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

SYDNEY, 6 MARCH 2007

Present

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

Members granted leave of absence to DG McGauchie AO in terms of section 18A of the *Reserve Bank Act 1959*.

GL Debelle, ML Edey, PW Lowe, AJ Richards

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

Minutes

The minutes of the meeting held on 6 February 2007 were approved.

Board Members

- R Battellino

Members congratulated Mr Battellino on his appointment as Deputy Governor.

- GJ Kraehe AO

Members congratulated Mr Kraehe on his appointment to the Board and welcomed him to his first meeting.

Financial Markets and the Bank's Operations

Given that developments in financial markets had dominated the economic news over the past month, the Governor suggested that the Board begin its discussions by looking at those developments.

The key point was that there had been a substantial amount of volatility in financial markets during the month. This had followed a long period of low volatility, which had been interrupted only during the May–June period of 2006 when markets reacted to fears of rising inflation. The source of the volatility in recent weeks was different and, while not entirely clear, it appeared to be related to three developments: the fall in the Chinese share market; concerns about the US sub-prime mortgage market; and the recent movements in the yen.

The fall in the Chinese share market could not be traced to any particular event, though it may have reflected concerns about measures, such as a capital gains tax, the authorities were contemplating to curb speculative excesses in asset markets. The fall quickly spread to other markets and the associated increase in risk aversion in global financial markets had persisted since then. Members noted that the fall of 15 per cent in the Chinese market over the past month needed to be seen in the context of a rise of 135 per cent over the course of 2006. The fall in Chinese share prices was the trigger for downward moves in share markets around the world: over the subsequent week, markets were 9 per cent lower in Japan, 7 per cent lower in Europe, 5 per cent lower in the US and 6½ per cent lower in Australia. Emerging markets experienced larger falls, in some cases of over 10 per cent.

CONFIDENTIAL

2

Bond spreads in Asia widened as a result of investors' increasing risk aversion, though these remained at relatively low levels. US 10-year bond yields declined by around 25 basis points to 4½ per cent in reaction to weaker US economic data and the fall in the Chinese share market. Bond yields in the euro area declined by less than in the US, given the relatively stronger economic conditions. Japanese yields also fell only slightly. Yields in Australia moved closely with those in the US and there was no change in the differential.

Market participants now expected short-term interest rates in the US to fall later in the year, whereas no change in monetary policy had been expected previously. An increase in short-term rates in the euro area was expected to be announced by the ECB in the days following the Board meeting, with a further increase in the next six months.

There had been a strong appreciation of the yen in February. This seemed to be due to some unwinding of the carry trade as a result of rising aversion to risk among investors following the financial market volatility emanating from China.

Board members spent some time discussing developments in the US mortgage market. It was noted that the sub-prime (or lower quality) part of the mortgage market, where documentation was less than for standard mortgages and the credit history of borrowers was generally poor, had been growing as a share of total mortgage origination over the past two years, and had reached about 15 per cent (compared with about 1 per cent in Australia). Within the sub-prime component, the proportion accounted for by variable-rate loans had been growing, to reach about 5 per cent of the total mortgage stock, with the rest accounted for by fixed-rate loans.

Members were briefed on the sharp increase in defaults on sub-prime mortgages. These defaults were now approaching 10 per cent of sub-prime mortgage origination. In contrast, defaults on prime fixed- and variable-rate mortgages in the US had remained stable in recent years, at around 1 per cent in aggregate. It was apparent that credit standards had deteriorated over the past few years and some borrowers had become overcommitted. In some cases, when loan 'honeymoon' periods ended, borrowers had been unable to pay interest at the current variable rate. Poor underwriting standards and elements of fraud among mortgage originators were being exposed; some originators were going bankrupt and investment banks caught up in this part of the market had suffered sizeable falls in their share price.

A recent survey by the Federal Reserve indicated that lenders overall had tightened credit standards significantly. Members commented that there was some risk of an overreaction, leading to a credit squeeze. This could prolong the housing slowdown, and posed a downside risk for the US economy.

Turning to financial market developments in Australia, members noted that the decline in the local share market of about 4 per cent in the past month had taken the overall share price index back to the level at the start of the year, which was a better performance than in many other countries.

Corporate profits of listed companies, in aggregate, were about 25 per cent higher in underlying terms in the second half of 2006 compared with the same period of 2005. Profits of resource companies had risen by about 40 per cent. Using the most recent earnings data, the aggregate price-earnings ratio had declined to about 15 in February, which was in line with the longer-run average.

Analysts' forecasts for growth in corporate earnings of resources companies in the current financial year had been lowered, to 30 per cent, but the forecast for 2007/08 for this group of companies was for growth of about 8 per cent. This latter figure was broadly in line with the forecasts for earnings growth of other companies in both 2006/07 and 2000/08.

CONFIDENTIAL

Market expectations were for no change to monetary policy in Australia during 2007.

International Economic Conditions

Growth of Australia's trading partners, which had averaged around 5 per cent over the past three years, was expected to continue at about 4½ per cent in the next two years, based on Consensus forecasts, with growth becoming more evenly spread geographically.

In the US, estimated GDP growth in the December quarter had been revised down to just over 3 per cent, which was still above trend. A slowing to about 2½ per cent was expected in the year ahead, which would constitute a 'soft landing'. Towards the end of 2006, all sectors apart from housing construction contributed to output growth. Housing permits and starts had fallen substantially and members noted that this would feed through to construction activity over time. The recent monthly figures for these indicators had been volatile, and it was unclear yet whether they were starting to level out. While there was an excess in the housing stock, the current level of housing starts was sufficiently low to begin to wind back unsold inventories.

A range of indicators revealed that the market for established houses in the US was also weak, but so far the effect of this on consumption had been minimal. Although there had been some slowing in retail sales, consumption overall had contributed strongly to growth in the December quarter. Good growth in incomes had underpinned consumer demand. Although the rate of growth of employment had eased in recent months, it remained adequate to absorb new entrants to the labour market and keep the unemployment rate steady. This implied that no extra slack in resource availability was being created at present and that inflationary pressures were largely unchanged. The latest CPI data showed that core inflation, which had picked up to 3 per cent in the second half of 2006 and then eased to 2¾ per cent, had risen in January. Headline CPI inflation was lower, but recent movements in oil prices had created considerable volatility in that measure.

In Japan, GDP had increased by 2.3 per cent over the course of 2006. Members agreed that this was a strong result, given that trend growth was relatively low in the face of a declining labour force. Economic conditions were returning to normal after the long period of deflation, debt overhang and falls in asset prices. Core CPI inflation was still negative, but bank lending was now growing and property prices in Tokyo were rising; though property prices were still falling on a nationwide basis, the rate of decline was falling steadily. Strongly rising profits were allowing companies to reduce debt.

Growth in the world economy was more balanced in 2006 than in the previous few years. In east Asia, GDP growth continued at a good pace in the December quarter, with year-ended growth of close to 5 per cent for the region as a whole. In India, the rapid pace of growth in recent years of over 8 per cent per annum had extended into 2006. India now represented 6 per cent of world GDP on a purchasing power parity basis, and 5 per cent of Australia's exports. GDP in the euro area picked up in the final quarter of 2006, taking growth over the year to 3.3 per cent.

Domestic Economic Conditions

The main high-frequency indicators of consumption were showing good conditions for that component of domestic expenditure. Retail sales had increased strongly in January and the year-ended growth rate of 6.7 per cent was the highest in the past two years. Particular strength had been seen in sales of household goods. Consumer sentiment had picked up in the past two months, though the series remained volatile. Motor vehicle sales had increased sharply in January, with a good part of the increase attributable to sales to businesses.

CONFIDENTIAL

In the housing sector, vacancy rates for rental dwellings had fallen further towards the end of 2006, with the national rate well below 2 per cent. Conditions in several cities and on a nationwide basis were the tightest on record, according to data provided by the Real Estate Institute of Australia. Gross yields for both houses and units had been trending down for the past two decades, in line with yields on other investments, and despite recent rises in rents, these yields were still low.

Building approvals had fallen particularly sharply in NSW and were now below the levels prevailing in both Victoria and Queensland. This could be partly explained by the differential in population growth between NSW and these states, but the large overshooting in housing prices in NSW up until 2003 had also been a factor. Members observed that it was possible that development policies in NSW were more constraining than elsewhere in the country.

Preliminary indicators of business investment were that spending in real terms was flat in the December quarter and over the course of 2006, following a period of rapid growth in the previous four years. Within the total, non-residential construction was still growing strongly. While total business investment had come off its peak share of GDP during 2006, it remained at a high level and was thereby generating a high rate of growth in the capital stock.

Growth in housing credit had increased over the period to the middle of 2006. It had since been a bit softer, particularly for investors, but still at relatively high levels compared with growth in incomes. Business credit growth had slowed only slightly during 2006, with annual growth currently about 16 per cent.

Turning to international trade, the current account deficit had increased to 5.9 per cent of GDP in the December quarter, as exports were estimated to have increased only slightly in the quarter while imports had recorded a sharp rise. These data were volatile and in an underlying sense the current account deficit had remained close to its cyclical high of about 6 per cent of GDP in the past few years.

The latest contract prices for the bulk commodities of iron ore and steaming coal had increased by around 10 per cent and 5 per cent respectively, while prices for coking coal had declined by 15 per cent. Taking account of their shares in Australia's exports, the new contract prices would have a roughly neutral net effect on the terms of trade. Base metals prices had been on a strong uptrend during 2006 and these prices fell only slightly in the week following the fall in the Chinese share market.

The oil price had been stable at about US\$60 per barrel for the past six months, apart from a brief fall to around US\$50 per barrel at the turn of the year.

In the labour market, despite the small fall in January, employment growth in year-ended terms had remained at 3 per cent. Business surveys continued to show that labour scarcity was a greater concern than a lack of work or sales. According to a survey of small and medium businesses, this had been the case for the past three years, but it was noteworthy that during that time one-third of respondents had no concerns.

The wage price index for the December quarter had indicated an increase of 1.1 per cent in the quarter and 4 per cent over the year. Adjusting for the fact that the recently announced minimum wage increase took effect in the March quarter 2007, rather than the September quarter 2006, which would have been the case under the previous wage-setting arrangements, underlying growth in the WPI was estimated to be about 4¼ per cent. This was the same as the peak in growth in 2005.

Information Paper – The Productivity Slowdown

For some time it had been difficult to reconcile the relatively weak GDP growth with the strength in employment and some other indicators of activity. This paper summarised efforts by the staff to explain the apparent productivity slowdown (or the puzzle of the missing GDP).

Several possible reasons had been advanced for the apparent slowdown in productivity growth in the past three years, from a benchmark of $1\frac{1}{2}$ – $1\frac{3}{4}$ per cent per annum in earlier decades, but no factor was able to provide an adequate explanation alone. Measurement issues may explain part of the slowdown, and it was possible that recent GDP estimates might be revised up somewhat. Some industry-level explanations included developments in the mining and utilities sectors, but not all of these were easy to understand, and a large part of the overall productivity slowdown could be traced to the non-market sector, for which it was extremely difficult to measure productivity.

Any genuine productivity slowdown that has occurred was likely to be related to the high level of capacity utilisation in the economy, especially in the resources sector, which had seen a large increase in the price of its output in recent years. Given that it often took time to put extra capacity in place, some firms may have chosen to meet increases in demand by taking on extra labour, which implied diminishing returns and lower labour productivity. However, these capacity-related effects on productivity should be temporary, rather than permanent. It was difficult to place much weight on some other explanations, such as declining benefits from information technology, which would suggest a more permanent slowdown, in part because they should be affecting productivity in other countries that have not shared Australia's apparent productivity slowdown. Members asked the staff to extend their work to review the debate about productivity in the 1970s, to see if any lessons could be drawn.

Looking ahead, members agreed that some pick-up in productivity growth was likely as the temporary restraints eased, but productivity growth would probably not return to the high rates seen earlier in the current expansion. Board members discussed the policy implications of the work that had been undertaken, noting that the uncertainties around estimates of trend productivity growth implied that significant attention needed to be placed on a range of direct measures of resource utilisation and on price and wage pressures in particular. If the true rate of productivity growth was lower than previously believed, the rate of wages growth that was consistent with meeting the inflation target would be correspondingly lower.

Members suggested publication of this work.

Considerations for Monetary Policy

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

The data that had become available over the past month suggested that economic conditions around the world had continued to be strong, with further indications that growth was spreading more evenly across the major economic regions. Domestically, the main data pertaining to inflation came from the wage price index for the December quarter. These showed that wages growth had remained relatively high but had not accelerated beyond $4\frac{1}{4}$ per cent, and did not cause members to reassess the judgement, reached after the release of the December quarter CPI, that underlying inflation would ease a little over the year ahead.

As monetary policy was currently exerting a mildly restraining influence on demand in the economy, with the cash rate and lending rates above normal, members were satisfied that no further policy change was warranted at this stage. The recent instability in financial markets added to the

CONFIDENTIAL

6

case for maintaining a steady setting of monetary policy for the time being. While members saw no case to change policy at this meeting, they were not sure that rates had been increased sufficiently to bring inflation back towards the centre of the target band. Economic and financial conditions would be monitored over the period ahead to determine if further adjustments to policy would be required.

The Decision

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



Chairman
3 April 2007