Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Hybrid 1 August 2023

Members participating

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, Alison Watkins AM

Others participating

Marion Kohler (Acting Assistant Governor, Economic), Christopher Kent (Assistant Governor, Financial Markets), Tom Rosewall (Acting Head, Economic Analysis Department)

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

David Jacobs (Head, RBA Future Hub), Penelope Smith (Head, International Department), Carl Schwartz (Acting Head, Domestic Markets Department)

International economic developments

Members commenced their discussion of the global economy by noting that headline inflation had declined further in most advanced economies, by a little more than expected in some cases, and that this had largely been led by energy prices over the prior year. However, core inflation remained well above the rates consistent with central banks targets and was proving to be persistent. While labour market conditions were gradually easing, conditions remained tight and unemployment rates were still at very low levels. Furthermore, members noted that wages growth remained above levels that would be consistent with many central banks inflation targets. While some portion of this may reflect a one-time correction to wage levels, and high wages growth could be partially offset by a contraction in profit margins or faster productivity growth, members noted that slower growth in wages was likely to be required for inflation to return to target. Many central banks in advanced economies still expected inflation to be at or close to their targets by the end of 2025.

Growth in advanced economies had slowed in response to tighter monetary policy and cost-of-living pressures, but not by as much as expected in some cases. While growth in the manufacturing sector had slowed in preceding months, services sector activity had been relatively resilient. The post-pandemic recovery in consumption had been notably stronger in the United States and Canada. More recently, consumption growth had slowed in many advanced economies. Members noted that there were some indications that households real disposable incomes and wealth were starting to increase, as inflation declined and housing prices stabilised or began to rise in a number of countries.

In China, the economic recovery had been weaker than expected after the lifting of COVID-19 restrictions at the end of

2022. In the June quarter, weak external demand had weighed on export growth and there was a further deterioration in conditions in the property market, placing additional pressure on financially stressed developers. By contrast, household consumption had continued to recover in the quarter, though it remained below its pre-pandemic trend. Inflation remained very low by global standards and relative to the authorities target.

Members noted that the outlook for the Chinese economy had been revised lower and was subject to a high degree of uncertainty. The outlook depended on how the recovery in household consumption evolved, and the scale and effectiveness of policy support, particularly in the property sector. Authorities had recently signalled a more positive stance on support for the property sector, but the extent of the shift was uncertain, and authorities continued to emphasise the containment of risks. Iron ore prices had increased in response to an expectation of further targeted stimulus for the property sector. By contrast, thermal coal prices had declined, partly because of weak industrial demand in China.

Members observed that growth in Australias major trading partners was expected to be lower than forecast in May, at around 3¼ per cent in 2023 and 3 per cent in 2024 well below the pre-pandemic longer run average. The downgrade partly reflected the revision to the outlook for China. Members considered the key uncertainties around the outlook. These included that advanced economies might need to tighten policy further if inflation pressures persist, and that there could be spillover effects if the Chinese economy were to be weaker than forecast. On the other hand, the recent run of data on activity especially for North America had surprised on the upside, and policy support could lift the outlook for the Chinese economy.

Domestic economic conditions

Turning to the domestic economy, members observed that consumer price inflation had eased by more than expected in the June quarter and had continued to decline from its peak at the end of 2022. Nonetheless, members acknowledged that inflation remained high and broadly based. Headline inflation was 0.9 per cent in the June quarter in seasonally adjusted terms and 6 per cent in year-ended terms. Goods price inflation had eased further in the quarter, and by more than expected, particularly for consumer durables. This was consistent with easing global cost pressures, alongside slowing growth in domestic demand. However, progress in reducing inflation had been uneven across goods categories, with grocery prices inflation (excluding fruit and vegetables) remaining high in the quarter. Services price inflation especially for market services had also remained high. And rent inflation had picked up further, to an annualised rate of around 10 per cent in the June quarter.

Trimmed mean inflation in the June quarter was 6 per cent in year-ended terms well above the inflation target but down from its peak at the end of 2022. The monthly inflation indicator also pointed to a continued decline in inflationary pressures through the quarter. The share of CPI items whose prices had increased faster than 3 per cent on an annualised basis had declined but remained above its pre-pandemic average.

Members observed that the updated staff inflation forecasts were little changed from those presented to the Board in May, and the forecast period had been extended to the end of 2025. Headline inflation was forecast to be around 3¼ per cent at the end of 2024 and back within the 23 per cent target range in late 2025. This forecast was based on a higher profile for the cash rate over the forecast period than three months prior, reflecting, among other things, increases in the cash rate in both May and June.

The easing in goods price inflation was expected to drive the decline in inflation over the year ahead. By contrast, domestic cost pressures arising from still-high levels of demand combined with ongoing tightness in the labour market and energy costs were expected to see inflationary pressures persist for some time. This would be particularly evident in services price inflation. The forecast for rent inflation had been revised up a little for the year ahead as higher-than-expected population growth had added demand to an already tight rental market.

Turning to wages, members noted that timely indicators of wages growth were steady at around 3½ to 4 per cent in the June quarter. Wages growth as measured by the Wage Price Index was expected to increase in the second half of 2023 because of ongoing tightness in the labour market, increases in award and minimum wages, and developments in public sector wages. Importantly, however, the forecasts were predicated on labour productivity growth returning to its pre-pandemic trend over coming years, which would be needed for the expected growth in labour costs to be consistent with the inflation target.

Labour market conditions remained tight, but a little less so than in late 2022. The unemployment rate had remained at 3½ per cent in June and had been around that level for a year. Employment had increased in line with the strong rate of population growth, keeping the employment-to-population ratio at its record high. Members noted that the population level was still a little below its pre-pandemic trend but that it had grown by more than anticipated, partly due to unexpectedly high numbers of international students. Meanwhile, hiring intentions of firms in the Banks liaison program had eased and firms had reported an improvement in labour availability in some sectors, partly supported by the arrival of foreign workers. The staff forecast was for the unemployment rate to increase to reach 4½ per cent by late 2024.

Members observed that the economy was expected to grow well below its trend pace over 2023 as cost-of-living pressures and higher interest rates weigh on demand. Growth in output was forecast to increase, albeit only gradually, over the remainder of the forecast period, supported by an easing of these headwinds and a pick-up in household wealth following the turnaround in the housing market. Year-ended GDP growth was expected to trough at 1 per cent at the end of 2023, before gradually picking up to around 2¼ per cent by the end of 2025. The near-term outlook was more subdued than it had been in May, with GDP per capita having declined in the March quarter.

Timely indicators suggested that household consumption growth remained subdued in the June quarter. Members discussed the decline in retail sales in the month of June, noting that this had followed a comparable increase in sales in May, with the timing of promotional activity contributing to the monthly variability. More broadly, the value of monthly retail sales had been essentially unchanged since September 2022. Growth in household consumption had slowed considerably over the prior year, consistent with developments in aggregate household real income and wealth. Members noted, however, that behind the aggregate picture was a diversity of experience among individual households as high inflation and higher interest rates worked their way through the economy. That said, disaggregated data on spending growth pointed to a common driver that high inflation is eroding real incomes and that this is playing an important role in the slowdown in aggregate consumption growth. Nonetheless, consumption outcomes for some mortgagors and renters were judged likely to be considerably weaker than the aggregate, since some of these households face acute financial challenges.

National housing prices had increased over prior months because of the combined effects of stronger demand and limited supply. Members noted that strong population growth had lifted demand for rental properties, as had a decline in the number of residents per dwelling since the start of the pandemic. Adding to this, households were able to pay more for housing because of strong nominal income growth. Rental vacancy rates had remained low across all capital cities, supporting strong growth in rents.

Construction activity continued to be limited by capacity constraints and a tightening in financial conditions. Cash flow constraints and an increase in insolvencies could create further delays in completions for some projects. Demand for new residential construction had been relatively weak but the staff forecasts were for this to pick up over coming years. Non-mining business investment in machinery and equipment had grown strongly in the March quarter and was expected to remain at a high level for some time. Export volumes were expected to grow modestly over the forecast period, driven by international student numbers growing at robust pre-pandemic rates and the ongoing recovery in international tourism.

International financial markets

Members noted that market participants expectations for central banks policy rates were little changed over July, having increased over May and June. The stabilisation of policy rate expectations mainly reflected lower-than-expected inflation data in several advanced economies, even as labour markets remained very tight. The US Federal Reserve, the European Central Bank and the Bank of Canada raised policy rates further in July, as expected, and market participants had not fully priced in further policy rate increases. In the United Kingdom, markets were pricing in at least one more rate increase.

Government bond yields had declined in some countries over July but generally remained higher than a few months prior, reflecting an expectation that central banks would hold policy rates at higher levels for longer. Meanwhile, market-implied measures of longer term inflation expectations for advanced economies generally remained consistent with central banks inflation targets. In Japan, yields on 10-year government bonds had increased following the Bank of Japans decision to amend the parameters of its yield curve control policy. Market-implied measures of longer term inflation expectations had increased for Japan but were still below the 2 per cent inflation target.

Over the month, equity prices had increased further and corporate bond spreads had narrowed. However, corporate bond issuance had declined over the prior year and intermediated credit growth had slowed in response to the substantial tightening of monetary policies. In China, equity prices and bond yields had risen a little from recent lows, in response to the prospect of further policy stimulus.

The Australian dollar had been little changed over the month on a trade-weighted basis. The exchange rate had appreciated earlier in the month, although concerns around the outlook for the Chinese economy and domestic economic data including lower-than-expected inflation had weighed on the exchange rate later in July.

Domestic financial markets

Members noted that market expectations for the path of the cash rate implied by money market rates had declined since the July meeting, as had market economists expectations. The decision to leave the cash rate unchanged in July had come as a surprise to some market participants. Expectations for increases in the cash rate had also declined following lower-than-expected June quarter CPI data and, to a lesser extent, weaker-than-expected June retail sales data.

Scheduled mortgage payments as a share of household disposable income increased to 9.4 per cent in the June quarter, around its historical peak. Members noted that banks had continued passing increases in the cash rate through to their customers, and that outstanding mortgage rates and scheduled mortgage payments were set to increase further as a high share of fixed-rate loans roll onto higher rates through the rest of 2023. Voluntary principal payments into borrowers offset and redraw accounts declined in the June quarter. Net flows into these accounts had declined to be noticeably lower than the pre-pandemic average, consistent with pressures on disposable incomes.

Credit growth had declined over the year to June, as expected given the tightening of monetary policy, although it had stabilised more recently. Housing credit growth had been supported by an increase in housing loan commitments since February, alongside the increase in housing prices.

Business credit growth had also stabilised, having slowed over the prior year, but lending to small businesses had been little changed for several years. Members discussed insights from the Banks annual small business finance panel, which had convened in July. While some panellists had sought finance to meet operating costs, others were hesitant to take on new debt given the economic uncertainties and higher cost of finance. Longstanding challenges for small businesses in accessing finance from banks remained, including rigid collateral requirements and onerous application processes. Several panellists had turned to non-traditional sources of finance, such as private equity and non-bank finance, although the aggregate value of these types of funding remained modest compared with bank lending.

Members noted that market pricing implied a one-in-three chance of a 25 basis point increase in the cash rate at the August meeting, with a 25 basis point increase fully priced in by the end of 2023. Around one in two market economists expected a rate increase at this meeting but the median view was also for only one further rate rise this year. The expectation from both market pricing and the median of market economists forecasts was that a 25 basis point increase would bring rates to their peak for the current tightening phase.

Considerations for monetary policy

In turning to the policy decision, members noted that the data released over the prior month signalled the economy was still on the narrow path in which inflation returns to target while employment and the economy continue to grow. The staffs revised central forecasts also had the economy continuing on that path. However, risks remained on both sides of the forecasts, including plausible scenarios in which inflation takes longer to return to target than members considered acceptable.

Members noted that the information received on inflation over the prior month had been reassuring. Inflation had fallen further and been a little lower than expected in the June quarter. However, members observed that there had not yet been any material slowing in services price inflation, and the experience globally had been that services price inflation was more persistent than expected. Members also noted that inflation for some services (including rent and insurance) may rise further, given those items historical patterns of persistence and the current conditions in these markets.

Members observed that the labour market had continued to show considerable resilience. The unemployment rate was very low and had remained around 3½ per cent for a full year. However, there were some signs that the labour market was at a turning point, including a small rise in the underemployment rate. More generally, members noted signs that the substantial rise in interest rates over the prior year was constraining demand, including in the retail sector, where the value of sales had not grown for some time.

Members considered the implications of the staffs forecasts. These forecasts were little changed from three months earlier and remained consistent with the economy staying on the narrow path that the Board is seeking to navigate. Members noted the conditioning assumption for the cash rate underlying these forecasts was higher than it had previously been, given the increases in May and June.

Members then turned to a consideration of the risks surrounding these forecasts. They noted that these were broadly balanced, but that the costs associated with these risks might be asymmetric in particular, it would be costly if a sustained period of high inflation led to higher inflation expectations.

Members discussed a range of scenarios for inflation, including the possibility that inflation does not return to the target band by around mid-2025. This could occur if services price inflation declines more slowly than forecast, the recovery in productivity growth incorporated into the forecasts does not eventuate or if wages growth is more responsive to the tight labour market than assumed. On the other hand, inflation could fall faster than anticipated if the decline in real household disposable income over the prior year weighs more heavily on consumption. More broadly, members noted the lags in the operation of monetary policy meant that the full effects of the 400 basis points of monetary policy tightening over the prior year were yet to be felt. Accordingly, members acknowledged the significant uncertainty about the economic outlook.

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

The case to raise the cash rate centred on the risk that inflation might prove to be more persistent than currently forecast. Members observed that, were this to occur, it would require the Board to raise the cash rate by more than otherwise to get inflation back to target, making it very difficult to preserve the gains made in employment over prior years. Raising the cash rate at this meeting would help to mitigate the risk of that undesirable scenario eventuating. In addition, members noted that the staffs forecasts were already conditioned on a further increase in the cash rate and that the cash rate was notably lower than policy rates in other countries, despite inflation in Australia being at least as high. Finally, members observed that the resumption of growth in housing prices could be a signal that financial conditions were not as tight as they had assessed.

On the other hand, the arguments for keeping the cash rate unchanged at this meeting centred on the observation that the Board had already tightened monetary policy significantly, there were signs that this was working as intended and the Board had time to wait and see how the economy evolves. Members noted that the full effects of the earlier tightening were yet to be recorded in the data. Even so, consumption had already slowed significantly, there were early signs that the labour market might be at a turning point and inflation was heading in the right direction. Considering this and the forecasts, members observed that there was a credible path back to the inflation target with the cash rate staying at its present level. This path was broadly in line with the staffs central forecasts.

Members agreed that the argument to leave the cash rate unchanged at this meeting was the stronger one. They noted that the recent information on inflation had been encouraging, the economy was expected to grow only slowly over the period ahead and this would help with the further moderation of inflation. At the same time, members agreed that it was possible that some further tightening of monetary policy might be required to ensure that inflation returns to target in a reasonable timeframe. Whether or not a further increase in interest rates is required would depend on the data and the evolving assessment of risks. In making its decisions over the months ahead, 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 unchanged at 4.1 per cent, and the interest rate on Exchange Settlement balances at 4 per cent.