On behalf of the Reserve Bank Board, I would like to warmly welcome you to this community dinner. Thank you for joining us this evening. We value this opportunity to hear firsthand from you about the challenges and opportunities you face. I would also like to take advantage of the timing of this dinner to explain today’s decision on interest rates.

As you would have heard already, earlier today the Reserve Bank Board decided to lower the cash rate by a quarter of a percentage point to 1¼ per cent. This decision comes after more than 2½ years in which we have held the cash rate steady. The last change was back in August 2016.

At its core, today’s decision was taken to support employment growth and to provide greater confidence that inflation will be consistent with the medium-term target.

I want to emphasise that the decision is not in response to a deterioration in our economic outlook since the previous update was published in early May. The economic outlook remains reasonable, with the main downside risk being the international trade disputes, which have intensified recently. The Australian economy is still expected to strengthen later this year, supported by the low level of interest rates, a pick-up in growth in household disposable income, ongoing investment in infrastructure and a brighter outlook for the resources sector. So today’s decision does not reflect a weaker outlook. Rather it reflects the fact that, even with the expected pick-up in growth, the Australian economy is likely to have spare capacity for a while yet.

Today’s easing of monetary policy will help us make further inroads into that spare capacity. It will assist with faster progress on reducing unemployment and will help achieve more assured progress towards the inflation target. So that is our rationale.

I know that many of you are likely to have questions about today’s decision. I would like to take this opportunity to provide answers to some of your probable questions. I am also happy to answer your
other questions after my prepared remarks.

The four questions that I thought it would be useful to answer are the following:

1. Why did the Board act today, after having held the cash rate steady for more than 2½ years?
2. Are there more interest rate reductions to come?
3. Should today’s reduction be fully passed through to mortgage rates? and
4. What about the savers – has the Board forgotten about them?

First, why move now, after holding steady for so long?

The answer is the accumulation of evidence. As you would expect, the Board is constantly sifting through masses of data and seeking to understand what are often conflicting signals about the economy. As we have gone about this task over recent times, there has been a progressive accumulation of evidence in support of two conclusions.

The first is that inflation pressures are subdued and they are likely to remain so.

And the second and related conclusion is that there is still significant spare capacity in the Australian labour market.

The most recent batch of data has provided further evidence in support of both conclusions. The March quarter CPI was low and it was below expectations, as was the previous reading on inflation. In addition, the wage data for the March quarter confirmed that wages growth remains subdued, although it has picked up from a year ago. And the recent labour market report also confirmed that strong employment growth is not making material inroads into spare capacity in the labour market. The Board judged that the accumulation of this further evidence meant that it was now appropriate to adjust monetary policy.

Given the importance of these two conclusions, I would like to elaborate a little on them and explore their implications.

The subdued inflation pressures reflect a number of factors. These include slow growth in wages, increased competition in retailing, the adjustment in the housing market – with rents increasing at the slowest pace in decades – and various government initiatives to reduce the cost of living pressures on households. These factors are all putting downward pressure on prices and they are likely to remain with us for some time yet.

Collectively, these factors have contributed to delayed progress in returning inflation to the 2–3 per cent target range. In underlying terms, inflation has now been below 2 per cent for three years and the latest reading was 1½ per cent. Looking forward, inflation is still expected to increase, but it is unlikely to be comfortably within the 2–3 per cent range for some time yet. So the progress on returning inflation to target is more gradual than we had hoped.

It is important to remember, though, that our inflation target is intentionally flexible and that the Australian economy has benefited from this flexibility over the past 25 years. The Board is aiming to
ensure that Australia has an average inflation rate of between 2 and 3 per cent over time. The focus is on the average and the medium term.

We have never sought to have inflation always between 2 and 3 per cent. The RBA adopted flexible inflation targeting before other central banks, and this flexibility has served us well. It has allowed the Board to set monetary policy so as best to achieve its broad objectives, with the ultimate aim of contributing to the economic prosperity and welfare of the people of Australia. It has also allowed the Board to look through temporary factors affecting inflation.

This flexibility, however, is not boundless. The point of our inflation target is to provide a strong medium-term anchor that helps deliver low and stable inflation, which, in turn, is an important precondition to sustainable growth in employment and incomes. If inflation stays too low for too long, it is possible that inflation expectations move lower – that Australians come to expect sub-2 per cent inflation on an ongoing basis. If this were to happen, it would be harder to achieve the medium-term inflation goal. So we need to guard against this possibility.

Moving on to our conclusion about spare capacity in the labour market.

For some years, most estimates of full employment, including our own, equated to an unemployment rate of around 5 per cent – it was thought that if unemployment went below that for too long, inflation would rise and become a problem. But, given the combination of the labour market and inflation outcomes we have seen of late, our judgement now is that we can do better than this – that we can sustain an unemployment rate of 4 point something.

It is also worth noting that the supply side of the labour market is turning out to be more flexible than we had earlier expected. The recent evidence is that when jobs are there, more people join the labour force and other Australians stay in work longer. Reflecting this, the participation rate is currently at a record high, despite demographic shifts that we anticipated would reduce participation. It is also the case that people are prepared to work extra hours when there is strong demand for their labour. Together, these observations support the conclusion that there is still spare capacity in the labour market and this is likely to remain the case for a while yet. The recent data have given us more confidence in this assessment and we have responded to this.

Over the past few years, one concern has been that lower interest rates could add to the medium-term risks facing the Australian economy as a result of high household debt. We need to keep a close eye on this issue, but this concern has receded recently. Lending practices have been tightened considerably and many lenders have become quite risk averse. The demand for credit has also slowed due to the changed dynamics of the housing market and slower income growth. So the risks on this front look to be less than they were previously.

This brings me to the second question: are interest rates going to be reduced further?

The answer here is that the Board has not yet made a decision, but it is not unreasonable to expect a lower cash rate. Our latest set of forecasts were prepared on the assumption that the cash rate would follow the path implied by market pricing, which was for the cash rate to be around 1 per cent
by the end of the year. There are, of course, a range of other possible scenarios and much will depend on how the evidence evolves, especially on the labour market.

If you accept the argument that a sustainably lower rate of unemployment in Australia is achievable, the question that we should all be thinking about is: how do we get there?

It is possible that the current policy settings will be enough – that we just need to be patient. But it is also possible that the current policy settings will leave us short. Given this, the possibility of lower interest rates remains on the table. Monetary policy does have an important role to play and we have the capacity to play that role if needed.

In saying that, I also want to recognise that monetary policy is not the only option. There are certain downsides from relying just on monetary policy and there are limitations on what, realistically, can be achieved. So, as a country, we should also be looking at other options to reduce unemployment.

One option is for fiscal support, including through spending on infrastructure. This spending not only adds to demand in the economy, but it also adds to the economy's productive capacity. So it works on both the demand and supply side.

Another option is structural policies that support firms expanding, investing, innovating and employing people.

All three options are worth thinking about.

From my perspective, the best option is the third one – structural policies that support firms expanding, investing, innovating and employing people. A strong dynamic business sector is the best way of creating jobs. Structural policies not only help with job creation, but they can also help drive the productivity growth that is the main source of improvement in our living standards. So, as a country, it is important that we keep focused on this.

I will now change tack and move to the third question: should today's reduction in the cash rate be fully passed through to mortgage rates?

My usual practice in answering this question has been to explain that there are a range of other factors that influence mortgage pricing, and then say 'it all depends'. There are often reasonable explanations for why the standard variable mortgage rate does not move in lock-step with the cash rate.

Today, though, I would like to break with my usual practice and provide a clearer answer. And that is: Yes, this reduction in the cash rate should be fully passed through to variable mortgage rates.

This answer is based on recent reductions in bank funding costs. Not only have these costs declined as a result of the change in monetary policy, but they have also declined because of movements in market-based spreads. Last year, these spreads increased and most lenders responded by increasing their standard variable rates by around 15 basis points. Over recent months, these spreads have reversed all the increase that occurred last year and returned to their 2017 levels. The result is that there has been a substantial reduction – at both the short end and the long end – in the cost of
banks raising funds in wholesale markets. Average rates on retail deposits have also come down. This means that the lower cash rate should be fully passed through into standard variable mortgage rates. Full pass-through would also mean that the economy receives the full benefit of today's policy decision.

That brings me to the final question: what about the savers, have we forgotten about them?

I know this question is on the minds of a lot of Australians, especially older Australians. I am reminded of this daily as people write to me telling me how the already low deposit rates are affecting their income. I am expecting to receive more such letters and emails after today's decision.

The Board had a thorough discussion of this issue at our meeting today. We recognise that many Australians have saved hard and rely on interest from term deposits to support their income and spending. Today's decision will reduce their income from this source and we understand why they would be disappointed with the outcome of today's meeting.

At the same time as paying close attention to this issue, the Board considered what was best for the overall economy. Our judgement is that lower interest rates will help the economy as a whole. At the moment, this benefit is likely to come mainly through two channels. The first is a lower value of the exchange rate than otherwise would have been the case. The second is a boost to the disposable income of the household sector. In aggregate, the household sector pays around two dollars in interest for every dollar it receives in interest income. So, in aggregate, lower interest rates reduce the net interest payments of the household sector and so boost overall disposable income.

In time, we would expect the lower exchange rate and the boost to disposable income to lead to more jobs, lower unemployment and a stronger economy. This should benefit us all, although I recognise that in the short run the effects are felt unevenly across the community.

It is partly because of this unevenness that I want to repeat a point I made in answering the second question. And that is: the best approach to delivering lower unemployment and a stronger economy is through structural policies that support firms expanding, investing, innovating and employing people. These policies can have distributional effects too, but the benefits are more broadly based. So, as I said, as we ease monetary policy, it is in the country's interest that other policy options are considered too.

That brings me to the end of my four questions and answers. I hope that this has helped you understand the Board's thinking and why we took the decision today. I am happy to answer other questions that you might have.

Thank you for listening and for joining us this evening.

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The Reserve Bank of Australia acknowledges the Aboriginal and Torres Strait Islander Peoples of Australia as the Traditional Custodians of this land, and recognises their continuing connection to Country. We pay our respects to their Elders, past, present and emerging.