CONFIDENTIAL

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

SYDNEY, 5 DECEMBER 2006

Present

GR Stevens (Chairman), RC Corbett AM, KR Henry, JR Broadbent AO, DG McGauchie AO, WJ McKibbin, HM Morgan AC

R Battellino, ML Edey

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

Minutes

The minutes of the meeting held on 7 November 2006 were approved.

International Conditions

Discussion of international economic conditions commenced with an assessment of the growth of Australia's trading partners. Weighted by shares of Australia's exports, the GDP of Australia's trading partners had increased by 4.7 per cent over the past year, which was a modest slowing from 2005. Looking ahead, the main question analysts were focusing on was the extent to which the slowing in the US economy would affect the world economy as a whole.

In the US, the latest data suggested that growth had slowed further in recent months from the average 3½ per cent pace of recent years. The housing sector remained the key to near-term prospects for overall growth. Construction activity was currently forecast to fall by around 20 per cent, and could fall by more given that housing starts had now declined by 30 per cent since the peaks at the start of the year. The consensus view was that GDP growth would slow to around 2½ per cent, but recent data suggested some downside risk to this expectation.

House prices in the US appeared to have peaked and had been flat for much of 2006, according to the average of the available measures; median prices, which are affected by compositional change, had fallen, while a repeat-sales index, which excluded compositional shifts, was beginning to level out. An important consideration for policy-makers was how the wealth effects associated with slowing – or even falling – house prices would affect household spending. While retail sales had softened in recent months, aggregate measures of personal consumption had not slowed much so far during 2006, and had been underpinned by the strong labour market, which had supported healthy growth in incomes. Growth in other parts of the US economy had continued to be strong. Corporate profits had increased by 30 per cent over the year to the September quarter and represented a rising share of GDP, and business investment was robust.

The latest data on inflation in the US indicated that the headline rate had fallen to 1¼ per cent, reflecting the influence of falling oil prices, which has a particularly large effect on the US CPI as the small tax component in retail gasoline prices leads to proportionally larger changes in the latter as oil prices change. The core inflation rate, which excludes food and energy, had eased from just under 3 per cent to 2¾ per cent. This was regarded by the Fed as still uncomfortably high, and the likely future trend in this measure would be key for the conduct of US monetary policy.

Growth in Japanese GDP was solid in the September quarter, though not as high as earlier in the year. The expansion was continuing, with business investment growing strongly, consumer confidence high and the labour market healthy. Following revisions, the core CPI was running at

about -½ per cent, which was making the Bank of Japan cautious in considering further monetary policy adjustments.

In China, growth in industrial production had eased to around 15 per cent, following a spike close to 20 per cent and generally higher rates of growth in the past year or two. Good growth in GDP had been recorded in most east Asian economies in the September quarter after a soft patch around the middle of the year. Over the past few years, China had become as important a destination for exports of east Asian economies as the US, but members noted that China would not be immune to the effects of the slowdown in the US. The share of Japanese exports to China had also risen in recent years, to be about the same as for Europe, though the US remained a more important export destination.

Economic growth in the euro area had continued to pick up gradually, with year-ended growth in GDP stable at around 2½ per cent in the September quarter.

India had recorded very strong growth over the past year or so, and GDP had increased by more than 9 per cent over the year to the September quarter. The size of the Indian economy was less than half that of China on a purchasing power parity basis, but together these two economies were steadily becoming more important parts of the world economy.

The crude oil price had moved above US$60 per barrel over the past month. This had been attributed to the effect of a cold snap in the US and the response by markets to production cuts proposed by OPEC.

Domestic Conditions

Members were informed that information received in the past few days had led to a revised estimate of GDP growth in the September quarter. The latest data for key partial indicators of expenditure and income suggested that quarterly output growth was now more likely to be around ½ per cent than the 1 per cent noted in the Board paper.

Retail sales increased solidly in October and year-ended growth had been steady at about 6 per cent since early 2006. Annual growth in sales by large retailers had been higher than that for small retailers for most of the year.

In the housing sector, building approvals for both houses and medium-density dwellings fell in October, though some correction from earlier increases had been likely. Approvals in individual States were volatile and disparate trends across the country were apparent. Vacancy rates for rental dwellings had declined further in recent months and, in most capital cities, were around the low levels reached in previous cycles. In all, recent housing-related data were consistent with construction activity having reached a trough, and a modest pick-up in activity in the year ahead was expected.

Nationwide house prices had increased in the September quarter, according to ABS data, which were somewhat stronger than those recently sourced from APM. House prices had risen in all capital cities except Sydney, where they remained relatively flat; prices continued to rise at an unsustainably fast pace in Perth, being 46 per cent higher over the year.

Turning to an assessment of domestic financial conditions, with a longer perspective it was apparent that the most recent pattern, i.e. where business credit was growing more rapidly than household credit, had been the norm during most of the 1980s. The string of corporate collapses following the boom in the late 1980s had prompted a decade and a half of conservative balance-sheet

management as businesses had aimed to keep gearing low. This situation was now changing and the current period of businesses gearing up could run for a while. In recent months, household credit growth had begun to slow, and this could be seen in both the monthly credit growth and loan approvals figures, in the latter case particularly in approvals to investors, which were down from their peaks earlier in the year.

Business investment was estimated to have fallen in the September quarter, and in year-ended terms and on a national accounts basis, growth was likely to have fallen below 5 per cent. This had followed annual growth rates of 10–20 per cent since 2002. Expectations of investment spending in the year ahead indicated that spending was likely to be flat, at a high level. Business investment as a share of GDP had been trending up for the past five years.

Commodity prices had been stable recently, but the main feature was the extent of the rise over the past three years: measured in domestic and foreign currency terms, commodity prices had increased by 70–80 per cent since late 2003. Base metals prices had increased by around 50 per cent in the early part of 2006, and following a correction after the peak in May, appeared to have resumed an upward trend since the middle of the year. Rural commodity prices were displaying the effects of the drought, with both wheat and wool prices rising sharply over the past 12–18 months. This was similar to the experience during the 2002 drought.

The current account deficit was estimated to have fallen in the September quarter, driven by a decline in the trade deficit to around ½ per cent of GDP. However, the latest data were not seen as heralding a trend decline in the current account deficit, as monthly trade data suggested the deficit would widen again in the short term.

In the labour market, a correction to the run of very strong monthly employment growth came with a significant decline in estimated employment and labour force participation in October. Year-ended employment growth remained above 2 per cent, which was still high relative to the recent pace of GDP growth. Unemployment fell to 4.6 per cent. Business surveys indicated that labour market conditions were still tight, with small and medium businesses continuing to report that difficulty finding quality staff was a greater concern than a lack of work or sales.

The wage price index indicated that wages growth had fallen to 0.8 per cent in the September quarter and 3.8 per cent over the year. These figures, which were lower than the recent pace of wages growth of over 4 per cent, reflected the changed timing of the minimum wage increase this year. Adjusting for this, in underlying terms wages growth had remained stable at just over 4 per cent, having increased slowly from around 3 per cent over the past eight years. Broadly the same picture was evident from the data on wage increases from enterprise agreements.

The sharp fall in petrol prices in recent months was expected to subtract ¾ percentage point from the CPI in the December quarter. This implied that the headline CPI rise was likely to be close to zero in the quarter; the CPI data would be released by the ABS in late January.

The Board was briefed on the revised inflation outlook following the latest data on wages and taking account of the November interest rate increase. The underlying rate of inflation was now expected to increase a bit further in the short term on a year-ended basis, and then drift down towards 2¾ per cent over the next two years. Headline inflation was forecast to decline sharply over the next year and thereafter to rise to be the same as the underlying rate.

Financial Markets and the Bank's Operations

Discussion of conditions in financial markets began with some assessment of the state of markets globally.

There were four main observations. First, the world remained in a low-interest rate environment, with policy interest rates in a majority of countries still below average. Australia was one of the few countries with its policy rate above the average prevailing since 1993, which was the start of the current low-inflation period. It was mainly the English-speaking countries that had rates above average. Secondly, the return on equity was high and the cost of debt low, and this was providing a major impetus to the re-gearing of the corporate sector globally, with the private equity boom being one symptom of this. Thirdly, perceived risks remained low, as indicated by default rates on debt, which were at historical lows, and lower volatility in financial markets. Taken together, these phenomena had produced a very benign environment for financial markets.

Turning to the regular update on current developments in financial markets, the main risk worrying markets at present was that the US economy would slow more than expected and that the slowing would spread to other countries. In recent months, markets had viewed this concern as greater than the risk of a resurgence of inflation. Markets thought it was likely that the Fed would cut the Fed funds rate in the first half of 2007, though the Fed had been trying to convey a message that such expectations were premature.

The 10-year bond yield in the US had fallen back to around 4.4 per cent in the past month, which was the same level prevailing a year earlier. Bond yields in Europe and Japan had also fallen; in Europe, the decline in bond yields had come despite expectations that the ECB would tighten monetary policy again at its next meeting. Recent movements in bond yields indicated that markets thought that the global interest rate cycle was reaching a peak.

The Chinese authorities had tightened monetary policy further, mainly by raising the required reserve ratio on banks. Interest rates had risen from the very low level prevailing in the second half of 2005, but were still below 3 per cent. Bank liquidity was high in China, reflecting the effect of foreign exchange intervention by the People's Bank of China.

The US share market rose early in November but declined later in the month following the release of softer than expected economic data. Overall, the market had been relatively strong, having risen by 12 per cent over the year to date. It was still 8 per cent below its peak in 2000.

Share prices had also been strong in other countries during 2006, noticeably so in Europe, where the rise had been 17 per cent over the year to date. The Japanese market had fallen slightly this year but the fall had followed a very strong rise in 2005. Share markets in emerging markets were ending 2006 in a strong position after a mid-year shake-out. These markets had risen by 20–25 per cent over 2006 to date, after even larger rises in 2005 as improving economic conditions had become apparent.

The US dollar had fallen significantly during November and early December. This had mainly been because of softer US economic data, though the fall had come against the background of concerns that Asian countries might diversify reserves holdings away from the US and towards Europe. The US dollar was close to the low point against the euro that was reached in late 2004. The fall against the yen had been more modest. On a trade-weighted basis, the US dollar had fallen a little in the past month and by 7 per cent over 2006 to date, but was no lower than in late 2004. Taking a longer perspective, the broad trade-weighted index in real terms, i.e. taking account of differences in inflation in the US and its trading partners, was currently around its average level of the past

30 years, and at least 10 per cent above the lows reached in the early 1990s. The fall in the US dollar had resulted in the Chinese authorities allowing the renminbi to rise slightly faster against it than in the past.

In Australia, financial markets had fully anticipated the interest rate increase following the November meeting of the Board, and the announcement had little further effect. Short-term yields had not changed much since then, and current yields implied no expectation of a further tightening of monetary policy in the next few months.

Longer-term interest rates in Australia had fallen, as they had in most other countries, though the falls had not been as large as there was not the same concern as in the US that the economy was losing momentum.

The Australian share market had been a little more volatile during November than in the previous few months, but ended the month slightly higher. Resource shares had fallen in the month, reflecting concern about the possibility of a slowdown in the US and the wider implications that would flow from that, but other sectors of the share market had risen further. The market overall had risen by 15 per cent over the year to date, which was another strong outcome. After including dividends, the increase for the year to date was close to 20 per cent, the fourth consecutive year of strong returns. In fact, returns had been strong and stable for over a decade, with only one year of negative returns in the past 12 years. This had been underpinned by the solid and consistent growth of the economy and company profits.

Company analysts had continued to revise up their estimates for overall profit growth in the year ahead, though within the aggregate, estimates of profit growth of resource companies had been revised down.

Despite the recent further rises in share prices, the current P/E ratio continued to be in line with long-run averages and slightly below the average for the low-inflation period. Dividend yields had also been maintained around average levels.

The Australian dollar had risen further against the declining US dollar in the past month, and had returned to the top of the trading range of the past three years. Although the Australian dollar had fallen slightly against the euro, in trade-weighted terms the Australian dollar was higher over the past month. At its current level, the TWI was also around its highs of recent years and about 10 per cent above its long-run average. The current level of the TWI reflected the fact that the Australian dollar had increased significantly against Asian currencies over the past 20 years; it had depreciated a little against other major currencies over that period.

Considerations for Monetary Policy

The Board noted that the November increase had been relatively well accepted by financial markets and the community. The recommendation to the Board was for no change in the cash rate in December.

The data on economic activity in the US had been a little weaker over the past month, though at this stage the outlook for the world economy was still for growth to continue at an above-average rate in 2007. The latest data on economic conditions in Australia had been mixed, with the most recent run of data on activity and incomes being quite moderate and further signs of easing in the demand for finance on the part of households.

The updated staff forecast for underlying inflation, taking into account the November tightening, was for it to remain around 3 per cent in the near term, then to decline gradually, to 2¾ per cent over the ensuing year or two. Board members also noted some risk that inflation could remain stubbornly high. Despite the well-behaved nature of the latest data on wages growth, members noted an apparent slowing of productivity growth. On the other hand, risks of inflation expectations rising would be lowered by the sharp fall in headline inflation in prospect over the year ahead.

Overall, the Board judged that with the existing stance of policy mildly restrictive, there was time to assess trends in the world and domestic economies over the summer before considering further action.

The Decision

The Board decided that the cash rate should remain at 6.25 per cent.

Chairman
6 February 2007