



RESERVE BANK OF AUSTRALIA

Minutes of the Monetary Policy Meeting of the Reserve Bank Board

Videoconference – 5 October 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

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

Anthony Dickman (Secretary), Penelope Smith (Deputy Secretary), 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 recovery in economic activity in advanced economies had continued in recent months. High vaccination rates had allowed restrictions on activity to be eased, which was supporting business conditions and, in turn, the demand for labour. Labour shortages were being reported in some countries, constraining hiring and boosting wages growth in certain industries, including in customer-facing areas such as hospitality. Labour force participation was still well below pre-pandemic levels in a number of large advanced economies, including the United States, the euro area and the United Kingdom. With students physically returning to school and health concerns abating, members thought it would become clearer in coming months whether workers had left the labour force temporarily or permanently.

Members noted that patterns in wages growth differed across advanced economies. Some economies that were experiencing a pick-up in wages growth, such as the United States and the United Kingdom, were also those that had experienced relatively fast wages growth and higher inflation prior to the pandemic. Employment was still well below pre-pandemic levels in these countries. In New Zealand, wages growth had also picked up in prior months, which was consistent with the Reserve Bank of New Zealand's assessment that spare capacity had largely been absorbed. The more modest wages growth in

Canada and the euro area was consistent with ongoing spare capacity in labour markets in these economies.

Members noted that the combination of strong demand for goods globally, supply bottlenecks and rising energy prices had caused measures of producer price inflation to increase to their fastest rate in many years. The prices of energy-related commodities, including liquefied natural gas (LNG) and thermal coal, were well above the levels prevailing at the start of the year; this reflected low inventories and strong demand, including from a weather-related boost to electricity production in the northern hemisphere and strong global goods production. Coal and LNG prices had also been supported by supply disruptions in Europe and Asia.

The pass-through of higher producer price inflation to underlying consumer price inflation had varied across countries. Increases in consumer price inflation had been most apparent in some large emerging market economies. Headline consumer price inflation in advanced economies remained high, though underlying measures of inflation had not risen to the same extent. Most central banks in advanced economies had continued to characterise pandemic-related price increases as either temporary or one-off price level changes that would have only a transitory effect on inflation.

Members discussed the slowing in economic activity in China over recent months, including the role of policies to reduce overall debt levels and emissions, as well as the effects of the pandemic. The previously announced caps on Chinese steel production and concerns about excess leverage in China's property sector had put further downward pressure on iron ore prices. However, onshore coal prices had surged as a result of strong demand, low inventories and domestic supply disruptions. More generally, members noted that renewed focus in China on achieving 'common prosperity', combined with a range of regulatory actions, had created more uncertainty about the medium-term outlook for policy settings and the economy in China. Some observers had interpreted these developments as an attempt to curtail the influence of the private sector, while others saw it more as the next stage of long-running strategies to reduce poverty and corruption and to promote social fairness.

Elsewhere in east Asia, economic conditions had been adversely affected by surges in COVID-19 cases and the reintroduction of containment measures through July and August. However, rising vaccination rates and declining case numbers in recent weeks had allowed for restrictions to be eased. Growth in goods exports continued to be very strong among the more export-oriented economies, with surveyed manufacturing conditions remaining strong in all the advanced Asian economies.

Domestic economic developments

Turning to the domestic economy and the outlook, members noted that the rapid increase in vaccinations, particularly in states with outbreaks of the Delta variant of COVID-19, would see restrictions on activity eased sooner than previously expected. The international border was also set to begin reopening earlier than had been assumed. In addition, the publication of roadmaps by some states had provided more clarity over the sequencing and pace of economic reopening. Information

from the Bank's liaison program indicated that many firms were preparing for the lifting of restrictions, and timely indicators of household spending and hiring intentions suggested the recovery in activity and employment would be well under way by the end of the year. Members noted that surveys of business and consumer sentiment had been fairly resilient during the recent lockdowns. In the central scenario, the economy was expected to have returned to its pre-Delta path by the second half of 2022. Nonetheless, members acknowledged that the recovery was likely to be uneven across the economy and that uncertainty would be a feature of the outlook for some time yet.

Timely data on mobility and spending indicated that consumption had stabilised in the latter part of the September quarter, following the sharp contraction beginning in June. The household saving ratio was expected to have increased sharply in the quarter, with lockdowns limiting households' ability to purchase many goods and services (particularly discretionary services). At the same time, pandemic assistance payments by the Australian Government and state and territory governments had supported the incomes of households that had experienced job losses or whose members were working reduced hours. The lifting of restrictions in New South Wales and Victoria was expected to lead to a solid recovery in household consumption in the December 2021 and March 2022 quarters. This would be supported by high accumulated savings, strong increases in household wealth and a rebound in employment. Even so, households' consumption of discretionary services was not expected to return to pre-pandemic levels until 2022.

Members observed that national housing market conditions remained very strong, with established housing prices continuing to rise rapidly. In Sydney, where private property inspections had been permitted, the volume of transactions remained relatively high. Meanwhile, in Melbourne, new listings and transaction volumes had declined significantly following the imposition of tighter restrictions on in-person inspections. Approvals for new dwellings, as well as for alterations and additions, had remained high across the country despite the end of the HomeBuilder application period. This was supporting the large pipeline of residential construction activity, which was expected to support dwelling investment over the following year despite some delays from disruptions in the September quarter. Approvals for private non-residential buildings had also increased in prior months, led by the office and industrial sectors, which was expected to support construction activity in the period ahead.

Members noted that restrictions on activity continued to have a significant effect on the labour market. Total hours worked had declined further in August to be 4 per cent below their June level. In New South Wales, hours worked had fallen by 13 per cent since June. The decline in employment had been more moderate, indicating that many employees had worked reduced hours but had not lost their jobs during the recent lockdowns. This included a large number of people who had been stood down on zero hours. The participation rate had declined further in August (reflecting a very large decline in New South Wales) as many of the people who had ceased being employed were classified as having left the labour force rather than as unemployed. As a result, the unemployment rate had been little changed at 4.5 per cent. Broader measures of labour underutilisation, which captured people working zero or reduced hours and net flows out of the labour force, had increased sharply since the middle of the year.

Forward-looking indicators of labour demand had been much more resilient than they had been during the lockdowns in 2020. The overall level of job advertisements remained high. There were indications that some firms in New South Wales were preparing to step up hiring ahead of the easing of restrictions in October. In addition, information from the liaison program continued to suggest that firms affected by the lockdowns had been reluctant to lay off staff given their experiences with labour shortages and strong labour demand prior to the Delta outbreak. Members noted that the central forecast scenario envisaged the level of employment, unemployment and participation to have broadly recovered to pre-Delta levels by around the end of the year, although there was considerable uncertainty around this projection.

In discussing the ongoing modest wages growth in Australia, members noted that the recent lockdowns and earlier reports of labour shortages had not appeared to affect most firms' expectations for wages growth, which were generally returning to around pre-pandemic norms. While reduced labour force participation had seen some countries experience wage pressures before employment had returned to pre-pandemic levels, this was not the case in Australia. Even in industries that had experienced strong labour demand, wages growth remained subdued. In reviewing wages growth across different types of wage-setting arrangements, members noted that a small share of people on individual agreements had received larger wage increases over recent quarters, in part reflecting earlier wage cuts that had been reversed. Overall, there were few indications from disaggregated wages data or from the Bank's liaison program to suggest that aggregate wages growth was likely to accelerate sharply in the period ahead.

Members concluded their discussion of domestic economic developments by observing that underlying inflation pressures in Australia were more moderate than in other advanced economies. This reflected a range of factors, including the relatively slow rate of wages growth in Australia. Members noted that, while it was possible that underlying inflationary pressures in Australia could build more quickly than currently envisaged, the central forecast scenario was still that domestic inflation would pick up only gradually over the medium term.

International financial markets

Members commenced their review of developments in international financial markets with a discussion of Evergrande, a large private Chinese property developer. Recent developments in Evergrande's financial position had led to a decline in risk sentiment across global financial markets in September. While Evergrande is small relative to the financial system in China, members noted a financial stability risk from spillovers to other developers and financiers if the resolution of Evergrande's problems were to be disorderly. Some other property developers had also experienced restrictions on their ability to borrow under China's 'three red lines' policy because they had some combination of high leverage, high gearing or low liquidity ratios. Members noted that a deterioration in confidence in developers could see a sharp withdrawal of credit provided to the sector and a decline in pre-sales, placing them under further stress. However, sharp price movements had so far been limited to Evergrande's own bond and equity prices, along with those of some other Chinese property developers and the equity prices of a small number of banks with large exposures to Evergrande. Broader financial conditions in China had

been stable, aided by liquidity injections from the central bank. Chinese authorities had also taken a number of steps to support credit growth to smaller private enterprises, which had slowed in recent months. The renminbi exchange rate had remained around its highest level in recent years.

Central banks in advanced economies had continued to provide significant policy stimulus. Some central banks had begun to reduce the extent of their policy stimulus, or were expected to do so over the coming year as the economic recovery progressed. Members noted that central banks' policy decisions had been informed by how close they were to achieving their policy goals. Although inflation had been above central banks' targets in most advanced economies and energy prices had risen noticeably in preceding months, inflationary pressures were generally expected to ease over time as supply constraints were resolved. Even so, inflationary pressures had been more persistent than previously expected in some countries, including the United States and the United Kingdom, and the rate of wages growth had picked up noticeably in some countries. This had led to an increase in long-term government bond yields and upward revisions in the path for policy rates implied by market pricing.

The Bank of Korea and Norges Bank had already increased their policy rates, and market pricing implied that the Reserve Bank of New Zealand was expected to increase its policy rate in the coming days. Market participants expected the Bank of England and the Bank of Canada to cease net purchases of government bonds by the end of 2021. Persistent inflationary pressures related to rising energy prices and labour shortages had brought forward the timing of the Bank of England's first policy rate increase implied by market pricing to early 2022. The US Federal Reserve (Fed) had indicated that it was likely to begin moderating the pace of its asset purchases in November, with an intention to cease net purchases by mid 2022. Market pricing implied that the Fed could start raising its policy rate in late 2022 or early 2023, consistent with the 'dot plot', which summarises Federal Open Market Committee participants' outlook for the federal funds rate.

Financing conditions for businesses in advanced economies had remained very favourable. Equity markets had remained close to recent highs, despite declines over the preceding month in response to concerns about the Chinese property sector and the rise in sovereign bond yields in advanced economies. Corporate bond spreads had remained low.

The Australian dollar had depreciated since mid 2021, to be around 3 per cent lower on a trade-weighted basis than at the start of the year. The depreciation from the middle of the year had been consistent with the decline in yields on Australian government bonds compared with those of other major advanced economies and, more recently, concerns around slowing momentum of the Chinese economy.

Members discussed the shift in Australia's balance of payments, including the large current account surplus. They noted the decline in private investment as a share of GDP following the mining investment boom and the large increase in private savings during the pandemic.

Domestic financial markets

The Bank's policy measures continued to underpin very low domestic interest rates. Members noted that, following the Board's decision in the previous month to proceed with the reduction in the pace of bond purchases to \$4 billion per week, and to maintain this pace until at least mid February 2022, bond yields had declined slightly and the Australian dollar exchange rate had depreciated a little. Subsequently, yields had risen, broadly in line with those in the United States. Market pricing implied that the first increase in the cash rate was expected around the end of 2022.

Banks' funding costs and outstanding lending rates had continued to drift down to new lows. New loans were being taken out at historically low rates, and existing borrowers were benefiting from refinancing at lower available rates. Loan commitments had remained high in August and growth in housing credit had picked up further in six-month-ended terms. Growth in business debt had picked up over recent months to the fastest pace since prior to the global financial crisis. This growth had been driven by large businesses, with debt of small businesses little changed in recent months. While banks had been open to providing loan payment deferrals to borrowers affected by lockdowns, take-up by households and small and medium-sized businesses had been very modest, in stark contrast to the experience of 2020.

Financing conditions in bond markets remained very favourable. Members observed that bank bond issuance had picked up a little in prior months, after having been subdued while banks drew down on the three-year funding provided by the Term Funding Facility. Issuance of residential mortgage-backed securities had also been strong, with the highest quarterly amount issued since the financial crisis. Corporate bond spreads remained very low, and corporate debt issuance had been robust.

Australian equity prices had declined over the preceding month, but remained close to recent highs. Prices of mining stocks had declined noticeably, following the sharp drop in iron ore prices, while stocks of companies exposed to travel had picked up as plans for the reopening of borders became clearer.

Financial stability

Members were briefed on the Bank's regular half-yearly assessment of financial stability risks.

Banks in advanced economies continued to be well capitalised, with ample liquid assets, and remained able to support the economic recovery. Profitability of large banks had increased, in part because new provisions for loan losses had fallen sharply and some banks had reduced their existing provisions for loan losses. Banks' capital ratios had increased with the higher profitability; Common Equity Tier 1 ratios were around 60 to 140 basis points higher than a year earlier, in part reflecting restrictions on capital distributions imposed by regulators during 2020. Given the improvement in economic conditions in advanced economies, regulators had begun to remove these restrictions on capital distributions and reduce regulatory relief. Many large banks had announced share buyback plans and increased dividends.

In China, authorities had continued to balance addressing increased financial system vulnerabilities with avoiding a realisation of those vulnerabilities that would sharply lower economic growth. This trade-off had been a feature of the significant focus on the liquidity crisis facing Evergrande. More generally, the

number of adjustments to policy occurring simultaneously had increased the potential for unintended outcomes.

In some emerging market economies, output remained below pre-pandemic levels, reflecting pre-existing macroeconomic and financial imbalances as well as lower vaccination rates and increases in COVID-19 cases, which had curtailed economic activity. These economies could face capital outflow and exchange rate depreciation if their interest rates did not increase alongside the increases expected in advanced economies; however, higher interest rates in emerging market economies would risk further delaying the economic recovery. Either sharp capital outflow and exchange rate depreciation or a sharp fall in output could trigger financial instability in these economies.

Low long-term sovereign interest rates and optimism about business incomes had contributed to high prices of financial assets and increased risk-taking. Some asset prices did not appear to reflect the risk to economic activity still presented by the pandemic. There could be widespread asset price falls if there were sharp increases in risk premiums or risk-free interest rates from unexpected inflation.

In many economies, there had been further significant rises in housing prices over the preceding six months. Low interest rates, in combination with strong household balance sheets as a result of limited consumption opportunities and government transfers, had contributed to these price rises. Regulators in some countries had indicated that housing prices had risen beyond the level suggested by their fundamental determinants, although in many countries growth in housing prices appeared to have peaked. Housing credit had grown faster than incomes in a number of countries and housing credit growth was around post-2008 highs in Canada, New Zealand, the United Kingdom and the United States. Some regulators had highlighted high household indebtedness and/or a rise in risky lending as a vulnerability, and macroprudential policies had been tightened in Canada, South Korea and New Zealand.

In Australia, households' balance sheets had strengthened over the first half of 2021, prior to the lockdowns brought on by the outbreak of the Delta variant of COVID-19. Households had been using accumulated higher savings to make excess home loan repayments into redraw and offset facilities. But there had also been a substantial rise in other deposits. Growth in household borrowing had increased, with aggregate household debt growing faster than income.

Housing loan commitments had increased strongly in the first half of 2021, but had declined slightly since mid year. Recent levels of loan commitments suggested that housing credit growth could reach a six-month-ended annualised rate of around 10 per cent by early 2022. Lending standards had remained sound, although the share of lending at high debt-to-income ratios had increased.

Given the build-up of risks associated with high and rising household indebtedness, the Australian Prudential Regulation Authority (APRA) had been in close consultation with the Bank and other agencies of the Council of Financial Regulators about an appropriate macroprudential policy response. Analysis suggested that these risks would be best addressed with a serviceability-based macroprudential measure, which would ensure that borrowers would have more income left over after home loan

repayments and other expenses. Other options that could be used to improve borrowers' buffers would be portfolio restrictions on individual lenders' shares of lending at high debt-to-income ratios and/or high loan-to-valuation ratios. APRA was scheduled to publish a macroprudential policy framework paper later in the year, which would outline the objectives for macroprudential policy, as well as the broad range of tools available to address different risks and how they could be implemented. The Bank would also shortly publish a special chapter on macroprudential policy in the October Financial Stability Review.

Business balance sheets were generally in a good position prior to the outbreak of the Delta variant. Most businesses had increased their liquidity buffers over 2020, with low interest rates providing support. Government payments and other measures, such as loan deferrals and rent moratoria, had also boosted cash flows for firms adversely affected by lockdowns. In aggregate, profits had increased in the first half of 2021 as the economy rebounded strongly; however, some firms were vulnerable as the ongoing restrictions had constrained their activity and, as a result, insolvencies were likely to rise.

The Australian financial system remained resilient. The loan-to-valuation ratios on most outstanding home loans meant that banks would be well protected against even large housing downturns. Expectations of heightened losses across all loans, which were formed early in the pandemic, were now unlikely to be realised. As a result, banks had started to release provisions, although at a gradual rate because of the uncertainty around the effects of the recent lockdowns. These factors had contributed to an increase in profits over the first half of 2021, which had returned to pre-pandemic levels. An increase in net interest margins had also contributed. Australian banks' capital ratios were well above regulatory requirements and were expected to remain above those requirements even after increased dividends and share buybacks.

Other risks to the Australian financial system continued to require ongoing vigilance. In particular, risks from IT systems remained acute and, in recognition of this, financial regulators had been working with financial institutions to bolster their cyber resilience. Financial institutions and regulators were also continuing to work on managing financial risks from climate change.

Considerations for monetary policy

In considering the policy decision, members observed that the outbreak of the Delta variant of COVID-19 had interrupted the recovery of the Australian economy and the available data pointed to a material decline in GDP in the September quarter. However, the setback was expected to be only temporary, with the economy anticipated to bounce back as vaccination rates continue to rise and restrictions are eased. In the central scenario, the economy would return to growth in the December quarter and to its pre-Delta path in the second half of 2022. Members also observed that the economic recovery was likely to be slower than in late 2020/early 2021. Much would depend on health outcomes and the nature and timing of the easing of restrictions on activity.

Wage and price pressures in Australia remain subdued. Members noted that while disruptions to global supply chains were affecting the prices of some goods, the effect of this on the overall rate of inflation

in Australia was limited. Wages growth and underlying inflation were expected to pick up only gradually as the economy recovers.

The Bank's package of policies – including record low interest rates, the bond purchase program, the yield target and the funding provided under the Term Funding Facility – was providing substantial and ongoing support to the Australian economy. Borrowing rates were at record lows, sovereign bond yields were at very low levels and the exchange rate had depreciated over prior months. The fiscal responses by the Australian Government and the state and territory governments had also been providing welcome assistance to household and business balance sheets.

Housing prices and credit growth had continued to rise strongly at a time of historically low interest rates, with strong demand for credit by both owner-occupiers and investors. Given the environment of rising housing prices and low interest rates, members continued to emphasise the importance of maintaining lending standards and agreed that loan serviceability buffers were appropriate. Members also agreed that, while less accommodative monetary policy would, all else equal, see lower housing prices and credit growth, it would result in fewer jobs and lower wages growth, which would in turn create further distance from the goals of monetary policy – namely, full employment and inflation sustainably within the target range.

The Board remained committed to maintaining highly supportive monetary conditions to achieve a return to full employment in Australia and inflation consistent with the target. It 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 materially higher wages growth than at the time of the meeting.

The decision

The Board decided upon the following policy settings:

- 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 \$4 billion a week until at least mid February 2022.

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