Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Sydney 7 March 2023

Members present

Philip Lowe (Governor and Chair), Michele Bullock (Deputy Governor), Mark Barnaba AM, Wendy Craik AM, Ian Harper AO, Carolyn Hewson AO, Steven Kennedy PSM, Carol Schwartz AO, Alison Watkins AM

Others present

Luci Ellis (Assistant Governor, Economic), Christopher Kent (Assistant Governor, Financial Markets)

Anthony Dickman (Secretary), David Norman (Acting Deputy Secretary)

David Jacobs (Head, Domestic Markets Department), Marion Kohler (Head, Economic Analysis Department), Penelope Smith (Head, International Department), Matthew Boge (Deputy Head, International Department)

International economic developments

Members commenced their discussion of international economic developments by noting that inflation remained well above central banks targets, though it had moderated over prior months. Headline inflation had come off its peaks as energy prices had fallen and outside the euro area core inflation had also eased as reduced supply-chain pressures had led to slowing goods price inflation. Services inflation remained high in most economies, reflecting the tight labour market conditions and still-firm demand for services, but had been broadly stable recently. Rents inflation was also high in most advanced economies, but there were signs from new rental agreements that this could start to ease in the United States. The latest monthly data on core inflation had mostly been stronger than expected and had picked up noticeably in the United States and some euro area countries.

Unemployment rates remained at multi-decade lows for many advanced economies and vacancy rates were still high. Nevertheless, employment growth had slowed and hiring intentions pointed to further moderation in coming months. Vacancy rates had declined from their peaks and vacancies had become slightly easier to fill. Members noted that wages growth had slowed from its earlier peaks in the United States and Canada, although in the United States it remained above rates consistent with sustainable achievement of the inflation target.

Growth in domestic demand slowed in late 2022 across most advanced economies, driven by weaker growth in household consumption, particularly the demand for goods. Members observed that there had been signs of strength more recently, with indicators of services consumption and from business surveys holding up in several advanced economies, and a strong pick-up in US consumption in January. The housing sector remained an area of weakness around the world, reflecting the tightening of financial conditions.

Members discussed that, in contrast to most other economies, China was still in the early stages of the post-pandemic economic recovery. Following the abrupt removal of tight COVID-19 restrictions at the end of 2022, demand had picked up rapidly; while little official data for 2023 were available at the time of the meeting, a range of high-frequency indicators, such as domestic airline passenger movements and business surveys, pointed to activity recovering quickly. In line with the focus on supporting economic activity, Chinese authorities had continued to introduce measures to support demand in the depressed property sector. In early March, the National Peoples Conference highlighted the policy priorities of Chinese policymakers for the coming year, which included a growth target of 5 per cent and a headline general government deficit of 3 per cent.

The stronger outlook for Chinese demand had supported iron ore and coking coal prices owing to the more positive outlook for Chinese steel production. Coking coal prices had increased further in February to be back in line with thermal coal prices, although this partly reflected supply disruptions in Queensland. Base metals prices had softened. Energy prices had declined to the levels of early 2022 before Russias invasion of Ukraine in part due to warmer-than-usual weather in Europe. Nevertheless, energy prices remained around two to three times higher than in pre-pandemic years.

Domestic economic developments

Turning to the domestic economy, members observed that the data over the preceding month had confirmed the expected slowing in activity in the December quarter and into early 2023. The key economic themes were largely unchanged: the labour market was still very tight, although conditions appeared to have eased somewhat; wages growth had picked up a little further; and inflation remained too high. Economic growth had slowed to a below-trend rate in the December quarter 2022, and overall private demand had declined. Early indicators suggested that sluggish growth in demand had continued into the March quarter.

The national accounts for the December quarter showed that quarterly GDP growth had moderated to 0.5 per cent. This was below trend and broadly in line with population growth, implying that GDP per capita had been flat. An increase in numbers of tourists and international students had provided a modest boost to activity. However, private demand had decreased as investment had declined and consumption growth had slowed notably, even as the saving rate had declined sharply in the December quarter, to be just below its pre-pandemic average. The recovery in household spending from the pandemic-related restrictions seemed to have mostly run its course. Retail sales had increased in January, but the broader trend was for slowing growth across most categories. Members observed that higher interest rates, falling housing prices and declining real household incomes as a result of the rising cost of living were acting to dampen household spending. Dwelling investment remained at a high level in the December quarter as firms continued to work through the large pipeline of work yet to be done. Demand for new detached housing, however, had fallen particularly sharply since mid-2022, which would weigh on future dwelling investment.

Housing prices nationally had fallen further in February and were around 8 per cent below their April 2022 peak. The pace of decline had slowed in several markets. Members observed that rental markets remained very tight and that this was continuing to flow through to growth in CPI rents. Vacancy rates for residential property in Sydney and Melbourne had seen the largest declines, reaching below their longer run average levels. In other capital cities and many regional areas, vacancy rates were at or around historical lows.

The outlook for business investment remained positive, but had softened a little. The ABS Capital Expenditure Survey for the December quarter 2022 (taken early in 2023) indicated that non-mining firms expected to increase nominal investment in the first half of 2023, with a small increase expected for the 2023/24 financial year as a whole. In the Banks liaison with businesses, firms generally reported around-average investment plans (in nominal terms) and intentions to persevere with projects despite rising costs. Capacity utilisation remained high across industries and the NAB Business Survey reported continued above-average business conditions and business confidence at around long-run average levels.

The unemployment rate had increased to 3.7 per cent in January, with employment falling a little in the month; however, this was still close to its 50-year low. Members noted that changes to seasonal patterns were making it difficult to gauge underlying labour market conditions. Relative to previous years, there was an unusually large number of people who were unemployed or not yet in the labour force and about to start a new job in January. Members noted that the February labour force data was expected to provide a clearer indication of whether the softness in the January data reflected changes to usual seasonal patterns or a genuine turning point in labour market conditions. Firms in the Banks liaison program reported that the demand for labour had remained strong, but had eased over preceding months in line with the job advertisements data.

Members noted that wages had increased solidly in the December quarter, although by less than had been expected following the very strong result in the September quarter. The Wage Price Index increased by 0.8 per cent in the December quarter, to be 3.3 per cent higher over the year. The private sector continued to drive the pick-up in wages growth, while public sector wages growth remained subdued. Taking the preceding two quarters together, private sector wages had increased at an annual rate of around 4 per cent, which was in line with the average increase for those private sector jobs that did receive a pay rise in the December quarter. Public sector wages growth was expected to increase in coming quarters as wage rises associated with recently announced state government wages policies took effect. Broader measures of wages from the national accounts continued to be volatile, reflecting compositional shifts in the labour market, such as changes in the share of higher and lower paid jobs. Looking through this volatility, members observed that over the preceding three years productivity had not increased in net terms, even as the disruption from the pandemic had largely ended, and therefore had not provided any offset to rising labour costs. As a result, unit labour costs had risen at an annual rate of more than 3 per cent over that period.

A range of timelier measures, such as newly lodged enterprise agreements and the estimate derived by CBA from its banking data, pointed to wages growth remaining solid in the March quarter. More generally, wages growth was expected to pick up further. Firms in the Banks liaison program expected annual wages growth in the private sector to level out at around 4 per cent. Those firms that had reported large wage increases generally expected more moderate outcomes over the coming year, while firms reporting smaller wage rises generally expected to pay larger increases. Unions longer term inflation expectations had picked up but were still in line with their expectations during the 20002010 period. Other measures of long-term inflation expectations remained consistent with the inflation target.

Members noted that the monthly CPI indicator for January pointed to an easing in inflation in the March quarter, consistent with the expectation that inflation was likely to have peaked in the December quarter; however, they also noted this indicator could be volatile from month to month. The monthly CPI indicator for headline inflation had moderated to 7.4 per cent over the year (from 8.4 per cent in December). Liaison information also indicated that imported upstream cost pressures had eased, although many firms reported that they were still adjusting to the earlier increases in costs for materials, energy and freight. Members noted that the February data would provide more information on domestic services inflation, which was not available in the January release.

Recent trends in company profits had attracted some public attention as a potential driver of high prices domestically. Members noted that the national accounts showed that the mining sector accounted for most of the increase in company profits over the preceding few years, with profits in the non-mining sector being little changed as a share of total income. This was consistent with the differential between growth in the GDP implicit price deflator, at more than 9 per cent over 2022, and CPI inflation, at 7.8 per cent over the same period, since most of the mining sectors profits had been derived from export revenue, which is not directly related to consumer prices.

International financial markets

Members noted that central banks in most advanced economies had increased their policy rates further to address high inflation, although many had reduced the size of increases as policy rates were judged to have reached or neared restrictive levels. While most central banks had noted signs that inflation was moderating, several had highlighted the risk of not tightening enough and indicated that policy settings might need to be restrictive for some time.

Members observed that market participants expectations of the path of policy rates in advanced economies had shifted up since the previous meeting, in response to stronger-than-expected labour market and inflation data. Market participants continued to expect that policy rates would peak around mid-2023.

Members noted that most central banks, other than the Bank of Japan, had continued to run down their holdings of assets purchased under quantitative easing programs. Some were allowing bonds to mature without reinvestment or were reinvesting only part of the proceeds from maturities, while others had actively been selling bonds purchased under their quantitative easing programs.

Consistent with the increase in market expectations for policy rates, government bond yields had increased in most major advanced economies since the previous meeting. Members observed that market-implied measures of longer term inflation expectations had remained between 2 per cent and 3 per cent in most advanced economies, indicating that markets expected monetary policy settings to be sufficiently restrictive to return inflation to central banks targets.

Private sector financing conditions had tightened a little in most advanced economies since the previous meeting. Equity prices had generally declined but remained higher than at the start of the year. Corporate bond spreads had increased somewhat but remained lower than in late 2022. Financial conditions in China were little changed following the sharp rise in equity prices, government bond yields and the renminbi since late November as the authorities stepped away from their strict COVID-19 restrictions and signalled a stronger focus on supporting growth.

The US dollar had appreciated a little over the prior month following stronger-than-expected economic data, but remained well below its 2022 peak. The Australian dollar was little changed in trade-weighted terms since the start of the year.

Domestic financial markets

Members noted that the expected path of the cash rate had shifted higher over the prior month, in response to the Banks communication following the February meeting and stronger-than-expected data overseas. Market pricing implied a 25 basis point increase in the cash rate at the March meeting and suggested that the cash rate would peak at around 4¼ per cent in the second half of 2023; this compared with an expectation prior to the February meeting of a peak at 3¾ per cent. Market economists were also anticipating further increases in the cash rate. Australian Government bond yields had risen over the prior month, though by a little less than government bond yields abroad.

Members discussed how the cumulative increase in the cash rate was passing through to household borrowers, noting that this is only one of several channels through which monetary policy affects the economy. Demand for new housing credit had declined sharply, as higher interest rates had led to weaker conditions in the housing market and reduced the amount that new borrowers could afford to borrow. Increases in the cash rate had continued to be passed through to reference rates for standard variable home loans, although banks had been competing for market share, which had dampened the extent to which actual loan rates had increased. In particular, banks were offering larger discounts to reference rates than in the past and borrowers were responding by refinancing with other banks at record levels, while others renegotiated a better rate with their existing lender.

Members noted that scheduled mortgage payments had increased further as interest payments had risen, and were projected to reach around a record share of households disposable incomes later this year. As their scheduled payments rose, households had reduced the extent to which they were making extra, ahead-of-schedule payments on their mortgages. In the December quarter, these extra payments had dipped a little below their long-run average, helping to support household consumption.

While these extra mortgage payments had eased of late, members noted that households had accumulated larger-than-usual extra payments on their mortgages during the pandemic, alongside other forms of savings. The historical experience suggested that households tend to use these additional payments as a mechanism to smooth consumption over time, including when faced with changing interest rates.

Members discussed households current ability and willingness to run down these and other savings buffers, and observed that this would have an important bearing on how the economy evolves in the period ahead. If households did draw down at least part of these cumulated savings, then it would help sustain spending in an environment of higher interest rates and cost-of-living pressures. However, if households saw such savings as wealth that they preferred to draw upon only gradually over a long period, then these buffers would play less of a role in supporting spending. Indeed, the higher interest rate environment created an incentive to repay home loans more quickly, which could see some households less willing than otherwise to draw upon their savings buffers.

Members also noted that these mortgage buffers were not distributed evenly among borrowers, as was the case for savings buffers more broadly. Some households had modest buffers, if any, and would feel more pressure to adjust their spending than households that could allow some of their additional savings to run down. Members remained mindful of the financial pressure facing some borrowers, although they noted that inflationary pressures would be affected by how borrowers overall responded to higher interest rates.

Considerations for monetary policy

In considering the policy decision, members observed that inflation in Australia remained too high, the labour market was very tight and wages growth had picked up. Surveys continued to signal that business conditions were favourable. GDP growth had softened over 2022, but rapidly rising prices meant that nominal GDP had continued to grow quickly. Members noted that the most important data released over the prior month covering GDP, the labour market, wages and inflation had all been a little softer than expected. They discussed the extent to which this should be interpreted as a signal that demand was weaker than previously assumed. Members noted that the shortfalls to expectations generally were not large and that there were various considerations suggesting it would be prudent not to place too much weight on one periods data. They also observed that there had been a few months of softer data in some other countries around mid-2022 that had been followed by stronger data, and that the same pattern could emerge in Australia. However, members agreed that it was appropriate to take some signal from the consistent pattern across recent data releases.

Market expectations for the future path of the cash rate had shifted up materially since the February meeting. Members noted that a similar increase had also occurred overseas, and the projected peak for policy interest rates remained around 100 basis points lower in Australia than in several other countries. Some central banks were projecting that GDP in their economies would contract over coming quarters. Members also discussed signs that the prior tightening in monetary policy in Australia was affecting economic and financial activity. Most notably, new housing loan commitments had fallen significantly. The value of extra home loan repayments had also declined as required payments had risen, consistent with households reducing the rate at which they were adding to their savings.

In light of inflation being too high and forecast to remain above target for two years, members agreed that a further tightening of monetary policy was warranted at the current meeting. This assessment was supported by the observation that the unemployment rate remained around a 50-year low and that business surveys continued to show that firms were operating close to full capacity, with business conditions remaining strong. Moreover, labour productivity had not increased over the preceding three years, which was contributing to robust growth in unit labour costs. Members agreed that the appropriate adjustment of interest rates was 25 basis points, the same as in preceding months.

Turning to the outlook for interest rates, members observed that further tightening of monetary policy would likely be required to ensure that inflation returns to target and that the current period of high inflation is only temporary.

While it was viewed as likely that headline inflation had peaked at the end of 2022, core inflation remained too high. Members noted that the staffs most recent forecasts were for inflation to return to the 23 per cent target only by mid-2025, and this was on the assumption that the cash rate is increased a little further. In addition, the national accounts had highlighted that productivity had not increased even at the slow rate recorded in the years before the onset of the pandemic; if this continued, it could mean that inflation could be more persistent than previously thought. Members also noted that the policy rate in Australia was below that in several other countries; while a number of factors might account for this, members were conscious of the effect of this difference on financial prices, including the exchange rate.

Notwithstanding this assessment, members noted that monetary policy was in restrictive territory and that the economic outlook was uncertain. These considerations meant that it would be appropriate at some point to hold the cash rate steady, to assess more fully the effect of the interest rate increases to date. As part of their deliberations, members discussed the lags in the effect of monetary policy and the cumulative impact of the significant increase in interest rates since May 2022. They noted that these lags complicate the task of assessing the outlook for the economy.

The outlook for consumption remained a key source of uncertainty. Consumption growth had slowed significantly, as real incomes fell because of high inflation, rising tax receipts and increased interest payments, and as housing prices declined. The staffs most recent forecasts assumed that consumption growth would remain subdued for some time, but it was possible that growth could slow by more than expected given very low levels of consumer confidence. Members noted that the information from liaison with retailers indicated that there had been little growth in retail sales over preceding months, although there was a considerable diversity of experience in this regard. More generally, members discussed the significant financial pressures that some households were experiencing.

Members also noted that the large stock of unexpected additional savings accumulated during the pandemic had not yet been drawn upon materially and that people were finding jobs and additional hours of work. It was possible that these savings might allow households to maintain their level of spending even as real incomes decline, especially if the labour market remained tight. However, it was also possible that some households had already exhausted these additional savings or would soon do so, and other households might choose not to spend their additional savings for several years.

Members noted that it was not yet possible to determine how these various considerations would balance out. They agreed that upcoming releases on employment, inflation, retail trade and business surveys would provide important additional information, as would developments in the global economy. Members agreed to reconsider the case for a pause at the following meeting, recognising that pausing would allow additional time to reassess the outlook for the economy. At what point it will be appropriate to pause will be determined by the data and the Boards assessment of the outlook.

The Board reiterated that its aim is to return inflation to the 23 per cent target range while keeping the economy on an even keel. It noted that this path remained narrow and there are risks in both directions. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that outcome.

The decision

The Board decided to increase the cash rate by 25 basis points to 3.6 per cent. It also increased the interest rate on Exchange Settlement balances by 25 basis points to 3.5 per cent.