CONFIDENTIAL

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

MELBOURNE, 3 APRIL 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 6 March 2007 were approved.

Domestic Economic Conditions

The Board's consideration of current economic conditions commenced with a discussion of the national accounts for the December quarter, which were released on the day following the previous meeting. Growth for the quarter was strong, at 1 per cent. The non-farm economy had grown by 1.4 per cent in the quarter and 3.5 per cent over the year, with the effect of the drought subtracting ¾ percentage point from GDP growth over the past year. This had brought growth in output in the quarter and over the year more into line with other indicators of economic activity – for example, conditions in the labour market and information from business surveys. Members were informed that the staff viewed the apparent lift in growth in the economy as mostly reflecting catch-up from the earlier period of softer growth, though at the margin there did appear to be a little more strength in demand than expected.

The stronger national accounts had also lifted measures of productivity. Non-farm labour productivity had increased by 1½ per cent over 2006, which was not far below average. This suggested that the earlier apparent weakness in productivity had been partly a consequence of measurement factors, though some puzzles remained.

Over the past year, domestic demand continued to run ahead of output, with net trade subtracting from GDP growth. Nonetheless, domestic demand had slowed, reflecting a lower rate of business investment growth, which had been partly offset by stronger consumption. The downturn in the housing sector was now reaching a trough. Growth in public demand had been significantly higher than growth in private demand, as the states had begun to spend heavily on infrastructure. The gap between domestic demand and output had been sustained for an extended period because domestic incomes had been boosted by the rising terms of trade in the past few years. This meant that while growth in export volumes had been poor, export earnings growth had been considerably higher.

The monthly data on consumption were pointing to a strong result for the March quarter. Retail sales had increased at a robust rate in January and February and year-ended growth had increased to 6½–7 per cent. By state, growth in spending over the past year was most rapid in WA, but growth in spending in NSW, though the lowest of the larger states, was still reasonable. Motor vehicle sales in the first two months of the year were running 6 per cent above the rate in the December quarter. Consumer sentiment increased in March towards the highs recorded in 2004.

The latest data on house prices indicated that prices in Sydney were flat in the March quarter, while rises were recorded in the other capital cities. In other data for the housing sector, monthly growth in housing credit was running at about 1 per cent in the past few months, after having been noticeably faster for a period in mid 2006. Loan approvals as a share of housing credit outstanding had been on a declining trend in the past three years, but had picked up in February.

Business investment growth had slowed to around 2 per cent per annum over 2006, following an extended period of growth around 10–20 per cent, driven by the mining and other sectors. The earlier rapid growth in investment meant that the current share of investment in GDP was high. Members noted that there was an inevitable element of pro-cyclicality in public investment spending, as periods of rapid growth in private investment spending tended to require complementary investment in public infrastructure.

Overall business conditions had picked up in the first few months of the year, according to the NAB survey.

Turning to international trade, import volumes had increased sharply in the December quarter, to be 10 per cent higher over the year, reflecting strong domestic demand. The terms of trade had risen further in the December quarter and were now clearly higher than the spike in 1974. The net effect on the terms of trade of the new contract prices for bulk commodities would be roughly neutral. With base metals prices having increased recently, the staff expected the terms of trade to rise a little further before beginning to fall over the next couple of years.

In the labour market, employment growth was strong in February and year-ended growth remained at 3 per cent. Despite a small fall in job vacancies shown by the ABS survey in the three months to February, the level of vacancies remained high and was consistent with other signs of tightness in the labour market.

Members turned their attention to recent developments in economic conditions in the Australian states, as outlined in the Information Paper on 'Regional Economic Performance'. The most comprehensive measure of growth in state economies was provided by gross state product, but these data were published only annually, with the most recent statistics available for 2005/06. In any event, the data indicated that some divergence in growth among the states was not uncommon, though it was noteworthy that NSW had underperformed the national average for five consecutive years. The current dispersion in growth was partly attributable to the upswing in commodity prices, which meant the underlying economic situation in the resource-rich states differed from that elsewhere in the country.

Another important factor in recent years had been divergences in housing cycles. As well as having direct economic effects, the housing cycle was interacting with population growth, adding to the economic divergence. NSW had experienced the most severe housing downturn, and population growth in NSW had slowed sharply in recent years. Recently, however, the rate of net interstate migration from NSW had declined.

Employment growth was seen as a more reliable, up-to-date indicator of overall growth in the states than indicators derived from the national accounts. Although NSW had been below average, all states had recorded reasonably good employment growth and falling unemployment in recent years. Members observed that the floating exchange rate and increasingly mobile labour and capital resources, coupled with fiscal stabilisers, which provided a mechanism to redistribute the effects of uneven growth among the states, were helping Australia as a whole to adapt to the terms of trade shock. They noted that the economy was coping better in the current episode, including with less inflation pressure, than in previous episodes of rising terms of trade.

International Economic Conditions

The discussion of international economic conditions focused on the latest developments in the United States. There had been more evidence of weakness in the housing sector, with permits to build falling in February, and it was not clear yet whether the downturn in residential building activity had ended. With construction falling, the stock of unsold new houses was being reduced, though it remained high. Overall growth in the economy had been good and resources in the economy remained close to being fully employed. However, a key question for the Federal Reserve was whether the prospective slowing in growth would be uncomfortably pronounced. While core capital goods orders had fallen sharply in recent months, which implied softer business investment, corporate profits and rates of capacity utilisation still remained high, which were supportive of continued growth in investment. Consumption had increased solidly over the year to February, driven mainly by growth in spending on services, as spending on durable goods had grown more slowly.

In all, GDP growth in the US was expected to slow from around 3¼ per cent in 2006 to 2¼ per cent in the current year. Despite the signs of slowing in the economy, core inflation remained relatively high and had edged up in the past few months, which suggested that the decline in inflation seen late last year may have been temporary. Slower growth in output would be required to ease the inflation pressure in the economy, but the problems in the sub-prime mortgage market raised the possibility of a greater degree of slowing than desired. This left US monetary policy delicately poised at present, with the Fed facing slightly higher inflation at the same time as growing downside risks to the real economy.

According to as yet unpublished IMF forecasts, world GDP growth was expected to slow from 5¼ per cent in 2006 to 4¾ per cent in 2007. The US was the main source of slowing next year. While other parts of the world were expected to slow a little, they were nevertheless likely to continue to record solid growth.

Outlook for the Australian Economy

Revised forecasts presented to the Board following the release of the December quarter national accounts and recent economic indicators were for non-farm GDP to grow by around 3½ per cent over the year ahead, which was a slight upgrade from the previous forecast of 3¼ per cent. Overall GDP growth was forecast to bounce back over the period ahead, assuming a return to more normal conditions in the farm sector. The inflation forecast was unchanged at 2¾ per cent, but the risks appeared to have shifted to the upside over the preceding month. These risks were mainly sourced domestically and were offset to some extent by the likely effect on inflation of the higher exchange rate and the increased downside risks to the US economy. The inflation outlook would be reviewed again next month to take into account the March quarter CPI result.

Financial Markets and the Bank's Operations

Developments in the US sub-prime mortgage market had received increased press and regulatory coverage since the previous meeting. Most observers felt that these developments posed downside risks to the US economy, though to date there was no evidence of a sharp contraction in mortgage approvals. Also, the associated heightened volatility in financial markets had dissipated quickly.

In terms of policy interest rates in major countries, the ECB had raised rates to 3.75 per cent and markets expected one more increase in the next six months. The Fed had not changed its policy settings, but the market expected weakness in the housing sector and investment to give rise to an easing in the next few months. The Fed's recent statements were interpreted to mean that it had moved from a tightening bias to a more neutral position, though as it remained concerned about inflation, an imminent easing in monetary policy was not likely. The Bank of Japan was on hold. In other countries, the RBNZ had tightened to 7½ per cent, and increases in rates in Switzerland and Norway were part of the process of normalising policy settings. In the third increase in the past year, the Chinese authorities had increased interest rates by 27 basis points to try to stem the growth in investment and credit.

Global bond yields had been relatively stable over the past month, and in the US were currently at 4.65 per cent. Spreads in emerging markets had narrowed over the month, following the period of heightened market volatility. US corporate spreads were largely unchanged, with the exception of junk bonds, which were still a little higher.

Equity markets over the past month had recovered a significant part of the earlier fall, including in emerging markets. The Australian market had outperformed other markets and was close to the recent peak. The Chinese equity market had rebounded strongly from the recent fall and had passed the earlier peak. While volatility in equity markets had spiked up in March, the increase was less than that seen in the April/May period of 2006 and during the 'dot com' boom and bust around the turn of the century.

Members noted that, based on analysis of P/E ratios, there was little sign of market overvaluation around the world, apart from China, where the ratio was high. However, they also noted that earnings forecasts generally assumed that the high share of profits in national income and high rates of earnings growth would continue. This may be overly optimistic. In Australia, P/E ratios were around average for all sectors except resources, where the ratio was currently a bit below average.

Turning to exchange rates, the US dollar had continued its gradual depreciation against the euro, though it remained strong against the yen.

Over the past month, the Australian dollar had risen against all currencies in the trade-weighted basket, with an overall increase of 3 per cent. The current exchange rate against the US dollar of just under US 82 cents was close to the high reached in December 1996. Over the past year, the TWI had increased by 10 per cent, with the rise mostly against the US dollar and yen as well as currencies closely linked to the US dollar. There had been less of a rise against other currencies, such as the UK pound, the euro and the New Zealand dollar. Measured on a trade-weighted basis and against the US dollar, the current levels of the Australian dollar were well above post-float averages. Against the yen, the Australian dollar had regained the level last seen in May 1997. However, against the euro, the Australian dollar was only about average since the euro's inception.

Market expectations for a tightening of monetary policy in Australia had increased since the previous meeting, with the market fairly evenly divided on the prospect of a move at this meeting.

Considerations for Monetary Policy

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

In discussing the recommendation, Board members focused on three main considerations.

First, most of the information that had come to hand over recent months was pointing to strength in the domestic economy. Retail sales, motor vehicle registrations and employment had all been solid in recent months. There were also signs of an upturn in the housing market. The national accounts had until recently been at odds with the more general run of data, but the stronger December quarter figures had brought them into line. Members noted that the forecast for growth of non-farm GDP over the year ahead had been revised up to 3½ per cent.

Second, while figures on the global economy had, on balance, continued to be strong in recent months, quite a number of commentators in the US were expecting that the problems in the sub-prime housing loan market would weaken the US economy more than had been predicted. It was noted also that the US Fed had become less convinced about the capacity of the economy to keep growing. Members agreed that any noticeable weakening in the US economy would almost certainly spill over to the rest of the world.

Third, the latest set of domestic price data, albeit somewhat dated, had been better than expected. It was not clear whether this was a genuine signal of declining price pressures or simply 'noise' in the data. New figures in a month's time would help clarify the situation.

In the light of all this, members agreed that the recent strength in the domestic economy would add some upside risks to the outlook for inflation. This, of itself, meant that the case for tightening policy was growing. On the other hand, the uncertainty about the recent path of inflation and about the outlook for the US and global economies meant that it would be prudent to wait another month, to see the March quarter CPI and evaluate further the US outlook, before taking any decision to raise interest rates further.

The Decision

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

Chairman
1 May 2007