Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Perth 2 May 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

Christopher Kent (Assistant Governor, Financial Markets), David Jacobs (Head, Domestic Markets Department), Marion Kohler (Head, Economic Analysis Department)

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

International economic developments

Members commenced their discussion of the global economy by noting that headline inflation had passed its peak in most advanced economies and core inflation had moderated. The easing in inflation had occurred as the supply-demand balance in goods markets had improved and earlier increases in energy prices had reversed. However, members acknowledged that inflation remained high and the decline in core inflation had slowed in recent months. Services prices were quite persistent and being underpinned by wages growth above rates consistent with inflation targets in several economies. Members discussed the implications of this for Australia, given the high degree of commonality in inflation globally since the COVID-19 pandemic. Most central banks expected inflation to return to their targets, but not in the year ahead.

Growth in advanced economies had slowed over the preceding six months or so, but by less than had been expected. Conditions in the services sector had remained resilient. Household consumption was being supported by ongoing increases in employment and wages, as well as relatively strong household balance sheets owing to the savings buffers that had been built up in preceding years. Real household disposable incomes had also stopped falling in most major advanced economies as headline inflation had declined. Timely indicators suggested that demand for labour had eased, but unemployment rates remained close to their historical lows.

Members noted that growth in Australias major trading partners was expected to remain below trend over the coming years, in the range of 3½ to 3¾ per cent, compared with growth of around 4½ per cent prior to the pandemic. However, growth in 2023 was expected to be a little stronger than previously forecast, and the trough in growth in advanced economies was expected to occur later. The risks to growth were perceived to be tilted slightly to the downside; in particular, members observed that the outlook for monetary policy remains uncertain, as central banks balance uncertainty about the pace of disinflation with the possibility of further stress in the financial sector.

The forecast for growth in China in 2023 had been revised higher, reflecting information that the economy had been less affected by, and bounced back more strongly from, the COVID-19 restrictions imposed during 2022 than had been expected. The bounce-back in growth in China had been driven by a strong recovery in consumer spending on services and ongoing robust growth in infrastructure investment. In contrast to most other economies, inflation in China was still below the authorities target.

Members noted that, while property developers in China remain under financial pressure and demographic trends continue to be unfavourable, there were clearer signs that demand for property may be strengthening. Housing demand had increased, with new sales well above their recent trough and prices for new housing rising in most cities. Despite this, concerns about the outlook for Chinese steel production had affected iron ore and coking coal prices received by Australian exporters over the preceding month. Global oil and gas prices had also fallen during April.

Domestic economic conditions

Turning to the domestic economy, members noted that inflation had eased in the March quarter, confirming the staff assessment that inflation had passed its peak. Despite this, inflation in Australia remained too high and broadly based. Headline inflation had declined to 7 per cent over the year to the March quarter and underlying inflation had declined to 6.6 per cent. Inflation had eased in the quarter for a number of goods-related categories, including consumer durables, groceries and new dwelling purchases. However, input cost pressures (both labour and non-labour) and strong demand continued to contribute to strong price increases for many services. Rent inflation in the CPI continued to rise, with an influx of net overseas arrivals over preceding months adding pressure to rental markets that were already strained.

The staff forecasts were for inflation to return to around the top of the target band by the end of the forecast period in mid-2025, consistent with the forecasts from three months earlier. Further disinflation in goods prices was expected to lead to a further decline in overall inflation, as was below-trend growth in aggregate demand. However, growth in unit labour costs, which had been strong in prior quarters, was expected to be a key driver of underlying inflation over the forecast period. Energy costs were also expected to increase over the coming years, although the Governments Energy Price Relief Plan would reduce the size of the increase in 2023/24 and provide targeted support to low-income earners and small businesses. Rent inflation was expected to continue to pick up over the coming year or so and add materially to inflation over the forecast period, including because of the recent increase in net overseas migration. Members considered a scenario in which goods prices fell over coming years, unwinding a portion of the preceding rise; in this scenario, inflation would return to the middle of the target band by mid-2025. However, this outcome was not considered particularly likely given trends to date and the absence of broad-based falls in goods prices internationally. Members noted that a range of indicators suggested that wages growth was running at an annual rate of around 3½ to 4 per cent in the March quarter. The Wage Price Index was expected to peak at around 4 per cent later in 2023, before easing slightly. The forecasts incorporated information that suggested strong wage outcomes for some workers were likely in the period ahead. Members noted that unit labour costs had been growing strongly, owing in part to the very limited productivity growth over the preceding three years. Various factors might explain the weak productivity outcomes, including COVID-19-related disruptions and strong growth in employment in government-funded services, where achieving productivity increases is often difficult. Members discussed the importance of unit labour costs in determining inflation over the forecast period and that a rise in productivity growth would be needed to ensure consistency of the wages growth forecast with the Banks inflation target.

The tightening in monetary policy over the preceding year had contributed to a slowing in output growth. Timely indicators suggested that growth in the March quarter had been subdued, especially in per capita terms. Population growth had been stronger than expected, reflecting a strong pick-up in net overseas migration as foreign students and working holiday makers returned. Despite the pick-up in population growth, output growth was expected to reach its trough in the second half of 2023 at 1¼ per cent and to pick up gradually after that as the effect of earlier policy tightening starts to wane, inflation moderates and housing prices recover.

Turning to the labour market, members noted that employment growth was very strong in the month of March and that growth in the March quarter had been concentrated in full-time employment. Members discussed how much of this persistent strength was because employment typically lags output and how much reflected ongoing strength in activity in the services sector. The unemployment rate remained near historical lows, at 3½ per cent, but was expected to reach 4½ per cent by late 2024. Conditions in the labour market were not as tight as a few months earlier, with some easing in indicators of hiring intentions and a modest decline in vacancies. The increase in numbers of overseas arrivals had supported strong growth in employment in prior months and had also helped alleviate labour shortages in some areas. Even so, labour shortages remained a constraint for many firms, including in the construction sector.

Recent indicators suggested that consumer spending was subdued in the March quarter. Information from the Banks liaison contacts pointed to a further modest decline in retail spending in April, with evidence continuing to suggest that some consumers had been trading down to cheaper items. Consumer sentiment remained weak, particularly among households with mortgages on their homes. Household disposable income had also been falling in real terms, given high inflation, rising interest rates and the effect of bracket creep on income tax payments as nominal incomes rise.

While the significant decline in housing prices over the preceding year had constrained consumption spending, housing prices had recently stabilised and some increases had been recorded. In recognition of this, the forecast for consumption growth by mid-2025 had been revised a little higher.

Demand for new housing had been weak but was expected to be supported by strong fundamentals in the medium term, including population growth over coming years. Despite higher rental yields, incentives to expand residential building had been impeded by high construction costs, the increase in interest rates and construction delays, including because of labour shortages. Building approvals, greenfield land sales and new home sales were all at their lowest levels in a number of years. As a result, building activity was expected to decline once the backlog of construction is worked through. A shortfall in supply relative to strong demand had translated into upward pressure on rents, which was expected to continue for some time.

In the business sector, the outlook for non-mining investment over the coming years had softened a little but remained positive. While non-residential construction activity was expected to be supported by a large pipeline of projects, a shortage of skilled tradespeople would constrain how quickly these projects can be undertaken. The outlook for mining investment growth was subdued and little changed from three months earlier.

Members noted that public demand was expected to remain at a high level over the next few years, even as pandemic-related expenditure fades. Spending would be supported by a substantial program of public engineering works and a general expansion of public consumption, as the population increases and due to specific schemes (including the National Disability Insurance Scheme). Export volumes were expected to grow further over the year ahead, driven by services exports. The forecast for services exports had been revised up owing to a significant upgrade in the expected number of students living in Australia and the expected return of international travel to pre-pandemic levels.

International financial markets

Members noted that international financial markets had stabilised in prior weeks as banking concerns had eased somewhat, although fragilities had again come to the fore with the failure of First Republic Bank in the United States. Alongside the earlier banking concerns, deposits had shifted into money market funds because of the safety of the short-dated government assets in which those funds invest. This accelerated a trend that had begun in 2022 as savers were attracted by the higher returns on those funds relative to bank deposits. Nevertheless, the recent actions of policymakers continued to support confidence in the broader stability of the global banking system. Banks share prices had picked up somewhat but remained lower than earlier in the year, while the broader equity market had been supported by corporate earnings, which had generally been better than expected.

Market participants expectations for the path of policy rates had shifted up a little for most central banks over the preceding month. Members observed that some central banks, including the Reserve Bank of New Zealand and Sveriges Riksbank, had increased policy rates further, emphasising the need to address persistent inflationary pressures. The US Federal Reserve, the European Central Bank and the Bank of England were expected to raise their policy rates further in the period ahead. Several central banks had also emphasised that policy rates were unlikely to decline later in the year, in contrast to market-implied expectations. Despite moving a little higher in the period leading up to the May meeting, the expected paths of policy rates generally remained below their levels before the collapse of Silicon Valley Bank. This partly reflected an expectation that the recent bank stresses would result in some tightening of broader financial conditions, especially in the United States, which by itself would weigh on demand and thereby help to reduce inflationary pressures.

In most advanced economies, government bond yields had risen somewhat as banking concerns had eased, although they were still lower than earlier in the year. The Australian dollar had depreciated a little further and was lower against the US dollar and on a trade-weighted basis than earlier in the year.

In China, financial conditions remained accommodative, with bond yields having declined recently as inflation remained lower than expected. Credit growth had increased, aided by policy measures in support of infrastructure spending and the property sector. However, many highly leveraged property developers still faced considerable financial stress.

Domestic financial markets

Members noted that the earlier increases in the cash rate had continued to pass through to broader financial conditions. Scheduled mortgage payments, which comprise interest and scheduled principal payments, had risen to almost 9 per cent of household disposable income in the March quarter an increase of around 1¾ percentage points from a year earlier. Scheduled payments would continue to rise even if the cash rate remains unchanged, given the large number of low-rate fixed-rate loans that will roll-off over the year.

Extra mortgage payments (over and above scheduled payments) had increased a little in the March quarter, resulting in a notable increase in total mortgage payments. By contrast, extra payments had declined materially over the prior year, which had offset much of the rise in scheduled payments over that time. Members discussed several potential interpretations of the recent increase in extra payments. It could reflect: a transfer of other forms of savings into mortgage redraw and offset accounts, as fixed-rate mortgages converted to variable-rate mortgages; or households constraining their non-essential spending to avoid running down the savings they had built up during the pandemic, particularly given that higher interest rates provide an additional incentive to save; or quarterly variation around a downward trend, as had been seen in the past.

Consistent with the effects of tighter monetary policy, credit growth had continued to slow. However, members observed that a range of indicators suggested that conditions in the housing market were stabilising. This partly reflected a rise in population growth, although shifting expectations for the outlook for monetary policy may also have contributed.

Market pricing suggested that no further increases in the cash rate were expected, which was little changed from the previous meeting. The decision to leave the cash rate unchanged in April had been widely anticipated by market participants. Most market economists expected no change at the May meeting, although some expected one or two more quarter-point increases in the months ahead based on a need to do more to address inflationary pressures. Those economists who expected no further increases noted that consumption growth had slowed, labour market tightness had eased a little and inflation had peaked; they also noted that the Boards approach was to bring inflation back to target in a measured fashion to preserve gains in the labour market.

Members reviewed the Banks approach to reducing its holdings of government bonds, which had been purchased during the pandemic to support markets and provide stimulus. As had been decided by the Board a year earlier, the strategy was to hold these bonds until maturity rather than selling them prior to that. This approach recognised that the Banks balance sheet was already set to decline rapidly given the maturity of funding under the Term Funding Facility, and that bond sales might complicate governments bond issuance and reduce the effectiveness of any future quantitative easing program.

Members agreed that this approach remained appropriate for the time being. However, they noted that the initial tranche of Term Funding Facility maturities would occur in coming months and would provide information on how financial markets respond as the Banks balance sheet declines. More generally, the Banks large holdings of government bonds exposed its balance sheet to a significant level of interest rate risk. Accordingly, members agreed it was appropriate to review the current approach periodically.

Considerations for monetary policy

In turning to the policy decision, members noted that inflation was still very high but had peaked, consumption growth was forecast to remain subdued for some time, and the unemployment rate was low and expected to rise gradually. Members judged that the forecasts were still consistent with the economy remaining on the narrow path on which inflation comes down steadily and the unemployment rate increases but remains below pre-pandemic levels. At the same time, members acknowledged that there were significant uncertainties, and that history highlights the challenges of staying on such a path.

Members discussed two options: holding the cash rate unchanged; or increasing the cash rate by 25 basis points.

The case for holding the cash rate unchanged rested on several arguments.

Members noted that inflation had peaked and was showing signs of slowing further. They considered the possibility that inflation could return to the centre of the inflation target band earlier than forecast if there was a reversal of some of the significant increase in goods prices recorded over preceding years. Members also noted that while wages growth had increased, it was still consistent with the inflation target if productivity growth picked up to its pre-pandemic rate. Further, indicators from liaison contacts and private sector surveys signalled that wages growth was stabilising.

Members observed that the outlook for consumption was weak and had been revised a little lower in the near term. They noted that consumption per capita was not expected to rise over the year ahead and discussed the possibility that consumption could turn out weaker than expected. Many households were experiencing significant financial pressures associated with the higher cost of living and increased mortgage payments, and a further increase in aggregate mortgage payments was expected as fixed-rate loans progressively expire. Subdued growth in consumption was expected to lead to a moderation in inflation, and it was possible that the forecast increase in unemployment could result in inflation slowing more quickly than expected.

Finally, members noted that the lags associated with monetary policy transmission and the extent of policy tightening over the prior year created additional uncertainty around the outlook for the economy. Given this, there was a case to continue to hold the cash rate steady in order to gather additional information.

On the other hand, there were several arguments supporting an increase in the cash rate.

While the staffs central forecast had inflation declining, inflation was not expected to reach the top of the target band until mid-2025. Members noted that, although this was consistent with the Banks mandate and objectives, it left little room for upside surprises to inflation given that inflation would have been above the target for around four years by that time.

In this context, members discussed the potential for upside risks to inflation. They noted the persistence in services price inflation in many other countries and discussed the possibility that Australia might have the same experience. Strong population growth and low rental vacancy rates could also see rents grow even faster than the central forecast envisaged.

Another upside risk to inflation was the possibility that productivity growth remains very weak. Members observed that the forecast for inflation to return to the top of the target band by mid-2025 was predicated on productivity growth returning to around the modest pace recorded prior to the pandemic. If this did not occur, growth in unit labour costs would be uncomfortably fast.

A related upside risk was the possibility that a prolonged period of high inflation leads to a shift in inflation expectations and a change in price- and wage-setting behaviour. If so, this would make it more difficult to bring inflation back to target within a reasonable timeframe. It would require even larger increases in interest rates and involve a worse outlook for the labour market.

Members also reviewed recent developments in asset markets in particular, they noted the depreciation of the exchange rate and the increase in housing prices. While several factors had contributed to these developments, the decision to hold interest rates steady in April was likely to have contributed. Although the Board does not target asset prices, members agreed that movements in asset prices provide relevant information and need to be considered when assessing the outlook for activity and inflation.

Members discussed the economic data over the prior month and their implications. They particularly noted the strong growth in employment in March, the high rate of services price inflation in the March quarter CPI, further evidence of persistent services sector inflation abroad, and some easing in the stresses in global banking markets.

In weighing up the two options, members recognised that the arguments were finely balanced but judged it was appropriate to increase interest rates at this meeting.

The information available over the prior month had confirmed that the labour market remained tight and that inflationary pressures were significant. That information also pointed to upside risks to the outlook for inflation. If these risks materialised, they would further delay the return of inflation to target, with the prospect of a damaging shift in inflation expectations. Further, members noted that the forecasts presented at the meeting were predicated on a technical assumption for the path of the cash rate that involved one further increase.

In reaching their decision, members acknowledged that there were still significant uncertainties surrounding the economic outlook, particularly for household consumption. But, on balance, given the Boards strong commitment to price stability and the importance of ensuring that inflation expectations remain anchored, members judged that a further increase in interest rates was warranted.

Members discussed how best to communicate the Boards decision. They concluded that it was important to emphasise the implications of the recent data releases as well as the updated set of forecasts and the evolving nature of the risks, including from weak productivity growth. Members reaffirmed the Boards determination to do what is required to bring inflation back to target, while emphasising that it is still seeking to traverse the narrow path. Members also agreed that further increases in interest rates may still be required, but that this would depend on how the economy and inflation evolve.

The decision

The Board decided to increase the cash rate target to 3.85 per cent and to increase the interest rate on Exchange Settlement balances to 3.75 per cent.