Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Sydney 6 June 2023

Members present

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

Members granted leave of absence to Alison Watkins AM in accordance with section 18A of the *Reserve Bank Act 1959*.

Others present

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

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

Penelope Smith (Head, International Department), Carl Schwartz (Acting Head, Domestic Markets Department), Meredith Beechey Osterholm (Deputy Head, Economic Research Department)

International economic developments

Members commenced their discussion of the global economy by noting that inflation in many economies remained well above central banks targets. Although headline inflation had continued to decline as energy prices fell and food price inflation eased, members noted that core inflation had remained sticky and shown little sign of easing. Services inflation, which had become the primary source of inflationary pressures across advanced economies, had continued at a high rate. This partly reflected strong wages growth, which remained above rates consistent with inflation targets in many economies. This, in combination with subdued growth in labour productivity, had resulted in a rapid rise in unit labour costs over the preceding year. Members acknowledged the implications of this for Australia, given the high degree of commonality in inflation experience globally since the pandemic. While central banks in advanced economies expected inflation to return to target, most do not see this as likely to occur in the coming year.

Members noted that economic growth in advanced economies was slowing gradually as contractionary monetary policy settings took effect. GDP in major advanced economies had risen only slightly in the March quarter and had declined in some euro area countries. Consumption growth had been subdued in the March quarter and indications were that this had continued into the June quarter. Business investment was yet to surpass pre-pandemic levels in most advanced economies. Other indicators of economic activity had been more resilient in recent months. Housing prices appeared to have stabilised in several countries, following significant declines over 2022, and survey measures of business conditions pointed to services sector activity having increased further in May.

In China, the growth momentum had waned in April after a strong bounce-back following the end of pandemic restrictions and the reopening of the international border in late 2022. As a result, the strength of the economic recovery had become more uncertain than a month earlier. Retail sales and industrial production had declined markedly in April and conditions in the property market had deteriorated.

Members noted that the price of iron ore had been broadly stable over the prior month, despite the soft run of Chinese data. More broadly, the soft outlook for global growth had led to falls in a range of commodity prices since the start of the year. Bulk commodity prices had declined and were now close to pre-pandemic levels. Prices of energy commodities had declined the most, with thermal coal and spot prices for liquified natural gas falling in response to relatively high levels of inventories and broader concerns about the outlook for growth. Oil prices had also fallen. If sustained, these declines would further dampen consumer price inflation globally over the second half of the year.

Domestic economic conditions

Members noted that growth in economic activity in Australia had slowed since mid-2022, as the post-pandemic recovery in spending faded and the substantial tightening in monetary policy worked its way through the economy. The national accounts, to be released the day after the meeting, were expected to show only modest growth. Members noted that the new policies announced in the Australian Government Budget had not had a material effect on the staff forecasts for economic activity and inflation.

There was growing evidence that household consumption growth had been subdued in the first half of 2023. Retail volumes had declined in the March quarter, despite strong population growth, and liaison with retailers suggested that conditions had softened further in the June quarter. Growth in spending on consumer services, including cafes and restaurants, had generally slowed but by less than other forms of consumption. Members discussed the significant financial pressure facing many households and the effect of this on communities and the economy as a whole. They also discussed the unevenness in household spending, noting that some households had drawn on the substantial additional savings built up during the pandemic, while other households were facing considerable budget constraints.

National housing prices had increased in recent months and households expectations for future rises in housing prices had strengthened. Members noted that, if sustained, this would imply less of a drag on consumption in the year ahead than had previously been envisaged. The increase had been broadly based across capital cities in May and was consistent with developments in a number of other countries. Members discussed the reasons for the unexpected strength in housing prices. They noted that strong population growth had supported demand for housing and that this was largely affecting the established housing market. Expectations that the interest rate cycle was near its peak might also have played a role. Orders for newly constructed housing remained weak and residential construction firms continued to report that high materials costs and shortages of skilled tradespeople were contributing to low margins and delays in work being completed.

Members noted that the labour market remained very tight. Nonetheless, conditions had eased slightly, alongside slower growth in economic activity. Employment growth over the prior six months had been a little less than growth in the working-age population over that period. Firms in the Banks liaison program had reported some improvement in labour availability. Acknowledging that the monthly data are volatile, members noted that the unemployment rate had ticked up to 3.7 per cent in April and the number of people employed had been little changed.

A range of measures suggested that wages growth had been in the 3½ to 4 per cent range. The pace of increase in the Wage Price Index (WPI) had risen to 3.7 per cent over the year to the March quarter, broadly in line with earlier expectations. The average size of wage changes in the private sector for those who received an increase had remained at around 4 per cent for the third consecutive quarter. In the public sector, wages growth had picked up to 3 per cent and a further increase was expected. Information from the Banks liaison program was also signalling that firms expectations were for wages growth to remain stable at around current levels over the year ahead.

The recent Annual Wage Review decision of the Fair Work Commission (FWC) had increased award wages by 5.75 per cent. This was higher than the expectation embedded in staff forecasts and would add directly to WPI growth in the September quarter, relative to the prior forecasts. In addition to this, a range of public sector enterprise agreements were being negotiated and it appeared likely that some of these would contain wage rises of at least 4 per cent for the first year, followed by smaller increases in subsequent years. Members observed that the FWC decision would support wages growth for around 30 per cent of workers (but a significantly smaller share of the total wage bill) whose wages are either directly or indirectly affected by award rates. Recently struck enterprise bargaining agreements would similarly see wages growth for those on enterprise bargaining agreements rise from current levels. Members observed that it was understandable that the lowest paid workers would be compensated for high inflation, but that it would be concerning if wages across a broad range of jobs were to become implicitly indexed to high inflation.

Timely indicators pointed to a gradual easing in inflation in the June quarter. The monthly CPI indicator for headline inflation had increased to 6.8 per cent over the year to April, a little higher than had been expected. However, this was partly due to the timing of price changes for volatile items, and growth in the indicator excluding volatile items and holiday travel had slowed, particularly in six-month-annualised terms. The easing in global upstream cost pressures and the more recent declines in commodity prices and shipping rates could be expected to lower firms costs, but the easing in consumer goods price inflation had been limited. Members acknowledged that additional information on the momentum of services prices inflation would become available over subsequent months.

Members noted that there were various other considerations that created upside risk for inflation. Retail electricity prices had risen over the preceding year, but unlike in other countries there would be an even larger increase in the year ahead. Rent inflation had been high in April, reflecting very tight rental market conditions across the capital cities, and appeared to be drifting up further. There had also not been as clear a moderation in goods price inflation in Australia as there had been in some other countries. In considering the outlook for inflation, members discussed the importance of productivity growth, noting that output per hour worked had not increased over the preceding three years.

International financial markets

Members commenced their discussion of international financial conditions by observing that the US Federal Reserve, the European Central Bank, the Bank of England, Norges Bank and the Reserve Bank of New Zealand (RBNZ) had increased policy rates further over the prior month to address high and persistent core inflation. Some central banks, including the RBNZ, had communicated that policy rates were now likely to be sufficiently restrictive or close to sufficiently restrictive. However, central banks had also emphasised that policy rates were unlikely to decline over coming months, in contrast to market-implied expectations.

Market expectations for the path of central bank policy rates had shifted higher over the prior month in response to stronger-than-expected inflation and labour market data. The suspension of the US debt ceiling and easing of concerns about stress in some parts of the US banking system had also contributed to these moves.

Government bond yields in advanced economies had also increased over the prior month. Members noted that the increase in nominal yields mostly reflected higher real yields, while market measures of longer term inflation expectations remained anchored in most economies. This implied that markets expected central banks to raise policy rates sufficiently to return inflation to target.

Private sector financial conditions had been little changed. US funding markets had stabilised after the banking stress in March and deposit outflows from banks had slowed. Members noted that US banks funding costs were likely to remain under pressure for some time, particularly for smaller banks.

In China, financial conditions had remained accommodative, with bond yields having declined a little in response to concerns around the strength of the economic recovery and expectations of further policy easing. Credit growth had eased alongside a slump in property sales and many highly leveraged property developers continued to face considerable financial stress.

The Australian dollar had ended the month little changed on a trade-weighted basis. Members observed that there had been two countervailing forces on the exchange rate over preceding months. Interest rate differentials between Australia and major advanced economies had generally been supportive, and members noted that the Australian dollar had appreciated noticeably in response to the decision to raise the cash rate in May. Meanwhile, the decline in commodity prices and concerns about the strength of Chinas economic recovery had weighed on the value of the Australian dollar.

Domestic financial markets

Members noted that increases in the cash rate continued to be passed through to higher lending rates. Scheduled mortgage payments had increased further and equated to around 9 per cent of household disposable income in April. The increase in average variable mortgage lending rates over the tightening phase had been less than the rise in the cash rate, reflecting competition in the banking sector. There were, however, some signs that competition for borrowers had started to ease. The continuing rollover of low fixed-rate loans into higher rate loans would contribute to a further increase in scheduled payments over the months ahead. Members noted that, based on increases in the cash rate to date, payments were projected to rise to the equivalent of around 10 per cent of household disposable income by the end of 2024.

Net flows into borrowers offset and redraw accounts remained positive to April, although extra mortgage payments were well below the highs seen during the pandemic. Increases in scheduled mortgage payments would reduce some borrowers ability to make these extra payments, but higher rates were also creating an incentive to hold savings in these accounts. The value of non-performing housing loans had risen a little but from a very low level. Measures of personal insolvencies also remained at low levels.

Members observed that new housing loan commitments had stabilised over preceding months, following declines of around 30 per cent from the peak in early 2022. Commitments had steadied among both owner-occupiers and investors, and across states. This pattern was consistent with housing prices having steadied after prior declines. Housing credit growth was also showing signs of levelling out after a period of deceleration.

Members noted that the decision to increase the cash rate in May had been unexpected by many market participants and contributed to bond yields in Australia rising by around 30 basis points over the prior month. For the June meeting, markets were pricing in about a 50 per cent chance of an increase in the cash rate and a little less than half of market economists expected an increase. These expectations had increased over the prior week, following the release of the monthly CPI and the FWCs decision. Further ahead, around half of economists surveyed expected 50 basis points of tightening by August, which was broadly in line with the probability implied by market pricing.

Considerations for monetary policy

In turning to the policy decision, members noted that inflation had passed its peak but remained well above target and was forecast to return to the top of the target range only by mid-2025. There was little spare capacity in the economy, with the unemployment rate very low. At the same time, members noted that consumer spending had softened significantly, with both higher interest rates and high inflation weighing on household purchasing power. Members observed that the economy still looked to be traversing a narrow path on which inflation comes back to target while the unemployment rate rises but remains low. They noted that there were significant risks and uncertainties to staying on this path.

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

The case for raising the cash rate by a further 25 basis points focused on the increased risk that inflation would take longer to return to target than had been expected. Members observed that inflation was already projected to be above target for a number of years and was expected to take somewhat longer to return to target in Australia than in some other countries. This extended timeframe reflected the Boards desire to bring inflation down while, at the same time, preserving as many of the gains in employment as possible. While this remained the Boards objective, members noted that a more prolonged period of above-target inflation would increase the risk that firms and households expectations for inflation rise. If this occurred, high inflation would become more persistent with the result that interest rates would need to be higher for longer. This would increase the risk of a sharp rise in unemployment.

In discussing the risks to the inflation outlook, members observed that the monthly indicator of headline inflation had surprised on the upside in April and that the decline in goods price inflation had been less than observed in other countries. In addition, services price inflation had not yet shown signs of moderating and the evidence from abroad suggested that it may prove to be persistent.

Members noted that wages growth was still consistent with the inflation target, provided productivity growth picked up to around the average pace that had been recorded before the pandemic. While future trends in productivity were uncertain, the outcomes over recent times had been disappointing. Members discussed the possibility of implicit indexation of wages to past high inflation and the potential for this to become widespread. Similarly, members observed that some firms were indexing their prices, either implicitly or directly, to past inflation. These developments created an increased risk that high inflation would be persistent, which would make it more difficult to keep the economy on the narrow path.

Members observed that the resumption of growth in housing prices would if sustained imply less drag on consumer spending in the coming year than had been envisaged. Members also noted that the stabilisation in housing loan approvals suggested that financial conditions may not have been as tight as they had previously judged. The downside risks to global growth had also abated a little as conditions in the US banking sector had stabilised.

Members concluded that these developments had shifted the balance of risks on inflation to the upside compared with a month earlier, although they also noted that there were some downside risks to inflation, including from developments in global markets and the slowdown in household spending in Australia.

The case for holding the cash rate unchanged at this meeting rested on the slowing in the economy and the possibility that the significant increases in interest rates to date would lead to the economy slowing more sharply than expected. Members noted that consumption growth was already quite weak, especially in per capita terms. Real disposable incomes were falling, especially for home loan borrowers, and many renters were experiencing difficult financial conditions. Members also noted that the scale of increase in the cash rate over the preceding year, lags in the transmission of monetary policy through the economy and the large number of fixed-rate loans scheduled to expire over coming months would see financial conditions tighten further. Given these developments, there was a risk of the economy slowing and unemployment rising by more than expected.

Members also discussed some of the downside risks to inflation. They observed that commodity prices had fallen quite significantly over preceding months, as had the price of international shipping, which could be expected to reduce pressure on consumer prices over time. Members noted that medium-term inflation expectations in financial markets had been little changed to date and that the moderation occurring in headline inflation could mitigate the risk of inflation expectations rising. They also observed that the staff forecasts had overestimated wages growth for a prolonged period prior to the pandemic and that productivity could prove stronger than expected.

In light of these considerations, members discussed the possibility of holding the cash rate unchanged at this meeting and then reconsidering at subsequent meetings, with the benefit of additional data.

Members recognised the strength of both sets of arguments, concluding that the arguments were finely balanced. They judged, though, that the case to raise the cash rate at this meeting was the stronger one.

The Board affirmed that its priority is to return inflation to target within a reasonable timeframe. The recent data suggested that inflation risks had shifted somewhat to the upside. Given this shift and the already drawn-out return of inflation to target, the Board judged that a further increase in interest rates was warranted. This increase would provide greater confidence that inflation would return to target over the period ahead. An extended period of high inflation would distort the economy and exacerbate cost-of-living pressures, hurting those on low incomes the most. Sustained high inflation would also lead to even higher interest rates in the future and a worse outlook for the labour market.

In taking the decision to increase interest rates again, members acknowledged the considerable uncertainty regarding the outlook for household spending and the financial stresses facing some households. Given this, they agreed to continue to monitor trends in household spending closely and consider the implications for the inflation outlook, as well as developments in the global economy and the domestic labour market. Members reaffirmed their determination to return inflation to target and their willingness to do what is necessary to achieve that.

Members agreed that the Governors speech the following day would provide an opportunity to explain the decision in more detail.

The decision

The Board decided to increase the cash rate target by 25 basis points to 4.1 per cent and to increase the interest rate on Exchange Settlement balances by 25 basis points to 4 per cent.