RESERVE BANK OF AUSTRALIA

Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Sydney – 5 September 2023

Members present

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

Others present

Christopher Kent (Assistant Governor, Financial Markets), Marion Kohler (Acting Assistant Governor, Economic)

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

Penelope Smith (Head, International Department), Tom Rosewall (Acting Head, Economic Analysis Department), Carl Schwartz (Acting Head, Domestic Markets Department)

International economic developments

Members commenced their discussion of the global economy by observing that headline inflation had continued to ease in year-ended terms in most economies because food and energy commodity prices were generally lower than they had been a year earlier. More recent increases in some food and energy prices presented upside risks to headline inflation in the months ahead. Nevertheless, many central banks in advanced economies expected inflation to moderate further and return to target during 2025.

Members noted that core inflation remained more persistent than headline inflation in advanced economies, though it had eased in many owing in part to a decline in core goods price inflation. By contrast, core services inflation remained high in most advanced economies, supported by the recent strength in demand relative to supply and strong growth in unit labour costs. Labour market conditions had eased gradually but remained tight, and unemployment rates were still at very low levels.

Economic growth in advanced economies had slowed in response to cost-of-living pressures and tighter monetary policy, but by less than previously expected. Growth in household consumption had slowed in the June quarter in many advanced economies and timely indicators suggested the slowing had continued into the September quarter. Business investment growth had picked up in recent quarters in a number of advanced economies. Activity in the services sector – which had been a key driver of growth in economic activity in the first half of 2023 – appeared to have lost some momentum in preceding months.

Members discussed recent developments in China, observing that conditions in the property market had deteriorated further and that other indicators of economic activity had remained soft. Chinese authorities had introduced several policy measures to support the property sector, but these had not yet materially changed buyer sentiment. Members noted that the sector faced significant challenges from financial stress among developers and further defaults posed a risk to economic activity. Inflation in China remained very low by global standards and relative to the central bank's target. A sharper slowing in China was a risk to the global outlook, as Chinese policymakers navigated the longer term challenges of slower structural growth and a rebalancing of the sources of growth in the Chinese economy.

Despite problems in the property market in China, members observed that iron ore prices had increased over the prior month, supported by ongoing demand for steel from other sectors and the possibility of further policy support. Oil prices had increased by nearly 20 per cent from their trough in late June, with larger increases for refined fuel prices.

Members noted that the numbers of tourists and students entering Australia from China had continued to recover but were not yet back to pre-pandemic levels; therefore, further increases were expected to support growth in Australian services exports in the near term. However, a sharper deterioration in China's economic growth posed a downside risk to the outlook for services exports and would also be expected to reduce the prices received for Australia's commodity exports. Lower output growth in China would also affect global output growth, which might in turn affect a range of Australian exports as well as the prices of Australia's imports. However, if this downside risk were to eventuate, these effects would likely be partly offset by a depreciation of the Australian dollar.

Domestic economic conditions

Turning to the domestic economy, members observed that inflation had continued to decline from its peak in late 2022 but remained high. Headline inflation, as measured by the monthly CPI indicator, had decreased to 4.9 per cent over the year to July, owing to declines in the prices of fruit and vegetables and fuel. However, fuel prices had increased sharply in August. By itself, this would boost headline inflation in the September quarter, relative to expectations in early August. Overall, however, inflation was still expected to continue to moderate over the second half of 2023.

Members discussed the composition of the latest inflation data, noting that inflation excluding volatile items and holiday travel and accommodation had eased further in July. The earlier easing in global upstream cost pressures, alongside slowing growth in domestic demand, had contributed to lower inflation for a range of goods. As expected, electricity prices had increased markedly in July as the higher default market offers came into effect, with some offset from government rebates. Members noted that there was limited additional information available for services inflation in the first month of each quarter. Rent inflation had increased to 7½ per cent over the preceding year, reflecting very tight rental market conditions across the capital cities.

Members noted that the labour market also remained tight, but a little less so than in late 2022. While the unemployment rate remained around the low levels of the preceding year, broader measures of labour underutilisation had increased a little and a range of indicators suggested the labour market was at a turning point. The easing in labour market conditions had reflected both an easing in growth in labour demand (following slower growth in economic activity) and strong growth in labour supply. Firms in the Bank's liaison program had reported an improvement in labour availability but that finding suitable workers continued to be more difficult than prior to the pandemic.

Wages growth remained solid in the June quarter. The Wage Price Index increased by 3.6 per cent over the year, broadly around the same pace as in the March quarter. Members noted that timely indicators also pointed to wages growth having been steady ahead of the implementation from July of the changes to award and minimum wages decided by the Fair Work Commission (FWC). The liaison measure of private sector wages growth was around 4 per cent in the September quarter to date, although it was too soon to assess the overall effect of the FWC wage decision on wages growth overall. Expectations of firms in the liaison program were for wages growth in the year ahead to remain around 4 per cent.

Members observed that a range of timely indicators suggested economic growth remained weak. Cost-of-living pressures and high interest rates had continued to weigh on growth in real household disposable incomes and consumption. The national accounts, which were scheduled to be released the day after the meeting, were expected to show that growth in consumption was weak in the June quarter. In per capita terms, consumption was expected to have declined. Timely indicators suggested that consumption growth had remained weak into the September quarter. Looking through the recent monthly volatility, retail sales had been little changed in nominal terms since late 2022 but remained well above pre-pandemic levels in both nominal and real terms.

The recovery in housing prices had continued over the prior month, supported by strong demand – driven in part by strong population growth – and limited supply. Increases in prices had been broadly based across regions and property types; in Sydney, prices were around 8 per cent above their early-2023 trough. The rental market was also very tight and would likely remain so owing to strong population growth, but there had been some tentative signs of an easing in conditions. Rental vacancy rates had increased slightly in some capital cities in recent months and, although growth in advertised rents (for new leases) had remained strong in most capital cities, it had slowed in most regional areas.

Demand for new residential construction had remained weak. In liaison, builders had pointed to a range of factors, including higher interest rates, higher construction costs and the effect of construction delays and insolvencies on buyer sentiment. Members noted that the recent weakness in demand for new detached dwellings was expected to weigh on dwelling investment once the construction backlog had been worked through. Private residential construction work done had declined slightly in the June quarter, suggesting there had been limited easing of capacity constraints associated with finishing trades. Contacts in liaison reported that build times had improved modestly in preceding months and anticipated that they would return to more typical levels in 2024.

Members observed that business conditions had been relatively stable at around average levels in preceding months. Business investment was expected to have increased solidly in the June quarter. That said, in liaison, firms' investment intentions for the coming year had softened a little, driven by a range of factors including a slowing economy.

International financial markets

Members commenced their discussion of conditions in international financial markets by reviewing recent developments in China. Financial pressures on property developers had intensified during August. Property sales had fallen further during the month, to be around the level of a decade earlier. The equity and bond prices of property developers had declined sharply as weakening demand for new property continued to weigh on earnings. Notably, one of China's largest property developers was restructuring its onshore debt and had failed to make timely payments on its offshore debt. Given the levels of stress in the sector, further defaults were widely expected.

Members noted that stress in China's property sector had potential implications for the broader economy and financial system there. Households in China hold a significant share of their wealth in housing assets, and weakness in the property sector may be affecting households' confidence and spending. Additionally, land sales to property developers are an important source of income for local governments, whose finances are already stretched. China's shadow banking sector also has significant exposures to the property sector, and a large financial services provider had missed payments on several trust products in August. Authorities had made some adjustments to policies in response to the stress, including by further easing home buyer purchase restrictions and extending some existing support measures, but these had not yet had a discernible effect.

The People's Bank of China had eased monetary policy a little further in August in response to slowing economic activity. Chinese Government bond yields had declined and the Chinese renminbi had depreciated to its lowest level since late 2022. Members noted that authorities in China had stepped up their efforts to limit the speed of exchange rate depreciation and deter speculation in the currency.

In advanced economies, expectations for central bank policy rates had been little changed over the prior month, with most advanced economy central banks either at or nearing the expected peaks implied by market pricing. Longer term sovereign bond yields of advanced economies had increased and yield curves had steepened. Longer term market-based inflation expectations had remained stable against a backdrop of moderating headline inflation. Equity prices in major markets had been little changed. Corporate bond spreads had declined over preceding months, reflecting both expectations that central bank policy rates were near their peaks and an easing of concerns about the likelihood of a recession.

The Australian dollar had depreciated over the prior month, reflecting concerns about the outlook for the Chinese economy and a broad appreciation of the US dollar as US Treasury yields increased.

Domestic financial markets

Members observed that market expectations for the cash rate had declined over the prior month or two, as had market economists' expectations. This followed the Board's decision to hold the cash rate steady at its August meeting and the slightly weaker-than-expected domestic data over the prior month, as well as the economic and financial news from China.

Members noted that the average outstanding mortgage rate in Australia was now higher than in several other peer economies, despite the policy rate in Australia being somewhat lower; this reflects the higher share of variable-rate mortgages in Australia and shorter maturity of fixed-rate loans. As such, the household cashflow channel of monetary policy for borrowers is more pronounced in Australia than in many other countries. Scheduled mortgage payments rose to 9.7 per cent of household disposable income in July, a little above the estimated previous historical high. Members noted that aggregate payments were set to increase further as more borrowers with fixed-rate loans roll off onto higher rates.

Credit growth had stabilised over prior months, having slowed earlier in the year. New housing loan commitments had declined in June and July to be almost 30 per cent below their peak in January 2022. New commitments as a share of housing credit were at low levels, consistent with large increases in mortgage rates and declines in housing prices since the start of the tightening period. However, housing loan commitments were 6 per cent higher than in February this year, consistent with the rebound in housing prices over that period. Investors accounted for about two-thirds of the rise in commitments over prior months, as commitments for owner-occupiers had risen only slightly.

Members observed that current market pricing implied no expectation of a change in the cash rate at this meeting, and around a 40 per cent chance of one further increase by the end of 2023. Market economists had also revised lower their expectations for further increases in the cash rate this year; the average expected peak in the cash rate had declined from 4.45 per cent prior to the August meeting to around 4.3 per cent subsequently. The number of economists no longer expecting a further increase in the cash rate had risen.

Considerations for monetary policy

In turning to the policy decision, members noted that inflation was still too high and was expected to remain so for an extended period. The experience in other countries continued to suggest that services price inflation might take some time to decline. Members also observed that the data received on wages over the prior month had been broadly consistent with the Bank's forecasts; the labour market remained tight but conditions were easing.

Members noted that the economy was experiencing a period of subdued growth. This was being led by household consumption, as high inflation weighed on household incomes and the effects of prior tightening in monetary policy worked their way through the economy. The outlook for the Chinese economy had also become more uncertain over the prior month, and there were several channels through which this could affect Australia.

Members noted the decline in market expectations for the peak in the cash rate since the previous meeting. At the same time, longer term yields in advanced economies had risen, suggesting investors had become more confident that inflation could return to target without a sharp slowing in the economy. Members also observed that housing prices in Australia had continued to increase, as strengthening demand from investors offset still-subdued demand from owner-occupiers.

In light of these observations, members considered two options for monetary policy at this meeting: raising the cash rate target by a further 25 basis points; or holding the cash rate target steady.

The case to raise the cash rate further was based on the expectation that inflation will remain above the Bank's target for a prolonged period and the risk that this period might be extended. This could occur if productivity growth does not pick up as anticipated or if high services price inflation is more persistent than expected. Members observed that, were inflation to remain above target for an even longer period, this could cause inflation expectations to move higher, which would be likely to require an even larger increase in interest rates in the future. Such an outcome would be costly for the economy. Members noted that the recent rise in petrol prices – an important input for households' inflation expectations – highlighted that the process of returning inflation to target could be uneven.

The case to hold the cash rate unchanged at this meeting was based on the observation that interest rates had been increased significantly in a short period, and that the effects of tighter monetary policy were yet to be fully realised. While evidence suggested interest rates were working to bring aggregate demand into closer alignment with aggregate supply, lags in the transmission of monetary policy meant that the full effects of the tightening since May 2022 would take time to be apparent in the data.

Members noted that there was a risk the economy could slow more sharply than forecast. Consumption could be weaker than expected, and the downside risks to the Chinese economy had increased. On balance, though, members concluded that recent developments had not materially altered the outlook or their assessment that the economy still appears to be on the narrow path by which inflation comes back to target and employment continues to grow.

In weighing up the two options, members agreed that the case to keep the cash rate target unchanged at this meeting was the stronger one. The recent flow of data was consistent with inflation returning to target within a reasonable timeframe while the cash rate remained at its present level. Members recognised the value of allowing more time to see the full effects of the tightening of monetary policy since May 2022, given the lags in the transmission of policy through the economy.

In reaching this decision, members noted that some further tightening in policy may be required should inflation prove more persistent than expected. In assessing the need for such a move, members affirmed that they will be guided by the incoming data and how these alter the economic outlook and the assessment of risks. In making its decisions, the Board will continue to pay close attention to developments in the global economy, trends in household spending and the outlook for inflation and the labour market. 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 target unchanged at 4.1 per cent, and the interest rate on Exchange Settlement balances at 4 per cent.

The Reserve Bank of Australia acknowledges the Aboriginal and Torres Strait Islander Peoples of Australia as the Traditional Custodians of this land, and recognises their continuing connection to country. We pay our respects to their Elders, past and present.