CONFIDENTIAL

RESERVE BANK OF AUSTRALIA
MINUTES OF MONETARY POLICY MEETING OF THE BOARD

SYDNEY, 3 OCTOBER 2006

Present

GR Stevens (Chairman), KR Henry, JR Broadbent AO, DG McGauchie AO, WJ McKibbin, HM Morgan AC. Members granted leave of absence to RC Corbett AM in terms of section 18A of the *Reserve Bank Act 1959*.

R Battellino, ML Edey

DH Emanuel (Secretary), AL Dickman (Deputy Secretary)

Minutes

The minutes of the meeting held on 5 September 2006 were approved.

Economic Conditions

The news on the domestic economy in the past month had centred on the release of the national accounts for the June quarter. This had been a puzzling set of figures, particularly when set against recent indicators of strength such as labour market conditions. On the international front, recent data were suggesting that overall growth next year would be lower than the very strong 2006 outcome, but still higher than average, even with a slowdown in the US economy.

International Conditions

In the United States, employment growth in the past few months had eased to a rate slightly below trend. The unemployment rate had levelled out at just over 4½ per cent. Developments in the labour market had typically been a good gauge of the business cycle, suggesting that the economy was experiencing a slowing at present. In view of the rising inflationary pressures in recent moths, some slowing was a healthy development; the main question was about its extent. For the moment, the best assessment was that growth was easing to a pace just below trend. However, with inflation still relatively high, the period ahead would be uncomfortable for the Federal Reserve. While the headline inflation rate was set to fall from around 4 per cent in the months ahead following the recent sharp fall in oil prices, the core measure, which excluded food and energy prices, had trended up in recent months. This measure was currently around 3 per cent on an annualised basis and recent monthly rates had not shown any signs of slowing.

Members were conscious that as the unwinding of the housing boom in the US could have unpredictable consequences, including significant adverse effects on household spending, the high-frequency data needed to be monitored carefully in the period ahead. In August, housing permits and starts were around 20 per cent below the peak six months earlier, but the extent of any further decline was likely to be a function of how much overbuilding had occurred in the upswing over the previous several years. Consumer spending was also being dampened by the declining or levelling out of house prices at present, but fears of a 'hard landing' being driven by the housing sector were regarded as exaggerated at this stage. Economy-wide indicators suggested that the softening in conditions was not as sharp as for the housing sector.

In Japan, the Tankan survey, conducted by the Bank of Japan, indicated that business conditions were trending up to levels comparable to those prevailing prior to the recessionary period. In the corporate sector, profits, which had been rising since the mid to late 1990s, had been used to retire debt; in the past few months lending to businesses had been growing for the first time in well over a decade.

Growth in industrial production in China remained high, suggesting no change to the outlook for ongoing strong growth in output. There continued to be some doubts over the quality of the Chinese economic data. With anecdotal evidence of rising costs in the coastal cities owing to rapid demand growth, prices for Chinese exports would need careful watching.

Another fast-growing part of the world economy was India, where output growth was 9 per cent over the year to mid 2006. In the past few years growth had stepped up from 6 per cent to around 8–9 per cent.

Both China and India had significantly increased their shares of the world economy and world trade over the past decade. In particular, with average growth in GDP of 9 per cent over the 10 years to 2005, China's share of the world economy had reached over 15 per cent on a PPP basis. In the case of India, average growth of 6 per cent per annum had seen its share of the world economy reach 6 per cent in 2005. Population trends were likely to boost the relative importance of India in the global economy for some time. India's population growth rate was more than double that of China, and by 2030 India would overtake China in terms of population according to official projections. Accompanying these broader trends had been a marked increase in both countries' share of Australia's exports. Members expressed interest in seeing trade figures by sector for these countries, which were of growing importance to Australia.

The euro area was experiencing better economic conditions than in recent years. Industrial production and measures of consumer and business sentiment had all trended up over the past year or so.

For the world economy as a whole, growth was set to slow from about 5 per cent in 2006 to 4½ per cent in 2007, according to Consensus forecasts, but this would still be above average. However, members noted that if the US economy slowed more noticeably than currently expected, this could well spread through the world economy more broadly.

Crude oil prices had fallen in the previous few weeks, to close to US$60 per barrel, as tensions in the Middle East had eased further. There had been signs of demand softening together with some positive news on oil discoveries. It was also likely that market dynamics had acted to correct part of the overshoot in prices around the middle of the year. Futures prices for oil were flat around the current spot price. If sustained, the latest developments in oil prices would reduce the December quarter CPI in Australia by around ½ of a percentage point.

Domestic Conditions

The focus of discussion on domestic economic conditions was initially on how to reconcile the lower-than-expected GDP growth rate reported for the June quarter and the year to June with other indicators that had shown rising growth rates in the first half of 2006. Although the national accounts for the most recent few quarters were estimates and could be subject to significant revision, the data had posed a number of puzzles. It was noteworthy that all three measures of GDP had indicated a slowing in growth to around 2 per cent for the year to the June quarter.

In looking at sources of growth in the June quarter and over the past year, members noted that consumption growth had been moderate, dwelling investment appeared to be levelling out and business investment had continued to grow strongly. With public demand growing above trend, this implied that growth in domestic final demand had continued to be robust. GDP growth was relatively low because demand growth had been met by a decline in inventories and ongoing rapid growth in imports. The inventories data were of low quality and prone to substantial revision, so there was likely to be some reversal of the drag from growth from that source in the near term.

In contrast to the data on output growth, conditions in the labour market had remained strong during the first half of the year, with strong employment growth and a further slight decline in the unemployment rate. The contrast between GDP and employment trends had persisted for the past 2½ years. Employment had increased at an above-trend pace since the end of 2003 but during that period GDP growth had been lower than the average for the current expansion. Other data on the labour market, e.g. for vacancies, were consistent with the strength in employment, so while some element of overstatement was possible in employment growth or hours worked, it was not likely to be significant. The implied sharp slowdown in productivity growth appeared implausible. Despite a number of possible explanations being canvassed, members felt that the conundrum of relatively slow output growth and high employment growth remained. They noted that growth in nominal GDP had been very rapid, owing in part to the rising terms of trade, and this had supported buoyant growth in government revenues. However, it was acknowledged that the measurement errors involved in converting nominal to real magnitudes in measuring GDP growth could be greater than usual at present, given the large changes in relative prices taking place.

Turning to indicators of economic activity in the September quarter, the NAB survey of non-farm businesses suggested that business conditions had remained high after the middle of the year.

In the household sector, conditions appeared likely to support continued moderate growth in spending. Falling fuel prices had been a factor favouring further growth, along with tax cuts and growth in wages and employment, though these had been partly offset by the effect of the recent increases in interest rates. Taking all these factors into account, real household disposable income was rising at around 3 per cent, while nominal retail spending appeared to be rising at around 6 per cent per annum. Consumer sentiment, one of the few indicators post-dating the August rate rise, in September had recovered about two-thirds of the sharp fall in August and was now around the long-run average level. Households spent 11 per cent of disposable income on debt servicing in the June quarter. The rising share of households which had an exposure to the investment property market over time had contributed a substantial proportion of the rise in total debt-servicing.

The housing construction sector was close to a trough. With approvals and commencements running below trend, this implied that the growing backlog would support growth in construction activity. Moreover, vacancy rates, which were at relatively low levels, had fallen further in recent quarters. Across the country, there had been a large cumulative downturn in New South Wales but thus far no downturn in Western Australia, which was the part of the country benefiting most from the resources boom. In the period ahead, it was likely that aggregate housing activity would shift from being a negative to a mildly positive influence on growth.

Conditions in the secondary housing market had been firm, though there were some signs of softness in the most recent data. House prices had appeared to increase up to around the middle of the year, but since then there had been some tentative evidence of a stabilisation. The rapid growth in house prices in Perth over the past several years was quite different from that seen in the other capitals, where prices had been flat between the end of 2003 and the end of 2005 and risen mildly since then. Auction clearance rates were a little lower in August, both in Sydney and Melbourne.

Household credit growth had increased around the middle of the year, but since then had eased back to around 1 per cent per month. Finance approvals had been lower in the past two months, which suggested that the more moderate credit growth would continue in the near term.

Business investment rose in the June quarter but year-ended growth eased to around 11 per cent. Further slowing in growth was likely, but the high level of investment in the economy nonetheless implied a significant contribution to the growth in productive capacity. Business credit growth had been rising, to about 16 per cent per annum.

Turning to the exports sector, receipts had been trending up. This had mostly reflected rising export prices but export volumes had increased by 1½ per cent in the June quarter. Further growth in export volumes was expected in the year or two ahead given the extent of new capacity put in place in the past few years. However, the outlook for rural exports was poor given continued dry conditions across most of the country.

Commodity prices had remained high in recent months. Base metals prices, which appeared to have peaked in May, had been broadly stable over recent months at a level around 50 per cent higher than at the start of the year.

The Board was briefed on the revised forecasts for output growth and inflation that had been prepared for the meeting. The outlook for underlying inflation was for it to remain close to its recent level of around 3 per cent. This would be reviewed following the prices data to become available during October.

Financial Markets and the Bank's Operations

There had been no changes to official interest rates in the major countries in September. Current policy rates in these countries were 5.25 per cent in the US, 3.0 per cent in the euro area and 0.25 per cent in Japan. Commentary from the Federal Reserve suggested that there may be a need for further rises in official interest rates to contain inflationary pressure, though the markets were of the view that interest rates had peaked.

During the month, longer-term market interest rates fell noticeably in most countries. Much of this was sourced to the US, where markets considered that the weakness in the housing sector could translate to a general slowing of the economy. Lower yields were supported by falling oil prices, which held out the prospect of lower inflation. Yields on 10-year bonds in the US fell to 4.6 per cent, 60 basis points lower than three months earlier. A fall of this magnitude was not unprecedented, but the fact that bond yields were now lower than the fed funds rate was significant. On previous occasions when this had occurred in the past decade, it had been a precursor to policy easing by the Fed. It was not clear that this was the right interpretation on this occasion as a number of structural factors, in particular strong capital flows from Asia, were still pushing bond yields down.

Bond yields in other markets did not fall by as much as in the US. In both Europe and Japan, bond yields remained well above the respective official interest rates.

The US share market was relatively strong in September, rising by a further 2 per cent, and prices had exceeded the peak in May. Expectations that lower oil prices would reduce inflationary pressures were an important factor behind the market's strength, but lower bond yields may also have been supporting higher share valuations.

Exchange rates had continued to be stable during September. The US dollar was little changed on a trade-weighted basis in the month, and had shown little net change over the past two years. The main development in foreign exchange markets in recent months had been the weakening of the yen, despite the improving prospects for the Japanese economy. Whereas in most countries a stronger economy was associated with a rising exchange rate, growing confidence of Japanese financial institutions had been encouraging them to take on more risk and increase their investment offshore, pushing the yen down. These capital outflows by institutions have been accompanied by higher investment offshore by Japanese households, seeking the relatively higher yields abroad.

In China, the rate of appreciation of the renminbi exchange rate had increased. It had taken almost a year to appreciate from 8.1 to the US dollar to 8.0, but in only three months the renminbi had moved from 8.0 to 7.9.

In the past month, emerging markets were subject to several potentially unsettling events, but none seemed to have had a significant impact. An example was the military coup in Thailand, which could have been negative for financial markets. As it turned out, the exchange rate, share market and bond spreads were not much affected. Similarly, some political instability in emerging European countries and Latin America did not affect bond spreads in these markets.

In Australia, there had been little change in short-term interest rates during the past month, though six-month money market yields declined slightly. Expectations of further tightening of monetary policy declined to only a 30 per cent chance by the end of the year.

Long-term interest rates in Australia had fallen, to around 5.6 per cent, though not to the same extent as in the US. The yield curve was inverse, i.e. with long-term yields below the cash rate. Unlike in the US, this had been the case for much of the past 18 months, and it was difficult to extract from it much of significance for policy.

The Australian share market had been relatively flat in September, reflecting some weakening in the prices of resource stocks, and as a result had underperformed the major markets overseas. A similar development had occurred in countries where resource stocks carried a high weighting in the share market, e.g. Canada. Prices of resource stocks were still noticeably below the peak in May, whereas prices of financial and industrial company stocks had mostly recovered the May peaks.

The corporate profit reporting season had largely ended. Overall, underlying profits of ASX200 companies were 35 per cent higher than in the June 2005 half-year. Much of the growth in profits had come from resource companies, whose profits increased by 72 per cent, but profit increases had been broadly based: 70 per cent of the top 200 listed companies had reported higher profits. Financial stocks had reported a 19 per cent rise in profits, while other industrial companies had reported a modest increase. Analysts have reduced their estimates of profit increases for the current and next financial years, mainly because of revised expectations for profit growth of resource companies. This represented a change in the recent trend, which had been for profits to be progressively revised up.

The Australian dollar had fallen slightly both against the US dollar and in trade-weighted terms, but remained well within its recent range. The Australian dollar had been more stable recently than either the Canadian or New Zealand dollars. The latter had risen quite sharply in the past few months but remained below the level reached late in 2005.

Board members were informed about some recent developments in hedge funds. In particular, the losses by Amaranth Advisors, which, at US$6 billion, were the largest since the collapse of LTCM in 1998, had caused remarkably little repercussion on financial markets, apart from gas futures. The lack of any wider contagion from these large losses was attributed to the overall size of the market and the dispersion of risks. Some facts about the Australian hedge fund industry were also outlined. Despite being the largest in Asia, the local industry was still small in absolute terms. Members noted that, under Australian arrangements, hedge funds were subject to the same regulations as any other fund manager, a better arrangement than in the US, where a lesser degree of disclosure applied to hedge funds. Members also noted that the credit exposures of local banks to hedge funds were relatively low, and were monitored by APRA.

Considerations for Monetary Policy

The recommendation to the Board was for no change in the cash rate in October.

The Board noted that over the past month there had been further evidence that the composition of economic growth across countries was shifting, but that overall growth, while likely to slow somewhat in 2007, would still be solid. Growth in the domestic economy in the first half of the year had been disappointing, though it had been difficult to reconcile the estimate of low growth in GDP with robust growth in employment and indications of a tight labour market. There had still been only limited data that post-dated the increase in the cash rate in August.

Members felt that it was very important to resist the current period of relatively high inflation and to ensure that inflation expectations were contained. With the staff forecast of inflation of around 3 per cent remaining uncomfortably high, the Board considered whether there was a case to tighten monetary policy again this month. However, given the preceding discussion on current economic conditions in the world economy and Australia, and allowing that the degree of slowing in growth shown by the national accounts potentially contained some genuine information, the Board judged that the case to tighten further was no stronger than it had been in the previous month.

Noting that several key data releases were scheduled for the month ahead, importantly including the September quarter CPI, the Board judged that a clearer assessment of the need for any further tightening could be made at the November meeting.

The Decision

The Board decided that the cash rate should remain at 6.0 per cent.

Chairman
7 November 2006