



RESERVE BANK OF AUSTRALIA

Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Hybrid – 1 June 2021

Members participating

Philip Lowe (Governor and Chair), Guy Debelle (Deputy Governor), Mark Barnaba AM, Wendy Craik AM, Ian Harper AO, Carolyn Hewson AO, Carol Schwartz AO, Alison Watkins

Luke Yeaman (Deputy Secretary, Macroeconomic Group, Treasury) attended in place of Steven Kennedy PSM (Secretary to the Australian Treasury) in terms of section 22 of the Reserve Bank Act 1959.

Others participating

Luci Ellis (Assistant Governor, Economic), Christopher Kent (Assistant Governor, Financial Markets), Alexandra Heath (Head, International Department)

Anthony Dickman (Secretary), Penelope Smith (Deputy Secretary), Bradley Jones (Head, Economic Analysis Department), Marion Kohler (Head, Domestic Markets Department), Andrea Brischetto (Deputy Head, Domestic Markets Department), Clare Noone (Senior Manager, International Department)

International economic developments

Members commenced their discussion of international economic developments by noting that the global outlook had improved over recent months and risks to the global economy had become more balanced. Global trade volumes had increased strongly and measures of new export orders were buoyant. COVID-19 case numbers had fallen in many advanced economies as vaccination rates had risen, and containment measures were being eased. Surveys of business conditions were strong, with manufacturing activity at high levels and conditions in the services sector continuing to improve. Fiscal and monetary policy measures had continued to support the recovery. In China, the economy was continuing to benefit from strong global demand for manufactured goods. The underlying drivers of the recovery there were also becoming more broadly based with the recovery in the consumption of household services.

Despite these positive developments, the global recovery had been uneven and this would continue to be a feature of the outlook for some time. Many emerging market countries, including India, continued to experience significant health and economic challenges. Vaccine supplies remained limited in many emerging market countries, hampering their economic recoveries. Containment measures had been reimposed in some countries in Asia following recent virus outbreaks and were likely to slow the recovery temporarily in these countries.

A key feature of the global economy during the pandemic had been the emergence of supply chain bottlenecks, which had contributed to lengthening delays in the delivery of some manufactured goods. Members noted that these bottlenecks had been caused by disruptions to current and earlier production and ongoing strong demand for goods. Many firms were attempting to rebuild inventories after they had declined to low levels. Shortages of global semiconductor chips and constraints on shipping capacity were reported as acute. This, in turn, had hampered downstream production for a variety of goods.

Global supply chain bottlenecks were generally expected to be transitory, although there was considerable uncertainty about how long they could take to ease. Considerations included the speed with which global demand rebalanced from goods back to services and how quickly containment measures were lifted in response to increased vaccination coverage and successful control of the virus. In parts of east Asia, businesses were responding to supply pressures by investing in new capacity. Large producers of semiconductor chips had boosted investment and projected substantial further increases in production over the following couple of years. Large shipbuilders were also planning to increase capacity following several years where investment in shipping had been weak, but this would take time.

In discussing recent developments in global inflation, members noted that global supply chain bottlenecks and higher commodity prices had contributed to an increase in producer price inflation in a number of countries. However, increases in wages and other production costs, which are key components of the overall cost base for many firms, had generally been more subdued. Wages growth in the United States had been noticeably stronger than elsewhere.

Year-ended consumer price inflation had increased in advanced economies because of the upstream price pressures and an increase in consumer demand as containment measures were relaxed. However, measures of underlying inflation that exclude volatile items had been lower. Goods account for less than half of the consumer price index basket in many advanced economies, muting the effect of upstream price pressures on overall inflation. In Australia, the exchange rate had appreciated alongside higher commodity prices at the end of 2020, further limiting the extent to which higher global goods prices were passed on to consumers.

Members noted that, in the short term, year-ended headline inflation was expected to rise temporarily around the middle of the year, owing to base effects and temporary price pressures as global supply chain bottlenecks and higher commodity prices drove consumer prices up. However, in most advanced economies, including Australia, spare capacity in labour markets was likely to contain underlying

inflationary pressures for some time. Measures of inflation expectations in advanced economies were around or below central banks' targets.

The Australian economy was continuing to benefit from higher commodity prices and strong demand for resource exports, despite ongoing difficulties in the trading relationship with China. Members noted that the terms of trade were likely to be near record levels in the June quarter and remain high in the near term. The price of iron ore briefly reached a record high early in May, before easing back to below the levels observed at the time of the previous meeting.

Domestic economic developments

Turning to domestic economic developments, members noted that the Australian economy was transitioning from recovery to expansion with more momentum than previously anticipated. This was the result of favourable health outcomes and substantial fiscal and monetary policy support. While uncertainty around the outlook had declined, further surprises in either direction were plausible given scenarios for the path of household consumption and saving, as well as the extent of stimulus from the substantial fiscal and monetary policy easing. Health outcomes also continued to be an important source of uncertainty, although this was likely to diminish as a greater proportion of the population is vaccinated.

Members noted that growth in household consumption had moderated in the March quarter following the strong rebound in the second half of 2020. The decline in consumption since the onset of the pandemic had been driven by the reduction in spending on discretionary services. However, it was expected that, as containment measures continue to be eased and more consumption possibilities become available, the recovery in spending on services would continue. While the most recent lockdown in Victoria would constrain spending on services in the June quarter, over the following couple of years household consumption was expected to be strong, especially in per capita terms, supported by higher employment, rising net wealth and lower levels of uncertainty.

Conditions in the residential construction sector remained buoyant. Residential construction activity had increased strongly in the March quarter, led by the construction of detached houses and alterations & additions. Despite historically low population growth, residential construction activity was expected to strengthen further over coming quarters, supported by government incentives, low interest rates and the very high level of building approvals over prior months. Building approvals and land sales were expected to ease back as the HomeBuilder subsidy had closed to new applications. However, the extension of the final commencement date for construction under this program implied that the effects of higher construction activity would be spread over the following 18 months or so.

Prices in the established housing market increased further in May. New residential listings had been above the levels recorded in previous years, but the total number of outstanding listings remained low, indicating that properties continued to be sold quickly. Auction volumes and housing turnover had also picked up strongly over recent months, and auction clearance rates remained above average. Rental

market conditions had continued to tighten outside of Melbourne and Sydney, with advertised rents increasing rapidly in regional areas and some capital cities. In Sydney, advertised rents had been increasing again after declining earlier in the pandemic. In contrast, rental market conditions remained weak in Melbourne, where advertised rents remained well below their pre-pandemic levels and the vacancy rate was still high.

Members welcomed the increase in business investment expenditure in the March quarter, led by machinery and equipment investment, and forward-looking indicators of business investment were more favourable than they had been for some time. Accommodative financing conditions and tax incentives were supporting the recovery in investment. Survey measures of business confidence, capacity utilisation and forward orders had all increased to very high levels in April. Non-residential building approvals and surveyed capital expenditure intentions also pointed to further growth in investment. However, even this recovery implied that non-mining investment would remain a relatively low share of overall output. Members observed that mining firms' investment intentions had been largely unresponsive to the increase in commodity prices over the preceding year.

Members noted that labour market data had been mixed in April. The rate of unemployment and underemployment had declined further in April, and while total employment had also declined in the month, full-time employment had increased. Unusually strong seasonal effects related to the timing of Easter and school holidays appeared to have reduced both employment and unemployment in April, as more people took leave or exited the labour force in the month. More broadly, leading indicators of labour demand, such as job vacancies, continued to point to further solid increases in employment in the period ahead.

In discussing spare capacity in the labour market, members noted that while the participation rate had increased to historically high levels, further increases were possible. The number of people who were recorded as outside the labour force but open to work in the near future was still quite high. Combined with other measures of potential labour supply currently classified as outside the labour force, this suggested there was still a pool of workers available to firms should the demand for labour continue to increase. Information from the Bank's liaison program and other surveys indicated that labour shortages were appearing in some parts of the economy. The reduction in access to foreign labour and reduced interstate mobility were cited by some firms as contributing factors. However, firms facing labour shortages were citing a preference for non-wage measures to attract and retain staff, such as one-off bonuses and more flexible working arrangements. Some firms were also opting to ration output because of labour shortages, rather than pay higher wages to attract new workers.

Recent data for the March quarter did not point to a meaningful pick-up in wages growth overall. Wages growth had remained around historically low levels, and many firms still had wage freezes in place. Wages growth was low across a broad range of industries. While a faster pick-up in wages growth was possible, members continued to expect a gradual increase in the following few years as spare capacity in the labour market was steadily absorbed.

In concluding their analysis of recent developments in the domestic economy, members discussed the further fiscal support announced in the Australian Government Budget. Receipts for the 2020/21 financial year were much stronger and outlays were lower than foreshadowed in December's mid-year fiscal update; the Victorian Government Budget in May reflected a similar pattern of revisions to receipts and outlays. Higher-than-expected iron ore prices, and the strong recovery in the labour market and household consumption, had all contributed to the strength in revenues. The underlying cash deficit for the Australian Government was therefore expected to be smaller in the current financial year than previously assumed. However, new spending commitments and an extension of tax relief measures were also announced for the coming years. These were expected to offer additional support for the recovery relative to the assumptions at the time of the mid-year fiscal update.

International financial markets

Financial market conditions had been broadly stable during May. Longer-term sovereign bond yields remained around levels seen since mid March and conditions in corporate bond markets remained highly accommodative. Equity prices in most major markets, including in Australia, were around record highs.

Members observed that central banks in advanced economies had reiterated their commitments to provide significant monetary policy support until there is evidence of sustained progress towards their goals for employment and inflation. In line with this guidance, market-implied policy rate expectations had been little changed in recent weeks. An exception was in New Zealand, where market expectations for the policy rate had moved higher after the central bank released projections showing a faster increase in the policy rate from mid 2022 than markets had expected. A few central banks had slowed their government bond purchases in prior months and the US Federal Open Market Committee had indicated in its meeting minutes that discussions to plan such an adjustment could begin at upcoming meetings. These communications were broadly consistent with market expectations.

The US dollar had depreciated since bond markets had stabilised in March and, on a trade-weighted basis, had returned to its level at the start of the year. The Australian dollar continued to trade in a narrow range despite significant movements in some commodity prices over the prior month.

Domestic financial markets

In domestic financial markets, the Bank's policy measures continued to underpin very low interest rates and the provision of credit. The yield on the 3-year Australian Government bond had edged lower over the preceding month to be a little below 10 basis points. The November 2024 Australian Government bond will become the bond with a residual maturity closest to 3 years in early August. Members observed that the yield on this bond implied that market participants did not, on balance, expect the yield target to be extended to that bond in August. Market expectations for the cash rate had been little changed, with market pricing still implying an expectation that the cash rate will begin to be increased from its current level late in 2022 or early in 2023.

The yield on 10-year Australian Government Securities (AGS) had declined slightly over May, but remained around levels of recent months. The spread between yields on 10-year AGS and US Treasuries was still close to zero.

The Bank's bond purchase program had run smoothly, with the second \$100 billion of bond purchases scheduled to be completed in September 2021. Members noted that the Bank was projected to own around 30 per cent of AGS outstanding and around 15 per cent of bonds issued by Australian states and territories outstanding by that time. This was at the lower end of other central banks' ownership share of outstanding government bonds. Members observed that market economists expected an extension of the program, with expectations ranging from a further \$50 to \$100 billion of purchases over the course of the 6 months or so after September.

Bank funding costs and lending rates overall were at historic lows. Draw-downs on the Bank's Term Funding Facility had picked up as the 30 June deadline for accessing the 3-year funding program approached. At the time of the meeting, banks had drawn down \$134 billion and a significant proportion of the remaining \$75 billion still available to banks was expected to be drawn down over subsequent weeks. Members noted that the facility is providing low-cost fixed-rate funding for 3 years, which means that it will continue to support low borrowing costs until mid 2024.

Members observed that the Bank's package of monetary policy measures had led to sizeable declines in mortgage rates, particularly for fixed-rate loans. As a result, the share of fixed-rate mortgages had risen to account for around 30 per cent of the stock of housing credit. Housing credit growth had continued to pick up, with ongoing strong demand from owner-occupiers, especially first-home buyers. Growth in credit extended to investors in housing had also strengthened from low levels. Business lending rates had also declined substantially over the preceding year, although lending to businesses had been little changed. Information from liaison with banks suggested that, while businesses' appetite to borrow had increased somewhat, many businesses had little immediate need to borrow and demand for credit remained uneven.

Members discussed the implications of climate change for monetary policy and the Bank's financial stability mandate through its effects on the economy and the financial system. Members noted that, both in Australia and abroad, the private sector had begun responding to climate risks in a number of ways, including by increasing disclosure of climate-related risks and developing 'green finance' products. Central banks and financial regulators had been actively accounting for climate-related risks in carrying out their policy and regulatory responsibilities. Domestically, the Bank is working closely with other Council of Financial Regulators (CFR) agencies on these issues, with a focus on building the foundations for financial institutions and corporations to understand climate risks and for the effective pricing of these risks by markets. The Australian Prudential Regulation Authority's Climate Vulnerability Assessment is a key CFR initiative that is expected to assist Australian financial institutions with the management of climate risk, and improve the consistency and effectiveness of climate-related disclosures.

Members observed that developments globally relating to the management and regulation of climate-related risk had become increasingly prominent in the asset allocation decisions of international investors. This development could affect the cost and availability of finance for corporations and governments. As a related matter, members observed that taxonomies were being established in a number of economies to provide corporations and investors with a framework to understand whether an activity or financial product is 'sustainable'. Members noted that particular taxonomies could become very influential in global financial markets, and these will have an important bearing on the cost and availability of financing the transition to lower carbon emissions for Australia.

Considerations for monetary policy

In considering the policy decision, members observed that the global economic recovery from the pandemic had continued and the outlook was for strong growth in output in 2021 and the following year. Policy settings and the pace of COVID-19 vaccinations had supported global economic activity, but the recovery remained uneven and the virus had not yet been contained in some countries. Global goods trade had continued to increase strongly and commodity prices remained at higher levels than at the beginning of 2021. Despite the more positive real economic conditions, wages growth and inflation in underlying terms remained low.

Sovereign bond yields had been steady in recent months, after rising earlier in the year in response to the positive news on vaccines and the additional sizeable fiscal stimulus in the United States. Medium-term inflation expectations had increased from around record lows to be closer to central banks' inflation targets. Central banks in major advanced economies had continued to signal that higher inflation would be temporary and restated guidance that they would continue to provide significant monetary policy support until there was evidence of substantial progress towards their goals for employment and inflation.

The economic recovery in Australia was stronger than had been expected, supported by fiscal measures and very accommodative financial conditions. The unemployment rate had fallen more quickly than expected and there had been reports of labour shortages in some parts of the economy. Leading indicators of employment growth, including job vacancies, pointed to ongoing strong employment growth, and the unemployment rate was expected to decline to around 5 per cent by the end of 2021.

Inflation and wage pressures remained subdued, despite the strong recovery in the economy and employment. A pick-up in inflation and wages growth was expected, but this was likely to be only gradual and modest. In the central forecast scenario, inflation in underlying terms was expected to be 1½ per cent in 2021 and 2 per cent in mid 2023. The reversal of some COVID-19-related price reductions would see inflation temporarily rise above 3 per cent in the June quarter before falling back below the target. Members noted that the strong focus on cost containment by businesses meant that it would take some time for spare capacity to be reduced and the labour market to be tight enough to generate wage increases consistent with achieving the inflation target. Moreover, it was likely that

overall wages growth would need to be sustainably above 3 per cent to achieve the target, and this is well above the current level.

Members observed that housing markets had strengthened further, with prices continuing to increase in all major markets. Housing credit growth had increased, with ongoing strong demand from owner-occupiers, especially first-home buyers. Growth in borrowing by investors had also started to increase in recent months, from low levels. Given the environment of strong demand for housing, rising housing prices and low interest rates, members continued to emphasise the importance of maintaining lending standards and carefully monitoring trends in borrowing.

Members agreed that the current package of monetary policy measures continued to support the economy by encouraging an ample supply of credit to the economy and keeping financing costs very low. The 3-year Australian Government bond yield had edged lower but remained consistent with the Board's target of around 10 basis points. Banks' overall funding costs were at historically low levels. Borrowing rates for households and businesses on outstanding loans had continued to drift lower and were also at historical lows. Members noted that, in addition to lowering domestic funding costs, the Bank's policy package had contributed to a lower exchange rate than would otherwise have been the case. Together, monetary and fiscal policy had supported the recovery in aggregate demand and the pick-up in employment.

Members discussed the key considerations for the decisions to be made at the July 2021 meeting on the 3-year yield target and the government bond purchase program. In discussing these considerations, members noted a return to full employment as a priority for monetary policy that would assist with achieving the inflation target. Consequently, monetary policy would be likely to need to remain highly accommodative for some time yet.

Regarding the 3-year yield target, the Board will consider whether to retain the April 2024 bond as the target bond or extend the target to the next maturity, the November 2024 bond. Members had previously agreed that the target of around 10 basis points would be retained. In addition, the Board had previously stated that it would not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. A key consideration for the decision regarding the yield target would be an assessment of the prospect of this condition being met some time in 2024. Members also discussed the likely effect of the decision in relation to the yield target on overall financial conditions.

In relation to the government bond purchase program, the Board would decide upon future government bond purchases at the July meeting ahead of the completion of the second \$100 billion of purchases in early September 2021. The options discussed included ceasing purchasing bonds in September (other than to support the yield target if necessary); repeating \$100 billion of purchases for another 6 months; scaling back the amount purchased or spreading the purchases over a longer period; and moving to an approach where the pace of the bond purchases is reviewed more frequently, based on the flow of data and the economic outlook.

Key considerations for the decision in July would be the progress made towards the Board's goals for employment and inflation, and the likely effect of different options on overall financial conditions. Observing that the bond purchase program had been one of the factors underpinning the accommodative conditions necessary for the economic recovery, members thought it would be premature to consider ceasing the program.

The Board remained committed to doing what it reasonably could to support the Australian economy, and would maintain highly supportive monetary conditions until its goals for employment and inflation were achieved. Members affirmed that the cash rate target would remain at 10 basis points, and the rate of remuneration on Exchange Settlement balances at zero, for as long as necessary. The Board would not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth would need to be materially higher than it is currently. This would require significant gains in employment and a sustained return to a tight labour market. The Board viewed these conditions as unlikely until 2024 at the earliest.

The decision

The Board reaffirmed the existing policy settings, namely:

- a target for the cash rate of 0.1 per cent
- an interest rate of zero on Exchange Settlement balances held by financial institutions at the Bank
- a target of around 0.1 per cent for the yield on the 3-year Australian Government bond
- the purchase of an additional \$100 billion of government bonds at the same rate of \$5 billion per week following completion of the first bond purchase program of \$100 billion
- the expanded Term Funding Facility to support credit to businesses, particularly small and medium-sized businesses, with an interest rate on new drawings until 30 June 2021 of 0.1 per cent.

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