CONFIDENTIAL

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

SYDNEY, 1 MAY 2007

Present

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

GL Debelle, ML Edey

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

Minutes

The minutes of the meeting held on 3 April 2007 were approved.

International Economic Conditions

The discussion of international economic conditions commenced with an assessment of the latest developments in the US economy. GDP growth in the March quarter had been 0.3 per cent, broadly around the ½ per cent quarterly rate that had been recorded for the past year. As a result, year-ended growth was now 2.1 per cent. Domestic spending had also been running at a quarterly pace of around ½ per cent for the past year, which represented a slowing from the above-trend pace previously. The main driver of the slowing in growth had been housing construction. Excluding the effect of the housing slowdown, growth had remained at around 3 per cent, which suggested reasonable strength in other sectors of the economy. Employment growth had exhibited a similar pattern to that of GDP growth: it was slowing but so far had remained rapid enough to push down unemployment.

In the US housing sector, there was some evidence to suggest that the forward indicators of construction, namely permits to build and starts, were bottoming out. These had fallen by 30 per cent since the peak in early 2006 and the level of starts was now low enough for stocks of unsold dwellings to be eroded. Nevertheless, even with no further falls in starts, housing activity was likely to be a restraining influence on GDP growth until the second half of the year.

In other parts of the world, growth remained strong. IMF and private-sector forecasts were that the overall slowdown in 2007 would be mild and concentrated in the US. Growth was forecast to be around 5 per cent in 2007, down from 5½ per cent in 2006. World growth was expected to remain around 5 per cent in 2008.

China had recorded further strong GDP growth in the March quarter, with the result corroborated by information on industrial production and retail spending. Members discussed the sustainable growth rate of the Chinese economy. This was difficult to measure as changes in internal labour migration patterns, in particular, could lead to significant changes in resource availability and productivity. Other influences on China's potential growth were domestic absorption and the capacity of other countries to absorb China's output, as well as the environmental implications of ongoing rapid industrialisation.

There had been little new information on the Japanese economy, which had recorded several years of good growth. The Tankan business survey showed that business conditions were currently above average and had continued to improve. This survey tracked GDP reasonably well. Bank lending growth appeared to have stabilised at around 2 per cent per annum, which was relatively low. Some other indicators also suggested that growth was levelling out.

The euro-area economy had strengthened over the past year, noticeably in Germany but growth in other countries had also increased. Industrial production was rising by 4 per cent, which was the fastest rate since 2000. Consumer and business sentiment had increased steadily over the past two years. Inflation was slightly higher and it was evident that the European Central Bank was looking to tighten monetary policy further.

In the UK, inflation of 3.1 per cent over the year to March had breached the 1 percentage point margin above the target, which had triggered an explanatory letter from the Governor of the Bank of England to the Chancellor. This was the first time this had been required since the current inflation-targeting and accountability arrangements were introduced a decade ago. While the economy had recorded a good average growth rate since the early 1990s and inflation was likely to fall below 3 per cent in the near term, signs of overheating in the housing market and the high exchange rate posed policy challenges.

In east Asia, there had been some cyclical easing in growth over the past year, driven by slower growth in exports to the US. GDP data for the March quarter were available only for Korea, where growth had slowed to 3.9 per cent from above 5 per cent a year earlier.

Domestic Economic Conditions

Members noted that consumer spending had accelerated in the past few months. While no new retail sales data had been reported since the previous meeting, motor vehicle sales in March were 6 per cent higher than the average in the December quarter. Consumer sentiment up to April was back to levels seen two or three years earlier. This series was volatile and only the low-frequency movements conveyed useful information.

Loan approvals as a share of housing credit outstanding were running at the low end of the recent range, but had picked up in the past few months following a noticeable slowing during the second half of 2006. A similar pattern was evident in the monthly growth of housing credit, which indicated that the easing in the demand for finance had not persisted.

Members discussed the sustainability of the current pace of overall household credit growth, having considered this on several previous occasions. While they noted that recent growth rates had been relatively fast, they also noted that many other countries had been experiencing fast credit growth. They concluded that structural changes were taking place in the way that households managed their financial affairs, which made it difficult to judge what a sustainable rate of credit growth might be. They acknowledged that the increases in household debt that had taken place over the past decade had, at least to date, not caused any systemic financial stress in the household sector.

The latest data on house prices indicated that prices in Sydney and Perth had been relatively flat in recent months and prices in other capital cities were rising modestly. In Sydney, the flat picture for average house prices masked a widening gap between prices at the upper end of the market, which were showing modest gains, and prices in the cheapest suburbs, which were still declining. Members noted that there had been an increase in repossessions in south-western Sydney, though the aggregate figures were still low. A similar development, though to a considerably lesser extent, had also occurred in parts of Melbourne.

In another indicator of activity in the secondary housing market, rising auction clearance rates in Sydney and Melbourne confirmed an improvement in conditions in those parts of the market where auctions were prevalent.

Total credit growth was steady at about 15 per cent over the year to March. Taking a longer perspective, over the past three years there had been a shift in the growth of credit from households to businesses, and in the past year or so growth in credit to businesses had exceeded growth in credit to households. This reflected a trend towards higher gearing among businesses in a world that had seen macroeconomic stability, low volatility and high returns to equity for several years. It seemed that businesses were assuming that these conditions would persist. Members expressed some concern about the possible wider economic and financial implications should this assumption prove unwarranted, though they recognised that the developments they had observed were at an early stage and the potential dynamics of the private equity developments, in particular, were difficult to assess.

Turning to international trade, growth in import volumes was estimated to have remained strong in the March quarter, exceeding 10 per cent on a year-ended basis, which reflected solid domestic demand. Export volumes had continued on the mild uptrend seen over the past few years. Strong growth in export prices was estimated to have driven a further sharp rise in export values in the March quarter. The relatively modest growth in overall export volumes in the face of robust external demand was best understood by examining disaggregated data for the resources component. Members noted that while iron ore and, to a lesser extent, coal exports had increased rapidly in recent years, a trend decline in oil exports, owing to the depletion of existing oil fields, had weighed on the figures for total resource exports.

Commodity prices had continued to rise in the past month. Over the past few years, all components of the base metals index had risen sharply; nickel prices had increased eightfold since 2003.

Members were informed that the likely effect of the current drought was to reduce farm GDP by 23 per cent in 2006/07. Assuming a return to normal seasonal conditions in the following year, farm output was expected to bounce-back from the lower level by 22 per cent, though of course these figures were highly uncertain.

Conditions in the labour market had remained strong, with a further rise in employment in March and a decline in the unemployment rate to a generational low of 4.5 per cent.

The CPI had increased by 0.1 per cent in the March quarter. A sharp fall in banana prices subtracted significantly from the overall result. Underlying inflation was assessed to have been about ½ per cent in the March quarter and 2.7 per cent over the year, having eased from 3 per cent over the course of 2006. Members noted that the result for the quarter was lower than expected, which meant that the two most recent quarterly readings on underlying inflation, which were both about ½ per cent, provided a signal that inflationary pressures had eased since mid 2006. They were informed that there was no single factor that could be identified as having caused the outcome to be lower than expected; rather, there appeared to have been a generalised pattern of moderating price increases.

Turning to the outlook for inflation, members took account of wages growth running at about 4¼ per cent, adjusting for the changed timing of the most recent minimum wage increase, and the fact that capacity utilisation was currently at its highest level on record. They also noted that domestic demand was increasing at a solid pace and labour resources were scarce, as suggested by the current low unemployment rate and indications from business surveys that a lack of suitable labour was the most significant constraint on production. Some disinflation from the higher exchange rate was expected in the near term, but this effect was not likely to be large. While the assessment was that underlying inflation could decline to around 2½ per cent, or possibly lower, in the short term, inflationary pressures were expected to re-emerge in 2008. As a result, the staff forecast was for inflation to follow a lower short-term trajectory than previously expected, but rise to about 2¾ per cent over the course of 2008. CPI inflation was forecast to fall below 2 per cent in the near term before rising back to the underlying rate. It was noted that the low headline CPI figures expected in the short term would be of some assistance in helping to contain inflation expectations and wage pressures.

Financial Markets

There had been little change in monetary policy among the major countries over the past month, but market expectations were for further tightening by some central banks.

In the US, no change to the Fed funds rate was expected at the meeting scheduled for 9 May. Although the market had priced in an easing by the end of the year, rhetoric from the Fed itself suggested concerns about inflation remained paramount. The European Central Bank was expected to raise rates twice more during the months ahead. In Japan, near-zero inflation meant that the Bank of Japan was not expected to change policy in the near term. Interest rates had been increased to 7.75 per cent in New Zealand, and further increases were expected to be implemented by the Bank of England, including at its meeting in the following week. The Chinese authorities had tightened credit conditions in the past month, and for the seventh time in the past year, in an attempt to rein in rapid growth of money and credit, which was a consequence of ongoing rapid accumulation of reserves.

Bond yields in the US and Japan were little changed in net terms over the past month, while German yields had increased. The narrowing in the spread of German yields to those in the US market reflected relatively stronger economic conditions in the euro area.

Yield spreads in the US corporate bond market had not fully retraced their rise following the period of volatility in financial markets in late February, but emerging market spreads had largely done so.

Developments in the US sub-prime mortgage market still bore close watching. Market conditions had settled considerably since earlier in the year, but members noted that it was not yet clear whether the effects of the recent problems had largely passed.

Turning to foreign exchange markets, the main development over the past month was the further depreciation of both the US dollar and the yen. On average against the major currencies, the US dollar was around the lowest point in the era of floating exchange rates. However, in real terms, i.e. adjusting for relative inflation in the US and its trading partners, the trade-weighted exchange rate had been lower in the late 1980s and early 1990s.

Several currencies had reached multi-year highs against the US dollar. The euro had reached its highest level since 1992, the British pound its highest level since 1981, the Canadian dollar was near a three-decade high, and the New Zealand dollar had reached a post-float high.

In China, the pace of appreciation of the renminbi against the US dollar had slowed. The exchange rate had appreciated by 7 per cent since the revaluation in July 2005. The Chinese authorities had continued to accumulate reserves at a rapid rate. These were now up to US$1.2 trillion, US$200–300 billion of which was earmarked for investment in assets other than US Treasuries. Noting that the US Congress had introduced a tariff on imports of glossy paper from China, in a test case before the WTO, members observed that global imbalances posed risks of increased measures to curtail free trade around the world; these were a greater risk to continued economic prosperity than the possibility of disruptive exchange-rate adjustments.

In contrast to the Chinese experience, the Indian rupee had approached the high levels seen a decade earlier, despite efforts at intervention by the Indian authorities. Foreign currency reserves in India had increased to US$200 billion.

The yen had been relatively steady against the US dollar in recent months, but was at an historical low point against the euro.

Similar to most other major currencies, the Australian dollar had risen noticeably against the US dollar and the yen in recent months. It was, however, little changed against the euro, pound, New Zealand dollar and Canadian dollar. Nonetheless, the trade-weighted index had recorded a two-decade high.

Share prices in most markets had rebounded since the falls in late February; the increases in European share prices had been greater than those in the US. Share prices in Japan had not been as strong as elsewhere, and had shown little change since the start of the year after the sharp increases in the previous two years. Chinese share prices had increased sharply since the beginning of the year and were now much higher than before the fall in February.

The Australian share market was among the strongest performers in recent months. Prices had risen by 9 per cent over the year to date, with the increase broadly based across sectors. Nonetheless, price-earnings ratios did not seem to be out of line with normal levels.

Market expectations for a tightening of monetary policy in Australia had been scaled back substantially following release of the March quarter CPI.

Considerations for Monetary Policy

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

In discussing the recommendation, Board members noted that there had been a modest slowing in US GDP, though this was not expected to lead to a pronounced global slowing; current forecasts were for a continued solid expansion in world GDP. Members also noted that recent domestic activity data had been solid. However, members felt that the most significant piece of news during the past month had been the CPI for the March quarter. They recalled that, at the time of the February Board meeting, December quarter data for underlying inflation had been lower than expected, but that at that point it had been difficult to discern 'signal' from 'noise' in the data. The latest CPI data were regarded as providing confirmation that prices had indeed increased more modestly over the past six months than had been the case around the middle of 2006.

Members noted that the outlook was now that underlying inflation would be around 2½ per cent in 2007, a little lower than earlier forecasts. However, they expected that the strength of the economy would again increase inflationary pressures in the medium term. In discussing how policy should respond to this, members agreed that the recent and prospective moderation in inflation meant that any pick-up in inflation would begin from a lower level. They also noted that monetary policy was already moderately restrictive, and the effects of previous policy tightening were still to be felt fully. The Board concluded that these considerations meant that there was more time to evaluate the strength of inflationary pressures and the appropriate monetary policy response, and accordingly, they decided that no change to the cash rate was necessary for the time being.

The Decision

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

Chairman
5 June 2007