CONFIDENTIAL

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

SYDNEY, 2 OCTOBER 2007

Present

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

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

GL Debelle, ML Edey

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

Minutes

The minutes of the meeting held on 4 September 2007 were approved.

Board Member

- JH Akehurst

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

International Economic Conditions

The Board's discussion of the world economy commenced with an update on the latest preliminary forecasts produced by the IMF. Since July, when the previous set of forecasts was prepared, there had been a small downward revision to expected world growth in 2008. The final forecast to be released this month may be a bit lower again, with most of the adjustment likely to reflect a delay in the recovery of the US economy rather than any further slowing. Even with these downward revisions, the forecast indicated that 2008 was expected to be the sixth consecutive year of above average growth in the world economy.

The United States economy had slowed to a 2 per cent per annum pace. Growth was set to remain at that rate for the next few quarters as the expected pick-up in activity had been pushed out. The main source of weakness had been the housing sector, which accounted for about 5 per cent of overall activity. The most recent figures for the leading indicators of housing activity had continued to fall, with no clear sign of a cyclical trough, which had previously been expected around mid year. In addition, house prices were falling, with the Case-Shiller index of monthly repeat-sales, derived from sales of houses in the 20 largest cities, now 5 per cent below its peak in 2006. Members considered that a dynamic in the housing sector was at play, in which people were reluctant to enter the market to build or purchase new homes so long as prices were falling. The stock of unsold new homes had peaked, but the fact the stock-to-sales ratio was still high suggested that a recovery in housing construction was still some way off. Labour market conditions in the United States had begun to soften in the past few months, with a fall in non-farm payrolls in August and downward revisions to the growth in payrolls in the preceding two months. Nevertheless, employment growth over the past year had been 1.2 per cent, which was sufficient to keep the unemployment rate broadly stable over that period.

In Japan, economic data had been volatile in recent months, making it difficult to obtain a clear sense of the pace of growth. The latest Tankan survey on business sentiment, conducted by the Bank of Japan, indicated that sentiment remained above average in the September quarter, but was below recent high levels. Overall, it appeared that growth was reasonable but the momentum had slowed recently. Employment growth was firm, at around 1½ per cent, and the unemployment rate had been trending down. The CPI continued to fall by around ¼–½ per cent per annum.

The Chinese economy had not showed any signs of slowing in the past few months. Industrial production was increasing at more than 17 per cent a year. China now accounted for around 15 per cent of world GDP on a purchasing power parity basis, about the same as for the euro area, and was the single largest contributor to global GDP growth at present. Members noted that there were increasing limits to the continued rapid growth of the Chinese economy, which bore watching. These included pollution, rapidly rising wages for middle management personnel and growing competition from other emerging Asian economies in manufacturing production.

Members reviewed data on global steel production as an indicator of the importance of China in the world economy. Crude steel production by China was rising by 15 per cent per annum, with growth in steel production elsewhere in the world flat. The share of China in world steel production was now approaching 40 per cent. Iron ore import volumes to China were also growing very strongly, with the share of China in total world iron ore imports around 45 per cent, having been only a bit above 10 per cent a decade ago. Australia was the largest supplier of iron ore to China.

Growth in other east Asian economies had picked up. In aggregate across the region, industrial production was now growing at around 8 per cent, about double the rate seen early in the year.

Data on industrial production and consumer and business sentiment in the euro area indicated that the pace of growth had eased but remained above average.

Conditions in commodity markets suggested that strong global demand was continuing despite the recent disruptions in credit markets in many countries. Base metals prices had risen since early August and had doubled over the past three years. Only part of the latest rise could be attributed to the depreciation of the US dollar. Oil prices had reached record high levels in the past few weeks, with the prices of both WTI and Tapis crude above US$80 per barrel. Spot prices of the bulk commodities of coal and iron ore, which are important Australian exports, had been strong, which suggested that the next round of contract price negotiations could see increases. Members noted that the outlook for commodity prices in general was firm.

Domestic Economic Conditions

Members briefly discussed the key features of the national accounts for the June quarter, which had been released shortly after the commencement of the previous meeting. Growth in the quarter had been ¼ percentage point higher than expected, with no special factors to explain this. Apart from housing, all components of demand were strong. Farm output fell by 26 per cent over the year to the June quarter, but this was expected to turn around in the current financial year. GDP growth over the year was 4.3 per cent, and non-farm growth of 5.2 per cent over the year was the highest since 1998. Non-farm productivity growth was 2 per cent over the year to the June quarter, and although a little slower than in the second half of the 1990s, the data no longer raised the same puzzles that they had a year earlier.

It was possible that the recorded increase in output growth overstated the true extent of acceleration, following a period in 2005 and 2006 during which it had been implausibly low. But, in general, the current data consistently showed a picture of strong growth and suggested that this had continued into the September quarter. The NAB survey of business conditions, generally thought to be a reliable indicator of overall economic growth, had picked up over the past year, and early indications were that business conditions in the September quarter were as strong as at any point since the start of the survey in 1989.

According to the national accounts, business investment had increased by 10 per cent over the year to the June quarter. The share of investment in GDP had been rising over the past several years, particularly for the buildings and structures component, and was near the level seen in the late 1980s.

Business credit had increased by more than 25 per cent over the six months to August on an annualised basis.

Turning to household spending and incomes, members noted that good growth in employment and wages had led to strong growth in incomes, which in turn had spurred a lift in the pace of retail sales, to around 7 per cent per annum. The national accounts measure of real household disposable income had increased relatively strongly over the year to the June quarter. While interest payments were increasing as a share of incomes, the annual growth of real disposable income after interest payments was still very strong, at over 6 per cent.

House prices were now picking up steadily across all cities, after being flat in Sydney up to the middle of the year. In Sydney and Melbourne, the rise in prices was mostly in the more expensive suburbs, especially so in Melbourne, but even in Sydney the least expensive suburbs had seen prices stabilising after their earlier falls. Auction clearance rates were significantly higher over the year to September in both Sydney and Melbourne, which post-dated the recent interest rate increase and were consistent with a strong secondary housing market.

It was probably too early to expect to see any significant effects of the credit market disturbances on lending to households and businesses. August data for housing loan approvals and housing credit showed that the spike in June, which was associated with superannuation-related investment activity, had been unwound in the subsequent two months. This suggested that loan approvals and credit growth were back on the same trends as before June, i.e. consistent with underlying growth in housing credit of around 1 per cent per month.

Dwelling commencements up to the June quarter indicated that, on a national basis, the downturn had been mild. In fact, the downturn had occurred mainly in NSW, with commencements in other states being flat over the past four years. Members observed it was unlikely that people would commit to build homes until they were convinced prices had bottomed, and although demand for property by investors was growing, rents may not yet have increased sufficiently to provide an attractive return on newly constructed accommodation.

In the rural sector, the lack of follow-up rainfall over winter had led to downward revisions to the recovery in farm output in 2007/08. ABARE had released its September quarter outlook, which included a halving in the forecast recovery in wheat production. Members noted that further downward revisions were likely in the months ahead. As an indicator of tightening conditions in the grains market, wheat prices had risen very sharply in the past few weeks.

The labour market had continued to be strong in August, with employment continuing to increase at a year-ended rate of 2½–3 per cent. Further increases in job vacancies had confirmed the tightness of the labour market. Members recalled that the wage price index had risen by 4 per cent over the year to the June quarter, which indicated no acceleration in wages. The national accounts measure of average earnings per head had increased by 5½ per cent over the same period, though this series was volatile.

Revised GDP and inflation forecasts prepared for this meeting were similar to those presented at the previous meeting, but took account of the higher-than-expected growth in the June quarter national accounts. The forecasts incorporated some natural slowing in growth from the recent unusually fast pace, which would be intensified by the dampening effect of the tightening of monetary policy in August and recent problems in credit markets. World growth was expected to be ½ percentage point lower, following the credit market disturbances, and growth in Australia was expected to settle at around 3¼ per cent per annum over the forecast period, which was about trend. Inflation in underlying terms was expected to settle just under 3 per cent, with the headline rate gravitating towards that rate by the end of 2008. The staff view was that if credit markets calmed down relatively quickly, there could be upside risks to both the output and inflation forecasts.

Financial Markets

Financial strains had continued during September but lessened noticeably following the reduction in the federal funds rate of 50 basis points announced by the Federal Reserve on 18 September. The market currently expected two further reductions in the federal funds rate, each of 25 basis points, by the end of the year.

Global money market rates, which had been volatile since early August, fell sharply following the announcement of the Fed's decision. However, spreads on short-term money market instruments remained elevated in major financial markets, particularly in Europe and the United Kingdom, where financial institutions had experienced significant difficulties.

Commercial paper markets were opening up again for good-quality issuers and for longer maturities, and volumes were stabilising. It was nonetheless unlikely that the market would reach its previous levels of outstandings and may no longer provide a source of funding for some purposes. Bond issuance, particularly by financial institutions, had picked up considerably in late August and into September, with yields generally higher than they had been before the crisis began.

In Australia, spreads on short-term interest rates had begun to narrow from the peaks reached in September, and to a greater extent than seen in other developed countries. Bank bill spreads remained above the levels prevailing prior to the onset of the financial turmoil, in part the result of a shift from offshore to onshore financing, which was easier and cheaper to accomplish in current market circumstances.

The financial market disruption had seen a marked change in global policy rate expectations. In part, the disruption had delivered a tightening in credit conditions that some central banks had otherwise been intending to effect through increases in policy rates. The market now expected the European Central Bank to remain on hold rather than tighten policy further, and policy interest rates in Japan were not expected to be raised any time soon. As noted, further easing was expected in the United States. The Bank of England was now expected to ease rather than tighten further.

The People's Bank of China had tightened monetary policy settings further during the past month. There had been no change to exchange rate arrangements, with the slow rate of appreciation continuing.

Government bond yields in the major countries had increased from their recent lows, following safe-haven buying by investors during August, and had returned to the range that they had traded in for the past few years.

The yield curve in the United States had not changed at the longer end following the cut in the federal funds rate, unlike in the easing episode in 2001, where longer-term rates fell significantly and generated an easing in conditions for borrowers on fixed-rate mortgages. The current yield curve implied that the market was expecting stabilisation in the economy with the possibility of rising inflation down the track. These movements had not generated much easing for those on fixed-term mortgages. Those on adjustable-rate mortgages were better off, but many borrowers faced resets in the period ahead.

Share markets around the world rose strongly during September, particularly in Australia and emerging markets. However, stocks of financial institutions remained well below their peaks. Several US financial institutions had recently reported third-quarter earnings, and most had reported losses associated with activity in the US sub-prime and related markets. Despite the losses, some profit reports were still quite strong.

The Australian share market had outperformed other markets over the past month and was back at record high levels. Resource stocks had been very strong and local financial institutions had not been marked down as much as those in the United States.

In foreign exchange markets, the US dollar had continued to decline and carry trades had been re-instated, which had favoured high-yielding currencies and prevented further appreciation of the yen against the US dollar. The euro was at an all-time high against the US dollar and the Canadian dollar had gone through parity; the US trade-weighted exchange rate had reached a record low. The strength of the pound sterling had been crimped by the effects of the Northern Rock crisis.

The Australian dollar had surged higher in September, after falling sharply during August, as the risk appetite of investors had returned. The current level of the exchange rate against the US dollar was just below the peak in February 1989. The most recent appreciation had pushed the exchange rate more than 12 per cent higher over the past year on a trade-weighted basis, and the Australian dollar had increased against all the currencies in the trade-weighted basket.

Turning to the domestic money market, members noted that Australian banks had been switching funding sources from offshore to onshore. After a very weak period during August and early September, bond issuance had started to pick up more recently. Bond issues by some domestic financials had been oversubscribed but spreads were higher than in the past few years; similar trends were in evidence for residential mortgage backed securities.

These higher funding costs were being passed through to interest rates on business loans, which tended to be priced off bank bill rates and had risen by about 25 basis points. However, the major banks were benefiting from an increased inflow of deposits, which contained the rise in average funding costs. This had allowed the majors to leave prime indicator housing rates unchanged and increase rates only on low-doc and non-conforming loans. Some of the non-bank lenders had announced increases in interest rates on loans of 10–15 basis points.

In relation to monetary policy, market expectations were for only a one-in-three chance of further tightening in Australia in coming months, but were higher for next year. Members noted that the September quarter CPI, which was scheduled for release later in the month, could change these expectations.

Considerations for Monetary Policy

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

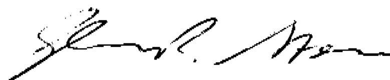
In discussing the recommendation, Board members observed that the US economy appeared to be facing a more prolonged period of soft growth than had previously been expected and that the credit market disruptions could have a noticeable adverse effect on both the US and the euro-area economies in the period ahead. Conditions in the Australian economy had been very strong this year and the outlook was for further robust growth, with underlying inflation remaining at an uncomfortably high level. High global commodity prices, and the prospect of further increases in prices for some important export commodities, were continuing to stimulate domestic demand and increase incomes. This would be likely to add to inflationary pressures over the medium term, though the recent appreciation of the exchange rate would exert some dampening effect.

Members noted that the stresses arising from the turbulence in global financial markets appeared to have eased somewhat over the past month, but nonetheless markets remained fragile and uncertain. More significant losses among overseas financial institutions were likely to emerge, which could dent confidence. The extent to which global credit conditions had tightened as a result of recent developments was not yet clear, but emerging economies such as China were likely to be less affected than the larger developed economies.

Members noted that a *prima facie* case to tighten policy further could be argued, based on the inflation risks from the strong momentum of the domestic economy and despite the slowing in the United States. However, the state of financial markets, while improving over the month, remained uncertain, which suggested caution in policy-setting. The potential effects of recent financial developments on the prospects for growth and inflation around the world and in Australia could become clearer over the coming month. Waiting would also allow time to assess the September quarter CPI and other data to be released before the next meeting.

The Decision

The Board decided that the cash rate should remain at 6.5 per cent.



Chairman
6 November 2007