Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Sydney 7 February 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), Ellis Connolly (Head, Payments Policy Department)

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

David Jacobs (Head, Domestic Markets Department), Marion Kohler (Head, Economic Analysis Department), Michael Plumb (Head, Banking Department), Penelope Smith (Head, International Department)

International economic developments

Members commenced their discussion of international economic developments by noting that global inflation remained very high, but looked to have peaked. Goods inflation had slowed noticeably in many advanced economies as supply chain and other upstream cost pressures had eased. However, services inflation remained high. Some of the strength in core inflation reflected strong domestic demand. Lower prospective growth in demand was expected to reduce both goods and services inflation over time. Similarly, although wages growth in advanced economies remained well above the average of recent years, indications were that it, too, might have peaked in some economies.

Members observed that a significant development for the global outlook had been the reversal in COVID-19-containment policy in China in mid-December 2022. The disruptions from the final phase of restrictions in November and the wave of illness in December had led to weak activity there in the December quarter. But early signs were that population mobility and economic activity had recovered quickly in January. The accelerated reopening of the economy had brought forward the expected recovery in consumption and supply capacity in China, removing some of the downside risk to the global outlook. Also noteworthy was that the Chinese authorities had refocused policy on supporting growth. Some of the announced measures would support activity in the property sector, which had been very weak.

The earlier reopening and other policy shifts in China had also led to expectations for higher steel production, and had lifted prices for iron ore and coking coal. These increases stood in contrast with the developments in most other commodity prices, which were below their recent peaks. Gas prices and thermal coal prices were sharply lower than a few months earlier, partly because favourable winter weather in Europe had reduced energy demand there. Other upstream costs, including for shipping, had also fallen further.

Members noted that global growth had slowed during 2022, in part reflecting the end of the initial bounce-back from the pandemic. However, the synchronised global tightening in monetary policy, high energy prices and cost-of-living pressures had also weighed on demand in the latter part of the year and would continue to do so over the period ahead. Growth in Australias major trading partners was therefore expected to remain well below its historical average over the coming two years. Some downside risks to growth in the major global economies had abated, including those stemming from Chinas previous approach to containing COVID-19.

Growth in consumption in the major advanced economies had slowed over 2022. Members observed that households had reduced the rate at which they were saving from current income in order to cushion consumption as real incomes had fallen, and the buffers were diminishing. Housing markets were substantially weaker and had led the downturn in activity in several countries. Conditions in labour markets were starting to ease, though labour demand was still rising and labour markets remained very tight, with unemployment rates around historical lows and vacancy rates high.

Members acknowledged that the global outlook was subject to a number of uncertainties, and there were plausible scenarios for both stronger and weaker growth and inflation than expected. The earlier reopening in China and clearer signs of a peak in energy prices and inflation elsewhere had focused attention on some of the positive factors for growth. Against that, the rapid and synchronised tightening in monetary policy could slow growth by more than expected. Regarding inflation, it could decline quickly in the face of slower growth and improved supply conditions. On the other hand, energy prices remained high, and if inflation expectations were to become de-anchored, it would be much more difficult to return inflation to target.

Domestic economic developments

Turning to the discussion of the domestic economy, members observed that domestic inflation was high and broadly based at the end of 2022. Headline inflation had reached 7.8 per cent over the year to the December quarter. Trimmed mean inflation was 6.9 per cent over the same period, higher than had been expected. While global inflationary pressures had started to ease, this had yet to translate here. An easing in inflation was expected over the months ahead, although strong domestic demand in some areas was continuing to push up prices.

Inflation in goods-related sectors remained high, with consumer durables inflation picking up in the December quarter, especially for clothing and vehicles. Inflation in services had picked up further, reflecting both strong demand and rising labour cost pressures, as well as the further pass-through of earlier rises in other input costs. Increases in prices for hospitality and travel-related services had been particularly pronounced. CPI rent inflation had increased further in response to tight rental market conditions; by contrast, inflation in new dwelling construction costs had continued to moderate from high rates. Electricity and gas prices rose strongly in the quarter, partly because government subsidies had delayed some of the increase from the preceding quarter.

Members observed that the December quarter inflation outcome pointed to there being more near-term underlying domestic inflationary pressure than previously thought, which was reflected in the revised forecasts. Further out, the outlook for headline and underlying inflation had been revised slightly lower, reflecting the expected effect of the Australian Governments Energy Price Relief Plan in mitigating some of the increases in energy costs. Based on a technical assumption that the cash rate rises to 3¾ per cent over time, headline inflation was expected to decline to 4¾ per cent by the end of 2023 and return to around 3 per cent by mid-2025. Underlying inflation was expected to decline to around the top of the target range by the end of 2024.

Members noted that wages growth had continued to pick up. Private sector wages growth had been stronger than expected in the September quarter and a stronger outcome than previously forecast was expected for the December quarter. This was supported by information from liaison contacts, with around one-third of private sector firms reporting wage increases above 5 per cent. Growth in the Wage Price Index was expected to rise to 4¼ per cent by late 2023, before easing to around 3¾ per cent by mid-2025 as conditions in the labour market ease. Members noted the high degree of uncertainty around this forecast.

Employment had continued to grow strongly in prior months, though not as rapidly as in the first half of 2022 when the economy was reopening. Members noted that labour supply had expanded, with the participation rate around its historical high and an increase in net overseas arrivals over the second half of the year. The unemployment rate remained at around 3½ per cent. Youth unemployment and broader measures of labour underutilisation also remained around multi-decade lows. The unemployment rate was expected to start picking up from around the middle of this year, to reach 4½ per cent by mid-2025. This would still be below the rates seen in the years prior to the pandemic.

Members observed that output growth had slowed during 2022 as the recovery from the pandemic had largely run its course. Year-ended growth was expected to slow to around 1½ per cent over 2023 and 2024, as higher interest rates, the higher cost of living and declining real wealth slowed growth. This outlook was largely unchanged from three months earlier.

Consumption growth was expected to slow further in coming quarters, due to both the completion of the post-pandemic recovery and the current pressures on household finances. In particular, recent increases in interest rates and still-high inflation would constrain real disposable incomes. Declines in net wealth, driven by lower housing prices, would also weigh on spending. Members noted that recent retail sales data indicated that growth in spending on discretionary goods had been moderating and retail trade volumes had declined a little in the December quarter. Liaison with retailers suggested that conditions had been mixed in January.

The outlook for business investment remained positive, supported by a large pipeline of projects. While shortages of materials and related supply-chain issues had eased, firms were still contending with cost increases and difficulties securing labour, particularly for construction. These factors had also slowed the pace of dwelling investment. At the same time, demand for both detached and higher density housing had declined. The softening in investor demand for higher density dwellings had occurred despite rising yields on units, with rental market conditions remaining tight. Immigration was expected to add to rental demand over the medium term, although a partial offset could be an increase in the average household size from its current low levels.

Export and import volumes increased strongly over 2022, reflecting the return to international travel after Australian travel restrictions were lifted. International travel was expected to continue to recover in coming quarters, especially now that quarantine requirements in China had been removed. Members noted that an increase in the number of foreign students in Australia partly explained recent upward revisions to population growth; their spending was also expected to lift services exports. Furthermore, the Australian economy was being supported by the relatively high terms of trade, which were expected to be a little higher in the near term, given the increase in some commodity prices following Chinas reopening.

Public spending had provided significant support to the economy over prior years, in response to the pandemic and more recently from flood-related assistance. Public demand was expected to be sustained at a high level over the coming year; the decline in public consumption as the pandemic and flood-related support rolls off was expected to be largely offset by capital investment programs.

Members concluded their discussion of the outlook by noting several sources of risk and uncertainty. The outlook for domestic growth and inflation remained highly uncertain, with plausible scenarios for both stronger and weaker outcomes. The boost to domestic activity from Australias high terms of trade could be greater than expected. On the other hand, the implications of economic contractions and disinflation elsewhere could unfold differently from the central forecast.

The competing forces affecting the outlook for consumption could net out to either stronger or weaker outcomes than currently forecast. Members observed that monetary policy affected activity and inflation with a lag and through several channels. The effects on the cash flows of the roughly one-third of households with mortgages generally comes through faster than the effect on the broader economy and inflation. The effects on households were also uneven. Some households had substantial savings buffers or were benefiting from the tight labour market and higher wages growth. It was not certain how far households would be willing to reduce current saving rates or draw down on extra savings accumulated during the pandemic to cushion consumption from the effects of declining real incomes; these accumulated buffers represented a larger share of household income in Australia than those remaining in many economies. On the other hand, many households were facing tighter budgets because of higher interest rates and the rising cost of living. Moreover, it was uncertain how far the earlier substantial equity built by homeowners from the run-up in housing prices would mitigate the effect of the current decline in housing prices on future spending decisions.

Members acknowledged that the forecast decline in inflation was also subject to a number of uncertainties. The fall in global goods inflation had not yet been evident in Australia, although it was expected to occur. It was possible that falls in goods prices in absolute terms could see inflation return to the middle of the target range by mid-2024. However, there were also upside risks to inflation, given its current broad-based nature. Price- and wage-setting behaviour could become more sensitive to strong demand and high inflation, given that households, firms and policymakers could be more attentive to rising costs when inflation is already high. There were upside risks to wages growth and it was possible that inflation and wage expectations could move higher, which would make the task of bringing inflation down more difficult.

International financial markets

Members observed that central banks in several advanced economies had slowed the pace of policy rate increases, noting signs of a moderation in inflation and economic activity, and citing the risks of over-tightening given the lags in the transmission of monetary policy.

Market participants expectations for the path of policy rates in most advanced economies over the year ahead had been little changed since the December meeting. Market pricing continued to indicate the expectation that policy rates would peak around mid-2023 and start to decline in the second half of the year. This was in contrast with central bank communications, which had indicated that policy settings would likely remain restrictive for some time. Members observed that market expectations for policy rates over 2023 and 2024 were lower in Australia than in several other advanced economies, including the United States, Canada and New Zealand.

Consistent with market expectations for policy rates, longer term government bond yields had declined since the start of 2023 in most major advanced economies. This reflected the declines in both longer term expectations for central bank policy rates and longer term inflation expectations. Members observed that market-implied measures of longer term inflation expectations for Australia had been stable at around 2½ per cent.

Private sector financing conditions had eased in most advanced economies since the previous meeting. Equity prices in most major markets had increased and corporate bond spreads had declined, reflecting revised expectations for global inflation, growth and policy interest rates. The removal of COVID-19 restrictions in China and a stronger policy focus on stimulating growth there had also led to a repricing of financial assets in China and globally.

The US dollar had depreciated further on a trade-weighted basis over prior months, including against the Australian dollar. This had occurred alongside declines in US Government bond yields relative to those of other major advanced economies. Further, the Australian dollar had been supported by more positive risk sentiment and higher prices for some key commodity exports following the reopening of the Chinese economy.

Members observed that the Australian dollar was around the same level as a year earlier on a trade-weighted basis. Members noted that, all else equal, tighter domestic monetary policy would usually result in an exchange rate appreciation; however, this had not occurred because other central banks had also been tightening monetary policy. Nonetheless, the synchronised policy tightening would result in lower global inflation than otherwise, which would place downward pressure on domestic inflation.

Domestic financial markets

Members observed that earlier increases in the cash rate were continuing to be transmitted to broader financial conditions. Housing credit had continued to slow and housing prices had declined further. Business credit growth had also slowed more recently. New loan commitments had declined, indicating that a further slowing in both housing and business credit growth was likely in the months ahead.

Banks overall funding costs had continued to rise. The cash rate increase in December 2022 had been passed through in full to standard variable home loan rates, as had been the case in preceding months. However, the average home loan rates actually paid by borrowers had risen by less than the cash rate over 2022, as competition had remained strong for good borrowers. Borrowers were seeking better deals on their home loans, for variable-rate loans as well as expiring fixed-rate loans, and a record share of mortgages were being refinanced with a different lender.

The full effects of the increase in interest rates were yet to be felt in mortgage payments. Members noted that about half of remaining fixed-rate loans, taken out during the pandemic at low interest rates, were due to roll off in 2023 onto higher rates. Taking account of this, and market expectations for further increases in the cash rate, households required mortgage repayments were projected to reach a record level as a share of household incomes.

Members observed that households had accumulated substantial additional savings over the course of the pandemic. This stock of savings was estimated to be larger than in most other advanced economies (relative to households disposable income). However, these additional savings might not be distributed evenly across households and it was unclear how and if these additional savings would be used.

More generally, members noted that the full effects of monetary policy tightening on activity and inflation occurred through a range of channels in addition to rising mortgage payments. These other channels include the effect of higher interest rates on asset prices, the exchange rate, the incentive for people to save, expectations of the future, access to finance and business investment plans.

Members noted that financial market pricing implied a further 25 basis point increase in the cash rate at the current meeting. The market-implied path for the cash rate had shifted slightly higher following the recent inflation data, and now indicated an expected peak of around 3¾ per cent by mid-2023. Accordingly, longer term yields on Australian Government Securities had risen a little since the December meeting. Market economists also expected further increases in the cash rate.

The future of money and payments

Members discussed a paper on the future of money and the Banks work agenda in the payments area. They noted the ongoing trend away from the use of banknotes towards electronic methods of payment and the associated growth in interest around the world in central bank digital currencies (CBDCs). Members discussed the implications of a retail CBDC for the structure of the financial system, the operation and transmission of monetary policy, and the Banks balance sheet. The staffs view is that there is not yet a clear public policy case to issue a retail CBDC, but such a case could emerge. Australia has a modern and well-functioning payments system, which meets most of the needs of households and businesses; there is good access to banknotes for those who wish to use a publicly provided form of money for making payments or storing value; and there is significant innovation in the payments system at present, including the adoption of fast payments services.

Members supported the Banks ongoing research on CBDC, which is focused on understanding the potential use cases and economic benefits of introducing a CBDC. In 2022, the Bank commenced a collaborative research project with the Digital Finance Cooperative Research Centre, which involves the issuance of a limited-scale pilot CBDC that is a real digital claim on the Bank. Industry participants in the pilot will be able to explore how a CBDC could be used to provide innovative payment and settlement services to households and businesses. The industry response to the project had been very positive, with a broad range of industry participants submitting use cases. A report on the findings will be published by the Bank around mid-year.

Members also noted the ongoing work of the Bank, under the oversight of the Payments System Board, to promote the efficiency, competitiveness and safety of the payments system. The Bank is focused on promoting competition in the card payments market, encouraging the delivery of new functionality on the New Payments Platform, and improving the speed and reducing the cost of cross-border payments.

Considerations for monetary policy

Prior to considering the policy decision, members noted that inflation in Australia remained too high and that the incoming data on prices and labour costs had tended to exceed expectations. While a significant part of this was attributable to global factors, strong domestic demand relative to the ability of the economy to meet that demand was also an important contributing factor. Members observed that inflation was likely to have reached its peak in the December quarter, but this could only be confirmed in a few months time. Trends in inflation in other countries contributed to this expectation. The central forecast was for inflation to decline to within the target range over coming years, but the pace and extent of decline remained uncertain. Medium-term inflation expectations remained well anchored and members agreed that it was important this remain the case.

The Australian economy grew at a solid pace over the second half of 2022. However, growth had slowed more recently and the outlook was for a further slowing. Growth in consumption, in particular, was expected to be subdued in 2023 as the post-pandemic recovery wanes, higher prices and household interest payments constrain real disposable incomes and falls in housing prices reduce net wealth. Interest rates on variable-rate home loans had risen substantially over preceding months and required mortgage payments were projected to reach their highest level on record (as a share of household disposable income). Nonetheless, members noted that measures indicate the extra savings accumulated in Australia over the preceding three years were very large. There were plausible scenarios in which consumption growth slowed by even more than forecast, as well as scenarios in which it was more resilient.

Members observed that unemployment was at its lowest level in nearly 50 years and that the number of job vacancies remained very high, even if somewhat less than in prior months. The Australian economy was benefiting from higher terms of trade and would benefit more than a number of other countries from Chinas reopening.

In light of these considerations and turning to the policy decision, members agreed that a further increase in interest rates was warranted. The recent inflation data had suggested more breadth and persistence in inflation than had been expected and that strong demand was leading to price increases in some parts of the economy. While inflation was expected to decline, there was a risk that it could persist at an uncomfortably high level, which would entail longer term costs.

Members also noted that the cash rate was lower than policy rates in many other comparable economies. While wages growth remained lower here than elsewhere, Australias positive exposure to higher commodity prices and the extra savings buffers accumulated by households were estimated to be larger than in other countries. There were also notable differences in fiscal policy and population growth around the globe. Members observed that the cash-flow channel of monetary policy was stronger in Australia than in other countries, given the high level of variable-rate debt. But members also observed that, after taking account of all the channels for monetary policy transmission, there was little evidence to suggest that the overall impact of monetary policy on activity and inflation in Australia was materially different than elsewhere.

The Board considered two options for its policy decision: a 50 basis point increase; and a 25 basis point increase.

The arguments for a 50 basis point increase stemmed from the concern that there had been a pattern of incoming prices and wages data exceeding expectations, and a risk that high inflation would be persistent. If it did persist, there would be significant costs, including higher interest rates and a larger increase in unemployment later on. Relatedly, members observed that the longer inflation stayed high, the greater the risk of price and wage expectations moving higher.

The arguments for a 25 basis point increase also recognised the need to bring demand and supply in the economy more into balance, but noted that inflation was expected to have reached its peak, that the outlook was for a softening in consumption growth and that there were many uncertainties around the outlook. Members observed that, while underlying inflation had been higher than previously forecast, headline inflation was below earlier expectations. The forecast was for inflation to fall within the target range by the end of the forecast period in mid-2025. Many households were facing tighter budgets and, in aggregate, real incomes were falling. There were plausible scenarios in which consumption growth was weaker than expected and inflation fell faster than forecast, as well as scenarios in which the opposite occurred.

Members acknowledged that there were arguments in favour of both options, but concluded that the case to increase the cash rate by 25 basis points at the present meeting was the stronger one. Members noted the uncertainty around the outlook and that the monthly meetings provided the Board with frequent opportunities to assess how these uncertainties were being resolved and to adjust policy if needed. With interest rates already having been adjusted substantially, there was less need to move by 50 basis points at this meeting.

Members noted that the forecasts for output and inflation had been prepared on the technical assumption of the cash rate reaching around 3¾ per cent. Consistent with this, members agreed that further increases in interest rates are likely to be needed over the months ahead to ensure that inflation returns to target and that the current period of high inflation is only temporary. In assessing how much further interest rates might need to increase, the Board will continue to evaluate developments in the global economy, trends in household spending and unemployment, the evolution of labour costs and the price-setting behaviour of firms.

The Board is seeking to return inflation to the 23 per cent target range while keeping the economy on an even keel. The path here is a narrow one 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 target by 25 basis points to 3.35 per cent. It also increased the interest rate on Exchange Settlement balances by 25 basis points to 3.25 per cent.