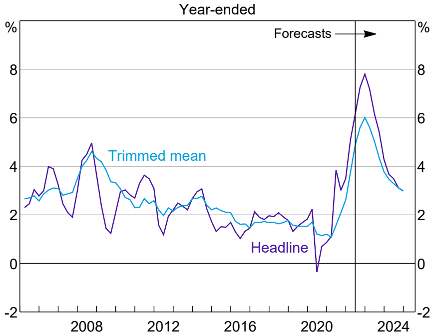
Contacts in the energy sector in the Bank's liaison program generally expect there to be further significant increases in retail utilities prices in 2023. As such, a further 10–15 per cent increase in retail utilities prices is assumed in 2023, although the exact size and timing of future increases remains highly uncertain. Businesses are expected to face larger increases in electricity prices than households because the wholesale component comprises a larger share of businesses' electricity bills. Any second-round effects on CPI inflation are likely to be spread out over a few years because businesses often purchase electricity on two- to three-year fixed-price contracts.

Global factors, including COVID-19-related disruptions to supply chains and the Russian invasion of Ukraine have accounted for much of the increase in inflation over the past year. While there are some early signs that these upstream pressures are easing, earlier increases to input costs are expected to continue boosting consumer prices for some time. Domestically, strong demand, a tight labour market, flood-related disruptions and capacity constraints in some sectors are contributing to the upward pressure on prices.

Graph 5.11

Inflation Forecasts

Year-ended



Sources: ABS; RBA

Inflationary pressures have broadened significantly since late 2021 and domestic factors are increasingly playing a role. Price increases are becoming more common, impacting not only consumer durables and newly constructed homes but also groceries and market services. Grocery inflation has been elevated in recent quarters and this is expected to continue in the second half of 2022 as requests from suppliers to raise prices are gradually implemented in supermarkets – for example, substantial increases in the price of milk were introduced in early July. Price increases for new dwelling construction have been very strong, and are likely to persist in the near term before easing later in the forecast period. Further, as HomeBuilder and similar state government subsidies conclude and fewer grants are paid, more buyers will pay the full price for dwellings, which will contribute to measured inflation. Rental price inflation has picked up and is expected to increase further over 2022 as the impact of low vacancy rates on higher advertised rents over the past year or so works its way into the stock of outstanding rental agreements.

From early 2023, inflation is expected to moderate as global supply-side problems continue to ease and commodity prices stabilise, even if at a high level. Higher interest rates globally will also help moderate demand pressures. The pass-through of upstream non-labour cost pressures is anticipated to wane, while growth in labour costs is expected to pick up over the forecast period.

Key domestic uncertainties

The effect of high inflation and cost-of-living pressures on wage- and price-setting behaviour and inflation expectations

Inflation in Australia and internationally is likely to be elevated for a longer period than originally expected and result in a decline in real wages. Cost-of-living pressures are changing how governments, businesses and households respond to changes in prices. Given the labour market is already tight, workers might be more able to demand and achieve higher wages to compensate for the increased cost of living, even in the absence of a lift in productivity. Information from the liaison program indicates that higher inflation outcomes are a factor in some current wage negotiations; this is likely to contribute to a pick-up in wages growth in the period ahead, though it is too early to tell what impact this is having on agreed wage outcomes. If employers pass these and other increased costs on to consumers, this could result in inflation remaining elevated for longer than currently anticipated.

Higher expectations of future inflation could lead to a broadening of second-round price increases by firms, leading to higher actual inflation. Indeed, retailers have indicated in liaison that they are now more willing to pass on input cost pressures to consumers, rather than accepting lower margins. To date, longer term measures of inflation expectations remain well anchored. It is important this remains the case in order to realise the path back towards an inflation rate between 2 to 3 per cent.

The outlook for household consumption

Household incomes have been sustained by robust labour demand, with stronger-than-expected growth in employment and hours worked in recent quarters. Persistently strong demand for labour could result in sustained momentum in household consumption. Further, many households have built considerable savings buffers during the pandemic; if households are more willing to spend from these liquid savings than from other forms of wealth, spending would also be stronger than anticipated for a time. In addition, stronger-than-expected growth in domestic demand would see domestic inflation pressures build further.

A decline in real disposable incomes for the average household could weigh on consumption growth by more than expected, particularly if household wealth is also declining. While many households should be well placed to absorb higher interest costs without significant spending cuts, some households have low savings buffers and high debt relative to incomes, and so their spending may fall more sharply than others. The additional pressure on household budgets from rising prices could exacerbate these downside risks to consumption, particularly for lower income households; that said, it is hard to predict how declining real incomes might be reconciled with the current tight labour market. Consumption growth could also be weaker than anticipated in response to larger-than-expected falls in housing prices or other asset prices. The magnitude of the decline of housing prices arising from higher interest rates is uncertain, especially given the high level of prices relative to incomes. The outlook for residential construction is likewise sensitive to the paths of housing prices and interest rates.

The impact of a tight labour market and supply shocks on price pressures

Measures of labour market spare capacity are forecast to decline to their lowest levels in several decades and the participation rate is expected to remain at historically high levels. With limited recent historical experience to draw on, it is difficult to know how labour market dynamics and wage and price pressures will evolve in these circumstances. The pace and composition of net overseas migration following the reopening of the international border is also a source of uncertainty for the labour market outlook; how much the border reopening will alleviate areas of acute labour shortages will depend on the effects on labour supply across regions, industries and occupations. Depending on these factors, it is plausible that unemployment falls even further, or that it drifts up towards the end of the forecast period, as growth in activity slows and the cost of labour increases.

How long the various supply-side issues facing the economy persist is another important source of uncertainty. These constraints could intensify or persist for longer than expected (as they have in some other economies). In time, businesses will be able to invest to expand their capacity to deliver goods and services; however, in the interim, inflation could be higher than expected and output growth lower, while capacity constraints bind. On the other hand, there are signs that global supply constraints are easing. Global prices of some goods could therefore stabilise or even decline in the period ahead, which would moderate inflation outcomes. This is especially likely if global demand slows more and sooner than currently expected. One way this might occur is if the simultaneous tightening of monetary policy across many economies impinges on demand by more than the sum of individual-economy effects would imply.

The longer term effects of the pandemic and changes in the pattern of globalisation on potential growth and full employment in Australia are uncertain but tilted towards capacity being more limiting than previously assumed. It is possible that some of the recent changes in spending and production patterns are long-lasting and reduce productivity. In this event, any given rate of growth could be more inflationary than before the pandemic.

The persistence of disruptions from COVID-19

An ongoing uncertainty for the economy is the persistence of disruptions from COVID-19 variants. The number of people working fewer hours due to sick leave has remained elevated, reflecting high COVID-19 case numbers as well as influenza. Should high infection rates persist for an extended period, due to the emergence of new variants or lower protection from vaccines and past infection, then supply disruptions may pose a downside risk to activity and labour market outcomes. It is expected that labour market adjustments will occur mainly through a reduction in hours worked. The effect on inflation is uncertain; lower household consumption and higher unemployment would weigh on inflation but further disruptions to supply could support upstream cost pressures and result in higher inflation for longer than currently expected.