CONFIDENTIAL

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

SYDNEY, 7 AUGUST 2007

Present

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

GL Debelle, ML Edey

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

Minutes

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

Recent Inflation Data and Outlook for the Australian Economy

Board members commenced their discussion of domestic economic conditions by reviewing the June quarter CPI, which had increased by 1.2 per cent in the quarter and 2.1 per cent over the year. The headline figures had been volatile in recent quarters, with sharp movements in petrol and food prices making it difficult to discern the trend. The Bank's measures of underlying inflation, which attempt to remove these temporary influences, indicated inflation of 0.9 per cent in the quarter and 2¾ per cent over the year, which was higher than expected prior to the release of the CPI.

In a general indication of increased inflation pressure in the June quarter, price rises were more common than price falls, with 60 per cent of the items in the CPI by weight rising by more than 2.5 per cent in the quarter. Prices of tradable items in the CPI had increased by 1 per cent over the year to the June quarter, having risen from the low point in 2003/04. The recent exchange rate appreciation was expected to reduce tradables inflation to about zero, with this effect apparent over the next one to two years. On the other hand, inflation among non-tradable items in the CPI, which was more reflective of demand and capacity pressures, had been running around a 3½ per cent pace over the past few years and was expected to rise. One important component of non-tradable prices was rent. Increases in rents, which accounted for about 6 per cent of the CPI, had picked up to 5 per cent over the year to the June quarter. Upward pressure on the CPI measure of rents inflation could continue as the REIA measure of newly tenanted properties was rising by over 8 per cent.

As a sign of inflation pressure arising from the high rate of capacity utilisation in the economy, members noted that the main factor constraining output, according to the NAB business survey, had shifted over the past two or three years to the availability of suitable labour. Prior to that, the main constraint had been a lack of sales and orders.

Members reviewed the outlook for output growth, which was unchanged from that presented at the previous meeting. Non-farm GDP growth was expected to be around 3¾ per cent annualised over the next two years, although recent quarterly figures had been volatile. Farm output was expected to add about ½ percentage point to GDP growth over the year ahead, with a boost to production following improved rainfall so far this year. The CPI forecast had been revised upward following the June quarter data. The current underlying inflation rate of 2¾ per cent was expected to drift up to around 3 per cent by the end of 2007 and remain at that rate or be a touch higher over the next two years in the absence of any monetary policy tightening. The headline rate of inflation would be kept down in the next one or two quarters because of the effect of lower banana prices, but thereafter was expected to track at around the same rate as underlying inflation.

Domestic Economic Conditions

In looking at the run of regular data releases over the past month, members noted the very strong credit growth in June for both households and businesses. Liaison indicated that the figures for households may have been lifted by borrowings associated with contributions to superannuation funds in June. Even abstracting from this, it was clear that housing loan approvals and housing credit growth had drifted upward since the start of the year. Business credit growth had increased sharply over the past few months and, at 22 per cent on a six-month-ended annualised basis, was now the fastest since the late 1980s. Members considered the pick-up in credit growth in the broader context of current financial conditions. Although the cash rate was noticeably above the average for the past decade, the current level of interest rates facing borrowers was characterised as mildly restrictive for new housing lending, being somewhat above the average level over the past decade, but about average for business lending on the same basis. Members observed that competition in business lending in recent years had led to a situation now in which there was very little spread between interest rates on business and housing loans.

Recently released census data had shown that home ownership had been relatively flat over the past two decades at a little over 70 per cent of households. Owner-occupiers with housing debt represented about 35 per cent of households. This proportion had fallen from the early 1980s to late 1990s, but in recent years had risen again as households were holding on to debt for longer periods and taking advantage of loan redraw facilities.

House prices had risen in all capital cities except Perth in the latest month, according to APM estimates based on transactions entered into in the first half of the year. Prices in Sydney had only recently begun to rise after a three-year period during which they had declined. There were indications that prices in the top end of the Sydney and Melbourne markets in particular were firming, but those in the lowest-priced suburbs had been weaker. Also, auction clearance rates, which tend to reflect activity in higher-priced suburbs, had picked up strongly in Sydney and Melbourne since late last year.

Retail sales had increased strongly in June after sales had fallen slightly in April and May. Looking through the short-term volatility occasioned by varying seasonal patterns in demand, year-ended growth in sales had been around 6–7 per cent for the past several months. Members noted that much of the short-term volatility in retail sales was accounted for by small retailers, whose sales were less accurately estimated by the ABS. Sales by larger retailers, which were fully enumerated by the ABS, had been more stable and accounted for a growing share of total retail sales over recent years. Consumer sentiment remained high in July, close to the record level reached a few months earlier.

In the residential construction sector, data on building approvals, while volatile from month to month, suggested that the cyclical low point may have been reached after a long period of gradual decline in the number of approvals.

Overall business conditions had increased in the June quarter, according to the NAB survey, and were around previously recorded peaks.

Labour market data had continued to be strong. There had been a modest rise in employment in June, following larger increases in the previous two months, and the year-ended rate of increase was 3 per cent. In an indication of the tightness of the labour market, the unemployment rate had been trending down over the past five years despite the upward trend in the participation rate.

Overall, members observed that the GDP data for the March quarter, which were discussed at the previous meeting, coupled with the latest readings from the labour force and business surveys were all consistent with a picture of considerable domestic economic strength.

International Economic Conditions

The outlook for the world economy had improved over recent months, although official forecasts were yet to reflect any assessment of the fallout from recent financial volatility. The latest quarterly forecasts from the IMF indicated upward revisions for world growth, from 4.9 per cent to 5.2 per cent for both 2007 and 2008. Downward revisions to expected growth in the United States, flowing from the housing downturn, had been more than offset by upward revisions for other parts of the world, notably China and India.

In the United States, the focus was on the likely effect of the housing downturn on overall growth in the year ahead. Thus far, non-housing components of demand had remained resilient. GDP growth in the June quarter had been 0.8 per cent and 1.8 per cent over the year, but excluding residential investment, year-ended growth in expenditure-based GDP had been 1 percentage point higher. Permits to build and housing starts were down by one-third and it was not clear if the trough of the cyclical downturn had been reached. The stock of unsold new homes was beginning to be worked off, but this was a slow process and the volume of sales was low.

In other countries, economic conditions were positive. Year-ended GDP growth in China was just under 12 per cent for the June quarter. Growth in Korea had picked up recently, in part reflecting the effect of higher demand from China and stronger US business investment. Conditions in the euro area suggested that growth and sentiment among businesses and consumers had moderated after the pick-up over the past year, but the economy overall remained relatively firm.

Financial Markets

The focus of developments in financial markets in recent weeks had been the fallout in credit markets from the sub-prime mortgage lending problems in the United States. While problems in the sub-prime market had been evident for some time, the latest bout of market volatility had arisen because the scale of leverage and extent of exposure among financial institutions associated with sub-prime lending had become more apparent. Thus far, it appeared that the exposure to sub-prime lending was spread fairly widely. The problems besetting Bear Stearns, which had been covered at the previous meeting, had worsened further in recent weeks. Australia had been home to a high-profile case of financial losses following exposure to the sub-prime market: a hedge fund, Basis Capital, had two funds, which had experienced large losses totalling around $650 million, causing the funds to collapse.

Members were informed about the structure of the hedge fund sector in Australia. It was thought that most of the exposure to sub-prime loans had already surfaced, as there were only a small number of funds whose predominant investment strategy was fixed income. Most funds were of the 'long-short equity' variety. However, it was possible that some 'fund of funds' could have some exposure to sub-prime products, but these would be part of a diversified portfolio.

The main risk of the fallout from the sub-prime problems related to the broad availability of credit, which by extension posed risks for activity in the US and other economies. It was likely that more exposures would emerge as hedge funds around the world would be forced to mark their positions to market, but as the market for these assets was not functioning, obtaining prices would be difficult. This could create a high degree of discomfort for many investors and could adversely affect the ability of those with excessive leverage to ride out the current period.

A consequence of the recent developments was a widening of market spreads, most significantly on low-rated corporate paper (junk bonds). It was important to note that while the price of debt had risen somewhat, there was also the important question over the quantity of finance that would be forthcoming. Some high-profile mergers and acquisitions had been withdrawn, which in themselves would not carry macroeconomic implications, but of greater consequence was the risk of contagion, namely the emergence of a generalised tightening of credit standards that could inhibit the capacity of businesses to borrow for investment. In this context, members noted that the proportion of US corporate debt that was sub-investment grade was now higher than during previous episodes of financial stress. They discussed the role of ratings agencies and possible regulatory issues that might arise in the current environment.

As a consequence of recent financial turbulence, US bond yields had reversed their rise of the previous two months, and were back at 4.75 per cent. Yields had also fallen on other bond markets, including Australia. The fall in government bond yields meant that, despite the rise in spreads, borrowing costs for AAA-rated issuers had actually fallen in the past month.

The turmoil in credit markets had spread to equity markets, which had also been volatile in recent weeks. However, the US market was still 2.5 per cent higher over the year to date and 15 per cent higher than the same period in 2006. The Australian market had generally outperformed others and was 5 per cent higher over the year to date, though had fallen by about 8 per cent since its peak in mid July. US financial sector stocks had seen their share prices fall sharply and this had particularly been the case for sub-prime lenders. Financial stocks overall were now back to their levels prevailing a year earlier. In Australia, Macquarie Bank's share price had fallen in tandem with US financial stocks, but it was still higher than a year earlier.

The problems in credit markets had seen an easing of monetary policy by the Fed again priced in by the end of the year. However, in Europe, the President of the European Central Bank indicated that the inclination was to raise policy rates at the next meeting. Over the past month, monetary policy had been tightened in the United Kingdom, Canada and New Zealand.

In China, several instruments of monetary policy had been tightened further over the past month as the economy gained strength and liquidity remained abundant.

Foreign exchange markets had been a little less volatile over the past month than earlier in the year. The US dollar had generally continued to decline and the yen had appreciated over the month, in a reversal of its recent depreciation.

The Australian dollar had been volatile in the past few weeks. It had been rising strongly through the course of July, reaching US88.71c, which was the highest level since February 1989, before falling sharply late in the month. Since then, the exchange rate had risen back to around US86c and 68.5 on the trade-weighted index. In effective terms, the Australian dollar had been relatively flat over the past month, though its deprecation against the yen and Swiss franc was an indication of heightened risk aversion in global markets. The currency nonetheless remained at a high level, and was 8 per cent higher on the TWI than a year earlier.

Following release of the June quarter CPI, market expectations had moved to a high probability of a tightening of monetary policy in Australia in August. Recent developments in financial markets had had little effect on these expectations.

Members briefly discussed changes in corporate gearing over recent years, against the background of rapid growth in business credit in the past year. They concluded that current leverage in the non-financial corporate sector was not at levels that would prompt concern, being about average relative to the past 25 years and concentrated in a few companies in the non-resources sector, notably utilities.

Information Paper – Labour Market Developments: A Longer-run Perspective

Members were briefed on the staff's assessment of longer-run trends in the sources of employment growth and the probable sources of future labour supply, in the context of the tightening of the labour market over recent years.

The key points discussed included the growing proportion of part-time employees in the workforce, to around 30 per cent of all employees, which had been associated with the changing industry composition of growth; the rising contribution of the services sector was of particular importance in this regard. Members also considered the contributions to employment growth from increases in skilled migration, increases in labour force participation and reductions in unemployment; each of these three components had contributed about one-third of the increase in employment growth in the past couple of years. Overall labour utilisation, according to an estimate of 'full-time equivalents', appeared to be relatively high but below previous cyclical highs.

The changes in trends in participation rates among males and females and among age cohorts were reviewed, with members being informed that the best prospects for further increases in labour supply in the near term would be from additional increases in the overall participation rate. Increases in participation in recent years had largely derived from older workers delaying retirement, and this could continue for some years given strong demand for labour and the fact that Australia had a comparatively low participation rate among older cohorts by international standards.

Considerations for Monetary Policy

The recommendation to the Board was for an increase in the cash rate of 25 basis points in August, to 6.5 per cent.

In discussing the recommendation to tighten monetary policy, Board members noted that the macroeconomic case was clear. The latest assessments of the outlook for the world economy had seen forecasts for the current and following year revised upward. Domestically, recent economic data had signalled a pick-up in the pace of demand and activity, which had been accompanied by higher-than-expected underlying inflation, as indicated by the June quarter CPI. High rates of capacity utilisation, ongoing reductions in unemployment and strength in the demand for finance suggested that pressures on inflation would intensify over the period ahead. These pressures would be offset only slightly, and over an extended period, by the recent appreciation of the exchange rate. The forecast was that underlying inflation on a year-ended basis would now rise to the top of the target band over the next six months and remain there subsequently.

Members gave careful consideration to the effect on the outlook for activity and inflation in Australia of the recent events in financial markets, particularly in US credit markets. They noted that these developments were important and could lead to a higher degree of risk aversion among investors, which would pose downside risks to demand and output in the US economy if they persisted. However, these risks were more in the medium term and the extent to which they would flow through to global growth, and ultimately to inflation in Australia, was unclear. In any case,

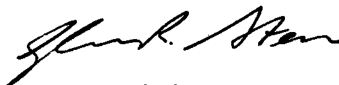
some slight dampening of the global growth outlook would be tolerable given that continuing high commodity prices remained an important source of stimulus to incomes and spending in Australia. It was not likely that a rise in the cash rate would, in itself, add to financial instability.

The case for a tightening in monetary policy had been building for some time. The main factor that had allowed time for further consideration was that, prior to this month, the two most recent inflation results had been unexpectedly subdued. The June quarter inflation result had changed this, as it had substantially lifted the outlook for inflation. Members judged that waiting further to see how events unfolded in credit markets may not clarify the picture in the near term, and that meanwhile a strong case existed for policy action now to forestall an unacceptable rise in inflation.

Taking all these matters into consideration, the Board judged that a somewhat more restrictive setting of monetary policy was required in order to keep inflation consistent with the target in the medium term.

The Decision

The Board decided that the cash rate should be increased by 25 basis points to 6.5 per cent, effective the following day.



Chairman
4 September 2007