Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Hybrid 4 July 2023

Members participating

Philip Lowe (Governor and Chair), Michele Bullock (Deputy Governor), Carolyn Hewson AO, Steven Kennedy PSM, Iain Ross AO, Carol Schwartz AO, Alison Watkins AM

Members had granted leave of absence to Mark Barnaba AM and Ian Harper AO in accordance with section 18A of the Reserve Bank Act 1959.

Others participating

Luci Ellis (Assistant Governor, Economic), Christopher Kent (Assistant Governor, Financial Markets), David Jacobs (Head, RBA Future Hub)

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

Marion Kohler (Head, Economic Analysis Department), Penelope Smith (Head, International Department), Carl Schwartz (Acting Head, Domestic Markets Department)

International economic developments

Members commenced their discussion of the global economy by noting that, while the year-ended rate had declined, inflation remained well above central banks targets in most advanced economies. Core inflation continued to be stubbornly high, driven by persistent services price inflation, which had become a focal point for many central banks. Rent inflation, which is a sizeable component of services, was high and increasing in several advanced economies, in part because housing supply takes time to adjust to price signals. Sticky services price inflation also reflected high wages growth, which remained above rates consistent with inflation targets in many advanced economies. Although labour market conditions were easing, this was occurring more gradually than many central banks had previously forecast and wages growth remained high relative to productivity growth.

Members noted that in major advanced economies, surveyed business conditions in the services sector had remained expansionary in June, but less so than in the prior month. By contrast, conditions in the manufacturing sector had remained weak. Indicators of consumption activity had remained subdued in advanced economies; although sentiment had improved alongside recoveries in real income growth and/or higher housing prices, sentiment generally remained below long-run averages.

Members noted that Chinas economic recovery had lost some momentum. Following a strong rebound from COVID-19 outbreaks and restrictions in early 2023, a range of economic indicators had signalled weaker conditions through April and May. Similarly, property market indicators in China had weakened further; housing starts had declined to their lowest level since 2006 and real estate investment had contracted further to be almost one-quarter below its 2020 peak. Consistent with considerable spare capacity, inflation in China remained well below the authorities target of 3 per cent. Inflation had also eased in several other Asian economies, in some cases such as India, Indonesia and Thailand to be consistent with central banks targets.

Commodity prices had been mixed over the preceding month, but most were significantly below their level a year earlier. Expectations that the Chinese Government would provide targeted policy support for the property sector had supported the price of iron ore. Natural gas prices in several markets had increased sharply, in part owing to higher seasonal demand and supply disruptions, but prices remained well below their peaks in mid-2022. By contrast, global agricultural prices had generally continued to decline and were expected to contribute to a further moderation in headline inflation, particularly in emerging economies where food staples formed a larger share of the CPI basket. However, the potential for future supply disruptions remained an upside risk to agricultural prices. Oil prices had been broadly unchanged over the preceding month, with production cuts by OPEC+ and the deterioration in the political situation in Russia having had little impact.

Domestic economic conditions

Turning to the domestic economy, members noted that economic growth in Australia had slowed considerably, reflecting the impact of higher interest rates and high inflation. GDP increased by 0.2 per cent in the March quarter and growth was expected to be similar in the June quarter; output growth was well below the estimated rate of increase in the population over the same period. The slowdown in activity had had only a modest effect on the labour market, with conditions remaining tight. Employment growth had continued to be robust and measures of spare capacity remained near multi-decade lows. Inflation had eased from its peak but remained too high. Market measures of short-term inflation expectations had declined from their peaks but also remained high; however, survey measures suggested that households expected the current high inflation rate to be mostly temporary.

Timely indicators pointed to a gradual easing in inflation over the first half of 2023. The monthly CPI indicator for headline inflation had eased to 5.6 per cent in year-ended terms in May. Across most components of the basket, the year-ended rate of inflation had eased over the preceding three months. Members observed that measures of underlying inflation had remained high in May at 6.4 per cent, excluding volatile items and travel. Food inflation remained high; while the 2022 flood-related effects on fresh food had unwound, the reversion in global food prices was yet to be seen in domestic prices. Furthermore, the increased likelihood of an El Niño event in 2023/24 and an associated downgrade for agricultural production could put upward pressure on some food prices over the coming year. Services price inflation remained high in the June quarter. This was consistent with ongoing strength in unit labour cost growth, with labour productivity broadly unchanged since mid-2019. Members noted that the largest part of the increase in domestic electricity prices was yet to be seen in domestic inflation data, with domestic prices increasing with a lag in response to the higher wholesale energy prices seen in 2022.

Recent housing-related inflation outcomes had been mixed. Inflation in new dwelling construction costs had eased as cost pressures on building materials had abated, even as shortages of tradespeople had continued to restrict activity. Members noted that, by contrast, rent inflation had continued to increase and was around 10 per cent in annualised terms in May. Indicators of rental vacancy rates and advertised rents pointed to ongoing tightness in housing availability.

Members observed that measures of spare capacity in the labour market remained near multi-decade lows. Employment growth had surprised on the upside in May (following a weak outcome in April) and the unemployment rate had declined to 3.6 per cent. Although economic growth was slowing, the continued tight labour market reflected the usual lags from activity to labour market outcomes. That said, a range of indicators suggested the tightness in the labour market had eased slightly and broader measures of underutilisation had increased a little from multi-decade lows in preceding months. Firms had also reported an improvement in labour availability in some sectors, though finding suitable labour remained more difficult than prior to the pandemic. Consistent with this, the job vacancy rate remained very high, though it had declined over the three months to May.

Timely indicators suggested that wages growth had been around 3½ to 4 per cent prior to the larger-than-expected award and minimum wage decision by the Fair Work Commission (FWC). Members noted that wages growth was expected to rise to around 4 per cent in the September quarter as the FWC decision flowed through to wage agreements. Broader measures of labour costs had grown around their fastest pace in over a decade compensation of employees increased by 11 per cent over the year to the March quarter, although much of the increase had owed to growth in employment and hours worked, with a more modest contribution from average earnings per hour.

Despite the strong growth in nominal labour incomes, total real household incomes had declined by 4 per cent over the year to the March quarter, as the contribution from labour income had been more than offset by rising prices, tax payable and higher interest rates. Members observed that the tax and inflation effects on aggregate household incomes had been larger than the net interest effect, with higher interest payments by some households being partly offset by higher interest receipts by other households. Members discussed how the disposable incomes of different types of households were being affected by higher interest rates in significantly different ways.

Reflecting declining real household incomes, growth in household consumption was weak in the March quarter. Members noted that, while growth in consumption and retail sales had slowed from the strong growth rates observed in the first half of 2022, the level of consumption was close to its pre-pandemic trend. The household saving rate declined in the March quarter to be below its pre-pandemic average (though some of this measured decline reflected high construction costs boosting imputed depreciation). Household consumption growth was expected to remain weak in the June quarter, based on timely indicators. That said, nominal retail sales had increased unexpectedly in May, though some of this related to higher food prices and changes in the timing of sales promotions.

The turnaround in the established housing market had continued in the preceding month. Members noted that housing prices had increased noticeably across all major capital cities in June, based on preliminary data. Sydney continued to lead the recovery; housing prices there had increased by around 5 per cent since February. High growth in population and nominal labour incomes and the difficulties associated with building new dwellings had supported demand for established housing nationally, despite recent increases in the cost of credit. The turnaround in the housing market, if sustained, was expected to support household consumption and dwelling investment.

International financial markets

Members noted that market participants expectations for central banks policy rates had increased again over the preceding month. This reflected incoming data suggesting that inflationary pressures may be more persistent than previously expected, further policy rate increases by several central banks, and central banks communication that further tightening is likely to be required. The Bank of Canada had raised its policy rate after a pause of several months, while the Bank of England and Norges Bank had raised policy rates by more than market participants had expected. Members noted that most central banks including the US Federal Reserve, which had paused in June were expected to raise policy rates at least once more in coming months. Moreover, policy rates were widely expected to remain restrictive for longer, given the persistence of core inflation at levels well above inflation targets.

Government bond yields had increased over the preceding month, underpinned by higher real yields. Market-based measures of longer term inflation expectations remained consistent with inflation targets in most advanced economies, including Australia. Indicators of private sector financial conditions were little changed overall. Equity prices in the United States, Japan and Australia had increased but remained stable in Europe. Corporate bond yields were also little changed, in part owing to a narrowing of sub-investment grade spreads following the suspension of the US debt ceiling. Conditions in banking systems remained largely stable, although credit growth had slowed further in the United States and Europe.

In China, the exchange rate had depreciated further as authorities lowered policy rates alongside the release of data confirming a slowing in the pace of the economic recovery. Headwinds to growth in China included persistent weakness in the property sector as well as a weaker outlook for manufactured exports, given slower growth in advanced economies.

The Australian dollar was little changed over the preceding month. The exchange rate had appreciated following the decision to increase the cash rate in June. Subsequently, it had depreciated following the release of the June meeting minutes (which had highlighted the finely balanced decision to raise the cash rate), the monthly CPI and concerns about output growth in China.

Domestic financial markets

Members noted that expectations regarding the path of the cash rate had increased in Australia, as had government bond yields. The expected path of the cash rate, as implied by money market rates, had risen following the decision to increase the cash rate by 25 basis points in June, the subsequent release of strong labour force data and developments abroad. The yield curve remained inverted that is, longer term yields were below those on shorter term maturities as had been the case since March. Inverted sovereign yield curves were also evident in some other advanced economies, including the United States, which had had an inverted yield curve since October 2022. Members discussed how inverted yield curves are consistent with tightening financial conditions and signal that market participants expect slowing economic growth in the future and associated reductions in policy rates.

Scheduled mortgage payments had increased to around a historical peak of 9.4 per cent of household disposable income in May. Scheduled payments would continue to increase (even if there were no further increases in the cash rate) as borrowers with fixed-rate loans rolled off onto higher variable rates and earlier increases in lending rates flowed through. The share of borrowers rolling off fixed rates to higher variable rates was high and would remain so for some months before declining markedly into 2024. Members acknowledged the difficulty in ascertaining the extent to which these low fixed-rate borrowers had been adjusting their spending and saving behaviour in anticipation of the increase in their scheduled payments.

New housing loan commitments had picked up in May, to be around 5 per cent higher than the low point reached in February. The increase in demand for housing finance was consistent with national housing prices and the fact that activity in the housing market had risen in the preceding few months. The recent rise in housing loan commitments had been broadly based, across the states and territories and for both investors and owner-occupiers. Despite the recent rises, housing loan commitments remained around 25 per cent below their peak in January 2022 in nominal terms and at low levels as a share of housing credit.

Market pricing implied a 35 per cent chance of an increase in the cash rate of 25 basis points at the July meeting, compared with around half of market economists expecting an increase. Overall, the market was pricing in two 25 basis point increases in the cash rate over the remainder of 2023, an expectation shared by around half of market economists.

Considerations for monetary policy

In turning to the policy decision, members noted that inflation in Australia remained very high, despite a decline in prior months, and was currently not expected to return to the top of the target range until mid-2025. Services price inflation, in particular, continued to be high. There was little spare capacity in the economy or the labour market, and the level of economic activity was high relative to some years prior. Further, the housing market had stabilised, with housing prices rising once again. At the same time, output growth had slowed materially. Consumer spending had been weak in the first half of 2023 because of the effect of higher inflation, increased tax payments and higher interest rates on households real disposable incomes. The tightening of monetary policy was still working its way through the economy, including as fixed-rate loans matured. Core inflation had proved stickier than anticipated in many advanced economies and several central banks had tightened policy unexpectedly or by more than expected in preceding months. Market expectations for the peak in policy rates in most advanced economies had also continued to rise.

Members discussed two options for monetary policy at this meeting: increasing the cash rate by a further 25 basis points; or holding the cash rate unchanged.

The case to increase the cash rate further was centred on the observations that inflation was forecast to remain above target for an extended period and there was a risk that this timeframe would be extended without further monetary policy tightening. Members noted that several CPI categories for which inflation was typically quite persistent already had too high inflation, including rent and services prices more broadly. They also observed that weak productivity was contributing to strong growth in unit labour costs. Furthermore, electricity prices had risen substantially on 1 July; while this was expected and had been incorporated in the staff forecasts for some time, there was a risk that the wider effects on inflation had not been fully captured.

The labour market remained very tight, notwithstanding some easing in conditions in the preceding month or so. While nominal wages growth appeared to have stabilised recently, members assessed that the environment would remain conducive to above-average increases in prices and wages under such levels of labour market tightness.

Members observed that inflation in advanced economies was proving to be more persistent than expected and that central banks had responded to this with unexpected or larger-than-expected monetary policy tightening over the preceding month. The policy rate in Australia was still lower than in many comparable economies and the recent experience of those countries highlighted the upside risks to inflation and the outlook for interest rates.

Members then turned to the option of holding the cash rate unchanged.

Members noted that monetary policy had been tightened considerably and rapidly over the prior year and the stance of monetary policy was clearly restrictive at the prevailing cash rate. The inversion of the yield curve signalled that the market expected the cash rate to be higher in the near term than it would be over the longer term, consistent with a contractionary monetary policy setting. In addition, mortgage interest payments (as a share of household disposable income) were around a record high in May and would rise further as fixed-rate loans continued to mature, even if the cash rate was not increased further. Members noted that the lags in the transmission of monetary policy through the economy meant that the full effects of the policy tightening that had occurred over the preceding year were yet to be observed. They acknowledged that it takes time for households and businesses to adjust their spending and investment plans, and that there were still significant resets of low fixed-rate loans ahead. Similarly, demand for labour typically responds with a lag, which implied that the current tightness in the labour market might also ease.

Members acknowledged that inflation was now declining, albeit from a high level, and that this would help mitigate the risk of a rise in medium-term inflation expectations. Members noted that global developments over prior months in particular, the fall in commodity and shipping prices had reduced upstream cost pressures for goods. More broadly, the slowing in economic growth was working to bring demand and supply into closer alignment, which, over time, would work to lower inflation.

Members also discussed the risk that output growth slows by more than expected. They noted that the slowing in economic activity in general, and consumption in particular, had been consistent with what could reasonably have been expected given trends in household income and wealth. However, members observed that there was considerable uncertainty about the resilience of household consumption and that the squeeze on many households finances could result in consumption slowing more sharply than implied by the current forecasts. Higher interest rates could also be expected to encourage households to save more, which would affect consumption. If that were to occur, the demand for labour would slow and the unemployment rate would be likely to rise beyond the rate required to ensure inflation returns to target in a reasonable timeframe.

The Board recognised the strength of both sets of arguments but judged that the case to hold the cash rate unchanged at this meeting was the stronger one. Noting both the uncertainty around the outlook and the significant increase in interest rates to date, members agreed to hold the cash rate steady and reassess the situation at the August meeting. Members agreed that some further tightening of monetary policy may be required to bring inflation back to target within a reasonable timeframe, but that this depended on how the economy and inflation evolve. At the August meeting, the Board would have the benefit of additional data on inflation, the global economy, the labour market and household spending, as well as an updated set of staff forecasts and a revised assessment of the risks. Members reaffirmed their determination to return inflation to target within a reasonable timeframe and their willingness to do what is necessary to achieve that outcome.

The decision

The Board decided to leave the cash rate unchanged at 4.1 per cent, and the interest rate on Exchange Settlement balances at 4 per cent.