Overview

Monetary policy was eased in 2019 to support employment and income growth and to provide greater confidence that inflation will be consistent with the medium-term target. This policy response is supporting the overall growth outlook through a number of channels. The Australian dollar is lower than it otherwise would be as a result of the policy easing; it is now around the bottom of its range in recent years. Interest rates faced by both borrowers and lenders are now at very low levels. The lower interest rates have contributed to increased demand for both new and existing homes. They also lower required debt payments for many households. The resulting extra cash flows can be spent or used to pay down debt faster, although this benefit is partly offset by reduced interest income for savers. The effects of the recent rate reductions take time to work their way through the economy and have their full impact on spending. Some of the early stage channels of policy transmission, such as new borrowing, higher asset prices and a depreciation of the exchange rate, are nonetheless proceeding as normal.

The low level of interest rates in Australia reflect the low interest rates globally as well as the only gradual progress towards the Bank's goals, as the Australian economy navigates a period of slow growth. This soft patch in growth is likely to extend into early 2020 because of the ongoing drought, the effects of the bushfires, and the effects on Australian exports of the recent outbreak of a new coronavirus in China. Beyond these shorter-term effects, the medium-term outlook for the Australian economy is broadly unchanged from three months ago.

GDP growth is expected to improve over the course of this year and next. Growth is expected to be 2¾ per cent over 2020 and around 3 per cent over 2021. This is a step up from the growth rates recorded over the previous two years. Part of this recovery reflects the expected transmission of the low level of interest rates to the housing market and household spending. A turnaround in mining investment is also expected, consistent with the publicly announced investment plans of firms in that sector. The recovery effort following the bushfires is likely to reverse the negative near-term economic effects of the fires on aggregate activity, but drought conditions are likely to continue to weigh on rural production and exports for a while yet.

The transmission of monetary policy is evident in established housing markets. Housing prices have turned around noticeably, especially in Sydney and Melbourne. Housing turnover, which is an important driver of some types of household spending, has increased, as has new borrowing, particularly by owner-occupiers. It is too soon to see any response to this in household spending, but over time the drag on consumption growth from the earlier decline in housing prices and activity should wane. That said, at this stage it cannot be ruled out that the sharp fall in housing prices has reduced the level of debt that households feel comfortable carrying, even after housing prices recover. So the effect of the cycle in housing prices on

spending might last longer than historical experience implies. The forecast for consumption takes some account of this.

A recovery in dwelling investment is likely to occur towards the end of this year in response to lower interest rates as well as the strong growth in established housing prices and population growth. Early indicators of demand and sales are already showing signs of turning around, which gives more confidence that the recovery will proceed as expected.

A key consideration for monetary policy remains the outlook for consumption. In the September quarter, consumption growth was weaker than earlier expected, and it is likely to remain subdued in the December quarter. Recent data have been consistent with households gradually adjusting their spending to the slower trend rate of income growth and it appears that adjustment may have accelerated in response to the prior period of falling housing prices. Consistent with this, there was also an increase in mortgage payments over the second half of last year. Tax cuts and interest rate reductions helped support income in the September quarter, although consumption remained subdued in the face of this balance sheet adjustment.

Consumption growth is expected to recover gradually over the course of this year and next. The low level of interest rates, a somewhat faster rate of income growth than in recent years and the recovery in household wealth are all expected to contribute to this turnaround. Lower rates have been assisting with the ongoing adjustment in household balance sheets by reducing debt-servicing costs. The Board took note that some survey measures of confidence about the future had declined, although measures of current business conditions and households' views about their finances, which tend to be more indicative of economic decisions, remain around average. The Board therefore assessed that the decline in confidence was most likely to be a reaction to the same developments that prompted recent policy easing, rather than to the rate reductions themselves. That said, the consumption outlook remains uncertain and its evolution will continue to be an important focus of the Board.

In line with the expected pick-up in GDP growth, employment growth is expected to increase over time, after having eased a little lately. As this occurs, the unemployment rate should also come down. The unemployment rate declined slightly through the December quarter, to be 5.1 per cent in the month of December. It is expected to remain in the 5–5¼ per cent range for some time before declining to around 4¾ per cent in 2021. The central forecast does not envisage a repeat of the recent unusually strong increase in labour force participation, but this cannot be ruled out if employment growth turns out to be stronger than expected.

Wages growth has been low and steady for some time, in line with the spare capacity still in the labour market, as well as the constraints implied by the wages policies of various governments. As the unemployment rate declines and the labour market tightens, some limited upward pressure on wage outcomes can be expected.

Inflation remains low and stable. The recent inflation data were in line with our expectations and confirmed a modest lift in CPI inflation over recent quarters to 1.8 per cent. Trimmed mean inflation was a little lower at 1.6 per cent. Both measures are forecast to increase gradually to 2 per cent over the next couple of years. The outlook for inflation in part rests on the expectation that the drag coming from housing-related inflation will dissipate as the housing market recovers following the easing in monetary policy. Early signs of this are evident in reduced discounting of the prices of newly built houses in the December quarter. Retail price inflation has generally been subdued, but the

drought has been putting upward pressure on the prices of an increasing range of food items.

The outlook for the Australian economy has in part been shaped by the evolving global outlook. The global economy has clearly suffered over the past year from the uncertainty and interruption to international trade caused by the US–China trade and technology disputes. Towards the end of 2019 and early 2020, indications were that global growth was poised to improve. The phase one partial trade deal between the United States and China has reduced the tensions between the two countries. This has alleviated but not eliminated an important source of uncertainty around the global outlook. It has also contributed to the accommodative financial conditions.

The outbreak of the coronavirus and the efforts of authorities in China and elsewhere to contain its spread represents a new source of uncertainty. This will reduce Chinese and global growth in the short term. With the situation still evolving, it is very uncertain how much growth will slow or for how long. Previous outbreaks of new viruses have had significant, but short-lived, negative effects on economic growth in the economies at the centre of the outbreak. It is difficult to know how representative these earlier episodes could be. The economic impact will depend crucially on the duration of its impact and measures taken to contain the spread of the virus.

The forecasts imply progress towards the inflation target and full employment, but that progress is expected to be only gradual. To maintain this progress, monetary policy is very likely to remain accommodative for some time. Given the only gradual nature of the progress, the Board has been discussing the case for a further easing of monetary policy in order to speed the pace of progress and to make it more assured in the face of ongoing uncertainties.

In considering this case, the Board has taken account of the fact that interest rates have already been reduced to a low level and there are long and variable lags in the transmission of monetary policy. The Board also recognises that a balance needs to be struck between the benefits of lower interest rates and the risks associated with having interest rates at very low levels. Internationally, there are increasing concerns about the effect of very low interest rates on resource allocation in the economy and their effect on the confidence of some people. Lower interest rates could also encourage more borrowing by households eager to buy residential property at a time when housing debt is already quite high and there is already a strong upswing in housing prices in place. If so, this could increase the risk of problems down the track.

After considering this balance, the Board decided to maintain the cash rate unchanged at its recent meetings. It recognises, though, that the balance between benefits and risks can change over time and it is dependent upon the state of the economy. If the unemployment rate were to be moving materially higher and there was no further progress being made towards the inflation target, the balance of arguments would tilt towards a further easing of monetary policy. The Board will continue to monitor developments carefully, including in the labour market. ✠