RESERVE BANK OF AUSTRALIA

Statement on Monetary Policy

August 2024

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Contents

Overview

Key messages

Inflation remains above target and is proving persistent.

Inflation continues to moderate but is some way above the midpoint of the 2–3 per cent target range. Inflation in the June quarter was broadly in line with the May *Statement* forecast, with headline inflation at 3.8 per cent over the year and trimmed mean inflation at 3.9 per cent. But the latest data also demonstrate that inflation is proving persistent and the quarterly underlying inflation rate has fallen very little over the past year.

Inflation is expected to take slightly longer to reach the target than was thought at the time of the May forecasts. Underlying inflation is forecast to return to the target range of 2–3 per cent in late 2025 and approach the midpoint in 2026. This is a slightly slower return to target than forecast in May and is due to greater inflationary pressures in the economy. In part, this owes to a stronger outlook for domestic demand, led by higher public demand and a recovery in household consumption as real disposable incomes and household wealth rise. But it also reflects the assessment that the economy's capacity to meet this demand is less than previously thought.

The cash rate remains unchanged to support inflation returning to target.

The outlook remains highly uncertain. Ongoing strength in the labour market, persistent inflation and still-high growth of both labour and non-labour costs suggest there are upside risks to inflation. At the same time, there is a risk that household consumption and economic activity pick up more slowly than expected. The unemployment rate is rising gradually, many households and businesses are under pressure and the lagged effects of monetary policy are uncertain. Conditions in the labour market could deteriorate by more than expected.

At its August 2024 meeting, the Reserve Bank Board decided to hold the cash rate. Inflation in underlying terms remains too high and it will be some time yet before inflation is sustainably in the target range. Data have reinforced the need to remain vigilant to upside risks to inflation. Returning inflation to target within a reasonable timeframe remains the Board's highest priority.

Policy will need to be sufficiently restrictive until the Board is confident that inflation is moving sustainably towards the target range. The Board will rely upon the data and the evolving assessment of risks to guide its decisions and remains concerned about the upside risks to inflation.

What's been going on in the economy?

Growth among Australia's major trading partners has been moderate, and progress on lowering inflation has been mixed.

A gradual recovery of economic growth is underway in many of Australia's major trading partners but has been weaker than expected in China. Temporary disruptions and ongoing weakness in the property sector have dampened consumption and broader economic activity in China and weighed on commodity prices. While growth also appears to be slowing in the United States, a gradual recovery is underway in most other advanced economies, although generally below estimates of potential growth.

Progress on bringing inflation back to targets has been mixed. Disinflation has resumed in the United States in recent months but has stalled in some other economies, particularly in Europe. In some economies, including Canada and Sweden, inflation has returned close to target. Unemployment rates abroad are generally increasing as labour markets move into better balance. However, wages growth has been high in most advanced economies, in part reflecting some catch-up following earlier high inflation.

A number of advanced economy central banks have lowered their policy rates and more are expected to do so over coming months. Market participants expect the US Federal Reserve to ease its policy rate a number of times in the coming months. Yields on government bonds have fallen as the policy rate and inflation expectations have declined. In China, authorities have eased monetary policy amid slowing economic activity, an uncertain economic outlook and softer credit demand. Government bond yields in China have continued to decline and the currency has depreciated against the US dollar. Globally, financial markets have been volatile of late.

Financial conditions in Australia remain restrictive but less so than previously assessed.

The current level of the cash rate is assessed to be restrictive. Ahead of the August Board meeting, financial market participants expected the cash rate to remain at current levels, and for monetary policy to begin easing around the turn of the year and to continue gradually through 2025.

Overall financial conditions are also assessed to be restrictive, but a little less so than at the time of the May *Statement*. In part, this reflects the decline in policy rate expectations in Australia and abroad, and the associated declines in bond yields. Higher housing prices are supporting household wealth and housing credit growth has picked up, suggesting that households have become more willing to borrow. Recent volatility in financial markets has the potential to affect financial conditions including through its impact on the Australian dollar, which has already depreciated of late.

In Australia, domestic demand was more resilient in early 2024 than previously thought. Household consumption and public consumption have both proved stronger than expected at the time of the May forecasts. The upside surprise to domestic demand has occurred alongside robust growth in imports, while exports were slightly softer than expected. As a result of the drag from net trade, Australia's GDP grew by less than expected in the March quarter.

The housing market remains tight, resulting in housing prices rising more briskly than expected in recent months and further strong growth in advertised rents. This reflects the lack of new housing supply and strong demand. Dwelling investment in early 2024 was weaker than anticipated as high construction costs made some projects unfeasible and labour shortages remain for certain trades.

Disinflation has slowed and, despite gradual easing, the labour market remains tight.

Underlying inflation eased slightly in the June quarter but remained high. Underlying inflation, as measured by trimmed mean inflation, declined a little to 0.8 per cent in the quarter and to 3.9 per cent in year-ended terms. Headline inflation increased in year-ended terms to 3.8 per cent. These outcomes are broadly as expected in the May *Statement* and show that the pace of disinflation has slowed.

The slow progress on disinflation over the past year suggests that demand continues to exceed the capacity of the economy to supply goods and services, and by a little more so than previously thought. This is consistent with firms continuing to report that they operate at relatively high levels of capacity utilisation and with input cost inflation remaining above longer run averages.

Labour market conditions continue to ease gradually. The unemployment rate moved up in June as expected. Even so, employment and average hours worked have surprised on the upside, vacancies remain high and some businesses continue to report labour shortages as a constraint on output. Wages growth remains high, particularly given still weak productivity growth, but business liaison suggests that growth in wages is expected to moderate over the year ahead.

How do we see the economy developing?

Growth in Australia's major trading partners is expected to continue to be moderate and inflation abroad is expected to ease further.

There has been little change in the overall outlook for growth among our major trading partners, although the near-term outlook for China has been revised lower. Inflation is expected to continue to ease in advanced economies, although persistent services inflation and a sharp rise in shipping costs pose upside risks.

The recovery in domestic economic activity is expected to be stronger than forecast in May, alongside a gradual adjustment in the labour market.

In Australia, the outlook for GDP growth has been upgraded for 2025. Public demand is forecast to be stronger than previously expected, reflecting recent public spending announcements by federal and state and territory governments. The level of consumption has been revised higher and growth is expected to pick up, supported by a rebound in real household disposable incomes and the rise in household wealth. Stronger growth in imports and weaker growth in dwelling investment is expected to provide some offset.

The labour market is expected to continue to ease this year, but to remain somewhat tight over much of the forecast period. The unemployment rate is forecast to continue to increase gradually, consistent with the softening in the leading indicators of labour demand. The expected recovery in GDP growth will support conditions in the labour market. Average hours worked are likely to decline and there will be fewer vacancies per job seeker, but employment is forecast to continue to grow.

Greater underlying inflationary pressures are expected to delay the return of inflation to target.

It will take a little longer for inflation to return to the midpoint of the target range than thought at the time of the May *Statement*. Underlying inflation is expected to be inside the target range of 2–3 per cent in late 2025 and approach the midpoint of the band in 2026. The upward revisions to underlying inflation reflect the stronger outlook for activity and the reassessment of capacity. Inflation is expected to ease gradually as excess demand in the economy declines. Persistence in some components of inflation is expected to limit the pace of disinflation.

Headline inflation is expected to moderate temporarily in the near term, owing primarily to one-off measures including those providing cost-of-living support to households. However, headline inflation is then expected to increase as energy rebates end (as currently legislated), before moving in line with underlying inflation once these temporary effects have passed.

Key risks to the outlook

The risks to the domestic outlook are assessed to be broadly balanced. Inflation may take longer to reach the inflation target if the labour market is tighter than currently assessed or if the recovery of domestic activity is stronger than anticipated, creating more inflationary pressure in the economy. There is also a risk that conditions in the labour market could deteriorate faster – for example, if household consumption does not pick up as expected, which would dampen input costs and inflationary pressure.

It is important to bring down inflation and keep long-term inflation expectations anchored at the inflation target. High inflation lowers living standards by eroding real incomes, and it is particularly challenging for those with lower incomes. The longer it takes for inflation to return to target, the greater the cost-of-living pressures on households and the greater the risk that inflation and wage expectations drift higher. History shows that, should this occur, it would require more monetary policy tightening and a costly period of higher unemployment to stabilise inflation expectations and return inflation to target. At the same time, a sustained period below full employment can have long-lasting effects on those who lose their jobs or are unable to find work.

What did the Board decide?

The Board decided to hold the cash rate to support inflation returning to target. Today's decision balances the dual objectives of monetary policy. It balances the risk of further setbacks to the time it takes to return inflation to target with risk that there could be a more significant easing in labour market conditions than forecast. Data have reinforced the need to remain vigilant to upside risks to inflation and the Board is not ruling anything in or out. Policy will need to be sufficiently restrictive until the Board is confident that inflation is moving sustainably towards the target range. Returning inflation to target within a reasonable timeframe remains the Board's highest priority.

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

Per cent

	Year-ended					
	Jun 2024	Dec 2024	Jun 2025	Dec 2025	Jun 2026	Dec 2026
GDP growth	0.9	1.7	2.6	2.5	2.5	2.4
(previous)	(1.2)	(1.6)	(2.1)	(2.3)	(2.4)	(n/a)
Unemployment rate[(b)]	4.0	4.3	4.4	4.4	4.4	4.4
(previous)	(4.0)	(4.2)	(4.3)	(4.3)	(4.3)	(n/a)
CPI inflation	3.8	3.0	2.8	3.7	3.2	2.6
(previous)	(3.8)	(3.8)	(3.2)	(2.8)	(2.6)	(n/a)
Trimmed mean inflation	3.9	3.5	3.1	2.9	2.7	2.6
(previous)	(3.8)	(3.4)	(3.1)	(2.8)	(2.6)	(n/a)

	Year-average					
	2023/24	2024	2024/25	2025	2025/26	2026
GDP growth	1.4	1.2	1.9	2.5	2.5	2.4
(previous)	(1.5)	(1.3)	(1.7)	(2.1)	(2.3)	(n/a)

(a) Forecasts finalised on 31 July. The forecasts incorporate several technical assumptions. The cash rate is assumed to move in line with expectations derived from financial market pricing; the cash rate is assumed to remain around its current target level of 4.35 per cent until early 2025 before declining to be around 3.3 per cent by the end of 2026. Other forecast assumptions (assumptions of May *Statement* in parentheses): TWI at 61.5 (62.2); A$ at US$0.65 (US$0.65); Brent crude oil price at US$79bbl (US$84bbl). The rate of population growth is assumed to have peaked in the September quarter of 2023 at 2.6 per cent, after which it is expected to decline back to its pre-pandemic average of around 1.4 per cent. Shading indicates historical data.

(b) Average rate in the quarter.

Sources: ABS; RBA.

Chapter 1
Financial Conditions

Summary

- **Financial conditions in Australia appear to be less restrictive than previously assessed.** Market participants have lowered their expectations for the path of the cash rate and there have been associated declines in bond yields. Housing credit growth has gradually increased, suggesting households may be more willing to borrow than we previously thought. Higher housing prices, as well as additional savings by households during the pandemic, have supported net household wealth, which may help to boost household consumption growth. Meanwhile, business credit growth has remained above its average following the global financial crisis and funding conditions for Australian financial and non-financial corporations have been favourable.
- **Nevertheless, Australian financial conditions remain restrictive overall.** The cash rate is above the RBA's range of estimates of the nominal neutral interest rate. Borrowing and lending rates are elevated and scheduled principal and interest payments for household debt are high as a share of household disposable income.
- **Most advanced economy central banks have either lowered their policy rates or are expected to do so over the coming months.** This is in line with an easing in labour market conditions and, in some economies, further progress on lowering inflation. The US Federal Reserve (Fed) has been waiting for continued evidence that inflation is sustainably declining towards target before lowering rates and market participants expect the Fed to begin easing policy in September. Government bond yields in advanced economies have declined as inflation and policy rate expectations have fallen.
- **In China, authorities have eased monetary policy a little further** amid slowing economic activity, an uncertain economic outlook and softer credit demand, particularly by households.
- **In Australia, following the release of the June quarter CPI data and the shift in market expectations for the Fed, market pricing no longer implies an expectation of any increase in the cash rate.** Lowering of the cash rate is expected to begin from around the turn of the year and continue gradually through 2025. Market participants expect the cash rate to remain around its current level for a little longer than in several other advanced economies, where policy rates are currently higher.
- **In trade-weighted terms, the Australian dollar is a little lower since the previous *Statement*,** which mainly reflects the depreciation of the Australian dollar against the Japanese yen. The trade-weighted index remains within the range observed since 2022.

1.1 Interest rate markets

Several advanced economy central banks have cut policy rates, while others are waiting for more evidence that inflation is declining sustainably towards target.

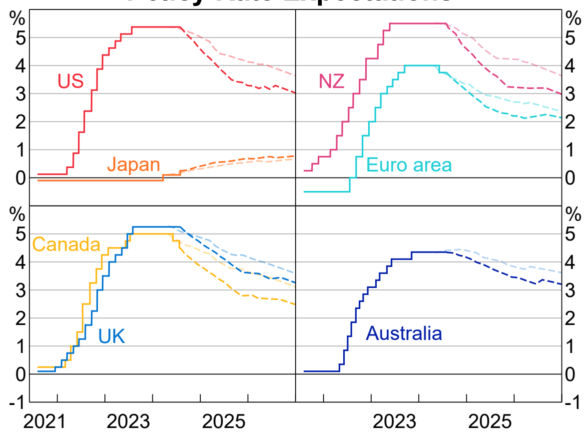
The European Central Bank (ECB), Bank of Canada, Bank of England and Sweden's Riksbank all cited lower inflation and subdued economic growth as the main reasons for recent rate cuts. Nonetheless, these central banks still consider their policy rates to be restrictive. Other central banks – including the Fed and Reserve Bank of New Zealand (RBNZ) – have left their policy rates unchanged but have signalled that they are closer to cutting rates due to progress on disinflation and easing of labour market tightness.

On the other hand, higher-than-expected wages growth and weaker productivity growth led Norges Bank to push back its guidance on when it might reduce its policy rate, with inflation not forecast to return to target before the end of 2027. The Bank of Japan (BoJ) raised its policy rate by 15 basis points to 25 basis points, citing increased confidence that it would sustainably achieve its 2 per cent inflation target. It signalled that it may tighten policy further from still accommodative levels.

Consistent with central banks' communications, further progress on disinflation in some economies and easing in labour market conditions, market participants' policy rate expectations have generally declined since the May *Statement*. The largest moves have been in the United States where recent inflation and labour market data have been weaker than expected (Graph 1.1).

Graph 1.1

Policy Rate Expectations*



* Darker dashed lines show expectations implied by current overnight index swap rates; lighter dashed lines show the same expectations as of 2 May 2024.

Sources: Bloomberg; RBA.

Advanced economy central banks are running down their asset holdings. The Fed has started to slow its balance sheet reduction by reinvesting a larger proportion of maturing assets. This is intended to reduce the risk of stress in money markets as reserves approach the level desired by the Fed. By contrast, the ECB has increased the pace of its balance sheet reduction, in line with previously announced plans that will see reserves decline more quickly to the level required to support its updated operating framework for monetary policy. The BoJ is still buying bonds, but it announced that it will gradually reduce its holdings of Japanese Government bonds by progressively tapering its purchases so that they only partly offset maturing holdings. This gradual approach is designed to reduce the potential for negative impacts on market functioning compared with a more rapid decline in bond holdings.

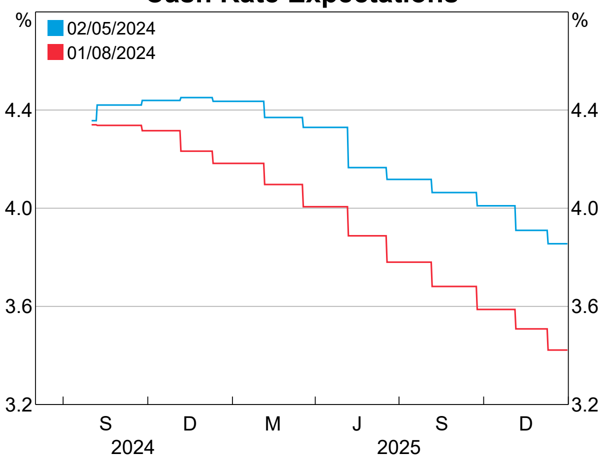
Central banks have emphasised that policy rates remain their primary monetary policy tool. The reduction of asset holdings is estimated to have had only a minor effect on financial conditions (relative to changes in policy rates in recent years), in part due to the gradual and well-signalled pace of reduction.

Market participants' expected path for the policy rate in Australia has shifted down materially since the May *Statement*.

Although markets have been volatile recently, market pricing currently implies an expectation that lowering of the cash rate will begin from around the turn of the year and continue gradually through 2025 (Graph 1.2). The expected rate path has moved substantially since May. It decreased following the May policy decision but retraced this decline following monthly inflation and labour force data released after the June meeting. Most recently, June quarter CPI data was weaker than market participants had expected. Coupled with a reassessment of the outlook for the policy rate in the United States, these developments have led the expected policy rate path in Australia to fall below that seen prior to the May *Statement*. That said, market participants expect that the policy rate will be cut later and by less than most other advanced economies, where policy rates were increased earlier and to a higher level than in Australia (Graph 1.2). As a result, the policy rate in Australia is expected to be a little above those in several other advanced economies towards the end of 2025.

Graph 1.2

Cash Rate Expectations



Sources: LSEG; RBA.

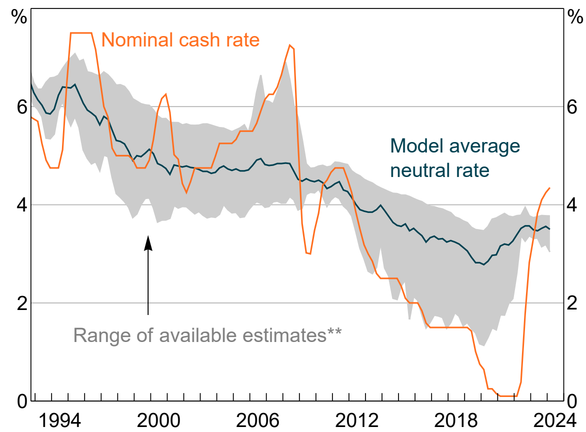
The cash rate is above the RBA's range of estimates of the neutral rate, consistent with other information suggesting that Australian financial conditions remain restrictive.

One way to gauge the stance of monetary policy is to compare the cash rate with estimates of the nominal neutral interest rate. Definitions of the neutral rate vary, but in essence it is the level of the cash rate that would neither stimulate nor restrain demand, such that inflation is in line with the midpoint of the target. Accordingly, the cash rate being above estimates of the neutral rate implies that policy is restrictive.

Estimates of the nominal neutral rate in Australia have increased a little since the pandemic (Graph 1.3). This reflects both slightly higher estimates of the real neutral rate and a small increase in trend inflation expectations (see Box A: Are Inflation Expectations Anchored?). However, estimates of the neutral rate are subject to considerable uncertainty, and different models and assumptions can produce different results.[1] Different horizons and measures of inflation expectations also give different estimates of the nominal neutral rate. For example, a rise in the measure of inflation expectations – other things equal – would imply a higher neutral rate. Internationally, evidence is mixed as to whether real neutral rates have increased since the pandemic.[2]

Graph 1.3

Nominal Neutral Rate*



* Nominal neutral rates are defined using trend inflation expectations.

** Range of central estimates corresponding to available models.

Source: RBA.

Currently, the cash rate is above the RBA's range of estimates of the nominal neutral rate. The cash rate is also above most estimates of the nominal neutral rate provided by market economists surveyed by the RBA. While these estimates are inherently uncertain, they are consistent with other information suggesting that Australian financial conditions remain restrictive. This includes a comparison of key financial indicators against historical averages, as shown in Graph 1.4, with conditions faced by many households (shown in orange) tighter than those faced by businesses (shown in purple). The Board, in making its policy decision, reviews a broad set of economic data and the outlook in order to determine whether financial conditions are restrictive enough to return inflation to target in a timely manner.

Graph 1.4

Financial Conditions*

2009–2024

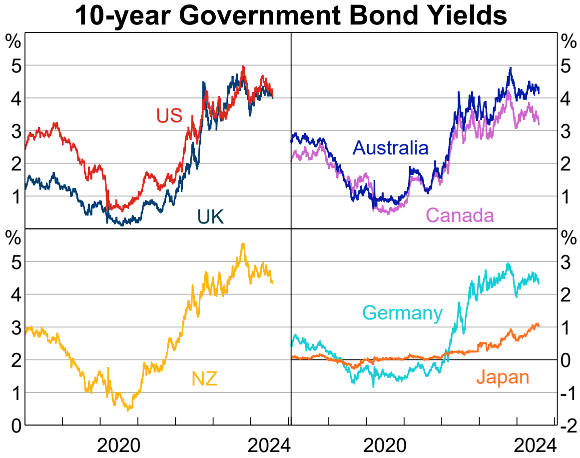
* Blue dots show current measures, green dots show the average over the sample and the grey bars show the middle 80 per cent of observations. Brown labels indicate reference rates, orange labels are conditions faced by households and purple labels are conditions faced by businesses.
** Calculated as a share of household disposable income.
*** Six-month annualised.
Sources: ABS; APRA; ASX; Bloomberg; major banks' websites; RBA.

Government bond yields in most advanced economies have declined since the May *Statement* as expectations for central bank policy rates have moderated, although Australian yields have declined by less.

Yields in most advanced economies have fallen well below their peaks from October last year but remain above their pre-pandemic levels (Graph 1.5). An exception is Japan, where yields have continued to increase in line with expectations that the BoJ will increase its policy rate further. The smaller decline in Australian bond yields relative to most other advanced economies largely reflects differences in monetary policy expectations. As a result of the smaller decline in Australian bond yields, the spread between Australian and US long-term yields has increased to be positive for the first time since January.

Graph 1.5

10-year Government Bond Yields

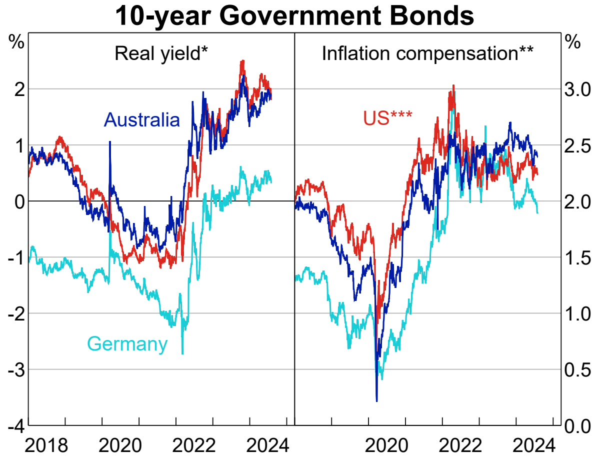


Source: Bloomberg.

Consistent with the moderation in global inflationary pressures, estimates of long-term inflation expectations implied by inflation-linked government bonds and inflation swaps (which include a premium to cover both inflation and liquidity risk) have declined across most economies, including Australia (Graph 1.6). Movements in long-term real yields have differed across economies, with declines in North America and modest increases elsewhere, while Australian real yields declined in response to the June quarter inflation data. Meanwhile, term premia are little changed since the May *Statement*, suggesting that investors have not changed the amount of compensation they require for holding nominal interest rate risk.

Graph 1.6

10-year Government Bonds



* The yield on inflation-linked bonds.

** Spread between yields on nominal and inflation-linked bonds.

*** Over the longer term, the price index referenced in US inflation-linked bonds has averaged 0.5 percentage points more than the PCE deflator targeted by the US Federal Reserve.

Sources: Bloomberg; RBA.

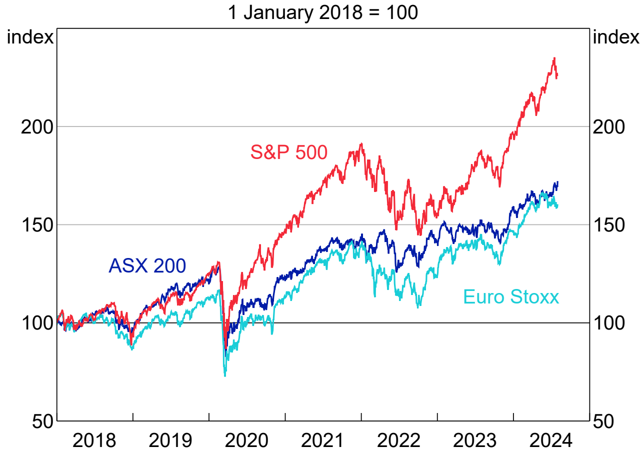
While financial market measures of long-term inflation expectations in Australia have eased a little in recent months, they remain around the midpoint of the target band after a period of being below that during the pandemic. (See Box A: Are Inflation Expectations Anchored?, which concludes that long-term inflation expectations remain anchored and consistent with the inflation target.)

1.2 Other measures of financial conditions

The prices of riskier assets increased further in May and June, though there has been some retracement of late.

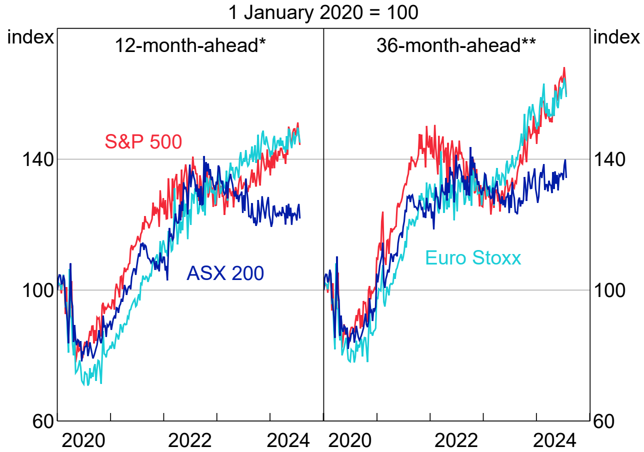
US equity markets rose particularly strongly before pulling back in recent weeks following lower-than-expected earnings for some large technology companies and the weak employment report in July. Australian equities have performed better than most other markets over recent months (Graph 1.7). The rise in equity prices since late 2022 has been driven by investors being willing to pay more for a given expectation of future earnings and, in the United States and euro area, expectations of strong earnings growth (Graph 1.8). Higher equity prices had not been associated with a material increase in equity raisings in the public market.

Graph 1.7
Equity Prices*
1 January 2018 = 100



* Total return basis.
Sources: Bloomberg; LSEG.

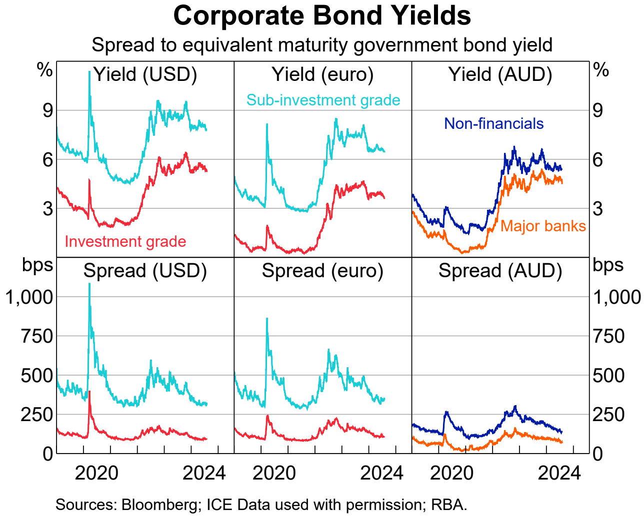
Graph 1.8
Forward Earnings Estimates
1 January 2020 = 100



* Analyst estimates of 12-month-ahead forward earnings yield multiplied by current index level.
** Calculated by growing the 18-month-ahead earnings estimate by the weighted average long-term growth rate based on analyst estimates.
Sources: LSEG; RBA.

Corporate bond yields have decreased over the past few months in the United States and euro area. Spreads on most corporate bonds remain at relatively low levels (Graph 1.9), though there have been modest increases of late in some markets. The low level of spreads occurred despite a rise in default rates on US and European sub-investment grade debt, particularly for floating rate leveraged loans. In Australia, non-financial corporate spreads narrowed over recent months, supported by strong demand from domestic and offshore investors. Corporate bond issuance has been above average in Australia and has increased in the United States and Europe. Companies have been seeking to take advantage of favourable conditions, while market reports suggest US companies have brought forward issuance to avoid potential market volatility around the upcoming Presidential election.

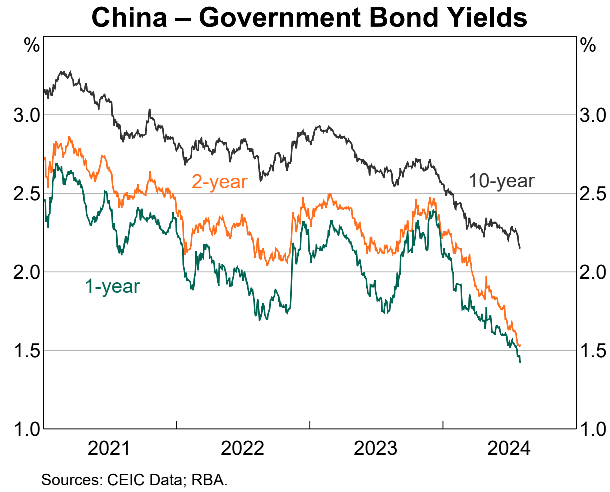
Graph 1.9



In China, authorities have eased monetary policy modestly amid weak demand for credit, slowing economic activity and an uncertain economic outlook.

The People's Bank of China (PBC) reduced its key policy rates and some banks lowered lending and deposit rates by up to 20 basis points in July. Chinese Government bond (CGB) yields have declined to historical lows, although in real terms are above the post-GFC average (Graph 1.10). The PBC has indicated that longer term CGB yields are not consistent with their assessment of China's economic outlook and have signalled that they may intervene in the CGB market to increase long-term yields; this may assist with some of the PBC's other objectives such as currency and financial stability. The Chinese renminbi has depreciated by around 0.3 per cent in the past three months and remains close to the weak end of the daily trading band as authorities maintain a strong CNY fix.

Graph 1.10



Credit demand has eased further, particularly from households, as the protracted property sector contraction continues to weigh on consumer and home buyer sentiment. Property developers remain under severe financial stress despite further support measures from authorities, including a relending facility to help state-owned enterprises purchase unsold properties from developers. The measures could provide some support to developer cash flows, but the scale of funding is small relative to unsold inventory. The authorities have continued to direct lending towards priority sectors – such as science, technology and manufacturing – which has helped to offset some of the impact of the property sector contraction on commodity prices.[3] However, aggregate business financing has eased further, which is likely to reflect weak profitability. This is consistent with broad-based declines in equity prices, particularly for property developers (Graph 1.11).

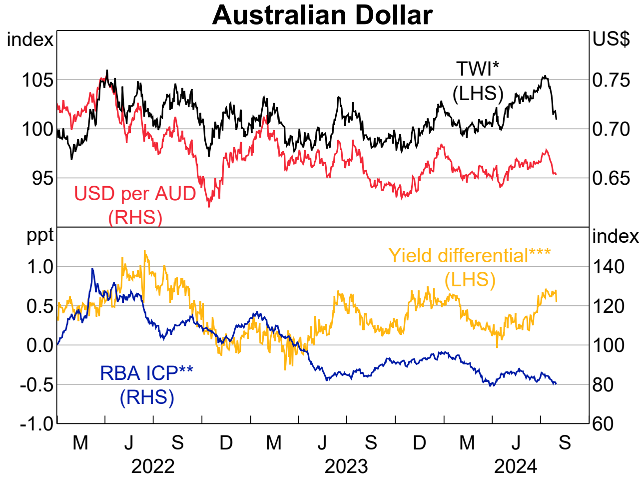
Graph 1.11
China – Equity Prices
January 2022 = 100

Sources: CEIC Data; RBA.

The Australian dollar trade-weighted index (TWI) remains within the range observed since early 2022, despite some sizeable moves in recent months.

The Australian dollar has depreciated a little on a TWI basis since the May *Statement*. A widening of interest rate differentials between Australia and other major advanced economies initially provided support to the Australian dollar. However, the appreciation was unwound amid a deterioration in risk sentiment, a liquidation of some Australian dollar carry trades against the Japanese yen – which are intended to take advantage of the higher interest rates on offer in Australia relative to Japan – and a decline in some key commodity prices over July. The significant volatility in the Japanese yen – in part driven by changing expectations of policy tightening by the BoJ – has also contributed to volatility in the Australian dollar over recent months. Nonetheless, the Australian dollar remains around early-2022 levels in trade-weighted terms, which is when major advanced economy central banks began tightening policy (Graph 1.12).

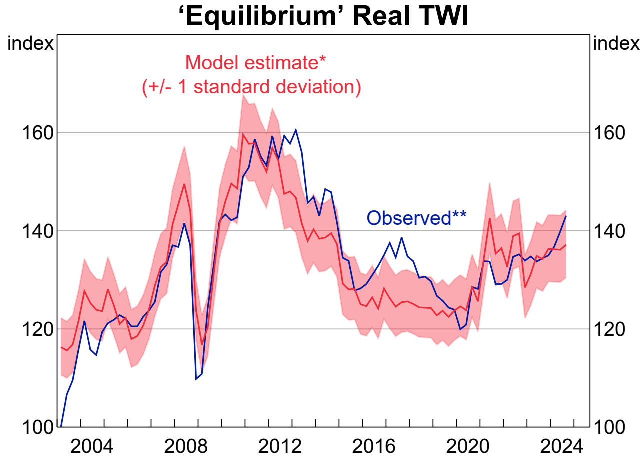
Graph 1.12
Australian Dollar



* Trade-weighted index; 31 December 2021 = 100.
** Index of Commodity Prices (USD terms); 31 December 2021 = 100.
*** Three-year Australian sovereign yield less yields of the United States, Japan and Germany, weighted by GDP.
Sources: Bloomberg; RBA.

In real terms, the Australian dollar TWI has appreciated during the September quarter to end-July and was higher than the model estimate implied by long-run historical relationships with the forecast terms of trade and real yield differentials (Graph 1.13).

Graph 1.13
'Equilibrium' Real TWI



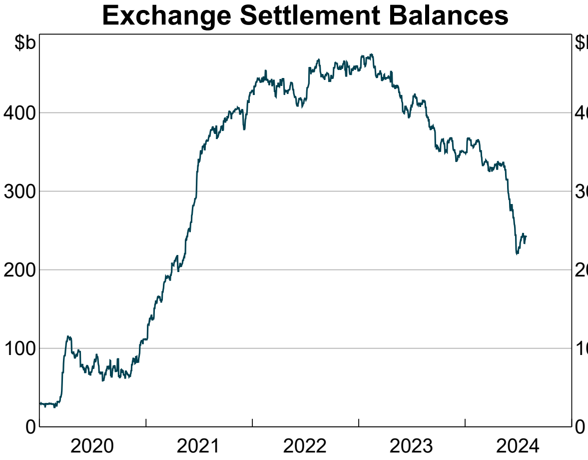
* Using terms of trade forecast and real Australian Government bond yield curve factors relative to the G3, see Chapman, Jääskelä and Smith (2018); standard deviation based on model errors.
** Quarterly average real TWI; March 2003 = 100.
Sources: Bloomberg; RBA.

1.3 Australian banking and credit markets

The Term Funding Facility (TFF) ended smoothly, though short-term funding rates have tightened modestly since around the end of the financial year.

The TFF has ended with the remaining $34 billion of funding repaid since the June Board meeting. This process contributed to a large decline in Exchange Settlement (ES) balances at the end of the financial year (Graph 1.14).[4] The seasonal accumulation of government balances associated with tax payments also contributed to declines in ES balances.

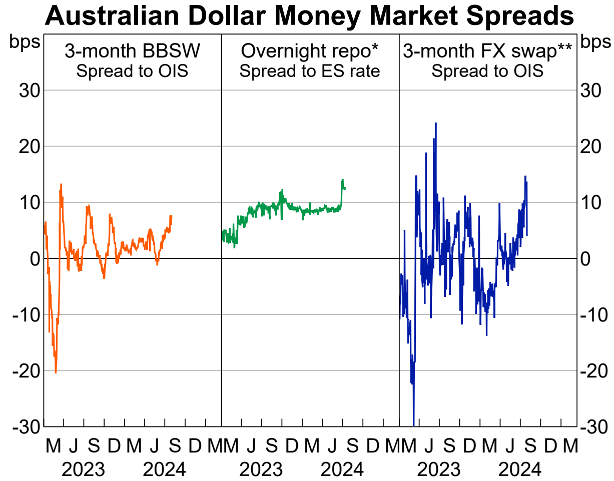
Graph 1.14



Source: RBA.

Despite this sharp reduction, banks' short-term funding markets and money markets have functioned well. Even so, Australian dollar short-term funding rates increased a little, including the cash rate trading closer to the target, and remained elevated in August. Volumes in the private repo market and at the RBA's market operations have also picked up. In liaison, market participants noted increases in the cost of short-dated repo funding and in the cost of borrowing Australian dollars in the FX swap market. The increases have been exacerbated by technical factors in these markets. For example, collateral and balance sheet limits are binding on some repo market participants, and in FX swap markets the liquidation of some major currency positions, including the Australian dollar against the Japanese yen, has also added to increases in short-dated Australian dollar borrowing costs. These increases are comparable with periods following previous financial year-ends, but market participants remain unsure of their likely persistence, resulting in an ongoing tighter level of short-term funding conditions (Graph 1.15).

Graph 1.15



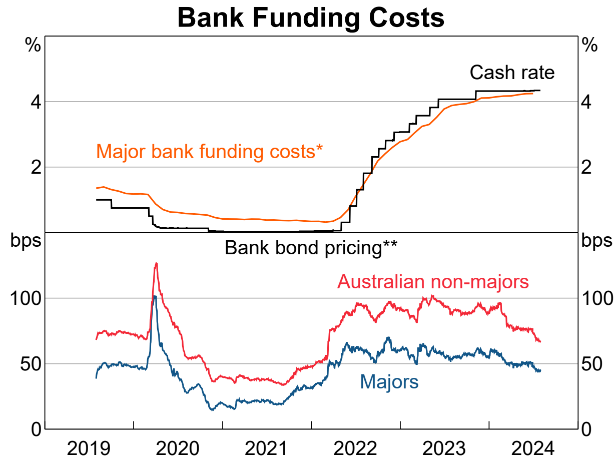
* ASX estimate of overnight repo in Australia.

** Implied AUD rate based on covered interest parity.

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

Banks funding costs have been little changed recently, and wholesale funding market conditions remain favourable for financial institutions. Bank bond spreads relative to the swap rate – a reference rate for the pricing of securities – have recently narrowed further and are at their tightest since early 2022 (Graph 1.16). Conditions in the asset-backed securities market, a key source of funding for non-bank lenders, continue to be favourable for issuers.

Graph 1.16



* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks.

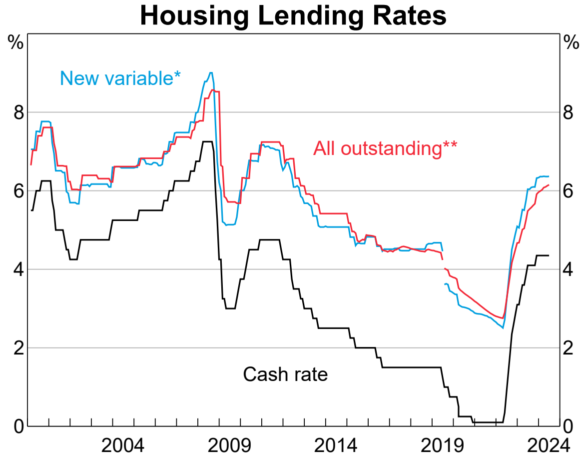
** Spread to swap; domestic secondary market; three-year target tenor.

Sources: APRA; ASX; Bloomberg; LSEG; major bank liaison; Private Placement Monitor; RBA.

Financial conditions for households remain restrictive but may be a little less restrictive than previously assessed.

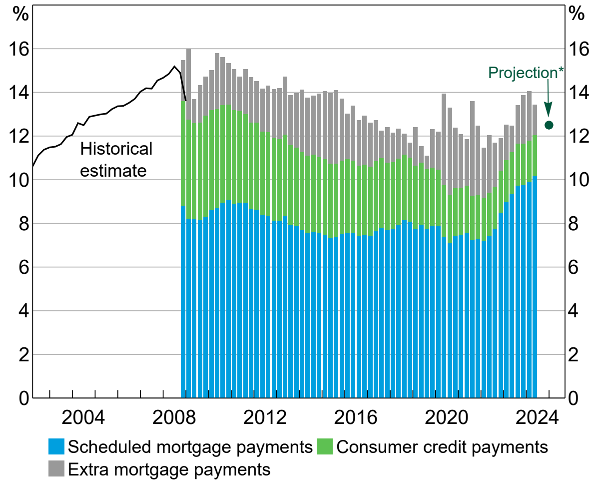
Scheduled payments are high as a share of household disposable income, which is one channel through which the tightening in monetary policy has contributed to weaker consumption growth (see Chapter 2: Economic Conditions). As expected, the average outstanding mortgage rate has increased by around 15 basis points over the year so far, as fixed-rate loans established at low rates in the pandemic continue to expire (Graph 1.17). Most of the pandemic-era fixed-rate loans will expire by the end of 2024, which is expected to increase the average outstanding mortgage rate by around a further 15 basis points. Total scheduled debt payments will therefore increase a little (Graph 1.18). Although housing and personal loans arrears have increased since late 2022, they remain around pre-pandemic levels and nearly all borrowers are expected to be able to service their debts even if budget pressures remain elevated for an extended period.[5]

Graph 1.17
Housing Lending Rates



* Perpetual data used to 2013; advertised package rates to July 2019; thereafter, data from the EFS collection.
** Perpetual data used to 2015; data from the Securitisation System to July 2019; thereafter, data from the EFS collection.
Sources: APRA; Perpetual; RBA; Securitisation System.

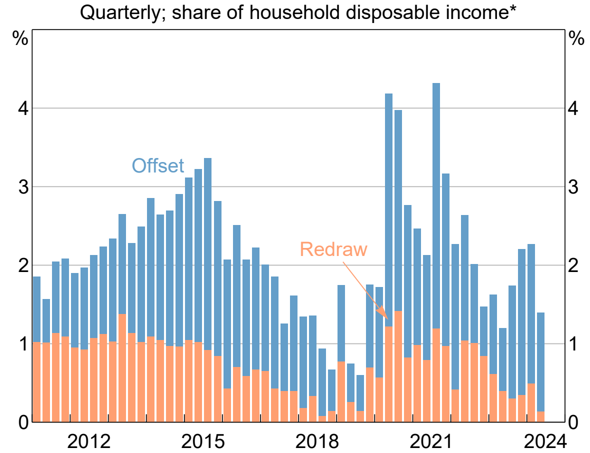
Graph 1.18
Selected Claims on Household Income
Quarterly; share of household disposable income



* Projection for total scheduled payments on household debt at end-2024, based on the current level of the cash rate.
Sources: ABS; APRA; RBA.

Payments into mortgage offset and redraw accounts had increased from mid-2023 to the March quarter of this year but declined in the June quarter (Graph 1.19). Mortgagors have strong incentives to save in offset and redraw accounts, and the share of borrowers with offset accounts has increased in recent years. In aggregate, households are saving at a lower rate than before the pandemic (see Chapter 2: Economic Conditions). At the same time, household net wealth has been supported by higher housing and other asset prices; all else equal, an increase in wealth tends to be associated with stronger consumption.

Graph 1.19
Flows into Offset and Redraw Accounts
Quarterly; share of household disposable income*



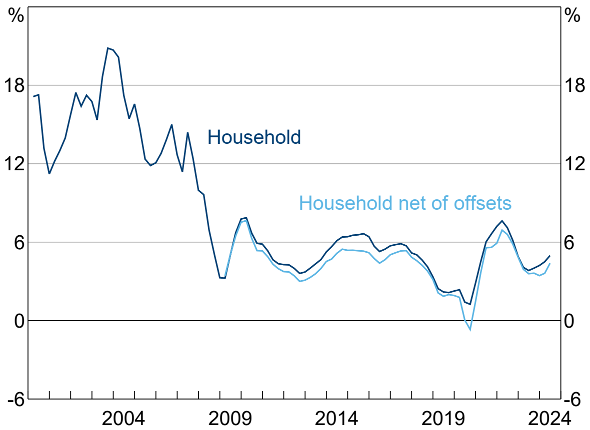
* Seasonally adjusted and break-adjusted.
Sources: ABS; APRA; RBA.

Household credit growth has gradually increased over the past year to be around its average following the global financial crisis (Graph 1.20). While high interest rates reduce the incentives for households to take on additional debt, growth of nominal disposable incomes are supporting households' ability to service those debts. The increase in household credit growth has been mostly driven by growth in mortgage debt, which makes up around 95 per cent of household credit. This growth has been accompanied by rising housing prices. Household credit growth net of payments into offset accounts also increased recently. Overall, the continued increase in both housing credit growth and household net wealth may suggest households' financial conditions, on average, are a little less restrictive than previously judged.

Graph 1.20

Household Credit Growth*

Six-month-ended annualised



* Seasonally adjusted and break-adjusted; including securitisation. Includes housing and personal credit.

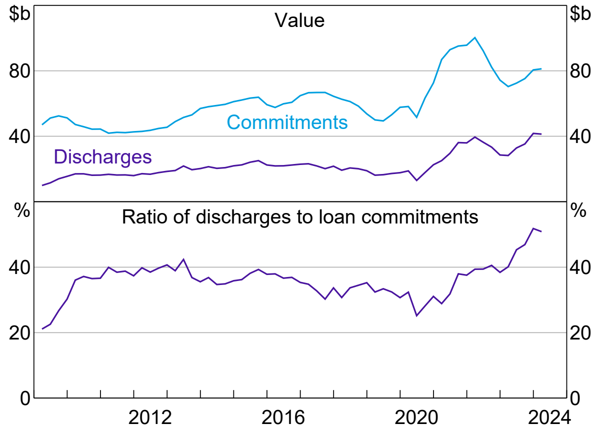
Sources: ABS; APRA; RBA.

New housing loan commitments have increased further but loan discharges associated with property sales have also risen (Graph 1.21). The rise in discharges may reflect the effect of the rise in interest rates, which increases the incentive to reduce or limit debt. Higher discharges by themselves weigh on the growth of credit. Over the past year, loan discharges have increased by more than the increase in commitments. This is consistent with home buyers on average taking on less leverage by using larger deposits, as well as with the possibility that investors with higher leverage are exiting the market and being replaced by other investors with less leverage. It may also reflect owner-occupiers taking on less new debt than otherwise.

Graph 1.21

Housing Loan Discharges*

Quarterly; seasonally adjusted



* Discharges and commitments are net of external refinancing.

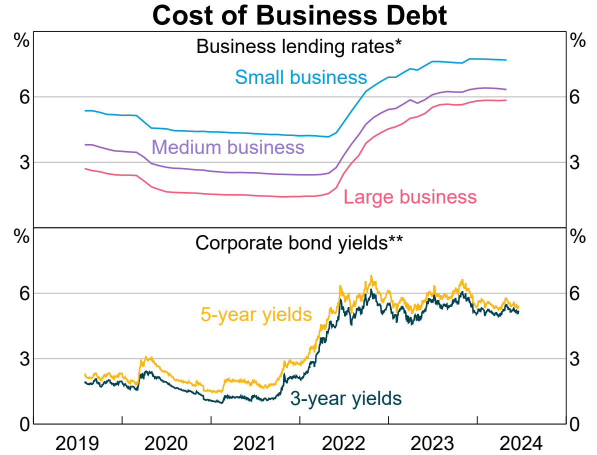
Sources: ABS; APRA; RBA.

Financial conditions have tightened for businesses over the tightening phase, though wholesale funding conditions have been favourable for larger non-financial firms.

The cost for businesses to borrow from banks and issue corporate bonds has increased substantially since April 2022 (Graph 1.22). Tighter monetary policy since May 2022 has passed through to higher rates on new and variable-rate debt for businesses. However, yields on corporate bonds have risen by less than the risk-free rate, and issuance has been above average (see discussion above). Also, the median interest coverage ratio of listed companies (earnings divided by interest expenses) was around its post-GFC average as at December 2023, partly supported by steady nominal earnings.

Graph 1.22

Cost of Business Debt



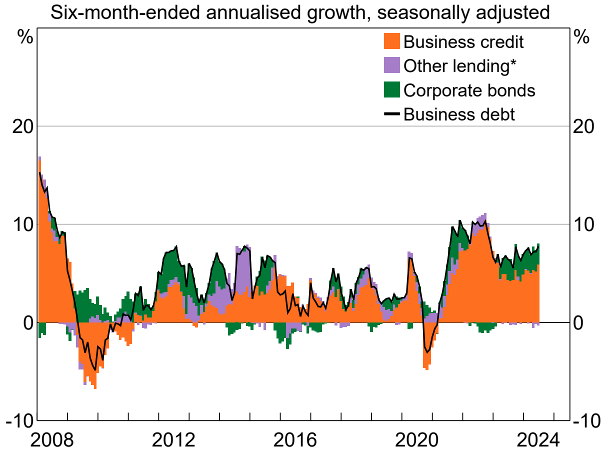
* Average variable interest rate on credit outstanding.

** For BBB-rated non-financial corporations.

Sources: APRA; Bloomberg; RBA.

The growth of business debt has remained above its post-GFC average, supported by corporate bond issuance (Graph 1.23). This has contributed to an increase in net external funding (which includes debt and equity issuance) for non-financial corporations, although internal funding (i.e. retained profits) remains the primary source of funding for private businesses in aggregate. Financial conditions for smaller businesses and businesses with higher leverage has remained more challenging.

Graph 1.23
Business Debt
Six-month-ended annualised growth, seasonally adjusted



* Lending to large businesses by institutions that do not report to APRA.
Sources: APRA; Bloomberg; LSEG; RBA.

Endnotes

1 RBA staff use three main types of models for estimating the neutral rate. The first type is a semi-structural model that infers the neutral rate as the cash rate that would prevail in the economy if output was at potential, inflation was at target and employment was full. The second type infers the neutral rate from financial market pricing for government bonds. The third type infers it from a statistical model that attempts to forecast the future level of the cash rate once all cyclical influences have dissipated. The neutral rate is generally modelled as a real interest rate (i.e. adjusted for inflation) while the cash rate is a nominal rate (i.e. includes inflation expectations). To compare the two, the neutral rate can be converted into a nominal interest rate by adding some measure of inflation expectations. See Ellis L (2022), 'The Neutral Rate: The Pole-star Casts Faint Light', Keynote Address to Citi Australia & New Zealand Investment Conference, Sydney, 12 October.

2 Overall, there is no clear international consensus as to whether post-pandemic economic trends (such as increases in public debt globally) are offsetting longer term structural trends that have weighed on neutral rates for many years (such as ageing populations and relatively weak productivity growth). See Benigno G, B Hofmann, G Nuño Barrau and D Sandri (2024), 'Quo Vadis, r*? The Natural Rate of Interest After the Pandemic', *BIS Quarterly Review*, March.

3 Baird A (2024), 'Urban Residential Construction and Steel Demand in China', RBA *Bulletin*, April.

4 For more information about the Term Funding Facility, see Black S, B Jackman and C Schwartz (2021), 'An Assessment of the Term Funding Facility', RBA *Bulletin*, September.

5 For more information on household balance sheets, see RBA (2024), 'Chapter 2: Resilience of Australian Households and Businesses', *Financial Stability Review*, March.

Box A: Are Inflation Expectations Anchored?

Inflation expectations are the rates of inflation that people expect over some future horizon. These matter because actual inflation partly depends on what people expect it to be and build into their wage- and price-setting behaviour. We consider inflation expectations to be 'anchored' if they are stable at a level that is consistent with inflation being maintained at the midpoint of the target band (2½ per cent) over an appropriate period. This Box outlines a range of measures of long-term inflation expectations and where we estimate them to be at present, concluding that long-term inflation expectations in Australia are anchored.

Inflation expectations influence actual inflation outcomes as well as the ease (or difficulty) with which the RBA can achieve the inflation target.

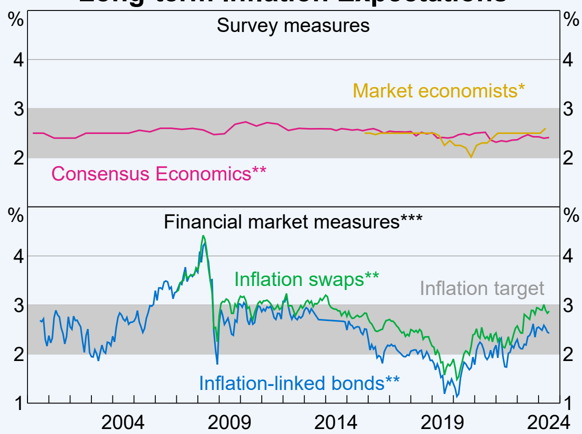
If workers and firms expect future inflation to be high, they will build those expectations into their wage and price setting, causing actual inflation to be higher than otherwise. For that reason, a key goal of policy is to 'anchor' these expectations on the midpoint of the target band. If long-term inflation expectations become less anchored, monetary policy will have to respond more strongly to stabilise inflation and output. A credible commitment to do what it takes to hit the inflation target is a key factor in keeping expectations anchored, which is why the Board remains resolute in its determination to return inflation to target.[1]

We monitor a range of measures of inflation expectations.

We look at measures of inflation expectations of households, firms, union representatives, market economists and other participants in financial markets over a variety of time horizons. In this Box we focus on long-term inflation expectations to infer whether inflation expectations are anchored because short-term inflation expectations can be affected by temporary factors. Graph A.1 shows the long-term measures of inflation expectations that are currently available with a sufficient history to infer if expectations are anchored; all of these measures refer to expectations about headline CPI.

Graph A.1

Long-term Inflation Expectations



* Average over the next 5–10 years.
** Average over the five years starting from five years ahead.
*** Inflation compensation.
Sources: Bloomberg; Consensus Economics; RBA.

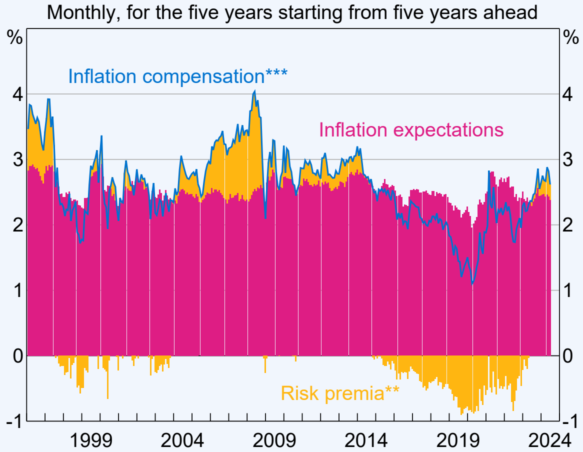
Survey measures of long-term inflation expectations of economists and forecasters tend to be quite steady around 2½ per cent. These measures are consistent with the inflation target.

Financial market measures of inflation compensation tend to move around a bit more than survey measures, but have mostly stayed within the inflation target band. These measures are implied from inflation-linked bonds and swaps; the returns on these are linked to headline CPI, so those who trade in them have an incentive to form accurate inflation expectations.[2] However, inflation compensation may not provide a clean reading of inflation expectations because investors tend to demand a premium over and above their inflation expectations to compensate for other risks, such as liquidity risk and/or inflation risk (i.e. the risk that their inflation expectations are wrong). To estimate inflation expectations, we need to separate these other risk premia from inflation compensation. It is difficult to disentangle which risks investors are demanding higher (or lower) risk premia for, but the drivers can have different implications. While there is little economic signal about inflation expectations from liquidity premia, an increase (or decrease) in the compensation demanded for the risk that inflation turns out to be higher (or lower) than expected points to a shift in people's perceptions of future inflation.

The inflation compensation implied by market measures has increased by around ½ percentage point since early 2023 and some measures are in the upper half of the target band (Graph A.1). Based on a range of estimates for bonds and swaps, as well as market liaison, we estimate that the increase in inflation compensation reflects a rise in inflation expectations and inflation risk premia, though more so the latter.[3] These markets are not very liquid, but liquidity has not changed much since 2023. Overall, this points to inflation expectations being around 2½ per cent (Graph A.2). While our assessment is that long-term inflation expectations of financial market participants are broadly anchored at the target, the increase in the premium for inflation risk could be a warning sign that the risk of a more substantial upward move in expectations has increased. We will continue to monitor this closely.

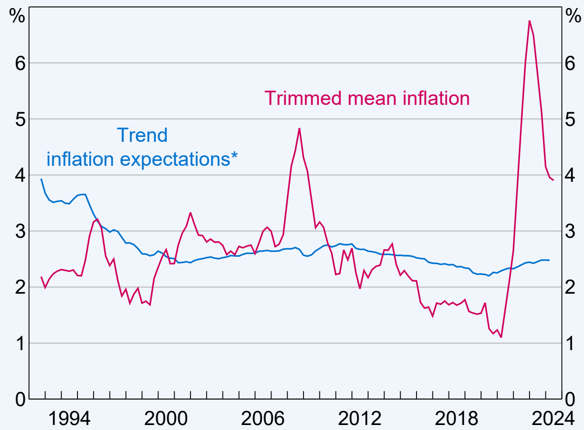
In addition to monitoring a range of measures, we also use a summary measure to capture the signal from various survey and market measures of inflation expectations over different time horizons. We call this 'trend inflation expectations' (Graph A.3).[4] This summary measure of forward-looking inflation expectations is a key input into the staff's forecasting models (along with a lag of inflation, which accounts for backward-looking, or so called 'adaptive', expectations). Our measure of trend inflation expectations has been quite stable over the inflation-targeting period, remaining within the target range. Over recent years, it has drifted up to be closely aligned with the 2½ per cent midpoint, after drifting below the midpoint during the low inflation period before the pandemic. Trend inflation expectations are currently assumed to remain at the target midpoint over the forecast horizon in the staff's forecasting models.

Graph A.2
Inflation Compensation Decomposition*
Monthly, for the five years starting from five years ahead



* To June 2024.
** Includes premia for liquidity and inflation risk.
*** 'Modelled break-even' inflation rate for bonds.
Sources: Hambur and Finlay (2018); RBA.

Graph A.3
Inflation Expectations and Inflation
Year-ended



* Computed using measures of household, market economist, union and financial market inflation expectations, over different time horizons.
Sources: ABS; Australian Council of Trade Unions; Consensus Economics; Employment Research Australia; Melbourne Institute; RBA; Workplace Research Centre.

A necessary condition for a measure of longer term expectations to be stable is that it is relatively insensitive to changes in actual inflation. We tested the sensitivity of long-term expectations, concluding that survey expectations and financial market measures tend to respond little to the latest inflation outcomes.

Our overall assessment is that long-term inflation expectations are still anchored.

The recent upward drift in some measures to around 2½ per cent, after a period of being below that, reflects closer alignment of expectations to the target. But there is a risk that a sustained period of inflation being above the target range could result in inflation expectations drifting higher. History suggests that if inflation expectations do rise above the target in this way, it would require more monetary policy tightening and a sustained and costly period of higher unemployment to lower inflation expectations and bring inflation back to target. Accordingly, it is important that inflation expectations remain anchored. Recognising this, the Board is committed to returning inflation to target within a reasonable timeframe.

Endnotes

1 For literature on the importance of a credible commitment, see Bernanke B (2003), 'A Perspective on Inflation Targetting', Speech at the Annual Washington Policy Conference of the National Association of Business Economists, Washington, DC, 25 March; Carvalho C, S Eusepi, E Moench and B Preston (2023), 'Anchored Inflation Expectations', *American Economic Journal: Macroeconomics*, 15(1), pp 1–47.

2 The fixed rate in an inflation swap – where one party receives a payment indexed to inflation in exchange for a payment predetermined by a fixed rate – is the implied inflation compensation over the period of the swap. For bonds, the implied inflation compensation (or the 'breakeven' inflation rate) is the difference in yields on a nominal bond and an inflation-linked bond.

3 For the bond market, we used a term structure model to decompose bond yields into expectations and risk premia: see Hambur J and R Finlay (2018), 'Affine Endeavour: Estimating a Joint Model of the Nominal and Real Term Structures of Interest Rates in Australia', RBA Research Discussion Paper No 2018-02. For the swap market (and as a cross check for the bond market), we produced alternative estimates of the inflation risk premium based on differences in long-term forward rates.

4 Trend inflation expectations are estimated using a model that puts more weight on measures that can statistically explain future movements in all the expectation measures.

Chapter 2
Economic Conditions

Summary

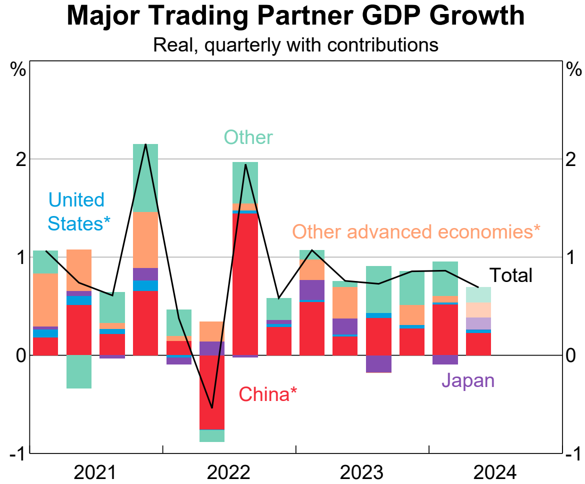
- **Growth in Australia's major trading partners appears to have eased by a little more than expected in the June quarter, mainly driven by a weaker outturn in China.** Nonetheless, the Chinese economy is on track to achieve the authorities' 2024 target of 'around 5 per cent growth'. A gradual recovery is underway in most other economies. In the United States, growth remains robust but is moderating. Overseas unemployment rates are generally increasing as labour markets move into better balance.
- **Disinflation has resumed in the United States in recent months, but progress has stalled in some other economies, particularly in Europe.** Inflation in six-month annualised terms is closer to target in economies such as Sweden and Canada where there are clear signs of spare capacity in the economy and labour markets.
- **In Australia, domestic demand was more resilient in early 2024 than previously forecast.** Household consumption and public consumption have both proved stronger than expected at the time of the May forecasts. The upside surprise to domestic demand has occurred alongside robust growth in imports, while exports were slightly softer than expected. As a result of the drag from net trade, Australia's GDP grew by less than expected in the March quarter; partial indicators suggest that GDP growth remained subdued in the June quarter.
- **The housing market remains tight, resulting in housing prices rising more briskly than expected in recent months and strong growth in advertised rents.** This reflects the lack of new housing supply and strong underlying demand. Dwelling investment in early 2024 was weaker than anticipated as high construction costs reportedly made some projects unfeasible and labour shortages remain for certain trades.
- **Underlying inflation eased slightly in the June quarter but remained high.** Underlying inflation, as measured by trimmed mean inflation, slowed to 0.8 per cent in the quarter, and slowed to 3.9 per cent in year-ended terms. Headline inflation increased in year-ended terms to 3.8 per cent. These outcomes are broadly as expected in the May *Statement* and show that the pace of disinflation has slowed. Long-term inflation expectations remain anchored at the inflation target.
- **Our assessment is that the demand for goods and services continues to exceed the supply capacity of the economy, and by a little more than previously thought.** Firms are continuing to report that they operate at relatively high levels of capacity utilisation, with input cost inflation remaining above longer run averages.
- **Labour market conditions are assessed as a little tighter relative to full employment than previously thought, but are still gradually moving into better balance.** Wages growth remains high relative to productivity growth, labour availability remains constrained and vacancies also remain high.

2.1 Global economic conditions

Overall, growth in Australia's major trading partners appears to have eased a little more than expected in the June quarter, driven by weaker growth in China.

Growth in China slowed significantly in the June quarter (Graph 2.1). Authorities noted that flooding and heatwaves temporarily restrained consumption and investment in the quarter. Strong external demand again contributed to growth, but by much less than in the March quarter. Strong growth in manufacturing investment is being partly offset by ongoing weakness in property investment, which has been the key headwind to growth in the post-pandemic period. Housing starts, sales and prices all indicate that conditions in the property sector remain very weak.

Graph 2.1

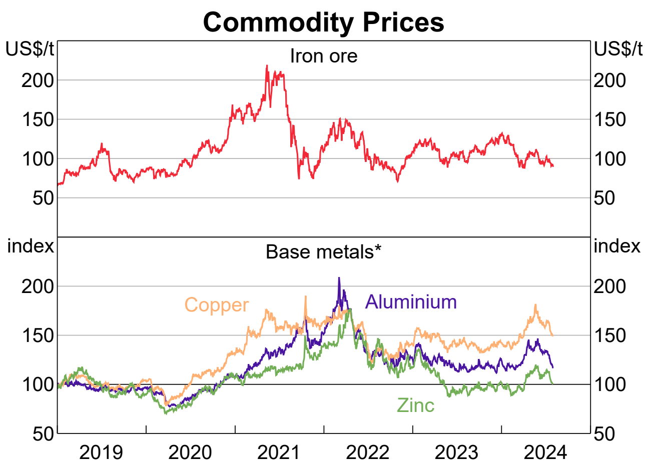


* For June quarter 2024, actual for the United States, euro area and China, forecasts elsewhere.

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

Weaker-than-expected activity outcomes in China have weighed on sentiment in commodity markets. Iron ore and base metals prices have declined recently, despite underlying demand remaining relatively stable and some ongoing concerns from disrupted production and closures of copper and zinc mines across a range of locations (Graph 2.2). At China's recent 'Third Plenum' (where authorities outline their long-term economic and political reform agenda) little was outlined to address the ongoing downturn in the property sector and lift sentiment in commodity markets. As expected, authorities in China did not signal a large change in short-term economic policy direction, though they did recommit to this year's growth target of 'around 5 per cent'. A number of key reforms were identified, which could potentially support growth in the short-to-medium term, particularly those focused on fiscal reform and increasing the provision of social services to migrant workers.

Graph 2.2



* January 2019 average = 100.

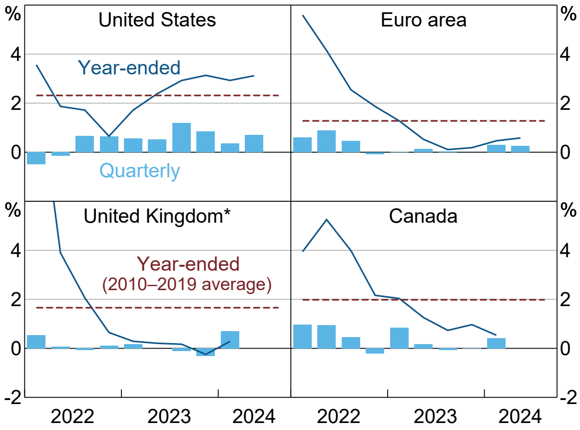
Sources: Bloomberg; RBA.

Elsewhere, growth has remained robust in the United States and is gradually recovering in most other advanced economies (though remains below trend).

GDP growth over the past year has been weak across most advanced economies, but now seems to be gradually recovering (Graph 2.3). In some economies this recovery has been stronger than expected, though growth is generally still below estimates of potential. By contrast, GDP growth in the United States strengthened and surprised to the upside in the June quarter, although overall the pace is continuing to moderate. Tight monetary policy continues to weigh on growth in advanced economies; while many central banks are cutting (or planning to cut) rates, monetary policy is still assessed as restrictive (see Chapter 1: Financial Conditions).

Graph 2.3

GDP Growth

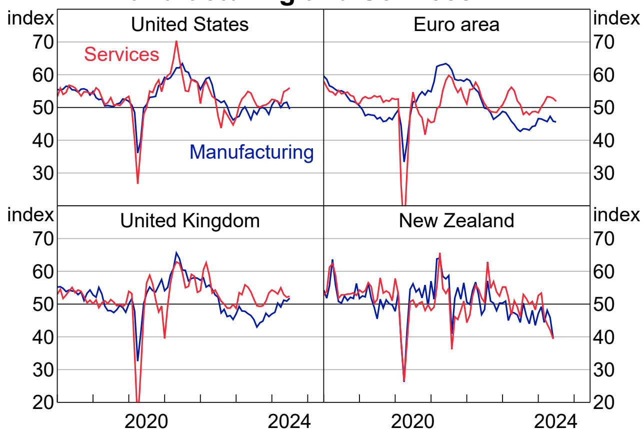


* Year-ended GDP growth for the March quarter of 2022 was 11.4 per cent.

Sources: LSEG; RBA.

Graph 2.4

Manufacturing and Services PMI*



* Purchasing Managers' Index; outliers during the COVID-19 pandemic were truncated.

Sources: LSEG; RBA; S&P Global.

Consumption in many advanced economies is recovering as real household disposable income has continued to increase. However, data on retail sales suggest the recovery has been a little slower than expected in some economies, including the euro area and Canada. In the United States, consumption growth in the June quarter was stronger than expected, though real household disposable income growth has declined in recent months, suggesting some moderation in consumption growth is likely underway. Business investment intentions have been mixed across advanced economies. In the euro area and Canada intentions are relatively weak but have improved in recent months, while intentions remain relatively unchanged in the United States.

Timely activity indicators generally signal continued recovery in growth into the September quarter. While surveyed business conditions in services sectors remain expansionary, recent data on manufacturing sector conditions are weaker and more mixed (Graph 2.4). Overall business conditions have moved into expansionary territory in the United Kingdom but have moved further into contractionary territory in the euro area. Conditions in New Zealand have deteriorated quite sharply into contractionary territory in recent months.

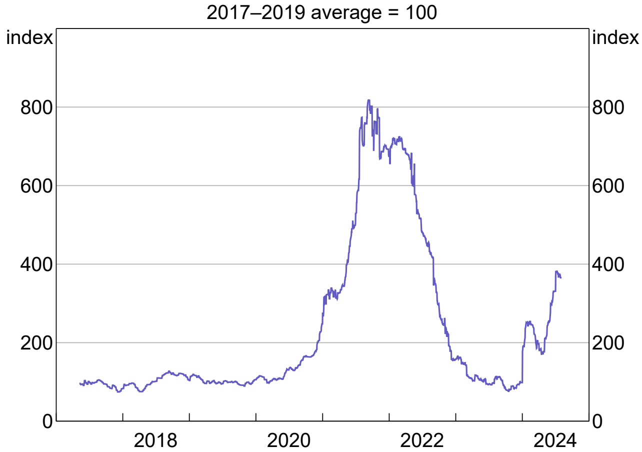
Shipping costs have increased significantly since May, which poses an upside risk to global goods inflation if sustained.

Recovering consumption and an associated inventories restocking cycle have contributed to strong demand for goods from China and east Asia. This is putting additional pressure on global shipping capacity, already strained due to the conflict in the Middle East and the associated increase in shipping travel times. Market participants also report some bringing forward of shipments ahead of actual and anticipated tariffs, though the effect of this is difficult to quantify. As a result, container rates have increased sharply since May (Graph 2.5). While this has not yet materialised in higher global goods inflation, it could pose an upside risk if sustained, with possible spillovers to goods inflation in Australia.

Graph 2.5

Container Shipping Costs

2017–2019 average = 100



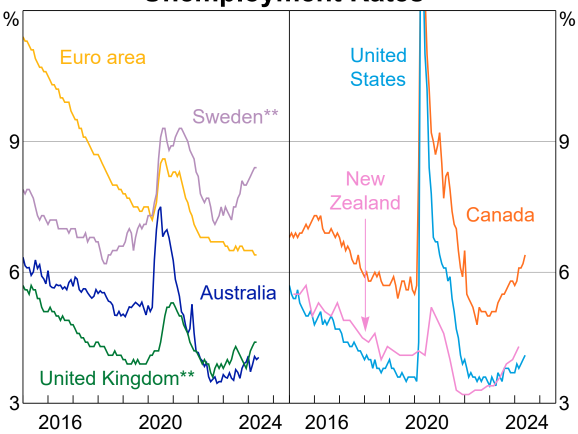
Sources: LSEG; RBA.

Labour market conditions are becoming more balanced across advanced economies and in some cases have eased a little faster than expected.

Unemployment rates have increased in most advanced economies, as labour demand has moderated and, in some cases, strong population growth has lifted labour supply (Graph 2.6). Large increases in unemployment rates have occurred in Canada, Sweden and New Zealand, consistent with greater slowing in activity (relative to potential growth) in these economies. With labour markets having become more balanced in most advanced economies, and vacancy rates having largely normalised, more of the easing in labour markets is now occurring through increases in unemployment rates (Graph 2.7). By contrast, labour market conditions remain tighter in Australia. Wages growth remains high in most advanced economies, in part reflecting some catch-up following earlier high inflation. Easing pressure in labour markets should help moderate wages growth, though persistently high wages growth remains an upside risk to inflation.

Graph 2.6

Unemployment Rates*



* Outliers during the COVID-19 pandemic were truncated.

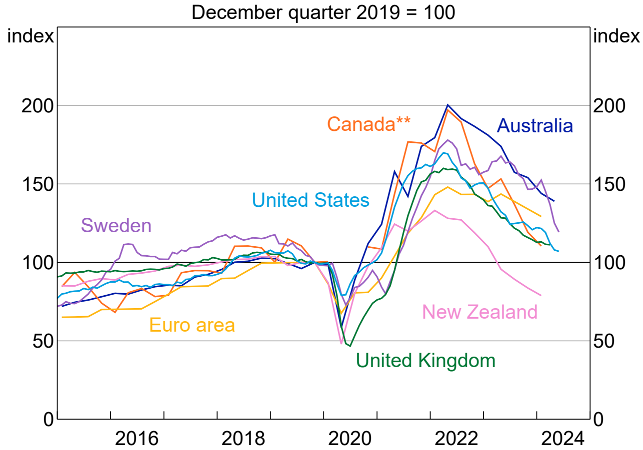
** Data for the United Kingdom and Sweden are three-month moving averages.

Sources: Eurostat; LSEG; RBA.

Graph 2.7

Vacancy Rates*

December quarter 2019 = 100



* Data for the United States, the United Kingdom and Sweden are monthly, and are indexed to November 2019.

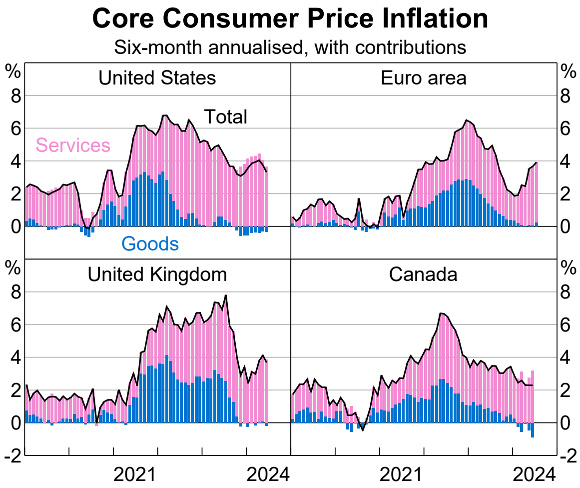
** Canadian vacancies data are unavailable for the June and September quarters of 2020.

Sources: Eurostat; LSEG; RBA.

Disinflation has resumed in the United States in recent months, but progress continues to stall in other economies, particularly in Europe.

Year-ended inflation continues to ease in most economies. In the United States, inflation has recently eased more quickly than expected after some signs of upward inflation momentum earlier this year. Recent inflation momentum, measured by the six-month-annualised rate, is in line with the target in Canada and Sweden, consistent with more spare capacity in these economies. However, in some other advanced economies, including the United Kingdom and euro area, progress in lowering core inflation has stalled or even reversed (Graph 2.8). Notwithstanding this, the Bank of England and the European Central Bank assess recent higher core inflation rates as part of a bumpy disinflation path and expect a further decline in inflation over time as demand and supply continue to rebalance. Both central banks have emphasised that a restrictive monetary policy stance will be maintained to ensure inflation sustainably returns to target.

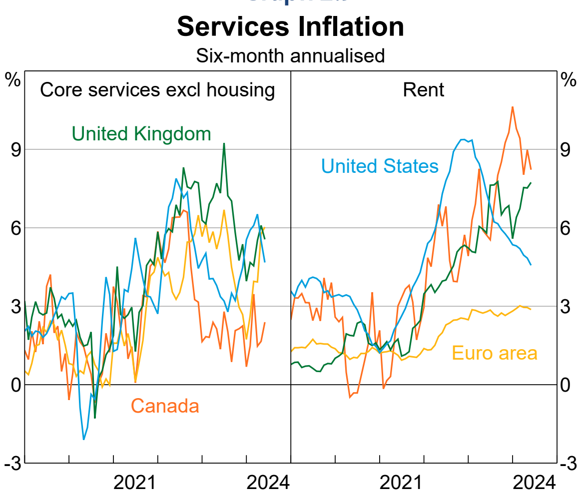
Graph 2.8



Sources: BLS; Eurostat; LSEG; ONS; RBA; Statistics Canada.

Core inflation has been held up by a noticeable pick-up in services inflation in several advanced economies, while goods inflation remains low. Non-housing services inflation remains high outside of Canada and has trended higher in the euro area and the United Kingdom in recent months; in part, this increase may be a lagged response to earlier cost pressures for some infrequently adjusted services prices (Graph 2.9). Rental inflation also remains high, and disinflation progress in this category has been slow. Although leading indicators such as advertised rents have started to ease, the pass-through to lower rental inflation is likely to take some time.

Graph 2.9



Sources: BLS; Eurostat; LSEG; ONS; RBA; Statistics Canada.

2.2 Domestic economic activity

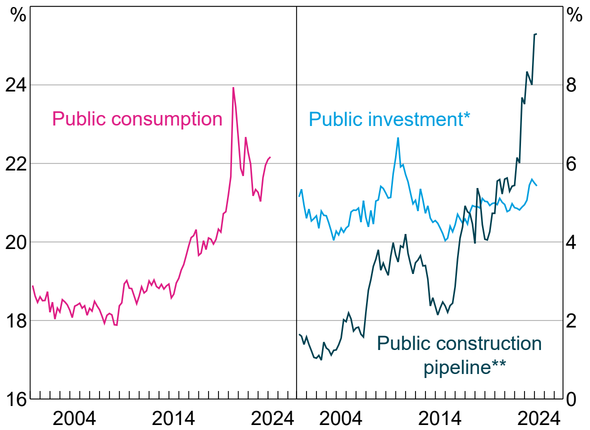
Restrictive financial conditions continue to weigh on private demand, but overall domestic demand growth was stronger than expected in early 2024.

Domestic final demand growth in early 2024 was slightly stronger than expected at the time of the May *Statement*, driven by household consumption and public consumption. Household spending surprised to the upside in the March quarter, with spending on utilities, transport and entertainment services stronger than anticipated. Growth in public consumption was also stronger than expected in the March quarter and has increased as a share of nominal GDP over the past year (Graph 2.10). Public consumption is being supported by expenditure on social benefits to households, such as the National Disability Insurance Scheme, Medicare and the Pharmaceutical Benefits Scheme. While public investment growth was weaker in the March quarter, a large pipeline of infrastructure projects is expected to continue supporting investment.

Graph 2.10

Components of Public Demand

Share of nominal GDP



* Adjusted for second-hand asset transfers between public and other sectors.

** Stock of engineering construction work yet to be done by the private sector for the public sector as a percentage of nominal GDP.

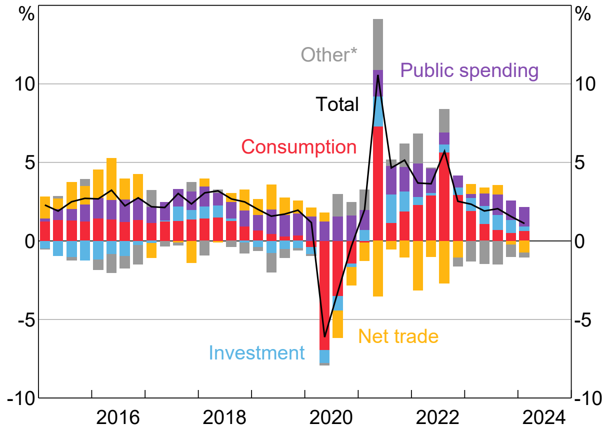
Sources: ABS; RBA.

The volume of imports of goods and services was higher than expected, resulting in weaker-than-expected GDP growth in early 2024 (Graph 2.11). Imports growth was strong in early 2024 and outpaced growth in domestic demand. Conversely, growth in exports slowed, reflecting soft spending by international students. A range of indicators suggest that the soft pace of growth in economic activity continued in the June quarter. The subdued pace of GDP growth has been helping to bring the level of aggregate demand into better balance with supply.

Graph 2.11

GDP Growth

Year-ended with contributions

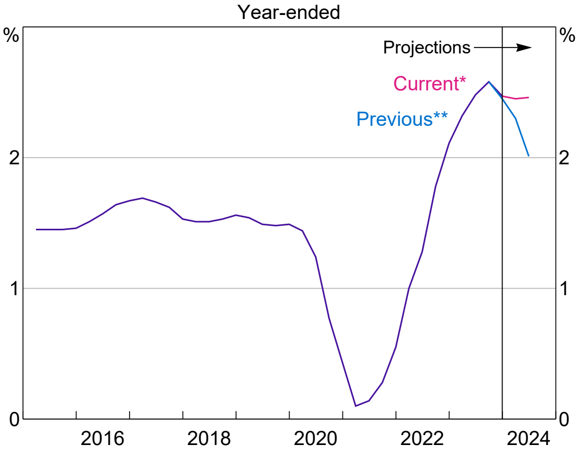


* Includes statistical discrepancy, ownership transfer costs and inventories.

Sources: ABS; RBA.

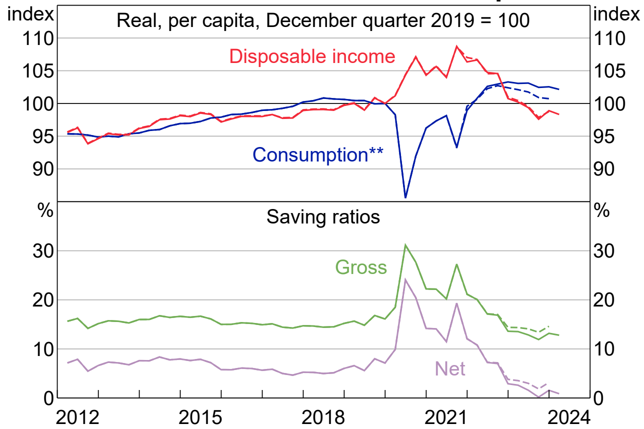
GDP declined further on a per-capita basis in early 2024. GDP growth was 0.1 per cent in the March quarter and 1.1 per cent over the year to March (Graph 2.12). In per-capita terms, GDP has declined by 1.6 per cent since its peak in mid-2022. In addition, Australian Bureau of Statistics' projections in the Labour Force Survey suggest that population growth was stronger in the first half of 2024 than expected three months ago, which in turn suggests that growth in the economy on a per-capita basis has been weaker than implied by the March quarter National Accounts data.

Graph 2.12
Population Growth



* Projections reflect ABS projections in the Labour Force Survey.
** Projections reflect a range of sources, including indicators from the ABS, migration policies, and estimates made by the Australian Government.
Sources: ABS; Australian Government; RBA.

Graph 2.13
Household Income and Consumption*



* Dashed lines represent the previous data vintage.
** Population denominator adjusted to exclude international students.
Sources: ABS; Department of Home Affairs; RBA.

Growth in household consumption remains well below pre-pandemic averages but has been stronger than previously thought.

Real disposable incomes have declined sharply over the past 18 months but have stabilised recently (Graph 2.13). The stabilisation in real incomes is the result of inflation declining, and a slowing in the pace of interest rate and tax payment increases. The implementation of the Stage 3 tax cuts and further declines in inflation are expected to result in real incomes growing strongly in the second half of 2024.

Household net wealth has increased steadily, which has helped to offset some of the impact of weak disposable incomes on consumption. Real household net wealth has increased by 5 per cent over the past year and is 22 per cent higher than prior to the pandemic. The increase in wealth since the pandemic has been driven by strong housing price growth, additional savings by households during the pandemic and equity price increases (see Chapter 1: Financial Conditions). Households' holdings of liquid assets, such as deposits, have also grown much more quickly than incomes over this period.

Household consumption growth has been stronger than forecast in the May *Statement*. Some of the upside surprise was driven by large revisions to the level of spending by Australian tourists overseas since mid-2022, and therefore has not affected our assessment of domestic inflationary pressures. Growth in the consumption of goods and services in Australia in the March and December quarters was also a bit stronger than expected, and partial data for the June quarter, including retail sales and bank transaction data, suggest this pick-up in growth was sustained.

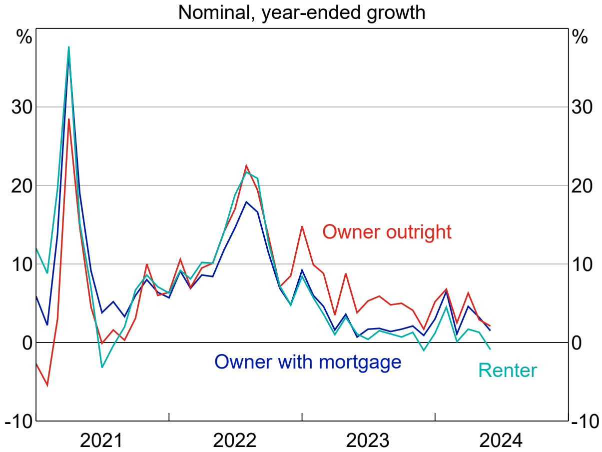
The revisions to consumption have lowered the household saving ratio. On both a gross and net (of depreciation) basis, the saving ratios are below their pre-pandemic levels but have been relatively stable over recent quarters. The extent to which households are willing to continue to save at this lower rate, particularly once real income growth starts to recover, represents a key uncertainty in the outlook for household consumption (see Chapter 3: Outlook).

Timely transaction-based spending data suggest that spending growth remains subdued for most households (Graph 2.14). This has been most pronounced for renters, who are typically younger. Many other households have also had to make difficult adjustments in response to the challenging conditions, such as those with limited or no financial buffers. Community service organisations report that demand for their services remains at a very high level compared with the years before the pandemic owing to cost-of-living pressures and a shortage of affordable housing.

Graph 2.14

CBA Household Spending Indicator

Nominal, year-ended growth



Source: CBA.

The increase in consumption growth has been partially offset by a slowdown in services exports. Growth in spending by inbound visitors to Australia eased further in early 2024, led by a moderation in spending by international students and tourists. The ongoing recovery in inbound tourism has been slower than expected at the time of the May *Statement*, largely driven by Chinese tourists. In recent months, offshore student visa grants have fallen sharply as the federal government has tightened requirements for student visa applicants; the government has also proposed caps on international student numbers.

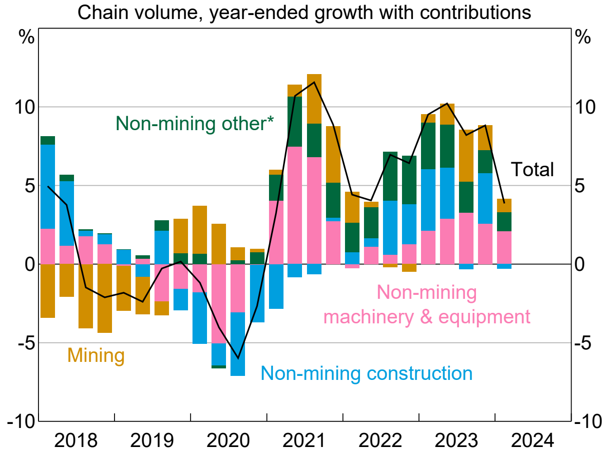
Growth in private business investment has moderated recently from the very high growth rates in 2023.

Business investment growth moderated in early 2024, by a bit more than expected, following strong growth over the prior 18 months. Non-mining construction investment fell in the March quarter, by more than expected, driven by falls in small to mid-sized projects that were mostly commenced and completed in the December quarter (Graph 2.15). However, non-mining construction investment has been supported by investment in renewable energy infrastructure, data centres, warehouses and continued progress on the pipeline of yet-to-be-done construction work, and this is expected to continue. Growth in non-mining machinery and equipment investment has slowed in recent quarters but the level of investment remains elevated. Non-mining software investment continues to grow strongly. Firms in the RBA's liaison program report that investment continues to be supported by a backlog of light commercial vehicle orders and data centre fit-outs (see Box B: Insights from Liaison). Firms also continue to invest in software platforms and a range of other digital services relating to data migration, cloud storage and cybersecurity.

Graph 2.15

Business Investment

Chain volume, year-ended growth with contributions



* Includes biological resources, artistic originals, non-mining software and non-mining research & development.

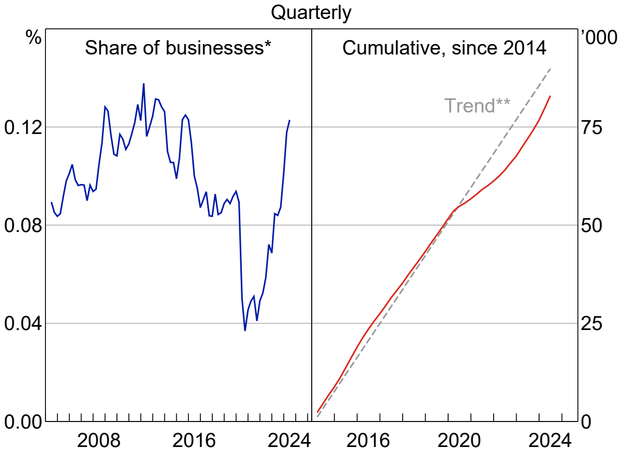
Sources: ABS; RBA.

Firms expect the pace of investment growth to slow further in the year ahead and nominal investment intentions for 2024/25 have been revised down slightly. Non-mining construction is still expected to grow at a similar pace to the previous year, while non-mining machinery and equipment and mining investment are expected to be relatively flat. Firms in the RBA's liaison program have also reported a moderation in planned investment spending for the year ahead, primarily citing higher input costs (particularly for labour), delays in non-residential construction approvals, a subdued outlook for demand and broader macroeconomic uncertainty. Similarly, information from the NAB business survey suggests that investment expectations have softened alongside elevated labour costs and a decline in forward orders.

As a share of all businesses, company insolvencies remain around their pre-pandemic average, having increased from record lows during the pandemic.

The level of company insolvencies remains below the pre-pandemic trend, despite increasing since 2022 (Graph 2.16). The increase reflects a slowing economy, the removal of pandemic support measures and the Australian Taxation Office resuming enforcement activities on unpaid taxes. Sectors more exposed to discretionary spending, such as arts and hospitality, now account for a larger share of insolvencies, while insolvencies in the construction sector have declined but remain elevated. Some construction firms in the RBA's liaison program have suggested that margins are stable or improving, but conditions are reported to remain challenging for firms, particularly subcontractors.

Graph 2.16
Company Insolvencies
Quarterly

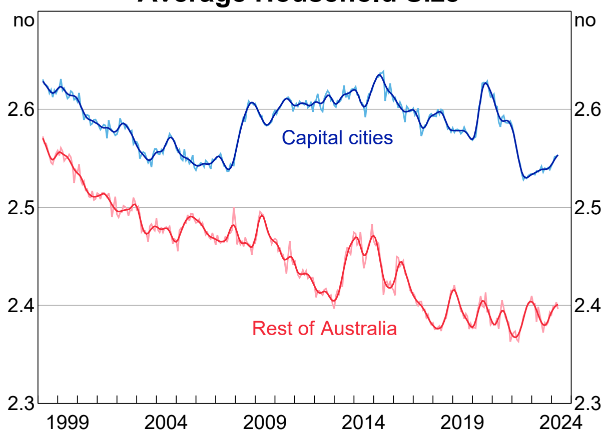


* Shares calculated relative to total businesses operating at the end of each financial year.
** Trend for cumulative insolvencies calculated using observations from 1999–2019.
Sources: ABS; ASIC; RBA.

Housing price growth has been stronger than expected and growth in advertised rents remains strong, as new supply continues to fall short of growth in underlying demand.

Underlying demand for housing has remained strong, but growth in demand appears to have moderated in recent months. Strong population growth and a low average household size continue to contribute to strong growth in underlying demand for housing. However, population growth appears to be past its peak and average household size has increased further in recent months, possibly in response to affordability constraints (Graph 2.17).

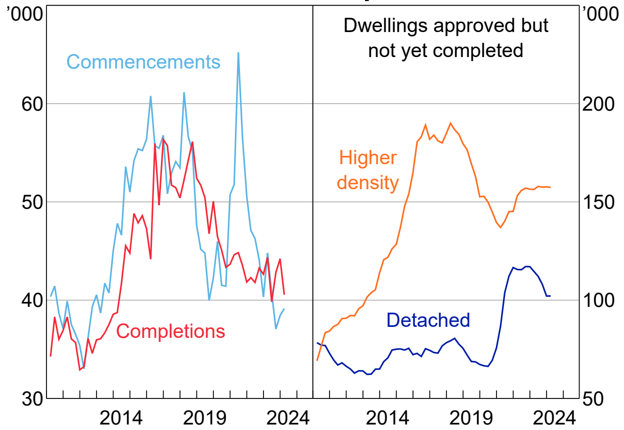
Graph 2.17
Average Household Size*



* Smoothed lines are 13-period Henderson trends.
Sources: ABS; RBA.

New dwelling supply remains weak, reflecting ongoing cost pressures affecting project feasibility and labour shortages for certain trades. Some contacts in the RBA's liaison program have suggested that high building costs are limiting the viability of many higher density projects at current prices, contributing to low numbers of building approvals and commencements. Labour shortages for certain trades, particularly finishing trades for higher density construction, are still contributing to new dwelling cost inflation and limiting progress in reducing the backlog of work to be done (Graph 2.18). Nonetheless, contacts report that weak new home sales have contributed to easing labour shortages for earlier stages of the detached housing construction process.

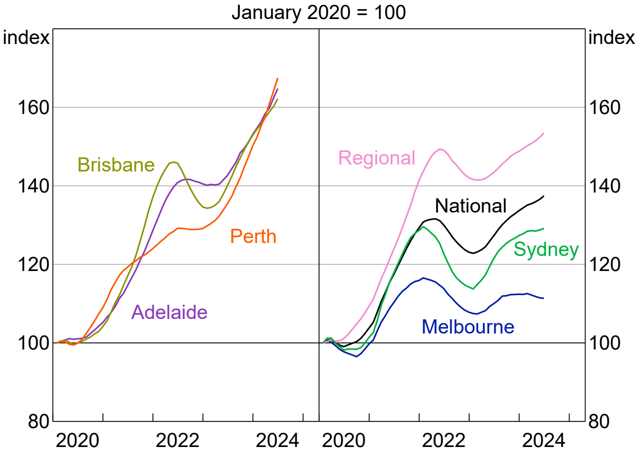
Graph 2.18
Residential Pipeline



Sources: ABS; RBA.

The ongoing imbalance between supply and underlying demand has led to further rises in housing prices and rents. National housing price growth has been stronger than expected over recent months (Graph 2.19). Price growth has remained stronger for less expensive properties within capital cities and property types. Growth in advertised rents has eased over recent months, which may reflect the impacts of affordability constraints and is consistent with the recent increase in average household size. Nonetheless, it remains above the growth rates experienced prior to the pandemic.

Graph 2.19
Housing Prices
January 2020 = 100



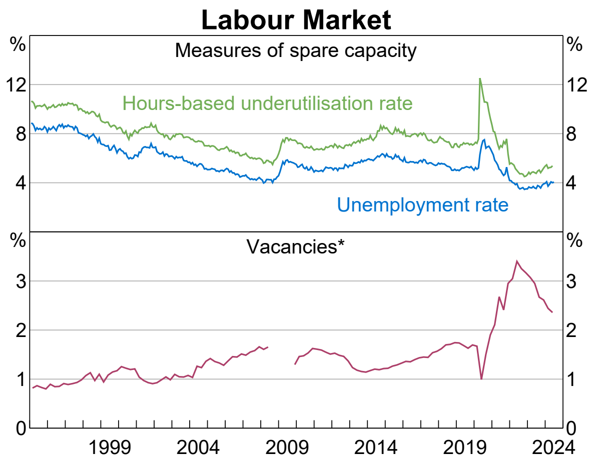
Sources: CoreLogic; RBA.

2.3 Labour market and wages

Labour market conditions have continued to ease gradually but recent data suggest there is less capacity than previously thought.

The easing in labour market conditions since late 2022 has occurred through a gradual increase in the unemployment rate, alongside declines in vacancies and average hours worked. The unemployment rate increased as expected to 4.1 per cent in June, 0.6 percentage points above its late-2022 trough (Graph 2.20). The unemployment rate remains below estimates of the rate consistent with full employment, and we now assess that there is less capacity than previously thought, consistent with high prices and wages outcomes over the past year (see section 2.5 Assessment of spare capacity). More cyclical measures of unemployment, such as the medium-term and youth unemployment rates, and the hours-based underutilisation rate – a broader measure of spare capacity – have also increased but remain low relative to pre-pandemic levels.

Graph 2.20



* As a share of the labour force; the ABS vacancies survey was suspended between May 2008 and November 2009.

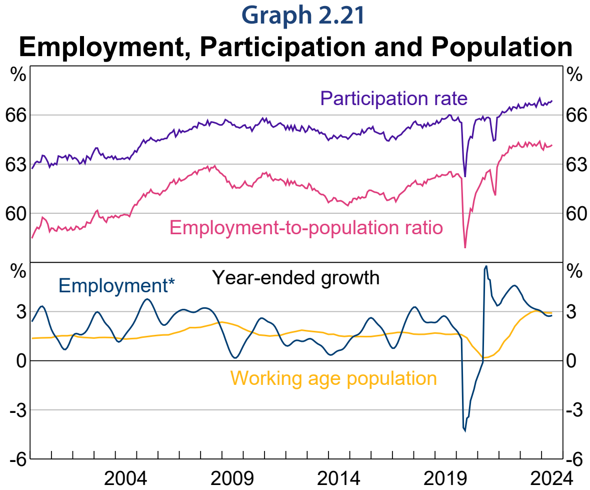
Sources: ABS; RBA.

Vacancies have fallen from their 2022 peak but remain further above their pre-pandemic levels than in peer economies (Graph 2.7). The relatively high level of vacancies is consistent with an elevated share of businesses reporting in surveys that suitable labour remains a constraint on output and indicates that the labour market remains relatively tight. Average hours worked have declined over the past year, owing largely to a decrease in the average hours worked by full-time workers and an increase in the share of part-time workers. More recently, average hours have been stronger than expected, and are slightly higher now than six months earlier.

Data on labour market flows suggest firms are responding to weaker demand mostly by hiring fewer additional workers rather than by laying off staff. While the rate of layoffs has increased modestly since 2022 alongside the gradual easing in labour market conditions, it remains low.

Employment growth has moderated but remains solid and is now around the same pace as working-age population growth. Employment growth in the June quarter was stronger than previously expected, consistent with population estimates being stronger than assumed. Accordingly, the employment-to-population ratio has remained near its historically high level. Employment has increased by around 240,000 persons since the start of 2024. Taken together, developments in average hours worked and employment suggest the demand for labour, in aggregate, has recently been stronger than previously expected. The labour force participation rate remains high and is slightly above its level in late 2022, supported by greater participation by females and older workers (Graph 2.21).

Graph 2.21



* Trend measure.

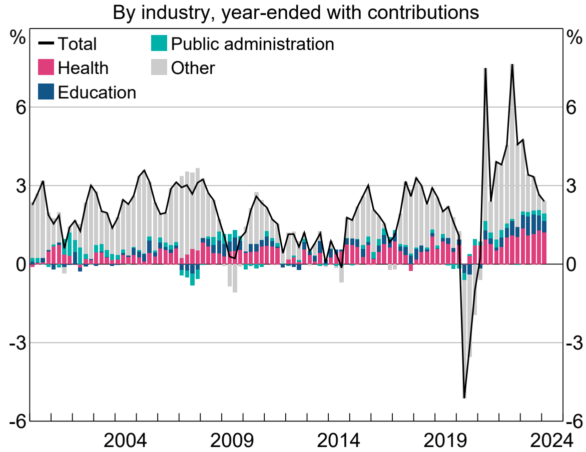
Source: ABS.

Aggregate employment outcomes have been supported by employment growth in industries that are typically less sensitive to the business cycle, including health care and education (Graph 2.22). By contrast, employment outcomes in more cyclical sectors, such as retail trade and hospitality, have slowed in recent quarters. Employment intentions of firms in the RBA's liaison program remain positive but have eased to be slightly below their long-run average.

Graph 2.22

Employment Growth

By industry, year-ended with contributions



Sources: ABS; RBA.

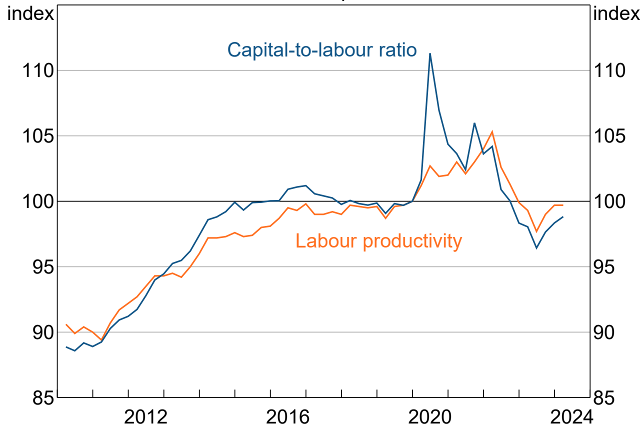
Productivity growth remains weak.

Non-farm labour productivity increased by 0.4 per cent over the year to the March quarter. Employment growth fell in the pandemic and rose sharply afterwards. As the capital stock takes time to adjust, this caused the capital-to-labour ratio and labour productivity to rise and then fall. The capital-to-labour ratio is now reverting to its pre-pandemic level, supporting the level of labour productivity (Graph 2.23). Multifactor productivity growth, which is the part of labour productivity growth not due to growth in the capital-to-labour ratio, remains weak. Looking through pandemic-related volatility, labour productivity is now around the same level as in 2016. Productivity outcomes have been weak in most market and non-market industries over the past few years, though especially in the mining and utilities industries.

Graph 2.23

Labour Productivity and Capital Deepening

Non-farm, December quarter 2019 = 100



Sources: ABS; RBA.

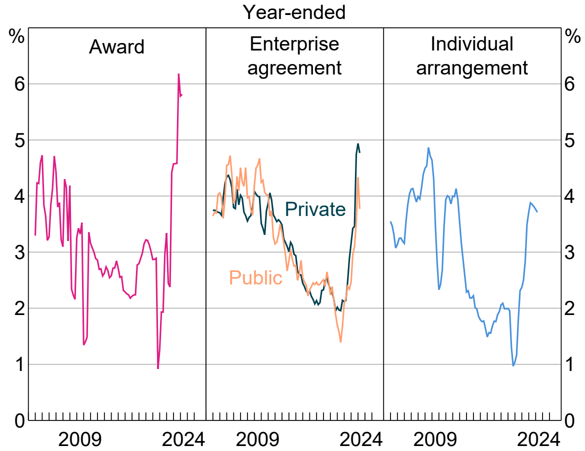
Wages growth appears to have passed its peak but remains higher than can be sustained by the trend growth rate of productivity.

Growth in the Wage Price Index (WPI) has been elevated over the past year, though it eased in the March quarter to 4.1 per cent. This easing in wages growth was broadly based, and growth in enterprise agreements was weaker than expected (Graph 2.24). The Fair Work Commission's recently announced 3.75 per cent increase to modern award wages, effective from 1 July, will also see a step down in award-linked wages growth. The proportion of jobs receiving a wage change has eased a little relative to a year ago, though the average size of wage changes remains large.

Graph 2.24

Wages Growth by Pay-setting Method*

Year-ended



* Excludes bonuses and commissions.

Sources: ABS; RBA.

WPI growth remains faster than can be sustained by trend growth in productivity without putting upward pressure on inflation. When productivity growth is positive, WPI is able to outpace inflation while still being consistent with inflation in the middle of the inflation target band. As trend growth in labour productivity is below its rate in previous decades, the sustainable WPI growth rate is lower than in the past and below the current rate of growth. In the short term, WPI growth could exceed the sustainable rate – for example, to catch up to a previous period of high inflation. However, we assess that the current pace of wages growth cannot be sustained in the long term without a higher pace of trend growth in productivity.

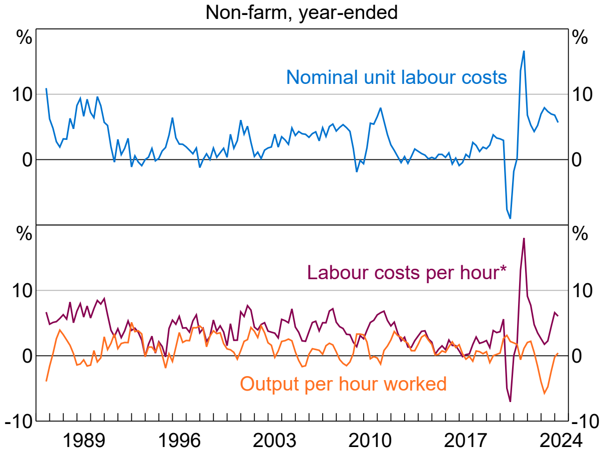
Unit labour cost growth is moderating gradually, but it remains higher than is consistent with inflation being sustainably at the midpoint of the target range.

Year-ended unit labour cost growth has remained high. Unit labour costs, which are labour costs adjusted by labour productivity, grew by 5.7 per cent over the year to the March quarter, well above its historical average pace (Graph 2.25). A lower pace of growth in unit labour costs is required for inflation to sustainably remain at 2.5 per cent in the long run.

Graph 2.25

Nominal Unit Labour Cost Growth

Non-farm, year-ended



* Compensation of employees plus payroll taxes less employment subsidies, divided by employee hours worked.

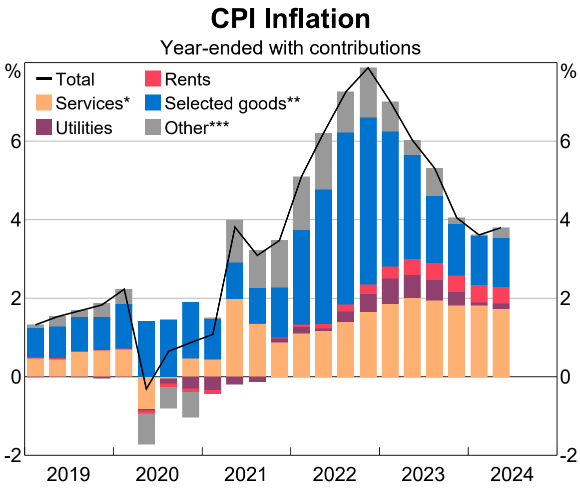
Sources: ABS; RBA.

2.4 Inflation

Inflation remains above target and the pace of disinflation has slowed.

Headline inflation remained high in the June quarter. Headline CPI increased by 1.0 per cent in the June quarter to be 3.8 per cent higher over the year, up from 3.6 per cent in the March quarter (Graph 2.26). The increase in headline inflation was driven, in part, by a strong increase in the prices of overseas travel and volatile items.

Graph 2.26



* Includes market services and administered items; excludes utilities, rents and holiday travel & accommodation.

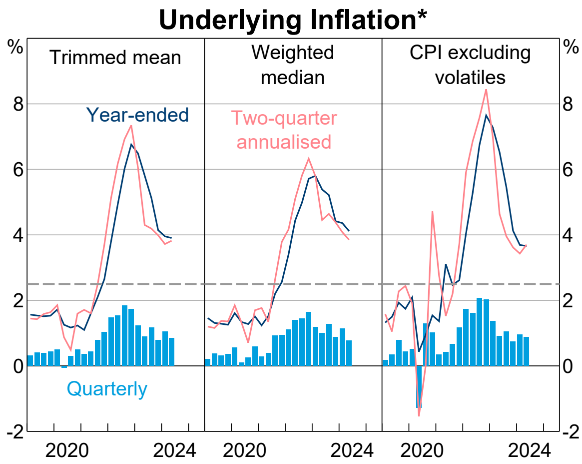
** Includes groceries, alcohol & tobacco, consumer durables and new dwellings.

*** Primarily holiday travel & accommodation and fuel.

Sources: ABS; RBA.

Measures of underlying inflation – which remove the effect of short-term volatility in a subset of prices – eased in the June quarter; trimmed mean inflation was 0.8 per cent in the quarter and 3.9 per cent over the year (Graph 2.27). This outcome was broadly as expected at the time of the May *Statement*. The recent slow pace of disinflation is consistent with the assessment that the labour market remains tight and aggregate demand continues to exceed supply.

Graph 2.27



* Dashed line indicates the midpoint of the inflation target.

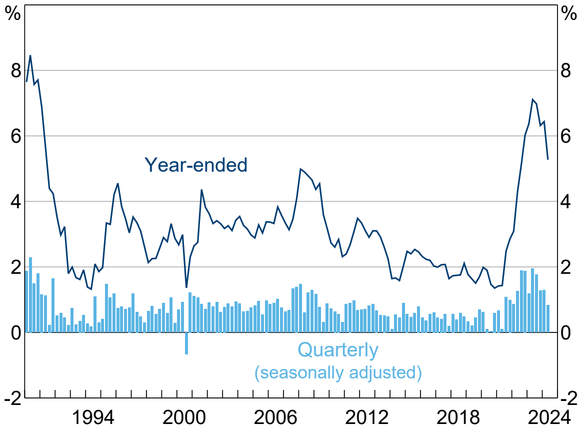
Sources: ABS; RBA.

Services inflation is easing from a high level.

Market services inflation eased in the June quarter. Market services inflation was 0.9 per cent in the June quarter and 5.3 per cent over the year, down from 6.4 per cent (Graph 2.28). The easing in year-ended inflation was broadly based across most market services, particularly those that are more discretionary, such as eating out and recreational activities. However, services inflation remains well above its historical average, consistent with the significant pace of growth in domestic non-labour costs and unit labour cost growth. Survey measures, including in the RBA's liaison program, suggest that firms are continuing to pass through much of this cost growth to prices, although soft consumer demand has made pass-through more difficult in some industries.

Graph 2.28

Market Services Inflation*



* Excludes domestic holiday travel & accommodation and telecommunications; adjusted for the tax changes of 1999–2000.

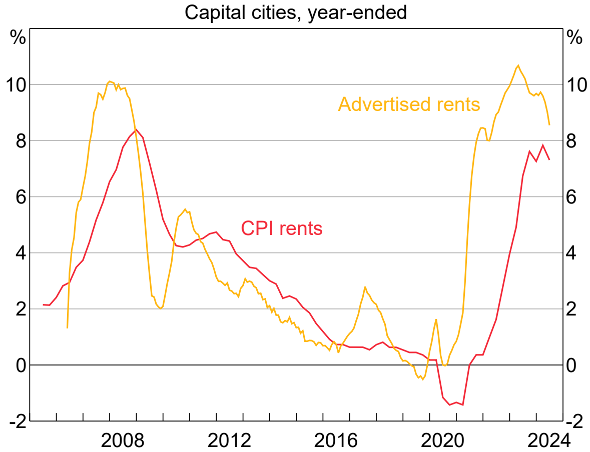
Sources: ABS; RBA.

Rent inflation remains high and this is expected to persist. Rent inflation – for the stock of rental accommodation captured in the CPI (which excludes regional areas) – was 2.0 per cent in the quarter and 7.3 per cent over the year (Graph 2.29). The slight easing in quarterly rents inflation was due to the regular indexation of Commonwealth Rent Assistance. Growth in advertised rents remains high, reflecting tight rental market conditions across the capital cities; however, it has started to ease recently, consistent with the increase in average household size. Rents on new leases flow through to CPI rents with a lag as only a small share of the stock of rental properties update leases in a given month, which implies that CPI rents inflation is likely to be high for some time.

Graph 2.29

Housing Rent Inflation

Capital cities, year-ended



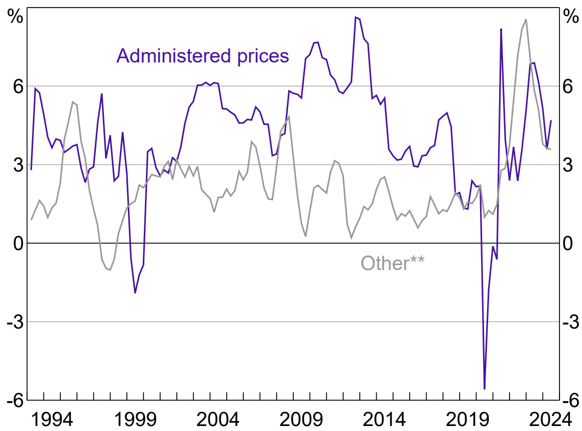
Sources: ABS; CoreLogic; RBA.

Inflation for goods and services with administered prices was slightly above its long-term average in the June quarter. Inflation in the prices of 'administered items', which are (at least partly) regulated or relate to items for which the public sector is a significant provider, picked up in the June quarter in year-ended terms. Key contributors to this pick-up were increases to health insurance premiums, as well as to electricity prices as some energy rebates unwound. Although these prices are affected by government policies, many services such as education and medical services are labour intensive and therefore are sensitive to growth in labour costs. Recent inflation in administered prices has also reflected an upward contribution from past high CPI outcomes, as some administered prices are influenced by indexation to the CPI. Nevertheless, inflation in administered items remains only a little above its long-run average. By contrast, inflation in the rest of the CPI basket is well above its average over the inflation-targeting period (Graph 2.30).

Graph 2.30

Administered Inflation*

Year-ended



* Adjusted for the tax changes of 1999–2000.

** All non-administered items of the CPI basket.

Sources: ABS; RBA.

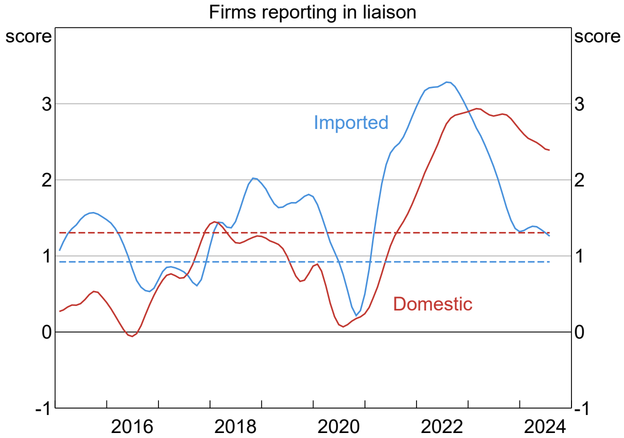
Goods inflation continued to ease, though at a slower pace than previously.

Goods (excluding volatiles) inflation continued to ease, although the pace of disinflation appears to have slowed. This is consistent with the earlier easing in price inflation of imported consumption goods having largely flowed through to domestic prices. The recent increases in shipping costs have elevated the risk of future disruptions, but most firms in the RBA's liaison program report that supply chains are largely operating as normal so far. Nonetheless, domestic labour and non-labour costs (including electricity, insurance, and warehousing and logistics rents) continue to place some upward pressure on goods prices (Graph 2.31).

Graph 2.31

Non-labour Costs*

Firms reporting in liaison



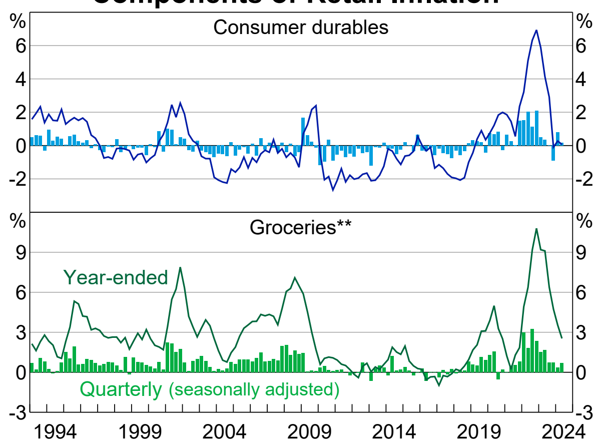
* Solid lines are outcomes over the 12 months before each observation, with the series averages since 2003 shown as dashed lines; smoothed with a 13-month Henderson trend; a score of 0 indicates a firm has reported no change.

Source: RBA.

Consumer durables inflation was around zero in the year to June. Lower price growth for these items is likely to have been supported by intensified cost discipline, with some firms in the RBA's liaison program reporting that a variety of approaches have been used (e.g. re-evaluating expenses and pushing back on supplier cost increases) to moderate cost and price growth. Groceries inflation continued to ease in year-ended terms (Graph 2.32).

Graph 2.32

Components of Retail Inflation*



* Adjusted for the tax changes of 1999–2000.

** Excludes fruit & vegetables.

Sources: ABS; RBA.

New dwelling cost growth has stabilised at a high level, above its pre-pandemic rate. Labour costs and some energy-intensive materials are driving ongoing cost growth, partly driven by the large pipeline of work and ongoing labour shortages for certain trades (see section 2.2 Domestic economic activity).

2.5 Assessment of spare capacity

Our overall assessment is that the labour market and broader economy are tighter than previously thought.

We previously judged the level of full employment to be a bit higher than prior to the pandemic, reflecting possible changes in the labour market such as increased capacity for workers to work remotely or the decline in the share of long-term unemployed. Temporary supply-side factors were also thought to be having a larger-than-usual influence on inflation and wages outcomes. Some of these factors have now abated and labour demand has eased, but disinflation has been slow and wages growth has remained persistently high relative to labour productivity outcomes. Given these developments, we assess the labour market and broader economy to be tighter than previously thought. Our assessment is consistent with a variety of indicators and information from the RBA's liaison program that suggest utilisation of labour and other inputs have remained above historical averages. Model-based estimates of spare capacity also suggest the gap between demand and supply is larger than thought at the May *Statement*.

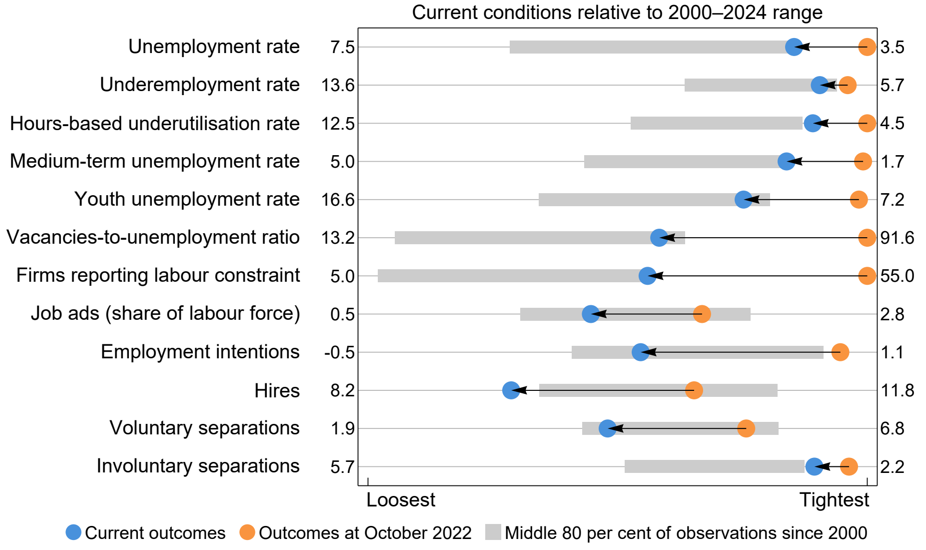
Labour market and capacity utilisation indicators suggest economic conditions remain tight.

A range of labour market indicators suggest the labour market remains tight but has eased further in recent months. Many indicators remain tight relative to their typical range of outcomes over the past two decades (Graph 2.33). Both the ratio of vacancies to unemployment and the share of firms reporting labour availability as a constraint on output continue to be well above pre-pandemic levels, despite declining from their 2022 peaks. Employment growth and average hours worked have eased by less than anticipated, and the labour force participation rate remains near record highs. Measures of labour underutilisation have increased but only gradually. The moderation in the labour market since late 2022 has been most evident in leading indicators, such as employment intentions, labour flow indicators and the hires rate – that is, the number of hires as a share of filled jobs.

Graph 2.33

Full Employment Indicators

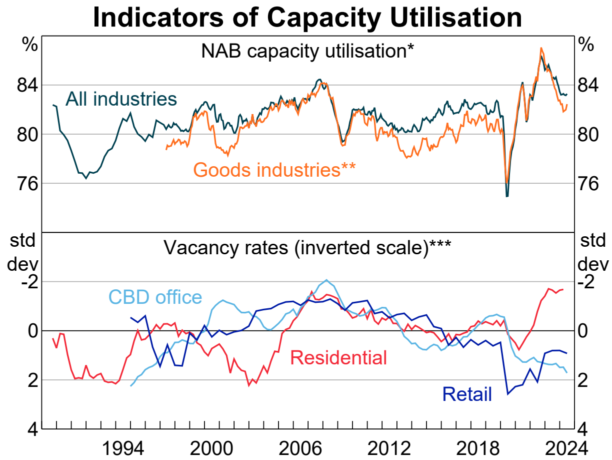
Current conditions relative to 2000–2024 range



Sources: ABS; JSA; NAB; RBA.

Indicators of capacity utilisation suggest some resources continue to be utilised intensively in the economy. Since the May *Statement*, the easing in survey measures of capacity utilisation appears to have stalled (Graph 2.34). Capacity utilisation for goods industries has ticked up in the past three months, while capacity utilisation for all industries has stabilised above the historical average over the first half of 2024. This suggests businesses are still using their labour and capital resources at higher-than-normal rates to meet demand. Vacancies data also shows the housing stock continues to be utilised intensively. Residential vacancies remain low as new supply of housing continues to fall short of growth in demand, putting upward pressure on residential rents. These outcomes – combined with tighter labour market conditions, the slow pace of disinflation, and wages growth that is higher than productivity outcomes – all point to a greater imbalance in the economy than previously thought.

Graph 2.34



* Quarterly data prior to May 1997, three-month moving average thereafter; excludes mining.

** Goods industries include manufacturing, construction, wholesale and retail.

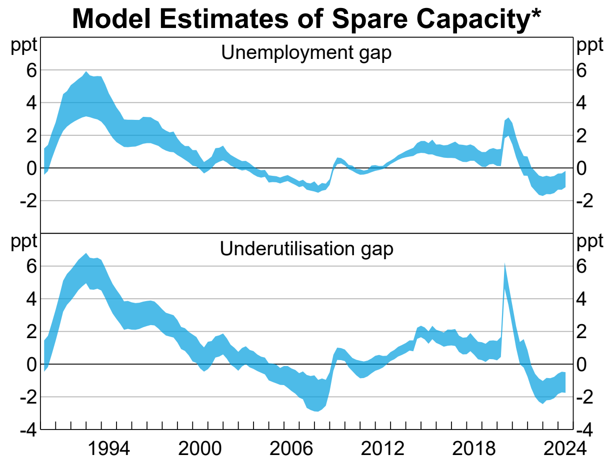
*** Series are standardised to measure the number of standard deviations each series is from its mean value; retail refers to regional retail centres.

Sources: ABS; JLL Research; NAB; RBA; REIA.

Model estimates of the gaps between demand and supply in the economy are larger than we had previously assessed.

Model-based estimates also suggest that the labour market has remained tighter than full employment, in line with elevated wages growth and high inflation (Graph 2.35). Both the unemployment rate and the broader hours-based underutilisation rate remain lower than estimates of rates that are consistent with full employment, resulting in negative unemployment and underutilisation gaps. These gaps have narrowed over the past year, suggesting the labour market is gradually moving towards full employment. However, estimates of the gaps are wider than assessed in the May *Statement*, reflecting elevated prices and wage outcomes over the past year that are consistent with more tightness than previously thought. There is substantial uncertainty surrounding estimates of full employment, although each of the model estimates in the suite that we consider implies that the labour market is tighter than full employment.

Graph 2.35



* Blue-shaded region shows illustrative range of central gap estimates from a selection of models; June quarter 2024 values are partial estimates; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

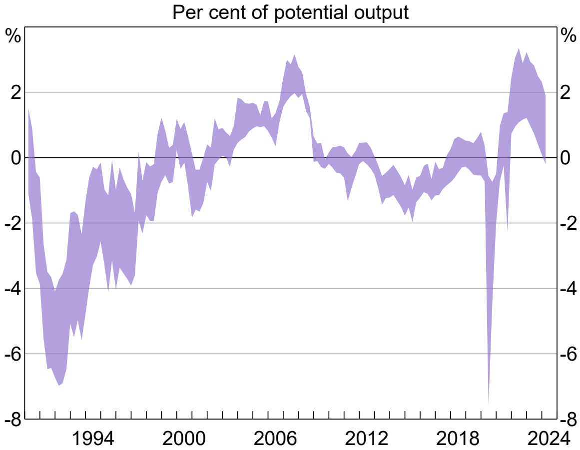
Sources: ABS; RBA; Ruberl et al (2021).

A range of model-based estimates suggest the output gap is positive but continues to narrow. Recent outcomes for actual output remain higher than estimates of potential output, suggesting aggregate demand continues to exceed the capacity of the economy to sustainably produce goods and services. Estimates indicate the output gap continued to narrow in the March quarter, reflecting subdued growth in output relative to potential (Graph 2.36). However, the range of output gap estimates is slightly higher and wider than assessed at the May *Statement*, suggesting more excess demand in the economy than previously thought, and greater uncertainty. The higher output gap estimates reflect tighter labour market conditions as discussed above, and inflation outcomes over the past year that are consistent with a higher output gap. The range of estimates is wide, reflecting differences in how models interpret these developments and their effect on potential output and the output gap.

Graph 2.36

Model Estimates of Output Gap*

Per cent of potential output



* Violet-shaded region shows illustrative range of central gap estimates from a selection of models encompassing different measures and definitions of the output gap; estimates are subject to substantial uncertainty, as well as revision due to data and model refinements.

Sources: ABS; OECD; RBA.

Box B: Insights from Liaison

This Box highlights key messages collected by teams based in Adelaide, Brisbane, Melbourne, Perth and Sydney during discussions with around 220 businesses, industry bodies, government agencies and community organisations over the period from the beginning of May 2024 to the end of July 2024.

Recent liaison discussions suggest that consumer demand remains subdued. Home building activity is expected to decline and some firms have scaled back their investment plans for the year ahead. Nevertheless, growth in wages, non-labour costs and selling prices has not eased much in recent months and remains higher than the long-run averages. Goods firms (i.e. firms producing, distributing and selling goods) expect their selling price inflation to slow noticeably over the year ahead but remain above its long-run average. Services firms expect little change in their selling price inflation over the next 12 months. Firms have been focusing more on cost management over the past 12 months, aiming to improve productivity and maintain or rebuild margins. Consistent with this, firms' hiring intentions for the year ahead are a little below their long-run average and there has been a small increase in the share of firms intending to decrease headcount.

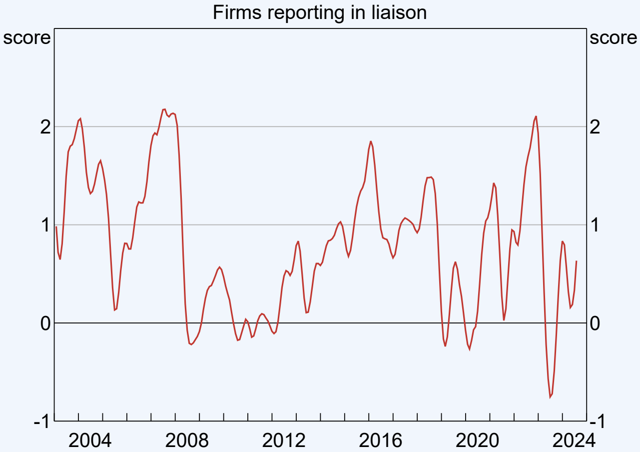
Consumers are price sensitive and cutting back spending in some areas.

Households are generally budget-conscious, trading down to cheaper items, concentrating spending in promotional periods and reducing non-essential spending. Retailers and hospitality firms generally report that underlying demand remains subdued (Graph B.1), although a recent increase in retailers' promotional activity has lifted sales revenues. Retailers' expectations for the year ahead are mixed; some retailers expect current conditions to persist for some time, while others are expecting a gradual improvement in spending following tax cuts, lower inflation and continued strong wages growth.

While the number of domestic tourism trips has not changed much over the past year, domestic tourism spending has declined in 2024. Households have chosen to take shorter holidays closer to home and reduce expenditure on experiences, tours and eating out. In contrast, tourism contacts report that demand from overseas visitors continues to increase and is expected to reach pre-pandemic levels over the next year or so.

International student commencements have declined at some higher education providers, reflecting changes to student visa eligibility and an increase in visa refusals. While there is considerable uncertainty around the outlook, contacts generally expect a decline in international student commencements at universities in the year ahead. In response, some educational institutions are seeking to reduce costs, investment and/or staff numbers. Domestic university student numbers remain lower than a few years ago, as more people choose to work rather than study given the still-strong labour market and higher cost of living.

Graph B.1
Wholesale and Retail Demand*
Firms reporting in liaison



* Outcome over the 12 months before each observation; smoothed with a 13-month Henderson trend; a score of 0 indicates a firm has reported no change.

Source: RBA.

Community service organisations report that demand for their services remains much higher than before the pandemic, due to cost-of-living pressures and a shortage of affordable housing. Contacts report that they are now supporting a broader range of clients, including dual income households and those with mortgages who are often seeking support for the first time. Clients are increasingly presenting with multiple and often interconnected personal and financial issues. Contacts expect this heightened demand to continue in the period ahead.

Home building is expected to slow further.

Most builders of new detached homes expect their workload to slow over the year ahead, as they complete their backlog of projects and have fewer new builds to commence due to weak sales over the past 18 months. Contacts believe that there is still considerable underlying demand for new housing, but it has not flowed into sales due to potential buyers' concerns about affordability and uncertainty about the outlook for the economy and interest rates. There is, however, considerable variation across states because of factors such as population flows and relative affordability; conditions in Western Australia are the strongest. Looking ahead, most contacts do not expect further falls in new home sales and suggest that they will gradually increase once buyers perceive that interest rates have stabilised.

Construction activity for new apartments has slowed significantly and many planned developments are on hold due to the high costs of construction (relative to the prices that buyers are willing to pay). Contacts expect construction costs to continue to increase, although at a slower pace than over the previous year. While the pace of growth in materials costs has slowed and supply chains have normalised, the cost and availability of labour remains a challenge in some areas. This is particularly the case for high-density projects that compete for labour with similar skills to those required by the large volume of infrastructure projects. Contacts also attribute higher construction costs to a decline in productivity, construction delays and the higher cost of finance.

Investment intentions have softened but remain around average levels.

Liaison contacts increasingly report that they plan to reduce investment in the year ahead. Some firms are pulling back on their planned investment due to high construction costs, a subdued outlook for demand and broader macroeconomic uncertainty. However, investment intentions for the year ahead remain around average levels overall, supported by infrastructure, renewables, industrial building, and digital transformation projects.

Some firms expect growth in engineering construction to moderate over the year ahead as infrastructure projects are completed and planned projects are delayed. Overall though, there remains a solid pipeline of work that is underway or expected to begin soon, particularly in the public and energy sectors. Firms continue to express concerns around the capacity of the construction industry to deliver some of these projects, particularly in smaller capital cities and regional areas, which may result in further delays and cost escalation.

Growth in costs and selling prices remains elevated and has been little changed in recent months.

Liaison contacts suggest that wages growth has been little changed over recent quarters (Graph B.2). Most firms expect stable or slower wages growth in the period ahead as they anticipate further easing in inflation and labour market conditions. Lower award rate outcomes in 2024 than in 2023 will also contribute to slower wages growth for some firms. Nevertheless, wages growth over the coming year is generally expected to remain above its long-run average.

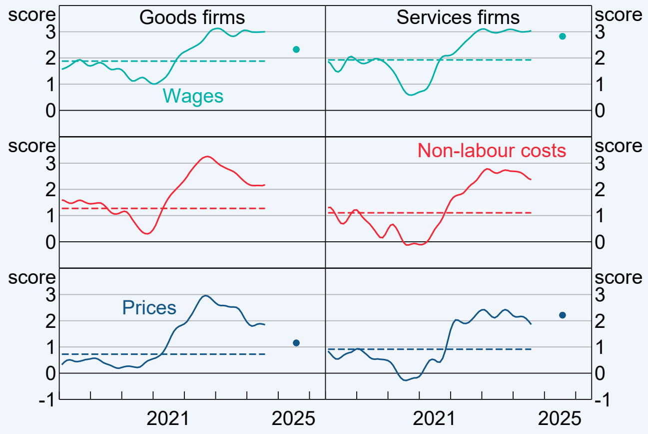
Growth in non-labour costs is slower than a year ago but remains above its long-run average. For goods-related firms, growth in non-labour costs eased from post-pandemic highs as international supply chains recovered, but has levelled out over recent months. Growth in non-labour costs for services firms also looks to have peaked but remains elevated. Within overall non-labour costs, goods and services firms continue to single out higher logistics, energy and insurance costs.

In aggregate, growth in selling prices has been little changed over recent months and stronger than firms expected a year ago. Goods firms generally expect their selling price inflation to slow noticeably over the year ahead but to remain above its long-run average. By contrast, household and business services firms expect growth in their selling prices to be little changed over the year ahead. Firms have been focusing more on cost management over the past 12 months, aiming to improve productivity and maintain or rebuild margins, given cost growth is still relatively high and it is reportedly becoming more difficult to pass cost increases through to prices.

Hiring intentions have eased and labour availability has improved over the past year, but firms say that recruitment remains challenging.

Growth in firms' headcount has continued to slow. Hiring intentions for the year ahead are a little below their long-run average and there has been a small increase in the share of firms that intend to decrease headcount (Graph B.3). The easing in labour demand over the past year has been most notable for consumer-related contacts such as retailers, wholesalers and household services firms, as well as mining and some construction contacts. Voluntary staff turnover rates have fallen, and labour availability has risen, compared with a year ago. Despite this, contacts indicate that the labour market remains fairly tight, as staff turnover rates are still generally above average and finding suitable labour continues to be difficult for many firms.

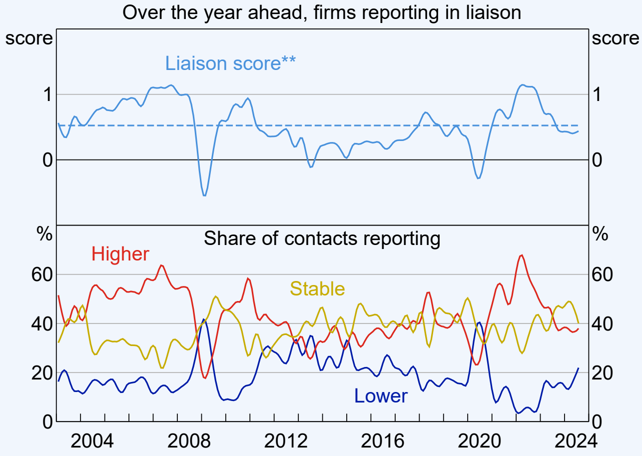
Graph B.2
Costs and Prices*
Firms reporting in liaison



* Solid lines are outcomes over the 12 months before each observation, with the series averages since 2003 shown as dashed lines; dots are expectations over the next 12 months from July 2024; smoothed with a 13-month Henderson trend; a score of 0 indicates a firm has reported no change; excludes mining.

Source: RBA.

Graph B.3
Employment Intentions*
Over the year ahead, firms reporting in liaison



* Smoothed with a 13-month Henderson trend.

** Dashed line shows average since 2003; a score of 0 indicates no change.

Source: RBA.

Chapter 3
Outlook

Summary

- **Growth in major trading partners (MTP) is expected to be moderate over the next couple of years, and inflation in advanced economies is expected to continue to ease.** There has been little change to the outlook for MTP growth, which is forecast to be around 3¼ per cent over 2024 and 2025. Forecasts for 2024 for the G7 economies and China are slightly weaker than three months ago, while they have been revised up in high-income east Asia. Inflation is forecast to continue to ease in advanced economies, though central banks' expected timing of inflation returning to target varies. While some recent inflation outcomes have surprised to the downside, persistent services inflation and a sharp rise in shipping costs continue to pose upside risks to global inflation.
- **The recovery in Australian GDP growth over the next year is expected to be stronger than forecast three months ago, reflecting projected continued strength in public demand.** Stronger growth in imports and weaker growth in dwelling investment is expected to provide some offset. Following a period of subdued activity, consumption growth is expected to increase in response to a rebound in real household disposable incomes, similar to expectations three months ago.
- **The labour market is expected to continue to ease this year, but to remain somewhat tight over much of the forecast period.** The unemployment rate is forecast to continue to increase gradually, consistent with the softening in the leading indicators of labour demand. The expected recovery in GDP growth will provide support to the labour market.
- **We assess that there is more excess demand in the economy and labour market than previously thought, both now and throughout the forecast period.** Inflation outcomes over the past year have been stronger than can be explained by our previous estimates of excess demand, wages growth remains high relative to the low productivity outcomes and a number of other survey and labour market indicators point to continued tightness in parts of the economy. This has led to a reassessment that the economy and labour markets are further away from balance than previously thought. A period of below-potential growth and rising unemployment are expected to reduce some of that excess demand. However, an expected pick-up in GDP growth will slow the pace of the economy returning to balance. There is a large degree of uncertainty about both the extent of excess demand in the economy and labour market and how quickly this will decline.
- **Underlying inflation is now expected to return to target slightly later than was forecast in the May *Statement*.** Underlying inflation is expected to be inside the target range of 2–3 per cent in late 2025 and approach the midpoint of the band in 2026. The upward revisions to underlying inflation reflect the stronger outlook for activity and the reassessment of capacity. Inflation is expected to ease gradually as excess demand in the economy declines. Persistence in some components of inflation is expected to limit the pace of disinflation.

- **Headline inflation is expected to moderate temporarily in the near term, owing primarily to one-off measures including those providing cost-of-living support to households.** However, headline inflation is then expected to increase as energy rebates end (as currently legislated), before moving in line with underlying inflation once these temporary effects have passed.
- **The risks to the domestic outlook are broadly balanced, though the costs associated with the risks differ.** If inflation takes longer to return to target than expected, this would be costly for both the employment and inflation objectives. If, however, demand does not recover as expected, this would lead to a more material easing in the labour market.

3.1 The global outlook

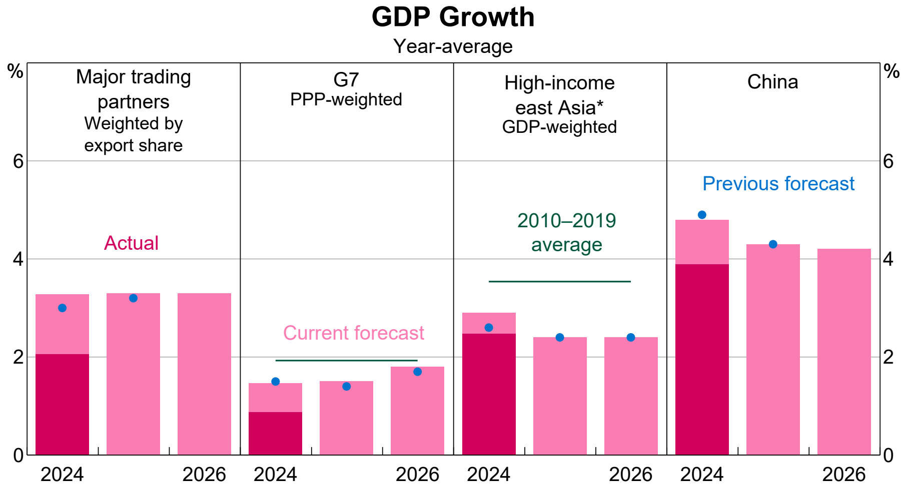
Growth in Australia's major trading partners is expected to be moderate.

Year-average GDP growth for Australia's major trading partners is expected to be around 3.3 per cent in 2024 and 2025 (Graph 3.1). The 2024 forecast is a little higher than was forecast three months ago; the 2025 forecast remains unchanged. A larger weight on China from the annual updates to the export shares in the growth of our major trading partners has lifted the forecast for 204; revisions to economy-level forecasts are largely offsetting in aggregate and reflect actual outcomes in the first half of the year. Stronger-than-expected growth to date across high-income east Asia has offset slightly weaker growth forecasts for the G7 economies and China than expected three months ago.

Forecast year-average GDP growth for China for 2024 is 4.8 per cent, slightly lower than previously forecast. The downward revision reflects weaker-than-expected GDP data in the June quarter and a worsening outlook for consumption and real estate investment, which have been partly offset by an improved near-term outlook for exports. This is still consistent with authorities' target for year-average growth of 'around 5 per cent' this year. Forecast growth for 2025 is unchanged from three months ago; growth is expected to slow to 4.3 per cent as growth in investment and exports weakens. The risks to Chinese growth remain tilted to the downside, given the weak sentiment in the property sector, the effect of ongoing strains in local government finances on infrastructure investment and any possible further increase in trade barriers.

Year-average GDP growth is forecast to increase gradually in many advanced economies over the forecast period, while growth in the United States is expected to continue to moderate. This forecast profile is unchanged from the May *Statement*, though there have been some offsetting revisions at the economy level to the near-term outlook that largely reflect March quarter GDP outcomes. Demand conditions are forecast to improve in most economies over the forecast period, led by growth in household consumption as real incomes continue to recover and as financial conditions ease.

Graph 3.1



* High-income east Asia is a GDP-weighted average of South Korea, Taiwan, Hong Kong and Singapore.
Sources: ABS; CEIC Data; Consensus Economics; LSEG; RBA.

Inflation is expected to continue to ease in advanced economies; while some recent inflation outcomes have surprised to the downside, persistent services inflation and a sharp rise in shipping costs pose upside risks.

Progress in lowering inflation has resumed in the United States and has also surprised to the downside in recent months in some other economies (including Canada and New Zealand). This has raised the prospect of a faster easing in inflation. By contrast, services inflation remains high in many economies and has recently increased further in the euro area and the United Kingdom; while central forecasts are still for further easing, this highlights the risk that disinflation progress could be slower than expected. Recent increases in shipping costs and a further escalation in trade or geopolitical tensions pose additional upside risks to goods inflation.

The expected timing for inflation to sustainably return to target continues to vary across economies but has been little changed since the May *Statement*. In the past three months, some central banks have cut policy rates and expectations for monetary policy easing have been brought forward in most advanced economies (see Chapter 1: Financial Conditions). The Riksbank and Reserve Bank of New Zealand expect headline inflation to return to target this year, while the Bank of Canada and the European Central Bank expect inflation to be at target in 2025. Most other central banks expect inflation to be around target in 2026.

3.2 Key domestic judgements

The central forecasts incorporate many judgements, such as the choice of models used and whether to deviate from the models given the signal from recent data or qualitative information from liaison. These judgements are considered and debated extensively throughout the forecast process. The three most important judgements for the staff's current assessment of the economic outlook are discussed below.

Key judgement #1 – There is more excess demand in the economy and labour market than previously assessed.

Estimates of how far the economy is from potential output or sustainable full employment are important inputs for wages and prices forecasts. However, as has been previously noted, there is a great deal of uncertainty around estimates of full employment.

Using information from model-based estimates, outcomes for wages growth and inflation and a range of labour market indicators, staff now assess that the level of full employment that the economy can sustain without creating undue inflationary pressures is lower than previously thought. While it is possible that changes in the labour market observed over recent years – such as lower levels of long-term unemployment and more flexible work arrangements – could contribute to a higher level of full employment, the evidence that these will be sustained is mixed. Inflation outcomes have been stronger than can be explained by our previous estimates of excess demand, and wages growth has been high relative to productivity outturns (even excluding the very strong award wages growth in September 2023).

This suggests that the economy and labour market have been further away from potential output and full employment than previously thought. All else equal, this starting point of greater imbalance between aggregate demand and supply implies that it will take longer for inflation to return to target. However, there is considerable uncertainty around this judgement, as explored in the risks section below.

Key judgement #2 – Household consumption is around a turning point and will increase in line with its historical response to changes in real incomes and wealth.

In per capita terms, consumption is expected to rise from the second half of 2024 after having fallen for the past 18 months. In making this judgement, the staff have taken signal from the upward revisions to consumption that were included in the March quarter National Accounts. The revised path for consumption is broadly consistent with past developments in household income and wealth (prior to the revisions, consumption appeared much weaker than implied by these relationships) and suggests that households have been willing to maintain a lower rate of saving than previously assessed. Both real household income and wealth are expected to grow strongly over the forecast period; real household disposable income growth is expected to increase notably from mid-2024 as a result of the Stage 3 tax cuts and further declines in inflation.

The consumption outlook is a key area of uncertainty given the recent data revisions and the experience in peer economies where consumption has been slow to recover despite an earlier increase in incomes. Risks around the expected recovery of consumption are discussed in detail below.

Key judgement #3 – The labour market will continue to ease at a gradual pace but will stabilise following the pick-up in GDP growth.

The unemployment rate is forecast to increase gradually over the next year, in line with past downturns of similar magnitude. But there are other margins of adjustment in the labour market, such as the number of hours that employees work and the number of vacancies advertised.

We expect that the adjustment to easing labour demand will continue to occur through lower vacancies and average hours, where firms will tend to hire fewer people rather than reduce existing headcount. This judgement is based on the fact that it is difficult to find evidence of a rapid deterioration of labour market conditions. Indicators of labour demand, such as job vacancies, have declined but remain at high levels. The hiring intentions of firms surveyed in the liaison program have softened but are only slightly below average. And while unemployment could rise sharply if businesses have hoarded labour and reach a tipping point, there is little evidence of this: survey measures of capacity utilisation remain above average and vacancies and average hours are at or above their long-run trends.

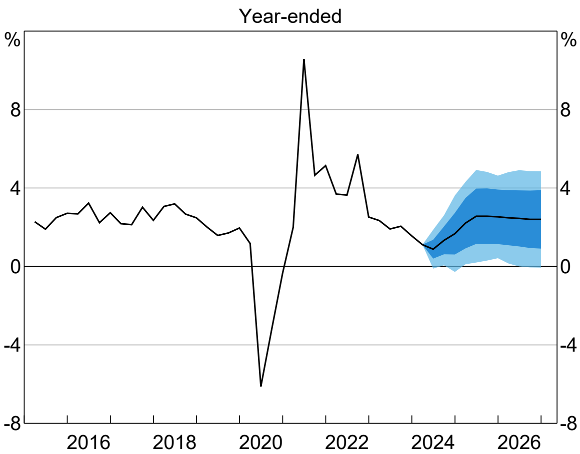
The risks that the unemployment rate could increase more rapidly, or not rise as much as forecast, are explored below.

3.3 The domestic outlook

GDP growth is projected to pick-up from mid-2024 as growth in household consumption and public demand support activity.

The outlook for GDP growth in 2024 is similar to three months ago (Graph 3.2). Imports growth was much stronger than expected in the March quarter and this has offset a stronger near-term outlook for public demand and household consumption growth relative to three months ago.

Graph 3.2
GDP Growth Forecast*



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

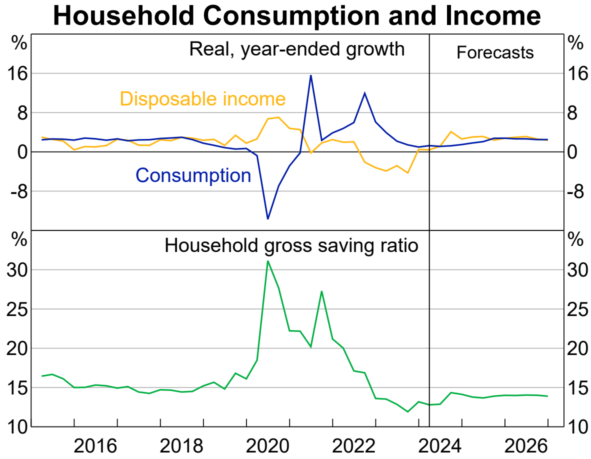
Sources: ABS; RBA.

The near-term upgrade to household consumption growth is consistent with stronger-than-expected outcomes in early 2024 and partial indicators, and largely reflects upward revisions to population growth in the first half of 2024. Overall, growth in private demand is expected to remain subdued for the rest of 2024 because of restrictive financial conditions. The forecasts are conditioned on a cash rate path derived from financial market pricing; it is assumed that the cash rate has already peaked, with market pricing implying little chance of a further increase. A 25 basis point reduction in the cash rate is fully priced in by early 2025, and the cash rate is expected to decline to around 3.3 per cent by the end of 2026.

Growth in GDP is expected to increase further in 2025, reflecting stronger than previously forecast public spending and a previously anticipated pick-up in household consumption growth. Relative to three months ago, GDP growth has been revised up in the year to mid-2025, with an upgrade to public demand growth partially offset by stronger growth in imports and weaker dwelling investment growth. The stronger outlook for public demand reflects ongoing spending and recent announcements by federal and state and territory governments.

Household consumption growth is expected to return to around its pre-pandemic average by mid-2025, supported by an increase in real income growth from the Stage 3 tax cuts and declining inflation, as well as higher wealth (Graph 3.3).

Graph 3.3
Household Consumption and Income



Sources: ABS; RBA.

The forecast recovery in dwelling investment growth is expected to occur later than expected three months ago. This reflects the signal taken from further weakness in the data in early 2024 and messages from the RBA's liaison program on growing feasibility challenges in higher density construction. Dwelling investment is expected to pick up from late-2025, supported by increasing demand for new housing as sentiment improves. Business investment growth is expected to be supported by the large pipeline of infrastructure work, digitisation and the renewable energy transition; the outlook for business investment is similar to three months ago. Exports growth is expected to be solid for most of the forecast period. The downside risks to the outlook for new international student arrivals have increased since May (see Chapter 2: Economic Conditions). However, if these risks were to materialise, they would detract from both the demand and the supply side of the economy as many students participate in the labour force.

Demand and supply will move closer to balance over the forecast period.

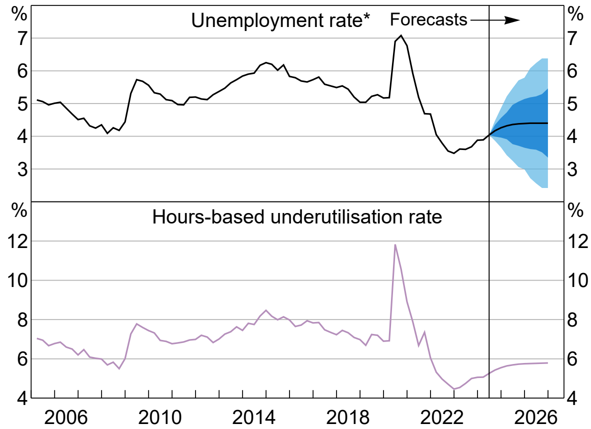
It is estimated that there is more excess demand in the economy than previously thought, but the gap is expected to narrow over the forecast period. This will bring the economy to a more balanced state. Over the next six months, subdued growth in aggregate demand is expected to bring demand and supply closer to balance. After which time, the output gap is expected to narrow more gradually, reflecting an expected increase in GDP growth, while potential output is assumed to grow by around 2½ per cent. The staff's assumption for potential output growth reflects a decline in population growth from its current high rate being offset by a gradual increase in trend productivity towards its pre-pandemic rate. However, there is considerable uncertainty around these assumptions as well as when the output gap will close.

The labour market is expected to ease further over the next year before stabilising at a level closer to full employment estimates.

Labour underutilisation rates are expected to rise further over the next year alongside subdued growth in economic activity, before stabilising in 2026 (Graph 3.4). The unemployment rate is forecast to increase further over coming quarters, reflecting the continued easing in leading indicators of labour demand such as job vacancies and hiring intentions. However, this increase is expected to be gradual, consistent with the mildness of the current downturn. Some of the labour market adjustment to subdued economic growth over the past year has occurred through a decline in vacancies and average hours worked; as discussed above, it is judged that this pattern will continue over the coming year. Following the pick-up in GDP growth from 2025, the unemployment rate is expected to stabilise around its peak.

Graph 3.4

Labour Underutilisation Rates



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

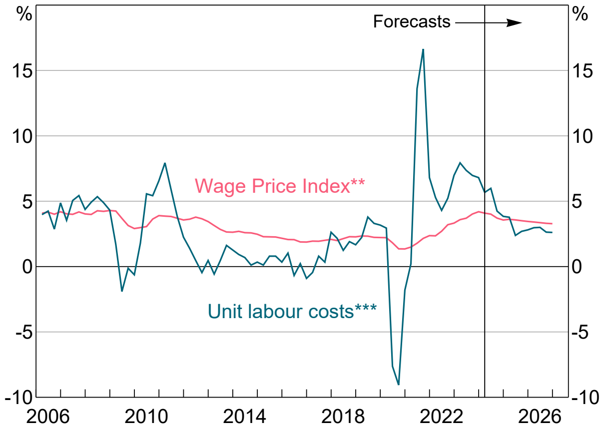
Sources: ABS; RBA.

Employment growth is forecast to be below working-age population growth for a time, contributing to the forecast gradual increase in the unemployment rate in the coming quarters. Participation in the labour force is expected to be sustained around recent high levels. Longer run trends of increased participation by females and older workers are likely to continue supporting the participation rate, with some offsetting effects from the cyclical slowing in the economy, although there is continued uncertainty around which of these effects will dominate.

Growth in nominal wages is expected to moderate somewhat as the labour market eases.

Wages growth looks to be past its peak and is expected to continue to slow gradually as the labour market eases. Wages outcomes in the March quarter eased a little and point to a softer pace of growth over 2024 (Graph 3.5). The Fair Work Commission's recently announced 3.75 per cent increase to modern award wages, effective from 1 July, will see a step down in award-linked wages growth compared with the previous year. Wages growth is forecast to continue to ease gradually as the labour market eases. However, the pace of nominal wages growth is expected to remain high relative to productivity growth. Real wages are forecast to increase over the forecast period as the pace of nominal wages growth declines more slowly than inflation.

Graph 3.5
Labour Income Growth*
Year-ended

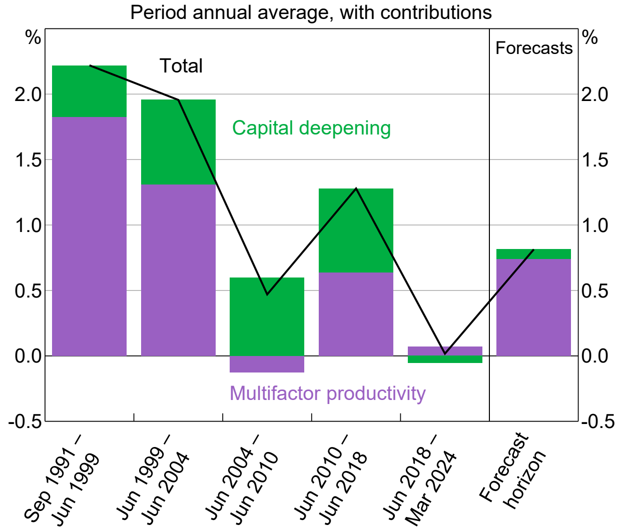


* Nominal.
** Excluding bonuses and commissions.
*** Non-farm.
Sources: ABS; RBA.

Growth in unit labour costs is expected to moderate over coming years. Growth in nominal unit labour costs – the measure of labour costs most relevant for firms' cost of production and so for inflation outcomes – is forecast to ease as nominal wages growth gradually eases and labour productivity growth picks up (see discussion below). If productivity growth does not pick up as assumed, nominal unit labour costs would remain a little above the rate consistent with inflation being sustainably at the midpoint of the target throughout the forecast period.

Labour productivity growth in 2024 is expected to be weaker than previously anticipated, though there is significant uncertainty around its outlook. The weaker outlook for productivity growth largely reflects a more gradual easing in growth in average (and total) hours worked. The outlook further out is little changed. Productivity growth is assumed to pick up and then stabilise around its long-run (excluding the pandemic) average rate over the forecast period. The pick-up in labour productivity growth mostly reflects a pick-up in multifactor productivity growth (MFP) (i.e. output growth from combining labour and capital input in better ways) (Graph 3.6). This pick-up could arise from a variety of sources, including increased rates of technology adoption, improved reallocation of labour between low- and high-productivity firms, improved labour quality and improved quality of job matching.[1] It is estimated the large inflow of less experienced entrants into the workforce who require more time to learn and upskill had a small negative effect on MFP growth in recent years. Any future changes in labour quality or the quality of job-matching outcomes are assessed to not have a substantial effect on MFP growth over the forecast period. The outlook for productivity – which is a key determinant of the economy's supply capacity, real incomes and hence living standards – is highly uncertain.

Graph 3.6
Labour Productivity Growth*
Period annual average, with contributions



* RBA calculations using quarterly National Accounts data.
Sources: ABS; RBA.

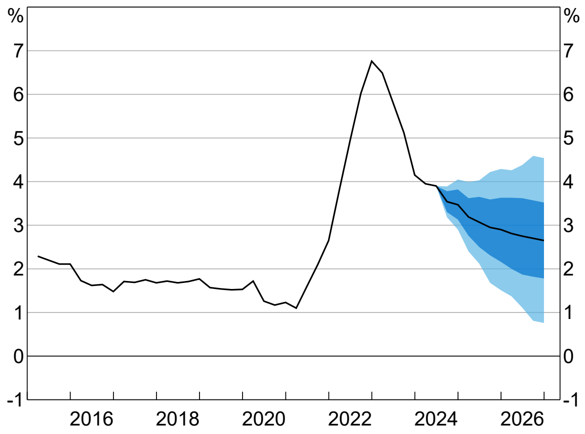
Underlying inflation is expected to return to the target range a little slower than previously forecast.

Underlying inflation is expected to ease more gradually than previously anticipated, falling below 3 per cent by late 2025 and approaching the midpoint of the band in 2026. The forecast for underlying inflation (as measured by trimmed mean inflation) is little changed in the near term compared with forecasts from the May *Statement*, with the June quarter inflation data confirming that the pace of disinflation has slowed. Relative to the May *Statement*, the forecast for underlying inflation has been revised higher from mid-2025 to reflect the assessment that there will be a little more excess demand in the economy than previously estimated (Graph 3.7). Inflation expectations are assumed to remain consistent with achieving the inflation target.

Graph 3.7

Trimmed Mean Inflation Forecast*

Year-ended



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

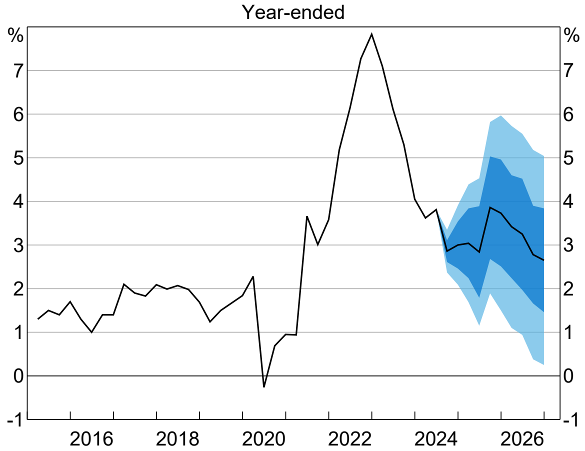
Sources: ABS; RBA.

Headline inflation is expected to dip below 3 per cent in the next year due to the government's cost-of-living measures (Graph 3.8). New and extended electricity rebates and increases to rent assistance are expected to subtract around 0.6 percentage points from year-ended headline inflation in the September quarter of 2024. However, the legislated unwinding of some policies in 2025 will push headline inflation to back above the target range before converging towards underlying inflation once these temporary factors have passed (see Box C: Headline and Underlying Inflation).

Graph 3.8

Headline Inflation Forecast*

Year-ended



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

Sources: ABS; RBA.

Services inflation remains high and is expected to decline only gradually over the coming year. Strong domestic cost pressures (both labour and non-labour inputs) have kept inflation outcomes high in recent quarters. Services inflation, such as in recreation and leisure services, is expected to ease only gradually as growth in input costs and demand moderates over the forecast period. The more gradual decline in services inflation relative to the earlier decline in goods inflation is in line with trends overseas. The experience abroad highlights the risk that services inflation could be more persistent than expected. Inflation of administered items (excluding utilities), which tend to have a higher rate of inflation than other components of inflation, are expected to remain fairly elevated over the forecast period.

Housing inflation is expected to remain high over the forecast period. Information from liaison is consistent with new dwellings inflation remaining higher for longer than previously expected, owing to ongoing capacity constraints in the construction sector alongside shortages for skilled trades. Rent inflation is expected to remain high over the forecast period; advertised rents growth remains elevated and it will take some time for increases in housing supply to flow through to rental prices on new leases and subsequently on the stock of rental properties. The increase in average household size, as seen in recent months, will alleviate some of the pressure on rental prices (see Chapter 2: Economic Conditions).

Goods inflation has eased and is expected to stabilise at a relatively modest pace over the forecast horizon. The earlier easing in imported inflation as global supply chains normalised last year has largely flowed through to domestic goods prices. Growth in domestic labour and non-labour costs is moderating (though both remain high), and information from liaison suggests retailers face pressure to contain price growth given subdued demand. That said, recent increases in shipping costs are a key risk to the outlook for goods inflation, although retail firms in liaison are yet to report that shipping costs are flowing through to their costs. Nonetheless, if shipping costs remain at their current high level, our estimates suggest this could add ¼ percentage point to inflation after about a year.

3.4 Key risks to the outlook

The risks to the domestic outlook for activity and inflation are broadly balanced, though the costs associated with the risks differ.

Persistent inflation outturns above target pose significant economic welfare costs to the Australian public, particularly those households with lower incomes that typically have smaller financial buffers. And inflation outcomes that are consistently above target risks a drift higher in inflation expectations, which would likely require more monetary policy tightening and a sustained and costly period of higher unemployment to reset inflation expectations and bring inflation back to target.

On the other hand, a materially weaker economy and labour market would likely see a faster return to the inflation target – however, this would be accompanied by a cost to the employment objective. A sustained period of excessive spare capacity in the labour market can have permanent effects on the workers who lose their jobs during these periods.

While we view the risks to the outlook overall as balanced, there is considerable uncertainty in the current environment. We use scenario analysis to highlight some potential risks to the key judgements underpinning the outlook. Some of the scenario analysis is undertaken using the RBA's main macroeconometric model (MARTIN).

Key risk #1 – There is more excess demand in the economy and labour market than currently assessed, meaning that the disinflation progress will stall.

The staff judge that even with the latest revision, it is more likely the current estimates of full employment overstate the amount of capacity in the labour market – that is, the level of unemployment that can be sustained without causing an increase in wages growth and inflation may be higher than currently estimated. Within the suite of models and indicators used to assess spare capacity, there is growing evidence that the labour market is even tighter than the staff currently assess. This implies further inflationary pressure and an increasing risk that the economy will not move into balance.

Alternatively, the recent high wages growth and inflation outcomes may be more transitory than previously thought, potentially because it has taken longer for the supply disruptions from the pandemic period to pass through, and/or because there have been structural changes in the labour market that allow a higher level of sustainable full employment.

Key risk #2 – The period of subdued consumption growth could be more persistent, or the recovery in consumption could be much stronger.

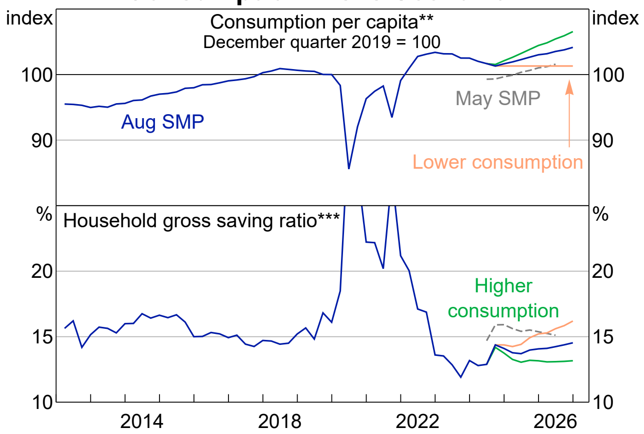
We see the risks to household consumption growth as balanced; however, different outcomes from the central forecast have a material effect on unemployment and inflation.

The expected recovery in consumption growth is judged to get underway in the second half of 2024. Two illustrative scenarios on the risks to consumption growth can be explored around the central forecast (Graph 3.9; Graph 3.10). In the 'lower consumption' scenario, consumption per capita is assumed to not grow at all over the forecast period. As per capita real household income is expected to grow strongly over the forecast period, this scenario implies that households save all of their growth in income. This would lead to GDP growth that is ½ percentage point lower over each of 2025 and 2026, resulting in an ongoing upward trajectory in the unemployment rate, but inflation would decline faster than in the central forecast.

In the 'higher consumption' scenario, it is assumed that most of the growth in income over the forecast period is spent. This could occur if a greater share of households have become liquidity constrained in recent years, or because households are willing to save less out of their current income followinga the significant increases in wealth since the onset of the pandemic. This would see the unemployment rate decrease from early 2025 back towards its current low level, but progress in reducing inflation to the midpoint of the inflation target would stall.

Graph 3.9

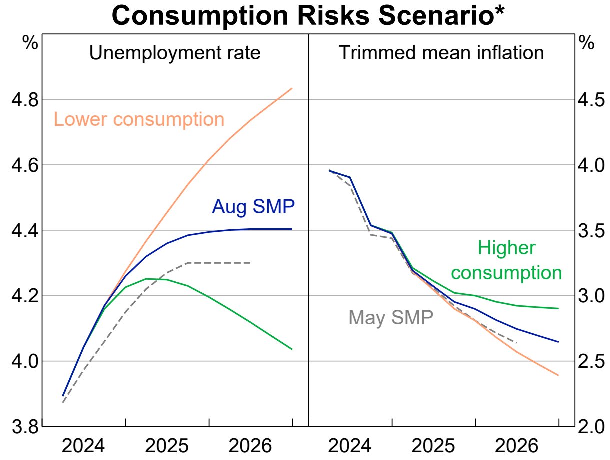
Consumption Risks Scenario*



* Scenario assumes exchange rate and policy path are fixed to August SMP assumptions.
** Population denominator adjusted to exclude international students.
*** Outliers during the COVID-19 pandemic were truncated.
Sources: ABS; Department of Home Affairs; RBA.

Graph 3.10

Consumption Risks Scenario*



* Scenario assumes exchange rate and policy path are fixed to August SMP assumptions.
Sources: ABS; RBA.

Key risk #3 – The labour market could deteriorate by more than expected.

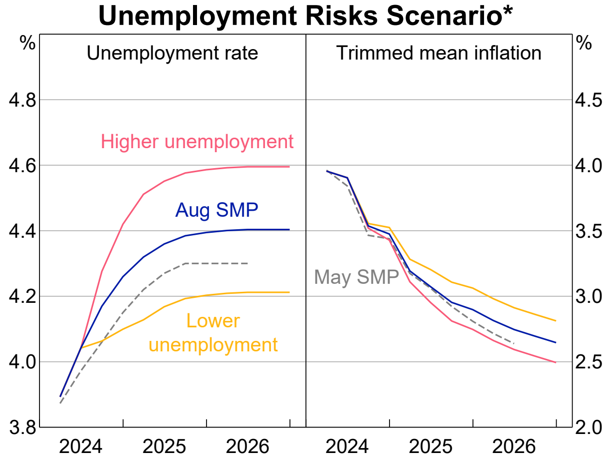
The increase in the unemployment rate is expected to be a little greater than previously expected, but to remain gradual. Two illustrative scenarios can be explored around the central forecast (Graph 3.11). In the 'higher unemployment' scenario, the unemployment rate could respond to the current period of subdued growth more substantially than expected. A sharper rise in the unemployment rate could occur if many firms currently have an excess of staff as a result of hoarding labour, or if the easing in the labour market via hours or vacancies adjustment has now run its course.

This would see unemployment rise more than expected, leading to a period of spare capacity in the labour market. This unemployment rate profile is closer to the median market economist forecast. If this played out, inflation would decline faster than currently forecast.

Alternatively, in the 'lower unemployment' scenario, the labour market may be stronger than forecast, pushing out the return of inflation to the target. Vacancies may remain above average, indicating that labour demand is holding up. The forecast pick-up in GDP growth could mean unemployment rises by less than expected if it is assumed that the usual relationship between GDP growth and unemployment holds over the forecast period. Moreover, if labour productivity is weaker than expected, more labour will be required for a given GDP profile. A smaller rise in the unemployment rate would mean that there would still be excess demand in the labour market, and it would take much longer to reach the midpoint of the inflation target.

Graph 3.11

Unemployment Risks Scenario*



* Scenario assumes exchange rate and policy path are fixed to August SMP assumptions.
Sources: ABS; RBA.

3.5 Detailed forecast information

The RBA forecasts reflect our best estimate of future economic outcomes and are published every quarter. The forecasts use a combination of single-equation models, leading indicators (for nowcasts and the near term) as well as applying appropriate judgement to incorporate information that cannot easily be captured by models (e.g. information from the liaison program or large shocks such as the pandemic). These forecasts are evaluated thoroughly during the forecast process to ensure they are internally consistent and produce a clear economic narrative. The full-system economic model (known as MARTIN) is run in parallel and used as a consistency check on the forecasts.

The forecasts incorporate several technical assumptions, which were finalised on 31 July:

- The cash rate is assumed to move in line with expectations derived from financial market pricing. At the time of the finalisation of the forecasts, the cash rate was assumed to have already peaked, with market pricing implying little chance of a further increase. A 25 basis point reduction in the cash rate is fully priced in by early 2025, and the cash rate is expected to decline to around 3.3 per cent by the end of 2026. This cash rate path is lower than at the time of the May *Statement*.
- The exchange rate is assumed to be unchanged at its current level, which is 1.1 per cent lower on a trade-weighted basis than at the time of the May forecasts.
- Crude oil prices are assumed to be broadly unchanged around their current levels for the rest of the forecast period, which is around 6.2 per cent lower than at the time of the May forecasts.
- Although population growth is past its peak, the assumed level of the population has been revised higher based on recent ABS projections. Migration policy changes are expected to provide some offset over the forecast period, with year-ended population growth expected to decline back to its pre-pandemic average of around 1½ per cent by mid-2025.
- Table 3.1 provides additional detail on forecasts of key macroeconomic variables. The forecast table from current and previous *Statements* can be viewed, and data from these tables downloaded, via the Statement on Monetary Policy – Forecast Archive.

Table 3.1: Detailed Forecast Table[a]

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

	Jun 2024	Dec 2024	Jun 2025	Dec 2025	Jun 2026	Dec 2026
Activity						
Gross domestic product	0.9	1.7	2.6	2.5	2.5	2.4
Household consumption	1.1	1.5	2.1	2.8	2.7	2.5
Dwelling investment	–4.4	–1.7	–0.7	0.3	1.1	1.9
Business investment	1.4	0.1	2.2	2.7	2.8	2.9
Public demand	4.0	4.3	4.1	3.0	2.7	2.7
Gross national expenditure	2.4	2.6	2.6	2.6	2.5	2.6
Major trading partner (export-weighted) GDP	3.2	3.4	3.4	3.2	3.3	3.3
Trade						
Imports	5.0	7.6	4.2	3.5	3.1	3.2
Exports	–0.8	2.8	3.9	3.1	2.7	2.4
Terms of trade	–0.9	–3.1	–3.7	–2.4	–2.7	–2.8
Labour market						
Employment	2.7	1.9	1.2	1.4	1.5	1.6
Unemployment rate (quarterly, %)	4.0	4.3	4.4	4.4	4.4	4.4
Hours-based underutilisation rate (quarterly, %)	5.3	5.6	5.7	5.7	5.8	5.8
Income						
Wage Price Index	4.0	3.6	3.6	3.5	3.4	3.3
Nominal average earnings per hour (non-farm)	6.6	3.8	4.3	4.1	4.1	3.6
Real household disposable income	1.1	2.6	3.0	2.7	3.3	2.7
Inflation						
Consumer Price Index	3.8	3.0	2.8	3.7	3.2	2.6
Trimmed mean inflation	3.9	3.5	3.1	2.9	2.7	2.6
Assumptions						
Cash rate (%)[c]	4.3	4.3	4.0	3.6	3.3	3.3
Trade-weighted index (index)[d]	62.6	61.5	61.5	61.5	61.5	61.5
Brent crude oil price (US$/bbl)[e]	85.0	78.9	78.9	78.9	78.9	78.9
Estimated resident population[f]	2.5	2.0	1.4	1.4	1.4	1.4
Memo items						
Labour productivity[g]	0.8	0.1	1.9	1.3	1.0	1.0
Household saving rate (%)[h]	1.2	2.4	2.2	2.6	3.1	3.4
Real Wage Price Index[i]	0.2	0.5	0.7	–0.3	0.1	0.6
Real average earnings per hour (non-farm)[i]	2.7	0.8	1.5	0.4	0.8	0.9

(a) Forecasts finalised on 31 July.

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

(c) The cash rate is assumed to move in line with expectations derived from financial market pricing. Prior to the May *Statement* the cash rate assumption also reflected information derived from surveys of professional economists. For more information, see A Change to the Cash Rate Assumption Method for the Forecasts.

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

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

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

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

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

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

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

Endnotes

1 See Bruno A, J Hambur and L Wang (2024), 'Measuring Labour Quality in (Closer to) Real Time Using Emerging Microdata Sources', Paper for Joint ABS-RBA Conference on Human Capital, June; Wiley G and L Wang (2024), 'Skills Match Quality Following the COVID-19 Pandemic', RBA *Bulletin*, July.

Box C: Headline and Underlying Inflation

This Box discusses the differences between headline and underlying measures of inflation and how the RBA uses them to guide monetary policy decisions. Headline inflation measures changes in the prices of goods and services that are bought by households, and is the measure that the RBA targets to be between 2 and 3 per cent. The Reserve Bank Board sets monetary policy such that inflation is expected to return to the midpoint of the target range. Assessing whether inflation will sustainably be at the midpoint may require looking through temporary volatility in prices. Measures of underlying inflation, which remove the effect of volatility in prices of some items, help to inform this assessment.

Headline and underlying inflation are forecast to follow different paths over the next couple of years (see Chapter 3: Outlook). Headline inflation is likely to be lower than underlying inflation in the near term, largely due to the Australian Government's temporary measures to reduce the cost of living, and then increase as these measures unwind. The RBA closely monitors both headline inflation and underlying measures of inflation as they inform the outlook in different ways.

Headline inflation reflects the change in prices of items consumed by households and is the target for monetary policy.

The headline rate of consumer price inflation reflects changes in the prices of a representative basket of goods and services that households buy, as measured by the consumer price index (CPI). The CPI includes prices for thousands of items, including groceries, rents, transport and household appliances.

The RBA's flexible inflation target is for the headline rate of inflation to be between 2 and 3 per cent.[1] The Reserve Bank Board sets monetary policy such that inflation is expected to return to the midpoint of the target range in an appropriate period of time, and remain there on an ongoing basis. In doing so, it considers the conditions needed for inflation to be sustainably at the midpoint of the target range. This includes, where necessary, looking through temporary volatility that does not reflect the underlying pace of inflation in the economy.

Paying attention to underlying measures makes sense because headline inflation can be affected by large swings in the prices of individual items that are unrelated to broader conditions in the economy. Such swings can occur for several reasons, including a temporary shock to supply from a natural disaster or due to global events, or a change to a government policy that results in a large change in the price of a particular item. For example, Russia's invasion of Ukraine in 2022 reduced global energy supplies, leading to spikes in energy prices.

Underlying inflation removes the effect of volatility in a subset of items.

The RBA monitors a range of measures of underlying inflation that remove the effect of short-term volatility in a subset of prices. For example, the Australian Bureau of Statistics (ABS) calculates a measure – CPI excluding volatile items – that excludes fruit, vegetables and fuel, as they frequently exhibit large price changes. The ABS also calculates measures that exclude large price changes in a given period, regardless of whether the item is typically volatile. Trimmed mean inflation, for example, is the average rate of inflation after 'trimming' away the items with the largest price changes (positive or negative).[2]

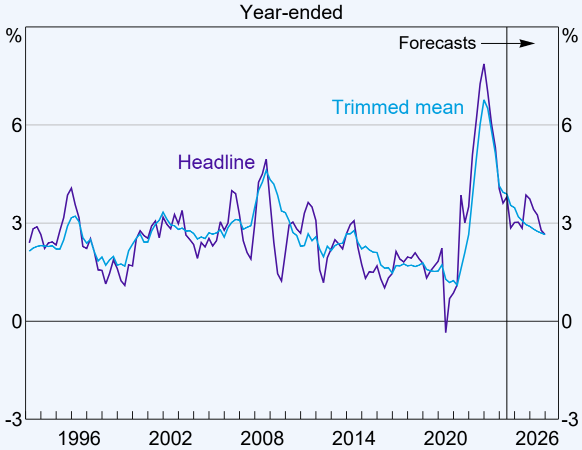
The RBA considers the outlook for underlying inflation when assessing current monetary policy settings.

The RBA – and many other central banks – monitors and forecasts underlying inflation measures (Graph C.1).[3] This allows the Reserve Bank Board to look through volatility in prices and the effect of one-off or temporary measures that do not influence the underlying degree of price pressures in the economy. Considering forecasts of underlying inflation allows the Board to set monetary policy to return inflation sustainably to target.

This is because measures of underlying inflation are more likely than headline inflation to reflect current inflationary pressures, as they generally provide a better indication of price changes across most goods and services. This means they are more likely to reflect the future course of inflation and are useful for forecasting headline inflation. Evidence shows that headline inflation tends to move towards the trimmed mean, while the reverse is not true.[4] To construct inflation forecasts, the RBA first forecasts trimmed mean inflation (informed by economic models), and then forecasts headline inflation by accounting for changes in specific prices that we can be relatively confident will occur in the future.[5]

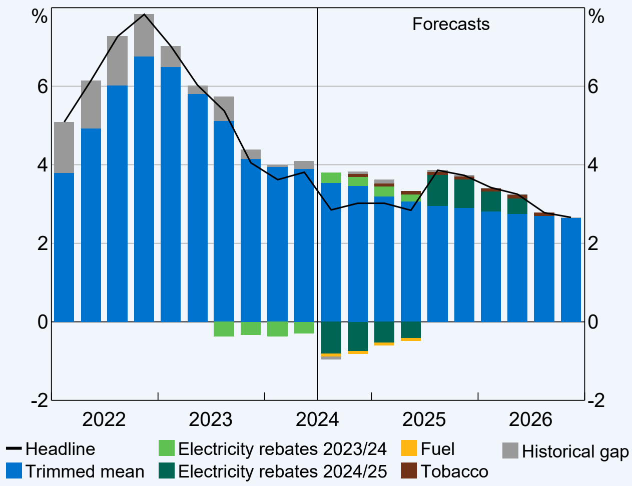
Over the next two years or so, the differences between the forecasts for underlying and headline inflation primarily reflect changes in government policies to provide cost-of-living relief to households. Year-ended headline inflation is forecast to be ¾ percentage point lower than trimmed mean inflation in the September quarter of 2024. Most of this difference can be attributed to the recent introduction of new state and federal energy rebates (Graph C.2). By contrast, the year-ended rate of headline inflation in 2025 is forecast to be almost 1 percentage point higher than trimmed mean inflation, reflecting both the legislated unwinding of the 2024 electricity rebate and an increase in the federal tobacco excise.[6] While these policy changes will affect the rate of headline inflation (and at the margin might affect inflation expectations), it is assessed that they will not materially affect underlying inflationary pressures.

Graph C.1
Headline and Trimmed Mean Inflation*
Year-ended



* Excludes interest charges prior to the September quarter of 1998; adjusted for tax changes of 1999–2000.
Sources: ABS; RBA.

Graph C.2
Headline Inflation*
Year-ended with contributions



* Contributions to headline inflation.
Sources: ABS; RBA.

Endnotes

1 Treasurer and Reserve Bank Board (2023), *Statement on the Conduct of Monetary Policy*, 8 December.

2 That is, after ranking each item in the basket by the size of price changes, it is calculated by the weighted mean of the middle 70 per cent of the distribution of price changes. For more information, see RBA (2024), 'Inflation and its Measurement', Explainer.

3 For examples of global approaches, see Conway P (2024), 'The Road Back to 2% Inflation', Reserve Bank of New Zealand Speech, 19 June; Bank of Canada (2020), 'Understanding Inflation', Explainers; Ehrmann M, G Ferrucci, M Lenza and D O'Brien (2018), 'Measures of Underlying Inflation for the Euro Area', ECB *Economic Bulletin*, June.

4 See Brischetto A and A Richards (2006), 'The Performance of Trimmed Mean Measures of Underlying Inflation', RBA Research Discussion Paper No 2006-10. This result has also been verified more recently: tests for Granger causality suggest that trimmed mean inflation predicts headline inflation, whereas headline inflation does not predict trimmed mean inflation. Forecasts of headline inflation based on the trimmed mean also have lower forecast errors relative to forecasts based on headline inflation. In addition, the gap between headline and trimmed mean has historically tended to revert towards its mean of zero.

5 See Cassidy N, E Rankin, M Read and C Seibold (2019), 'Explaining Low Inflation Using Models', RBA *Bulletin*, June.

6 These differences between headline and trimmed mean inflation are within historical ranges, and larger differences were apparent at the onset of the pandemic.