Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Sydney 4 April 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), Bradley Jones (Assistant Governor, Financial System), Christopher Kent (Assistant Governor, Financial Markets)

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

Andrea Brischetto (Head, Financial Stability Department), David Jacobs (Head, Domestic Markets Department), Marion Kohler (Head, Economic Analysis Department), Penelope Smith (Head, International Department)

International economic developments

Members commenced their discussion of the global economy by noting that inflation remained high and well above central banks targets. Inflation in many economies had declined from earlier peaks but progress in returning inflation to target had slowed. Recent monthly core inflation data had been higher than expected in a range of advanced economies. Nevertheless, inflation in advanced economies was still expected to decline over coming quarters as economic activity slowed and input price pressures continued to dissipate.

Indicators of domestic demand across advanced economies had been mixed. Retail sales had increased in early 2023 in a few economies, although volumes generally remained below their peaks. The housing sector remained subdued in many economies, reflecting the tightening of monetary policy over the prior year. Most of these indicators pre-dated the financial stability concerns and financial market volatility prompted by bank failures in the United States and Switzerland. However, members observed that very timely measures of activity in the services sector had been resilient; survey measures of services output had remained solid in March in many countries and household sentiment in the United States had been little affected. At the same time, some commodity prices had declined.

Members noted that labour markets had remained tight, but less so than a few months earlier. Employment growth had moderated in a number of advanced economies over the preceding six months. Although job vacancy rates had declined, they remained unusually high. Central banks and Consensus Economics panel were forecasting that unemployment rates would increase gradually from their multi-decade lows in many advanced economies. Wages growth had slowed in the United States and United Kingdom but remained above rates consistent with their central banks inflation targets.

Domestic economic activity in China had begun to recover rapidly in the early part of the year from earlier COVID-19-related disruptions. Services sector activity, retail sales and industrial production had all recovered strongly in the first two months of 2023. Leading indicators suggested an improvement in property-related activity was under way following an extended period of weakness; new housing sales had increased sharply in preceding months and new property prices had increased in most cities. Chinese authorities had announced a target for output growth in 2023 of around 5 per cent.

Members observed that commodity prices had mostly declined over the prior month, alongside heightened volatility in financial markets and the associated increase in uncertainty about the economic outlook. Oil prices had initially declined but had reversed following an announcement by the Organization of the Petroleum Exporting Countries in early April of forthcoming production cuts; oil prices remained around 30 per cent below their peak level following Russias invasion of Ukraine in February 2022. Coal and gas prices had also declined, but they remained well above levels that had prevailed in the years prior to the invasion. The iron ore price had declined a little and base metals prices had been broadly stable.

Domestic economic developments

Turning to the domestic economy, members noted that while inflation in Australia remained too high, the tighter monetary policy stance was gradually flowing through to the real economy. The labour market remained tight, but less so than a few months earlier. Recent data releases on employment, retail trade and business surveys had been broadly in line with expectations. However, estimates of population growth had been revised up, owing to stronger net overseas migration. This would have implications for the outlook for economic activity and the housing market, and possibly the labour market. Members also considered the impact this would have on inflation.

Recent prices data had remained consistent with the assessment that headline inflation peaked at the end of 2022. According to the monthly CPI indicator, which can be volatile, inflation had been 6.8 per cent over the year to February, compared with a peak of more than 8 per cent over the year to December 2022. Members noted that goods price disinflation had been an important driver of the moderation in outcomes in the monthly CPI indicator, consistent with the experience overseas. Other partial indicators of inflation from surveys, liaison and company earnings calls also showed that pricing pressures had eased somewhat since mid-2022. Nonetheless, inflation remained high and broadly based and services inflation had continued to increase. Long-term inflation expectations remained consistent with the inflation target.

Members noted that electricity prices would increase sharply in the September quarter. Regulators had released their draft determination of the default offers for retail electricity prices, with default offers expected to rise by 2030 per cent in most states. If these increases flowed through to the market offers as expected, energy prices (for both electricity and gas) were expected to add ¼ percentage point to headline inflation over the 2023/24 financial year (after accounting for the estimated impact of the bill relief measures in the Australian Governments Energy Price Relief Plan).

Members observed that the labour market remained tight, although the balance between labour demand and supply had improved. A strong increase in employment and hours worked and a decline in the unemployment rate to 3.5 per cent in February confirmed that the soft outcomes in January were the result of changes in seasonal patterns rather than underlying weakness. Indicators of future labour demand had moderated since mid-2022 but remained high. While some measures of job advertisements had risen modestly in early 2023, the ABS measure of vacancies had continued to decline. Firms in the Banks liaison program continued to report moderately positive hiring intentions and that finding suitable labour had become less of a challenge.

Members observed that timely indicators suggested wages growth remained solid. Wages measures derived from banking data and advertised salaries for newly listed jobs pointed to a further pick-up in wages growth in the March quarter. Firms in the Banks liaison program expected annual wages growth in the private sector to level out at a little below 4 per cent. Wages growth in the public sector was likely to increase in coming quarters as recently announced state government wages policies take effect. Of note, the Fair Work Commission had awarded wage increases to NSW rail workers above the state wage cap and had commented that significant declines in real wages would occur under the existing NSW Government wages policy. The Australian Government had indicated that it supported increases in the minimum wage in line with inflation.

Measures of business conditions and capacity utilisation generally remained high. Even so, survey measures of business confidence and of forward-looking metrics, such as orders, painted a softer picture. The staffs assessment of information from the Banks liaison program also suggested that private final domestic demand had moderated.

Growth in household consumption had remained sluggish in early 2023. Members acknowledged that higher interest rates, lower housing prices and declining real household incomes reflecting the rising cost of living were all dampening household consumption. Looking through recent volatility, the monthly value of retail sales had been little changed over the preceding six months or so. Card spending data and information from retailers pointed to subdued spending outcomes in March. Consumer sentiment remained at very low levels, particularly for the one-third of households with a home loan. The softness in consumer spending implied even weaker underlying demand in per capita terms, given the sharp increase in population growth.

Members noted that demand for new dwellings had fallen noticeably and that this would weigh on dwelling investment once the backlog of residential construction had been worked through. Construction firms faced a challenging combination of a weaker outlook for demand, longer construction timelines for existing projects due to staff shortages, and significant increases in input costs. Against this backdrop, information from the Banks liaison program indicated that cash flow had become difficult to manage for some construction firms and more insolvencies in the industry were expected.

National established housing prices had steadied in March, following an 8 per cent decline from their peak around a year earlier. Members observed that it was possible that housing prices would stabilise earlier than previously expected and at a level above the previously forecast trough. Stronger fundamentals, including growth in population and nominal incomes, were likely providing an offset to the higher cost of credit. Housing prices in Sydney had increased modestly while the rate of decline had eased in most other capital cities. Rental markets remained very tight and this was continuing to flow through to growth in CPI rents. Residential vacancy rates in Sydney and Melbourne had seen the largest declines to be below their long-run average levels. The average household size had increased slightly in capital cities in preceding months and had been increasing for some time in regional areas.

International financial markets

Members noted that the recent banking system problems in the United States and Switzerland had created stress and volatility in financial markets, especially bond markets. The US Federal Reserve (the Fed) and the Swiss National Bank (SNB) had acted to restore confidence in banks by providing extraordinary liquidity support to banks.

Members observed that many central banks, including the Fed and the SNB, had nevertheless increased policy rates further to slow the pace of inflation in their countries. At the same time, financial stability concerns had caused market-implied expectations of the path of policy rates to decline sharply. Market pricing was consistent with participants ascribing some probability to a wide range of scenarios. These included the possibility of a sharp slowdown in economic activity related to further strains in the banking system and other scenarios where problems in the banking system are contained and central banks need to tighten policy further to address high inflation.

Government bond yields had declined and their volatility had increased significantly, particularly for shorter term maturities, as market participants adjusted their expectations for the path of policy rates and demand for liquidity increased. Lower sovereign yields had partly offset a broader tightening in global financial conditions associated with higher spreads on corporate debt, particularly for lower-rated issuers, and a decline in equity prices. Members noted that there had been very little issuance of corporate bonds rated below investment grade in the United States and Europe in the wake of the problems in the banking system. While equity prices had since largely recovered for the broader market, equity prices of banks were still noticeably lower amid concerns about their future earnings. Banks may have reduced capacity to expand their lending to households and businesses as investors had become more cautious about providing funding to banks and via markets more generally. Members noted that, although financial stability concerns had eased somewhat over the week preceding the meeting, the overall tightening of financial conditions would be an additional headwind for the global economy.

Members noted that conditions in foreign exchange markets had remained relatively stable. The Australian dollar had depreciated a little following the monetary policy decision at the previous meeting and again as global financial stability concerns had emerged. However, over the preceding year or so the Australian dollar had been steady on a trade-weighted basis. The cost of funding US dollars through foreign exchange swap markets had increased for some currencies following the failure of Silicon Valley Bank, especially for the yen and the euro, but the increase had subsequently been largely reversed following coordinated action by several central banks to improve the provision of liquidity. This included offering liquidity via standing US dollar swap line arrangements. The price of Australian dollar swaps had been little changed over the prior month.

Domestic financial markets

Developments abroad had led to volatility in Australian financial markets. Members noted that these markets had continued to function and that conditions had subsequently improved. Banks had been well advanced with their funding plans prior to the episode, so they had been able to pause their issuance of securities during the period of strain in global markets around mid-March. They had since resumed issuance both domestically and offshore, and overall volumes were ultimately above average in March. Similar trends were also evident in the domestic mortgage- and asset-based securities markets, which are an important source of funding for non-banks.

Members observed that there had been only a small effect on banks funding costs from higher risk premiums in global markets. Spreads on banks bonds had risen slightly, and by much less than had been seen during the pandemic or the global financial crisis, suggesting a high level of confidence in markets about the creditworthiness of Australian banks. Similarly, equity prices had declined a little for Australian banks but by much less than for other major banking systems. Accordingly, banks and other Australian deposit-taking institutions (ADIs) remained well placed to repay loans from the Term Funding Facility (TFF) as these began to mature from early April. The TFF had lowered funding costs during the pandemic and the repayments would add a little to banks overall funding costs. However, the TFF accounted for only a small portion of ADIs overall funding. Some of the effect of the rise in the cash rate so far on the cost of this funding had also already occurred because ADIs had hedged at least part of their TFF funding back to short-term interest rates.

Members considered the effect of the monetary policy tightening to date and noted that the earlier increases in the cash rate had continued to flow through to household mortgage payments. This was one of a number of channels through which tighter monetary policy was affecting the economy. Required mortgage payments, which encompass interest and scheduled principal payments, had reached around 9 per cent of household disposable income. Members noted that, based on the current cash rate and as a share of household disposable income, these required payments were projected to be around an historic high later this year and reach around 10 per cent late in 2024. The further increase reflected variable-rate mortgages taking a little time to adjust to earlier cash rate movements and the further expiration of fixed-rate loans. Banks had announced further increases to advertised deposit rates in February and March, although the cumulative increase in overall deposit rates remained less than the increase in the cash rate.

In aggregate, the rate at which households were making extra mortgage payments in addition to their scheduled payments had slowed, suggesting less free cash flow. However, members noted that these payments tended to be lower in the second half of the financial year compared with the first half and that mortgage holders still had a large stock of additional savings buffers.

The Boards decision to increase the cash rate in March had been widely anticipated and the accompanying communication had moderated expectations for future increases. Market-implied expectations for the cash rate subsequently fell further, in tandem with moves in other advanced economies, following developments abroad.

Members noted that current market pricing suggested that the cash rate was expected to be unchanged in coming months before being lowered later in the year. However, as was the case abroad, market pricing reflected an average of both upside and downside scenarios. Market economists had expected, in roughly equal number, either a pause in the cash rate at the current meeting or a further increase of 25 basis points, although most had expected one or two further increases in the cash rate at some point over the months ahead.

Financial stability

Members discussed the Banks regular half-yearly assessment of financial stability risks.

Members noted that financial stability risks had increased globally despite loan arrears remaining very low. The failure of some regional banks in the United States in March had occurred because of weaknesses in their business models and risk-management practices. The vulnerabilities that had left these banks susceptible to a run on their deposits were not systemic across larger US banks and other banking systems (including in Australia). Nonetheless, the heightened risk aversion, increased volatility in some financial markets and deterioration in liquidity conditions had caused liquidity stress to be transmitted to other parts of the international banking system. This had contributed to the regulator-facilitated takeover of Credit Suisse by UBS, following a lengthy period where concerns had been raised about Credit Suisses underlying profitability, risk controls and governance practices.

Members observed that the broader global banking system had remained resilient in the face of these stresses. While financial conditions had subsequently stabilised, supported by the actions of authorities and earlier reforms to ensure that large banks maintain high levels of capital and liquidity, banking regulators and policymakers more generally were considering the lessons to be drawn from recent events. This included how best to ensure banks remain resilient to shocks in the digital era, including because deposit withdrawals can occur more rapidly than in the past.

Members noted that if further banking stresses were to materialise, a more marked tightening in global financial conditions would ensue. This would increase borrowing costs further and reduce the supply of credit to households and businesses, which could accelerate a downturn in the broader credit cycle. Members noted that the combination of tighter monetary policy, high inflation and slowing economic growth was already putting financial pressure on some households and businesses in many countries. There also remained a risk that any disruptions in the functioning of financial systems could be amplified by liquidity mismatches at leveraged non-bank financial institutions, as had occurred on a number of occasions in preceding years.

While volatility in Australian financial markets had also increased in response to the recent global events, members observed that Australian banks were strongly positioned to weather this and continue lending to households and businesses. This reflected that fact that Australian banks are well regulated, strongly capitalised, profitable and highly liquid. Nonetheless, the Australian Prudential Regulation Authority had intensified its oversight of domestic financial institutions following recent events and, together with the Bank and other agencies of the Council of Financial Regulators, had been closely monitoring developments for any adverse effects on the financial system as a whole.

Turning to the financial position of Australian households and businesses, members noted that most were well placed to manage the impact of higher interest rates and inflation, supported by continued strength in the labour market and high savings buffers. However, this resilience was unevenly distributed. Some households and businesses were already experiencing financial stress, and the pressure on household budgets was likely to continue. Members noted that those households on lower incomes, including renters and relatively recent borrowers with larger debts relative to their income, were among those most affected. Smaller businesses, which tend to have more variable-rate debt and volatile income compared with larger firms, were more exposed to rising interest rates. Some building construction firms had faced ongoing margin pressures as a result of fixed-price contracts written before the sharp increase in input and labour costs. These firms had accounted for a large proportion of the recent pick-up in insolvencies to their pre-pandemic level. Banks non-performing business loans had remained low as a share of total business lending. Lenders were expecting an increase in the share of households and firms falling into arrears on their loans in the period ahead, but from a very low level. Further, the share of banks housing loans in or close to negative equity was very low, reflecting the generally sound lending standards and large run-up in housing prices prior to the more recent declines. This would limit the losses for borrowers and banks in the event of default. Members noted that if unemployment were to rise more sharply than expected, the share of households and businesses falling into loan arrears would increase further. However, stress-testing exercises had suggested that banks would be well placed to continue lending to households and businesses even in the face of a substantial deterioration in economic conditions.

Members noted that commercial real estate valuations had recently declined from high levels in Australia and abroad, and that further declines were in prospect. The potential for a deterioration in underlying tenant demand, in response to slowing economic activity, was a source of downside risk to valuations for offices. However, Australian banks exposures to commercial property were small and generally characterised by conservative lending standards. Non-bank institutional investors and foreign bank branches were more exposed to commercial real estate in Australia. While non-bank lenders also had some exposure to commercial real estate, and on slightly different terms from banks, their small size helped to limit potential risks to the financial system.

Finally, members noted the ongoing focus of regulators and financial institutions on a range of threats to financial stability arising from outside the financial system. These included the increasing intensity of cyber-attacks on financial institutions, the potential for an escalation in geopolitical tensions, which could result in disruptions to trade and international capital flows, and potential climate-related disruptions to parts of the financial system.

Considerations for monetary policy

In turning to the policy decision, members noted that inflation remained too high, the unemployment rate was very low and surveyed business conditions were still strong. At the same time, there had been a material slowing in the growth of consumer spending. Members noted that Australias banking system was unquestionably strong and that the underlying issues that had sparked bank failures abroad were not present domestically because of the different structure of Australian banks and adherence to more stringent regulatory arrangements. They also noted that most households were well placed to navigate the financial challenges associated with higher prices and interest rates, especially if employment remained resilient. However, there were parts of the household sector that are under financial stress and, as a result, would have to scale back their spending to minimise the need to draw upon savings. Members also observed that financial market pricing implied an expectation that the cash rate would be unchanged for some time, but that this reflected the weighted average of a range of different scenarios.

Members began their discussion of what these factors meant for the policy decision by noting that it was still possible to navigate the narrow path of bringing inflation down in a timely way while keeping the economy on an even keel. They agreed that this remained the Boards aim but acknowledged that the path was a narrow one.

Members first discussed the case for a further 25 basis point increase in the cash rate target at this meeting. This case was again founded on the observation that inflation remained too high and the labour market was very tight. Members noted that the forecasts produced by the staff in February had inflation returning to the target range only by mid-2025 and that it would be inconsistent with the Boards mandate for it to tolerate a slower return to target. These forecasts were conditioned on monetary policy being tightened a little further. Overseas experience in preceding months also raised a concern that high inflation could be more persistent than had been expected. In addition, members noted that imbalances between demand and supply in the housing and energy markets may limit how quickly inflation declines. Members considered the argument that, in these circumstances, it was better to continue to raise interest rates to ensure inflation is brought back to target faster, noting that monetary policy could be eased quickly if an adverse shock caused inflation and economic activity to slow by more, or more rapidly, than forecast.

Members also noted that most households were in a strong financial position and would be able to absorb higher prices and interest rates without needing to materially draw down on their savings, although some households were already having to do so. Only a few households with mortgages were at risk of having negative equity in their homes, even if prices were to fall somewhat further.

Two other pieces of information accumulated since the previous meeting were relevant to the case for tightening monetary policy further.

One was the upgrade to near-term projections for population growth. Members noted that this could put significant pressure on Australias existing capital stock, especially housing, which would in turn manifest in higher consumer prices. They observed that there were already signs that the recent fall in housing prices might be smaller and more short-lived than expected. Although higher immigration might reduce wage pressures in industries that had been experiencing significant labour shortages, members noted that the net effect of a sudden surge in population growth could be somewhat inflationary for a period. Members acknowledged that the rise in population growth was to some extent temporary and follows a period of very weak population growth.

The second piece of information was the increased risk of larger wage increases in parts of the economy, including in the public sector, later in the year. Members observed that the flowthrough to inflation from wages in social and public sector industries is somewhat diffuse, given the prevalence of administered prices, but judged that it was nonetheless likely to have some impact. Overall, wages growth remained consistent with the inflation target, provided there was some pick-up in productivity growth.

Members then discussed the case for not changing monetary policy at this meeting. This case rested on the observation that monetary policy had already been tightened significantly in a short period. The full effects of this on the economy were yet to be observed, given the lags in the transmission of monetary policy. Members judged that monetary policy was already restrictive. For example, given the current cash rate, required repayments on home loans, as a share of disposable income, were anticipated to rise to around their highest level on record. Members discussed the uncertainties surrounding the impact that this historically rapid increase in interest rates would have on the economy. They noted that there were already signs that tighter monetary policy had contributed to a slowdown in the housing market, a material slowing in consumption growth, and financial pressure for a segment of households with housing loans.

Members assessed the value of pausing at this meeting to gather more information on the economic outlook. Over the coming month, members observed that they would receive another quarterly reading on inflation, additional monthly readings on the labour market, household spending and business conditions, and further information on developments in the global economy and financial markets. The staff were also due to present a full set of updated forecasts at the following meeting. This suite of additional information would be valuable in reassessing the economic outlook and the extent to which monetary policy would need to be tightened further, especially given the range of uncertainties surrounding the outlook. Members also noted that pausing after a run of monetary policy changes would be consistent with the typical pattern of policymaking before the pandemic.

Members recognised the strength of both sets of arguments, but, on balance, agreed that there was a stronger case to pause at this meeting and reassess the need for further tightening at future meetings. Members agreed that it would be helpful to have additional data and an updated set of forecasts before again considering when and how much more monetary policy would need to be tightened to bring inflation back to target within a reasonable timeframe.

In considering communication of the Boards decision, members observed that it was important to be clear that monetary policy may need to be tightened at subsequent meetings and that the purpose of pausing at this meeting was to allow time to gather more information. Members also agreed that the strength of the Australian banking sector meant that financial system resilience was not a consideration in the decision to pause at this meeting. They thought that the Boards future cash rate decisions would depend on developments in the global economy, trends in household spending and the outlook for inflation and the labour market. The Governor noted that his speech to the National Press Club the following day would provide an opportunity to explain these issues in more detail. He would also affirm that 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 leave the cash rate target unchanged at 3.6 per cent. It also decided to leave the interest rate on Exchange Settlement balances unchanged at 3.5 per cent.