5. Economic Outlook

The global economic outlook has firmed this year because of progress in vaccinations and additional fiscal support in some economies. Overall growth in the global economy and in Australia's major trading partners is expected to rebound solidly this year and next (see 'The International Environment' chapter).

Even so, the recovery is expected to be incomplete over the forecast period in many economies, with China and the United States notable exceptions. The near-term outlook has also become more varied across economies recently as vaccination rates and policy support remain uneven and, in some cases, countries are facing another wave of infections. Underlying inflationary pressures are likely to remain contained in most economies for some time given spare capacity in labour markets, though the rebound in commodity and input prices will support inflation at least in the near term.

The Australian economy is transitioning from recovery to expansion phase earlier and with more momentum than anticipated. The unique features of the pandemic and policy response have seen the economy rebound much faster than in previous downturns. Along with favourable health outcomes and the removal of restrictions on activity, this snap-back in activity has been supported by extraordinary fiscal and monetary support. GDP growth in the December quarter 2020 was stronger than expected and the recovery in activity and the labour market again exceeded expectations in the March quarter. GDP is now expected to have reached its pre-pandemic level in the March quarter 2021 and there were more people employed in March than before the pandemic. The unemployment rate has declined quickly, to 5.6 per cent in March, a little above the rate before the pandemic.

In response to this stronger starting point for the forecasts and improved outlook further out, the baseline scenario for GDP and employment has been upgraded relative to the February *Statement on Monetary Policy*. Under the baseline scenario, GDP is expected to grow by around 4¾ per cent over 2021 and 3½ per cent over 2022. The level of GDP is still expected to remain a little below that forecast before the pandemic, mostly due to lower population growth; in per capita terms, GDP is expected to be on a higher trajectory, supported by higher per capita household income and a strong contribution from public demand. The unemployment rate is expected to continue declining, to around 5 per cent by the end of 2021 and 4½ per cent by the end of the forecast period in mid 2023. The lower forecast unemployment rate results in wages growth and underlying inflation picking up a bit faster than previously anticipated. Inflation is expected to be close to 2 per cent by mid 2023 in the baseline scenario.

The baseline scenario is based on the assumption that the domestic vaccine rollout accelerates in the second half of the year, allowing the international border to be reopened gradually from early 2022. This scenario assumes that no further large outbreaks and accompanying extended hard lockdowns occur within Australia, and that restrictions, when imposed, are brief.

Overall, Australian households and businesses appear to be adjusting well to the tapering of fiscal and other temporary support measures. But the nature and speed of the next phase of growth is still characterised by uncertainty, particularly around household consumption and the extent of spare capacity given the disruptions to the supply side of the economy induced by the pandemic. The outlook is also likely to be uneven across industries for some time yet, reflecting the closed international border, restrictions in parts of the services sector, large shifts in consumer preferences, ongoing supply disruptions and slower population growth.

Given this uncertainty, 2 alternative domestic scenarios (an upside and downside) are considered, based largely on different assumptions for household consumption:

- A stronger economic trajectory than the one envisaged in the baseline scenario is possible if households increase spending by more than expected. This could be in response to stronger wealth effects and a decline in uncertainty that boosts households' willingness to draw down on savings, which reinforces already improving conditions in the labour market and feeds back into faster income growth. Conditions supporting a faster pick-up in consumption would also support stronger private investment. In this scenario, the unemployment rate declines at a faster pace and to a lower level (around 3¾ per cent) than in the baseline scenario. This contributes to inflation picking up to around 2¼ per cent by the middle of 2023.
- A weaker trajectory could instead eventuate if households choose to consume their income and/or their prior savings at a slower pace than assumed in the baseline scenario. In this downside scenario, wealth effects on consumption are smaller, as households divert more of their financial resources to strengthening their balance sheets. Subdued consumption and private investment results in weaker labour income and the unemployment rate remaining above pre-pandemic levels in this scenario; this in turn sees underlying inflation remaining around 1½ per cent over the forecast period.

The domestic economy is expected to absorb spare capacity gradually

The level of GDP is expected to be around 2 per cent higher by mid 2023 than expected at the time of the February 2021 *Statement* (Graph 5.1; Table 5.1). The starting point for the forecasts is stronger than previously expected, following recent outcomes both for output and the labour market, and growth momentum in coming quarters is also a little stronger.

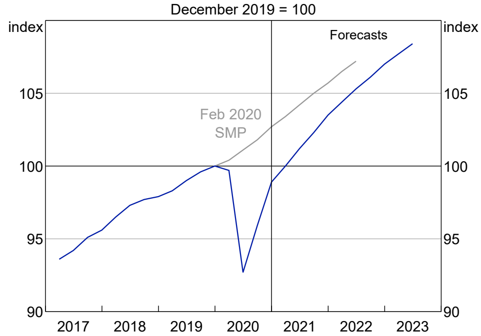
Growth in activity is expected to be broad-based in the period ahead, led by the household sector and public demand. A pick-up in business investment is also now underway and expected to continue, supported by strong balance sheets, rising business confidence, and a steady decline in both spare capacity and general uncertainty.

The outlook for the labour market has improved further. The starting point for the forecasts is noticeably better than anticipated at the time of the February *Statement*. Forward-looking

Graph 5.1

GDP

December 2019 = 100



Sources: ABS; RBA

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

Per cent

	Year-ended					
	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
GDP growth	−1.1	9¼	4¾	4	3½	3
(previous)	(−2)	(7¾)	(3½)	(3¼)	(3½)	(3)
Unemployment rate[(b)]	6.8	5¼	5	4¾	4½	4½
(previous)	(6.8)	(6½)	(6)	(5½)	(5½)	(5¼)
CPI inflation	0.9	3¼	1¾	1¼	1½	2
(previous)	(0.9)	(3)	(1½)	(1½)	(1½)	(1¾)
Trimmed mean inflation	1.2	1½	1½	1½	1¾	2
(previous)	(1.2)	(1¼)	(1¼)	(1½)	(1½)	(1¾)
	Year-average					
	2020	**2020/21**	**2021**	**2021/22**	**2022**	**2022/23**
GDP growth	−2.4	1	5¼	5	4	3¼
(previous)	(−2¾)	(¼)	(4)	(3¾)	(3¼)	(3¼)

(a) Forecasts finalised on 5 May. Forecast assumptions (February Statement in parenthesis): TWI at 64 (63), A$ at US$0.77 (US$0.76), Brent crude oil price at US$68bbl (US$56bbl), population growth of 0.2 per cent over 2021 (0.2 per cent) and 0.4 per cent over 2022 (0.4 per cent); cash rate in line with market pricing out to 2022 (and held constant thereafter); and other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2021 Board meeting. 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

indicators of labour demand have strengthened further, suggesting momentum in employment growth is likely to be sustained in the near term. It is also likely that there will be fewer job losses arising from the end of the JobKeeper program than previously expected. Beyond the near term, the stronger profile for activity underpins the upward revision to employment. The unemployment rate is expected to continue to decline over the forecast period, to around 4½ per cent by mid 2023. Consistent with this, wages growth and inflation are expected to pick up a little faster compared with the previous *Statement*. By the end of the forecast period in mid 2023, wages growth is expected to be around 2¼ per cent, with inflation just below 2 per cent.

Labour market

Conditions in the labour market have continued to improve more quickly than anticipated; employment and total hours worked in March were higher than before the pandemic, and the decline in the unemployment rate to 5.6 per cent in March (averaging 5.9 per cent in the quarter) has occurred considerably faster than was anticipated at the time of the February *Statement*.

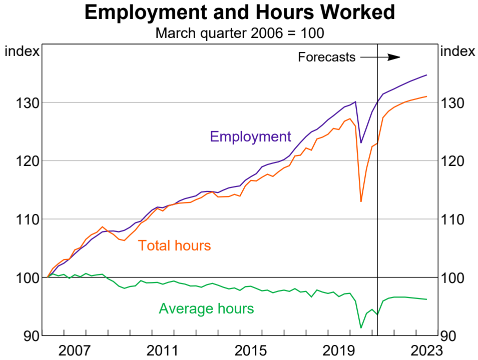
Employment growth is expected to remain strong over the next few months given solid momentum in activity, buoyant forward indicators of labour demand and other available information suggesting a muted effect from the end of the JobKeeper program in March (Graph 5.2). From late 2021, employment growth is expected to moderate in line with activity.

Continued employment growth should drive further declines in the unemployment rate, which is now expected to move down to around 5 per cent by the end of 2021 (Graph 5.3). Additional but more moderate declines are expected over the rest of the forecast period, with the unemployment rate falling to around 4½ per cent by mid 2023. Other measures of labour market spare capacity, such as underemployment, have returned to around pre-pandemic levels, though before the pandemic underemployment was at quite high levels.

The forecasts imply labour force participation will increase a little further over the year ahead and remain elevated for the rest of the forecast period. Strong labour demand should encourage workers to join and/or remain in the labour force, and structural drivers (such as increases in the pension eligibility age and more flexible working arrangements) should also continue to support an increase in participation.

Graph 5.2

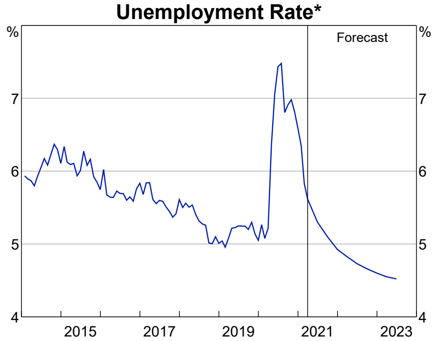
Employment and Hours Worked



Sources: ABS; RBA

Graph 5.3

Unemployment Rate*



* Actual data is reported on a monthly basis; forecast is projected for each quarter

Sources: ABS; RBA

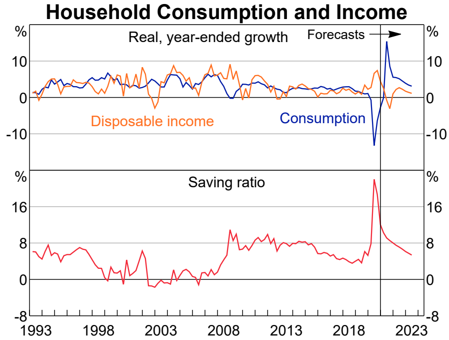
Household consumption, income and saving

Strong household spending is expected to underpin GDP growth across the forecast period, supported by the further lifting of activity restrictions, a stronger outlook for household disposable income, wealth effects from higher housing prices, and reduced uncertainty (Graph 5.4). Timely indicators suggest that consumption growth moderated in the March quarter from 4¼ per cent in the December quarter, partly as a result of the short sharp lockdowns in a number of states. Consumption is expected to have been around 1½ per cent below its pre-pandemic level at the end of March. As economic outcomes continue to improve and more consumption possibilities become available, households are likely to rebalance more of their spending back towards services.

The outlook for household disposable income growth is supported by stronger employment translating into higher labour income. It is also assumed that tax policy is unchanged, so that growth in household tax paid remains at or

Graph 5.4

Household Consumption and Income



Sources: ABS; RBA

below the pace recorded in the years leading up to the pandemic. Higher housing prices lead to higher household wealth, which is expected to flow through to stronger consumption over several years. Both income and wealth effects boost consumption per capita, and together their effects largely offset the effect of slower population growth on aggregate consumption.

The household saving ratio is expected to decline from around 12 per cent in the December quarter 2020 to 8 per cent by end 2021. Further out, the saving ratio is expected to return to around its average level over the 5 years prior to the pandemic. As uncertainty associated with the pandemic fades and restrictions ease, households are expected to avail of opportunities to spend. Households are assumed to treat the additional savings they accumulated through the pandemic (much of which was the result of limited spending opportunities) as an increase in wealth and as such consume only a small share of these savings over the forecast period. A more aggressive drawdown of accumulated savings is possible, and is considered in the upside scenario discussed below.

Dwelling investment

Over 2020, containment measures did not have a material impact on residential construction activity; instead, government grants, lower interest rates and JobKeeper payments supported both activity and profitability in the sector. Dwelling investment returned to its pre-pandemic level in the December quarter, around 2 quarters earlier than previously expected, proving to be one of the more resilient parts of the economy through the pandemic. Residential construction activity is expected to grow steadily over 2021, as the large volume of development applications approved under the Australian Government's HomeBuilder scheme and similar state-based grants are worked through. The recent announcement of the extended deadline for the commencement of HomeBuilder projects means that some of this activity will be spread out over a longer period than previously assumed.

While a large share of construction related to the HomeBuilder scheme is expected to represent a pull-forward in activity, low interest rates and the strong rebound in housing prices are expected to sustain growth in dwelling investment across most of the forecast period. Investment in higher-density residential construction is expected to remain subdued over the next year or so; this is due to low levels of building approvals over most of the past 3 years and lower investor appetite for these types of properties than seen over recent housing cycles. A gradual recovery in population growth should support a decline in rental vacancy rates in larger capital cities and a pick-up in higher-density investment towards the end of the forecast period.

Business investment

Non-mining business investment is expected to increase steadily over the forecast period. Following a 10 per cent decline after the onset of the pandemic, it is expected to return to its pre-pandemic level by early 2022 and expand thereafter. Investment began recovering in the December quarter, which was sooner than expected, and stronger reported business confidence and investment intentions support the more favourable outlook being sustained. This follows a period where the ratio of non-mining investment to output has been low relative to history.

In the near term, the upward revision to non-mining investment is mainly accounted for by higher machinery & equipment investment, which continues to respond to tax incentives, as well as improved business conditions and declining spare capacity, particularly in goods-related industries. With a stronger domestic recovery and firms' improved balance sheet position, machinery & equipment investment is expected to be higher throughout the forecast period than in the February *Statement*. The profile for non-residential construction investment is also higher throughout, though it recovers at a more gradual pace than machinery & equipment investment due to the lags in the approval and planning of construction projects. For this higher profile to be realised, a sustained pickup in building approvals will be needed over this year.

The forecast profile for mining investment has been revised up a little. Profitability in the sector is picking up strongly in response to the recovery in commodity prices, and higher oil prices have improved the viability of some LNG projects. But despite buoyant commodity prices there have been few indications to date that major miners plan to expand iron ore-related investment in response to higher prices.

Public demand

Public demand is expected to contribute to GDP growth across the forecast period. The large public investment programs announced over 2020 are expected to remain an important contributor to growth. National accounts data for the December quarter showed a modest increase in public investment, which could suggest that spending is occurring a little more slowly than projected in state and Australian Government budgets. In line with this, the forecast for near-term growth in public investment has been lowered a little; however, it is assumed that public investment will pick up quickly in subsequent quarters. Further delays in obtaining equipment and/or progressing approvals, along with constraints on labour availability, pose downside risks to the public investment forecasts.

The profile for public consumption has been upgraded to incorporate some expected additional spending related to the vaccination program. Other pandemic-related spending is expected to decline across the forecast period, but is offset by expected public consumption commitments stemming from longer-term factors such as the ageing population. The release of the Australian Government Budget on 11 May will contain further information relevant to the outlook for public demand.

External sector

The outlook for exports has been upgraded a little, driven by higher rural and resource exports. Rural production benefitted from favourable weather conditions last year and some of this strength is expected to persist as the larger winter crop harvest continues to be exported. Coal exports have been revised higher as firms have been able to find alternative buyers more quickly than anticipated following the significant decline in sales to China. Education exports are forecast to grow a little slower over 2022 than previously expected because of ongoing uncertainty around international travel restrictions. An earlier return of travel to New Zealand has been factored in, reflecting the travel bubble established in April.

The forecasts for import growth have been revised up because of stronger domestic demand, including business investment, and the recent appreciation of the exchange rate. This outweighs the effects of household consumption shifting back towards services, which are less import intensive. There remains a downside risk to trade in services if the wider reopening of international borders is delayed. While the effect of reduced tourism activity on GDP would likely be offset to some extent by Australians spending more at home, lower education exports would also drag on GDP.

The terms of trade have been revised higher throughout, boosted by higher profiles for rural, iron ore, LNG and base metal prices (Graph 5.5). If commodity prices remain around current levels, the terms of trade in the June quarter 2021 will be near their previous peak in 2011, which was around the height of the mining investment boom. As in the February *Statement*, iron ore prices are expected to decline from near record levels over the forecast period, contributing to a fall back in the terms of trade.

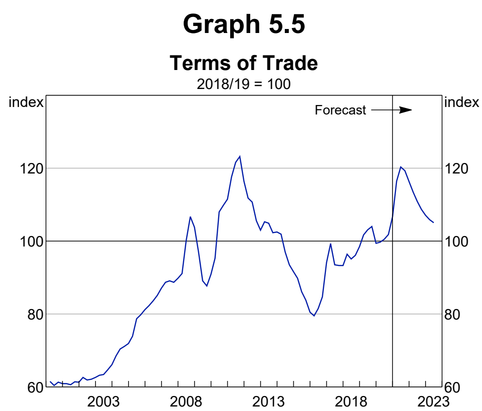
Wages and inflation

The faster improvement in the labour market is expected to result in labour market spare capacity being absorbed a little more quickly than previously expected. This should put some upward pressure on wages growth over time. After historically low year-ended wages growth of below 1½ per cent in the second half of 2020, growth in the Wage Price Index (WPI) is expected to pick up to a little under 2 per cent over 2021, before gradually increasing to around 2¼ per cent by mid 2023 (Graph 5.6).

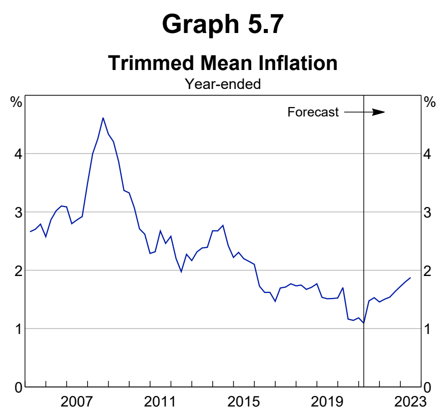
The upward revisions to the outlook for wages are predominantly for private sector wages; the outlook for public sector wages is little changed. Many of the private sector firms that had implemented temporary wage cuts last year reversed them in the December quarter (a little sooner than previously expected). Liaison indicates that many of the firms that currently have wage freezes in place plan to unwind them in coming months, while fewer firms plan to implement new ones. Public sector wages growth is expected to pick up over this year as some earlier wage freezes unwind, but then settle at a lower rate than in recent years reflecting various governments' wage cap policies.

The GDP and labour market forecasts represent a stronger outlook than presented in the February *Statement*, and this is reflected in the forecasts for inflation. Even so, underlying inflation is still expected to increase only gradually over the next few years, to be close to 2 per cent in mid 2023 (Graph 5.7). However, the extent of estimated spare capacity in the economy is uncertain, which means it is plausible that wages growth and inflation could be slower or faster than currently envisaged in the baseline.

* Total hourly rates of pay excluding bonuses and commissions
Sources: ABS; RBA



Sources: ABS; RBA



Sources: ABS; RBA

Headline inflation is expected to spike to above 3 per cent over the year to the June quarter 2021, largely because the initial declines in prices from pandemic-related policies (such as free child care and preschool) drop out of the year-ended calculation. This temporary spike has been revised up a little, given automotive fuel prices have risen further recently. Headline inflation is expected to be slightly below trimmed mean inflation over most of the latter half of the forecast period; the recent extension to commencement deadlines for the HomeBuilder program will result in government grants being paid out more gradually than previously expected, subtracting a little from headline CPI each quarter until late 2022.

Inflation outcomes are expected to vary considerably across components. Prices for some consumer durables, for example motor vehicles, are expected to increase further in the near term due to ongoing supply disruptions and strong demand, though business liaison information suggests that these effects are less acute than they were over 2020. Prices for newly built dwellings are likely to be a little stronger than previously expected, driven by strong demand for detached housing; however, the treatment of HomeBuilder and similar state-based grants will provide some offset in terms of measured new dwelling price inflation in the CPI. The forecasts reflect the disinflationary effects of weaker demand for some services, government subsidies and rebates, administered price freezes and the end of the annual 12.5 per cent tobacco excise increase. Utilities prices are expected to continue to fall for some time, because of recently announced reductions in regulated prices, low wholesale prices and increased electricity supply from renewables.

Upside scenario: stronger consumption

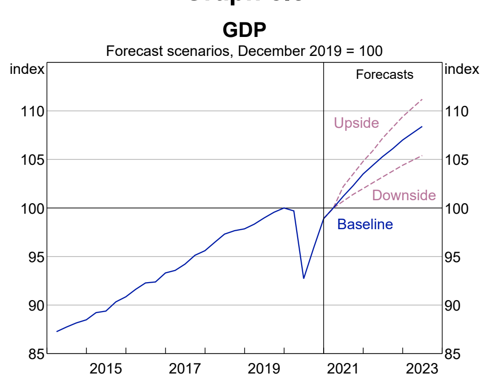
A plausible upside scenario centres on stronger household consumption, where increases in housing and equity prices raise households' desire to consume by more than assumed in the baseline scenario. At the same time, the ongoing improvement in labour market conditions boosts labour income, out of which households consume, and increases households' willingness to draw down on savings that were accumulated during 2020.

Stronger household consumption in the upside scenario leads the saving ratio to fall more sharply than in the baseline to around 2¾ per cent by mid 2023. Higher consumption and reduced uncertainty about the outlook also underpin faster growth in business investment and employment. This puts additional downward pressure on the unemployment rate. In this scenario, the stronger labour market leads to a faster pick-up in wages growth and inflation over the next couple of years. With the unemployment rate falling below 4 per cent, inflation rises to be back within the target range by mid 2023 (Table 5.2; Graph 5.8; Graph 5.9; Graph 5.10, Graph 5.11).

Downside scenario: weaker consumption

A weaker trajectory than envisaged in the baseline scenario is possible if households increase their spending more gradually because they choose to save more of their income and/or use more of their accumulated savings for

Graph 5.8



Sources: ABS; RBA

Table 5.2: Scenarios – Comparisons of Key Economic Variables[(a)]

Percentage change over year to quarter shown

	Scenario	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
Gross domestic product	*Baseline*	–1	9¼	4¾	4	3½	3
	Upside	–1	10¼	6	5	4½	3¾
	Downside	–1	8½	3¼	2½	2¼	2
Unemployment rate (quarterly)	*Baseline*	6.8	5¼	5	4¾	4½	4½
	Upside	6.8	5¼	4½	4¼	4	3¾
	Downside	6.8	5¼	5¼	5¼	5½	5½
Trimmed mean inflation	*Baseline*	1.2	1½	1½	1½	1¾	2
	Upside	1.2	1½	1½	1¾	2	2¼
	Downside	1.2	1½	1½	1½	1½	1½

(a) Forecast assumptions (February Statement in parenthesis): TWI at 64 (63), A$ at US$0.77 (US$0.76), Brent crude oil price at US$68bbl (US$56bbl), population growth of 0.2 per cent over 2021 (0.2 per cent) and 0.4 per cent over 2022 (0.4 per cent); cash rate in line with market pricing out to 2022 (and held constant thereafter); and other elements of the Bank's monetary stimulus are in line with the announcement made following the February 2021 Board meeting. Shading indicates historical data, shown to the first decimal point. Forecasts are rounded to the nearest quarter point.

Sources: ABS; RBA

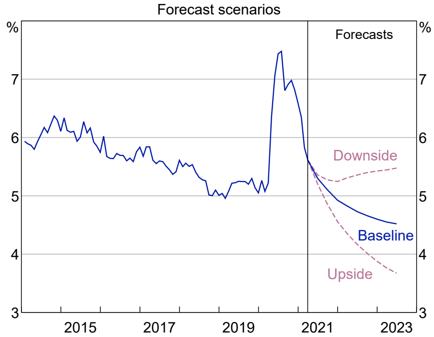
purposes other than consumption. The downside scenario assumes that some households respond to increases in their wealth due to higher asset prices by less than implied in the baseline, in part because they prefer to continue strengthening their balance sheets. High debt levels among some households might be one catalyst for this; a different trigger for prospective home owners could be rising housing prices and the related need to accumulate larger down payments.

This scenario involves a more sluggish increase in activity than assumed in the baseline scenario. A slower pick-up in consumer spending sees the saving ratio remain high throughout the forecast period, edging down to around 8½ per cent by mid 2023. Lower consumption growth weighs on business income, prompting some firms to delay investment plans. Employment growth slows as these firms put off hiring decisions or lay off additional workers. In this scenario, the unemployment rate remains around

Graph 5.9

Unemployment Rate

Forecast scenarios

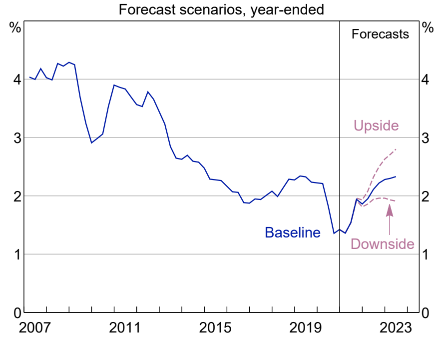


Sources: ABS; RBA

Graph 5.10

Wage Price Index Growth

Forecast scenarios, year-ended



Sources: ABS; RBA

5¼–5½ per cent. The slower reduction in spare capacity in the labour market drags on wages growth, resulting in underlying inflation remaining below 2 per cent.

Other domestic risks and uncertainties

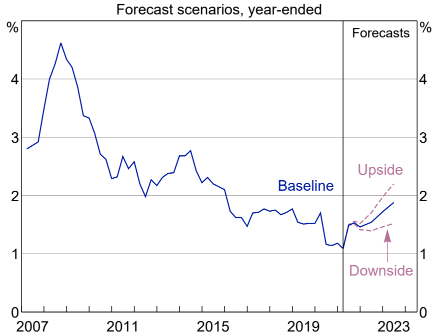
The upside and downside scenarios considered above illustrate 2 plausible alternative paths for the economy based on different underlying assumptions around the ability and willingness of households to consume. Beyond this, other sources of uncertainty remain, although, as set out below, risks to the economic outlook have become more balanced.

Global health outcomes are still highly uncertain. The uneven pace of vaccine rollout globally could stifle the global recovery, as could the emergence of virus strains that vaccines are less effective against. This would also affect when international travel restrictions can be lifted, and therefore the pace of recovery in domestic services trade and consumption. Scarring effects in certain industries and parts of the country could be more pronounced in such an environment. An extended closure of the international border would also depress domestic population growth and thus reduce demand and trend growth in the economy's productive capacity.

Graph 5.11

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

The size, composition, timing and effectiveness of additional global and domestic fiscal measures is also a source of uncertainty, including for the investment outlook. One related domestic uncertainty is whether fiscal initiatives designed to spur the recovery in dwelling and business investment have mainly pulled forward demand or instead helped to set it on a new higher trajectory. It is possible that dwelling and business investment is stronger than currently anticipated even after targeted fiscal support measures expire, particularly if overall demand conditions remain strong and commodity prices remain at elevated levels. Furthermore, high commodity prices provide an additional source of government revenue and could support more fiscal stimulus than is currently assumed. Alternatively, public investment could be slower to roll-out than foreshadowed in the Australian Government and state budgets if capacity constraints start to bind.

The outlook for housing and financial asset prices always entails a degree of uncertainty, and households' propensity to spend out of wealth becomes more salient in such an environment. If the expected growth in household wealth fails to materialise, consumption growth over the forecast period could follow a lower path; the reverse is true should household wealth increase by more than anticipated in the baseline scenario. Developments in the labour market and the general level of uncertainty experienced by households at that time would be additional contributors to weaker or stronger household consumption.

The baseline scenario implies further reductions in spare capacity in the labour market (and the economy more generally) over the forecast period. However, it is uncertain how much spare capacity might remain, and how quickly its absorption might feed into upward pressure on wages and prices. Experience in the years prior to the pandemic suggests that the unemployment rate would need to be well below 5 per cent before wages growth and inflation might be expected to pick up quickly. Currently, both wage and price inflation are at a much lower level than over the past decade and, because of inertia in wage setting norms and inflation expectations, it may take some time for prices pressures to build even if spare capacity is absorbed more quickly than expected.

Alternatively, unusual aspects of the current environment, including constraints in the supply side of the domestic and global economies, could mean that domestic wages growth and inflation pick up earlier and faster than expected. This could occur due to an extended period of supply-chain bottlenecks and firms' reduced ability to address labour shortages through interstate or international migration (see 'Box C: International Border Closures, Slower Population Growth and the Australian Economy'). More generally, the uneven nature of the recovery in supply and demand, along with the effects of various stimulatory policy measures, could see some unusually large movements in a subset of wages or prices in the period ahead. Depending on where these pockets of price pressure emerge and how long they last, it is possible that some households and businesses revise up their expectations for inflation.