



RESERVE BANK OF AUSTRALIA

Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Videoconference – 3 August 2021

Members present

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

Others participating

Luci Ellis (Assistant Governor, Economic), Christopher Kent (Assistant Governor, Financial Markets)

Anthony Dickman (Secretary), Penelope Smith (Deputy Secretary), Michele Bullock (Assistant Governor, Financial System), Alexandra Heath (Head, International Department), Bradley Jones (Head, Economic Analysis Department), Jonathan Kearns (Head, Financial Stability Department), Marion Kohler (Head, Domestic Markets Department)

International economic developments

Members commenced their discussion of international economic developments by noting that the global economy had continued to recover from the largest contraction in decades, supported by a substantial fiscal and monetary policy response and the easing of measures to contain the virus in some countries. There were widening gaps in the outlook across economies, however, which largely reflected differences in health outcomes and progress with the vaccination of populations. Higher vaccination rates and the associated relaxation of containment measures had enabled a rapid recovery in several advanced economies, but in countries with low vaccine coverage, the rapid spread of the Delta variant of COVID-19 was tempering the economic outlook. Access to vaccines was an ongoing concern for some emerging market countries and high case numbers were putting health systems under considerable strain.

The medium-term outlook for Australia's major trading partners generally remained solid. The Chinese economy continued to grow in line with pre-pandemic expectations. In a number of economies in Asia, strong global demand for goods had led to stronger export growth and increased investment in manufacturing capacity, although a resurgence of the virus and restrictions on activity in some countries were weighing on domestic demand. The recovery was expected to continue in countries in North

America and Europe where progress with vaccination programs allowed for an easing of containment measures. Fiscal settings remained highly stimulatory in the United States.

Members noted that substantial spare capacity remained in most advanced economies' labour markets, despite the strong recovery in economic activity. In contrast to Australia, employment, participation rates and hours worked remained well below pre-pandemic levels in many countries. Lower labour force participation in some countries reflected the impact of prolonged school closures on child care responsibilities, lingering health concerns and ongoing provision of wage subsidies.

Headline inflation had picked up in a number of advanced economies. However, this was in large part the result of pandemic-related disruptions, including supply chain bottlenecks and unusually high shipping costs, which were likely to be temporary. Members observed that there were both upside and downside risks to global inflation in the near term, and that the outlook for inflation in the medium term would largely depend on how quickly spare capacity in labour markets was absorbed and how wages responded to this.

Domestic economic developments

Turning to domestic economic developments, members noted that the recovery had established strong momentum prior to recent outbreaks of the Delta variant of COVID-19. GDP had recovered to its pre-pandemic level in the March quarter and timely indicators suggested that growth in private demand had remained strong in the June quarter. Labour market conditions had also strengthened further in the June quarter.

More recently, outbreaks of the Delta variant and accompanying lockdowns had introduced a high degree of uncertainty to the outlook for the second half of 2021. Members observed that economic activity and employment were expected to decline in the September quarter. The high transmissibility of the Delta variant raised the possibility that a more gradual reopening of the economy in affected areas would be needed compared with earlier episodes of lockdown restrictions. Under the assumption that further lengthy lockdowns would be limited, the economy was forecast to rebound from the current setback later in the year as restrictions are eased, consistent with the previously observed pattern in Australia and overseas.

Members noted that the prospects for recovery beyond the effects of the recent virus outbreaks are supported by a number of factors. These include the underlying momentum in the economy and strengthened balance sheets prior to the recent virus outbreaks, the substantial fiscal support offered to households and businesses in areas affected by lockdowns, progress with the vaccination rollout and the ability of the economy to adapt. In the meantime, health outcomes would continue to present the main source of uncertainty for the economic outlook.

Beyond the near term, the level of output at the end of the forecast period in 2023 was expected to be a little higher than had been forecast in May, underpinned by stronger private investment and public

demand. Under the baseline scenario, GDP was forecast to grow by a little above 4 per cent over 2022, and around 2½ per cent over 2023.

Members noted that household spending had been tracking strongly in the months prior to the recent lockdowns. Consumption had continued to recover over April and May before restrictions affected spending in June. Timely indicators suggested that household consumption would contract in the September quarter in response to the extended lockdown in Greater Sydney and the shorter lockdowns elsewhere. This was expected to account for much of the quarterly decline in GDP. Later in 2021 and early the following year, consumption was forecast to recover in affected areas. The outlook for consumption in 2022 and 2023 was expected to be supported by increased opportunities for spending on discretionary services as restrictions are eased, together with higher household income and wealth. The household saving ratio was expected to increase temporarily in the September quarter, reflecting reduced consumption in areas affected by the lockdowns, before declining steadily thereafter.

The outlook for dwelling and business investment would continue to be supported by accommodative financing conditions and fiscal policy measures. Recent lockdowns and restrictions on construction activity in Greater Sydney and elsewhere were anticipated to affect both residential and non-residential investment in the September quarter, but this was generally expected to lead to plans being deferred rather than cancelled. Residential building approvals had eased, as expected, following the end of the application period for the HomeBuilder program. However, approvals remained at a high level and the large volume of residential building work in the pipeline was likely to support dwelling investment for some time. The recovery in non-mining investment over the forecast period was expected to be led by spending on machinery and equipment, underpinned by tax incentives, high levels of business confidence, declining spare capacity and strong business balance sheets. Mining investment was at its highest level since 2017 and a further gradual increase was expected over the forecast period, mainly to replace existing capacity. Growth in mining investment was likely to be modest relative to the very high levels of commodity prices.

Members noted that conditions in established housing markets remained strong, in contrast to the experience during the extended lockdowns in 2020. National housing prices had increased further in July following a 6 per cent increase in the June quarter. Prices for detached houses and units in Sydney had continued to increase in July despite the lockdowns. Owner-occupiers had accounted for a large share of purchases in the period to mid 2021, but investor activity had picked up in recent months. The number of newly listed properties for sale had declined recently; however, online auctions were reported to have become more common and sales activity had held up well compared with the experience during the lockdowns in 2020. Members also noted that advertised rents for houses had continued to increase in recent quarters. In regional areas and smaller cities, growth in rents had been strong and vacancy rates remained very low. Rental conditions in apartment markets in Sydney and Melbourne had begun to stabilise following the earlier decline in rents.

Members observed that labour market conditions had continued to improve at a faster-than-expected pace through the June quarter. The unemployment rate had declined to 4.9 per cent in June and labour

force participation remained around record highs. The rate of underemployment was around its lowest level in a number of years. Growth in full-time employment had been particularly strong. Job vacancies had been at record high levels and there had been ongoing reports of labour shortages in parts of the economy.

Improvements in labour market conditions were expected to reverse temporarily in the September quarter as a result of the lockdowns in Greater Sydney and other parts of the country. The restrictions on activity were expected to result in a substantial decline in average hours worked. Labour force participation was also expected to decline for a period as people delayed searching for work while restrictions on mobility remain in place, as had been seen during previous lockdowns. Some employment losses were expected, although a fall in labour force participation was anticipated to limit the increase in the unemployment rate. The high level of job vacancies and increased fiscal support would also help limit job losses. However, much would depend on health outcomes and the duration of the lockdowns.

Looking further ahead, members noted that the eventual lifting of restrictions and underlying strength in economic conditions are expected to result in the labour market recovery regaining momentum. In the baseline scenario, the unemployment rate was forecast to decline to around 4¼ per cent by the end of 2022 and to 4 per cent by the end of 2023, which was lower than previously forecast. Members noted that, in the preceding half-century, this was a level that had been reached only briefly during the mining investment boom and in the early 1970s, when the structure of the economy had been very different.

With the unemployment rate expected to decline to a lower level than previously forecast, wages growth and inflation were also expected to pick up at a slightly faster pace. The Wage Price Index was forecast to increase gradually to around 2¾ per cent by the end of 2023, and broader measures of growth in labour costs were expected to be running at a slightly faster pace by that time.

CPI inflation increased to 3.8 per cent over the year to the June quarter, although most of this increase reflected the reversal of earlier large falls in certain prices related to the pandemic. Much of the 0.8 per cent increase in the June quarter was accounted for by large increases in the prices of fuel and fruit and vegetables, and the unwinding of earlier electricity rebates. Members observed that there would continue to be some divergence between headline and underlying inflation as some of the recent one-off boosts to inflation were unwound. Underlying inflation had stabilised recently, and was a little below ½ per cent in the June quarter and 1¾ per cent over the year. Underlying inflation was likely to remain subdued over subsequent quarters, given the expected decline in activity in the September quarter and the absence of broad-based inflationary pressures, and then gradually increase to 2¼ per cent by the end of 2023.

Members discussed the balance of risks to the forecasts. The baseline scenario assumed that the domestic vaccine rollout would accelerate in the months ahead, reducing the frequency and severity of lockdowns and allowing the international border to be reopened gradually from mid 2022. It also assumed that the Greater Sydney lockdown would extend through the September quarter, with some

further brief and/or less severe restrictions assumed to occur in parts of Australia in the December quarter.

A downside scenario assumed more extended and widespread lockdowns and a more gradual reopening of the international border than in the baseline scenario. In this scenario, restrictions on the consumption of discretionary services, coupled with precautionary behaviour, would be expected to result in a higher rate of household saving and lower household consumption. Private investment and services exports would also be lower. Lower activity would result in the unemployment rate rising in subsequent months and remaining above 5 per cent over coming years. In this scenario, underlying inflation would be expected to remain in the range of 1¼–1½ per cent through to 2023.

Members also considered an upside scenario premised on the assumption that the virus would be contained more quickly than in the baseline scenario, with household consumption and private investment increasing rapidly once containment measures are lifted. In this scenario, households would be more willing and able to consume out of their savings and wealth than in the baseline scenario, supported by higher household income and fewer restrictions on discretionary services. International travel would recover more quickly once the international border was reopened, boosting services exports. In this scenario, the unemployment rate would be expected to decline more rapidly and by more than in the baseline scenario, with inflation increasing to the upper half of the target range by the end of 2023.

International financial markets

Yields on longer-term government bonds had fallen over preceding months in many countries, as optimism about the global recovery was tempered by the rapid spread of the Delta variant of COVID-19 and the risks of future variants emerging. This had unwound much of the increase in yields seen globally earlier in the year, which had reflected a faster-than-expected economic recovery and a rise in inflation expectations to be more consistent with central banks' inflation targets. Much of the recent declines in longer-term bond yields in the United States and Australia had reflected declines in real yields.

Despite the renewed concerns over the pace of the global economic recovery, market pricing implied that the expected path of central bank policy rates was still higher than at the start of the year. Some central banks were widely expected to lift policy rates before the end of 2021 because they were nearer to their inflation goals, while other central banks were not expected to raise their policy rates for a number of years.

Several central banks had reduced their purchases of government bonds, or were soon expected to do so. Members observed that the Reserve Bank of New Zealand had halted its asset purchases in July and market pricing implied that it was expected to start raising the policy rate before the end of 2021. This had followed stronger-than-expected data, which suggested that capacity constraints were evident in the New Zealand economy.

Financing conditions for businesses in advanced economies had remained highly favourable. In corporate bond markets, spreads to risk-free rates had remained low and bond issuance had remained around, or in some cases above, pre-pandemic levels. Equity prices had remained high in these countries, including Australia. Share prices in the United States and Europe had been supported by recent positive earnings reports.

In China, equity prices had fallen sharply following a tightening of regulations on private-sector companies in the technology and education sectors. More broadly, financial conditions in China had been supported by an unexpected reduction in reserve requirements for banks. By contrast, some other emerging market central banks had started to raise their policy rates in response to rising inflation, despite slow recoveries in output.

The US dollar had appreciated against most currencies over the preceding couple of months. The Australian dollar had correspondingly depreciated to around its lowest levels in 2021. Members noted that this had occurred despite commodity prices being at high levels.

Domestic financial markets

In Australia, the Bank's policy measures continued to underpin very low interest rates. Members observed there had been little movement in yields following the announcement of the Board's decisions in July to maintain the yield target for the April 2024 bond and to continue purchasing government bonds, following the completion of the current program in early September 2021, at a reduced rate of \$4 billion per week until at least mid November 2021.

With the ongoing lockdowns and other containment measures affecting economic conditions and the outlook in the near term, yields on longer-term Australian government bonds had declined by a little more than those globally, to be back around early 2021 levels. A number of market economists had suggested that the Board might reconsider its decision to taper bond purchases. Market pricing continued to imply expectations that the cash rate would increase to around 25 basis points in the second half of 2022, but the expected path thereafter was a little lower than it had been a month earlier.

Members discussed the fact that banks' funding costs and lending rates had drifted down to new lows. Funding costs had benefited from significant final drawdowns from the Term Funding Facility in June and deposit rates having edged down further. In turn, average interest rates on outstanding housing and business loans had also continued to drift lower.

Credit growth had picked up in June for both households and businesses, although members noted that these data largely predated the recent lockdowns. Firms' demand for credit had picked up strongly in June, with sizeable contributions from large and medium-sized businesses. This potentially reflected the pick-up in business confidence in preceding months and followed subdued demand over much of the previous year. Demand for housing finance had strengthened further in June, with growth in housing credit rising to nearly 6¾ per cent on a six-month-ended-annualised basis. Overall, it appeared that

banks' lending standards were being maintained. Non-bank housing credit growth had been particularly strong over recent months, with non-bank lenders benefitting from favourable conditions in securitisation markets.

Members noted that measures to contain the virus in a number of states might result in a reduction in demand for new loans from July, particularly if these measures remained in place for an extended period. Banks had offered support to household and business borrowers affected by the lockdowns, and the Australian Prudential Regulation Authority had provided regulatory relief for these support measures, as it had done in 2020.

Considerations for monetary policy

In considering the policy decision, members observed that the recent outbreaks of the Delta variant of COVID-19 had interrupted the recovery and that the near-term outlook was highly uncertain and dependent on health outcomes. However, the economy had entered the current episode of outbreaks and lockdowns with more momentum than previously expected, and fiscal and monetary policy support was already cushioning the economic effects. Domestic financial conditions remained highly accommodative and the fiscal responses by the Australian Government and the state and territory governments were providing welcome support to the economy at a time of significant short-term disruption.

Experience to date had been that, once virus outbreaks were contained, the economy bounced back quickly. The vaccination program would assist with containment of the virus and longer-term economic recovery. Although uncertainty had increased, the central scenario was still that the Australian economy would grow strongly again next year. Prior to the recent outbreaks, the labour market recovery had been stronger than expected. Job vacancies had been high and there had been ongoing reports of labour shortages in parts of the economy. The unemployment rate was expected to increase in the near term, but then recover quickly when restrictions are eased and trend lower over 2022 and 2023 to reach around 4 per cent at the end of 2023.

Members observed that wages growth and underlying inflation would remain subdued for some time yet, despite the positive medium-term outlook for output and employment. Headline inflation had spiked to be temporarily above the target in the June quarter as earlier pandemic-related price declines were unwound. But, in underlying terms, inflation remained low. A pick-up in both wages growth and underlying inflation was expected, but this pick-up was likely to be only gradual. In the Bank's central scenario, it would take some years for the stronger economy to feed through into wage and price increases that would be consistent with the inflation target. Australia had no recent experience of unemployment rates that had been sustained at the low levels being forecast. A significant source of uncertainty was how wages and prices would behave at these low levels of unemployment.

Members noted that housing markets had continued to strengthen, with prices rising in all major markets. Housing credit growth had also increased. 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.

The Board remained committed to maintaining highly accommodative monetary conditions to support a return to full employment in Australia and inflation consistent with the target. Together, the low level of the cash rate, the bond purchase program, the yield target and the ongoing funding that had been provided under the Term Funding Facility were providing substantial support to the Australian economy in the face of the current lockdowns and the expected resumption of the economic expansion.

At its July meeting, the Board had decided to continue with the bond purchase program at a reduced rate of \$4 billion a week, once the second \$100 billion of purchases is complete in September 2021. This adjustment reflected the better-than-expected progress that had been made towards the Bank's goals and the improved outlook. The Board had agreed in July to keep the rate of bond purchases under review and adjust the rate of purchases in either direction as appropriate.

The current virus outbreaks and lockdowns had interrupted the recovery and many households and businesses were facing difficult conditions. Members therefore considered the case for delaying the tapering of bond purchases to \$4 billion a week currently scheduled for September 2021. They noted that the outlook for the economy is for a resumption of strong growth in 2022. Members judged that any additional bond purchases would have their maximum effect at that time, with only a marginal effect at present, which is when the extra support might be required.

Recognising that fiscal policy is a more appropriate instrument than monetary policy for providing support in response to a temporary, localised reduction in incomes, members welcomed the substantial fiscal measures that had been announced. Given these considerations, the Board reaffirmed the previously announced change in the rate of bond purchases. That said, the bond purchase program will continue to be reviewed in light of economic conditions and the health situation, and their implications for the expected progress towards full employment and the inflation target. The Board would be prepared to act in response to further bad news on the health front should that lead to a more significant setback for the economic recovery. In any event, the Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024. Meeting this condition will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently.

The decision

The Board reaffirmed the existing policy settings, namely:

- maintain the cash rate target at 10 basis points and the interest rate on Exchange Settlement balances of zero per cent
- maintain the target of 10 basis points for the April 2024 Australian Government bond

- continue to purchase government securities at the rate of \$5 billion a week until early September 2021 and then \$4 billion a week until at least mid November 2021.

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