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

PERTH, 4 SEPTEMBER 2007

### Present

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

Members granted leave of absence to RC Corbett AM in terms of section 18A of the *Reserve Bank Act 1959*.

ML Edey, KM Hall, PW Lowe

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

### Minutes

The minutes of the meeting held on 7 August 2007 were approved.

### Financial Markets

In view of the importance of developments in financial markets over the past month, including their implications for the outlook for the real economy, the meeting commenced with a discussion of those developments.

Financial strains had intensified in August as the contagion from the problems in the sub-prime mortgage market in the United States spread more widely. Particular financial institutions in Europe were affected as global investors became very risk averse, resulting in an unwillingness to roll over asset-backed commercial paper. This sapped confidence in broader financial markets. The problems were manifested mainly in liquidity shortages, which put pressure on central banks to increase the provision of liquidity.

Following an announcement by BNP Paribas in Europe that it was suspending redemptions in several funds, European overnight money market rates rose sharply above policy target rates, despite the ECB's intervention. From there, the problems spread to most countries in early August. For instance, the effective fed funds rate in the United States rose to 6 per cent compared with the target rate of 5.25 per cent. In response, the Fed injected large amounts of funds through its money market operations, which led the fed funds rate to fall well below the target rate for a time. However, yields on 90-day bankers' acceptances, which had been around the same rate as fed funds for most of the year, also rose sharply in early August and did not fall when the actual fed funds rate fell; rates on bankers' acceptances remained about 25 basis points higher during the month than their previous level, which represented an increase in the cost of funds for banks.

Yields on asset-backed paper increased the most, by around 60 basis points, and some parts of the market essentially shut down. Moreover, the most highly regarded institutions could roll over paper for only very short maturities and the flow-on effects were felt in the United States and elsewhere, including Australia.

The turbulence in credit markets had the effect of locking out financial institutions from raising term funds; this was particularly the case for mortgage lenders, with investors reluctant to invest beyond one week. 'Second tier' names had trouble raising even short-term funds. The difficulty the

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Fed had in getting cash to flow to the institutions most in need, despite the actual fed funds rate being well below target, led it on 17 August to cut the discount rate from 100 basis points to 50 basis points above the fed funds target rate. This action was designed to lessen the cost of emergency funding to around 7 000 banks that are members of the Federal Reserve System and have access to the discount window. The Fed also lengthened the term of borrowing from the discount window from typically overnight to 30 days and it signalled that it would consider accepting as collateral from banks the asset-backed paper issued by their affiliated structured-finance vehicles (also known as conduits). The same operational challenges for central banks were experienced elsewhere.

The risk aversion of investors around the world spread to equity markets, where sharp falls were recorded, particularly for financial stocks. US equities fell by nearly 10 per cent from their highs in July before retracing about half that in the latter part of August.

Global risk aversion was also seen in wider spreads for corporate bonds as investors turned to the security of government paper. Yields in bond markets around the world fell. For instance, yields on 10-year US Treasuries fell by about 65 basis points from their peaks in July, to around 4½ per cent; larger falls in yields were seen in the short-term Treasury bill market, typically a safe haven for investors.

Outstandings in the asset-backed commercial paper market fell by nearly 15 per cent in August, with the assets and funding presumably taken back onto banks' balance sheets. Members noted that the shift to extreme risk aversion implied that credit markets were no longer functioning effectively.

Policy rates of most major central banks had not changed over the past month. The injections of liquidity were technical operations and not meant to signify any change to monetary policy settings. However, expectations of a cut in the fed funds rate had risen, based in part on the statement accompanying the discount rate cut in mid August, which pointed to a change in the balance of risks in the real economy. Policy rates in Europe and Japan, which were previously seen as likely to rise, were now expected to be left on hold, and this was the case for most countries. The main exception was China, where there had been further measures to tighten monetary policy during August.

Australia was caught up in the dramatic retrenchment of risk in financial markets. The Bank met the sharp increase in demand for cash by providing additional liquidity to the market over the second half of August. Exchange settlement balances, which financial institutions hold with the Bank, exceeded \$5 billion in late August, the highest level since the late 1990s and well above the usual average level of around \$700 million. More recently, the Bank had drained some of the excess cash from the system as conditions had stabilised a little. The Bank's repurchase agreement (repo) operations had been largely in bank bills and certificates of deposit, rather than Commonwealth Government securities, in an effort to alleviate pressures in the interbank funding market, and the term of repos had tended to lengthen in the past month. These operations kept the actual cash rate in Australia firmly anchored to the target. Nevertheless, rates on three-month funds, in particular those representing the cost of borrowing offshore, rose sharply from early August. Consequently, banks turned back to the domestic market for their funding, even though funding costs there were also elevated.

Members were informed that the Bank was contemplating further widening the pool of collateral it would accept in repo operations given the funding problems currently being experienced by some mid-tier Australian banks, whose funding was heavily concentrated offshore. It was also the case

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that the class of paper currently accepted by the Bank as collateral was quite narrow by international standards. Members accepted that any change to these arrangements would be designed to improve liquidity and that the banks affected by the liquidity crisis had no problems with asset quality. They recognised the difficulty of communicating this change in arrangements to the market and asked to be informed when the Bank proceeded with the change.

In a wider discussion, members commented that the current crisis would lead some banks to change their business models and that if the higher funding costs were sustained, loan rates were likely to rise. At the very least, discounts on some housing loan products were likely to be reviewed. Such developments, if they occurred, would represent a de facto tightening of monetary policy. It was noteworthy that the recent turbulence in credit markets posed challenges for lenders, as profit margins had been squeezed, particularly for those reliant on securitisation, where the US asset-backed commercial paper market was currently no longer a viable source of funding. This implied a probable competitive realignment among lenders.

In relation to monetary policy, expectations of further tightening in Australia had been pared back in the past few weeks and the market now perceived little chance of a rate rise this year.

The Australian dollar had been particularly volatile in August. Volatility in the Australian dollar/yen exchange rate was the highest since the float, as fluctuations in market conditions led investors to reverse and then re-engage in carry trades during the month. Disorderly conditions in the foreign exchange market led the Bank to intervene for the first time since May 2001. The Australian dollar had fallen sharply in local trading on 16 August and when it continued to fall in thin market conditions in London, the Bank moved to steady the market, at first anonymously through an agent but later in New York in its own name. Following these interventions, the exchange rate stabilised at around US78¼ cents and then appreciated by nearly US1½ cents.

Although the Australian dollar strengthened in late August, it remained significantly below the peaks in July, particularly against the yen, and was about 7 per cent lower on a trade-weighted basis. However, taking a longer-term perspective, the exchange rate was still well above its post-float average in trade-weighted terms.

### **Financial Stability**

Against the background of recent events, the Board's discussion focused on three main issues: the longer-term structural issues raised by the global repricing of risk; the longer-term health of the Australian banking system; and developments in household balance sheets.

Members reviewed a number of issues arising from the repricing of risk, which came after a long period during which risk was widely considered to be underpriced. These issues included: the importance of liquidity for the smooth functioning of financial markets; the extent to which credit risk transfer markets had allowed banks to shed risk; and the problems posed by the growth in trading in complex instruments that were difficult for investors to understand and where price transparency was poor. Members also discussed the role of rating agencies going forward.

Members noted that the global repricing of risk was also clearly evident in Australian markets and, as with international markets, was most obvious in the spreads on banks' short-term paper and the premia on credit default swaps for banks. Both APRA and the Bank were holding discussions with the Australian banks about their liquidity, and the flow of information between the two institutions was working well.

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These developments were occurring against the background that the Australian banking system was highly profitable, well capitalised and viewed favourably by the international rating agencies. Loan quality remained high and, while the ratio of non-performing loans to total on-balance sheet assets had risen slightly over the most recent six months, it was low by both historical and international standards.

Reviewing household-sector balance sheets, members noted that generally these remained in good shape, reflecting the favourable macroeconomic environment. Household net worth had increased by around 10 per cent over the past year and household gearing ratios were still on the lower side in international comparisons. While the proportion of housing loans that was in arrears had increased over recent years, there were some signs that it was levelling out. Members also noted that an important factor contributing to the rise in the aggregate interest servicing burden was an increase in the share of households with debt. Despite the aggregate indicators being generally benign, members observed that there were pockets of difficulty, most noticeably in New South Wales. Arrears appeared to be concentrated in western Sydney. Court data also showed that the number of writs of possession was highest in this part of Sydney, while Census data showed that the share of households with an owner-occupier debt-servicing ratio above 30 per cent was considerably higher than in other parts of the country.

The Board's overall assessment was that the strength of the core Australian banking system was an important factor in alleviating some of the concerns arising from the deterioration in credit markets.

### **Domestic Economic Conditions**

The national accounts for the June quarter were released shortly after the meeting commenced. The data had come in stronger than expected by most commentators, with the national accounts painting a picture of very strong growth in the Australian economy up to the middle of the year. Growth in output had been 0.9 per cent in the June quarter and 4.3 per cent over the year; non-farm GDP growth over the year to the June quarter was over 5 per cent. Domestic spending had increased by close to 2 per cent in the June quarter and 5.6 per cent over the year, with public demand being a particularly strong component in both periods. As a result of the strong growth in output, measures of productivity had increased by almost 3 per cent over the year to the June quarter, well above average productivity growth in recent years.

While price indexes in the national accounts suggested that the increase in prices of consumer goods over the year to the June quarter was broadly similar to that indicated by the CPI, measures of wages in the national accounts were rising considerably more rapidly than shown by the wage price index (WPI). However, the national accounts series on compensation of employees was volatile and also conceptually different from the WPI.

Turning to the regular data series released over the past month, members noted that indicators of consumption for July were strong. Although volatile in the June quarter, retail sales had risen rapidly in both June and July, with the year-ended rate remaining at about 7 per cent. The data for large and small retailers showed that, in the past two months, sales by large retailers, which are fully enumerated by the ABS and hence more reliable, had picked up. Motor vehicle sales had also been strong in the past few months, to be running at about 10 per cent above average levels in 2006.

In the secondary housing market, house prices at the top end of the Sydney and Melbourne markets had strengthened, with the increases particularly sharp in Melbourne in recent months. However, prices at the lower end in Sydney, which had peaked in early 2004, were still flat or falling. In

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Perth, where rises in house prices in recent years had been extremely rapid, there was now a levelling out in prices. Overall, nationwide house prices were about 8 per cent higher over the past year.

Auction clearance rates in Sydney and Melbourne had risen strongly through the first half of 2007. There had been little change in the data covering the first few weeks of August, which suggested that the market for upper-end property sales had remained strong following the increase in the cash rate and housing interest rates early in the month.

In further signs of tight conditions in the housing market, rents had risen rapidly over the past year, with the REIA series for rents on newly tenanted dwellings rising sharply and vacancy rates close to record low levels in all capitals.

Overall business conditions, as measured by the NAB survey, had increased to around record high levels in the June quarter. This indicator appeared broadly consistent with the national accounts data over the recent period and confirmed that conditions had strengthened since the start of the year.

The labour market had continued to be strong in July, with a further rise in employment and steady unemployment at 4.3 per cent, which was a very low level. Despite this, there had been no acceleration in wage growth in the June quarter. The WPI had risen by 4 per cent over the year to the June quarter, which was the same rate prevailing for the past few years. Members acknowledged that this outcome was difficult to reconcile with the data on wages in the national accounts.

### **Revisions to the Outlook for the Australian Economy**

Revised GDP and inflation forecasts were prepared for this meeting, which attempted to take account of the turmoil in financial markets during August. The revised central forecast, prepared before the release of the higher-than-expected June quarter national accounts data, had taken about ½ percentage point off the forecast for non-farm growth prepared for the July meeting. This adjustment represented the estimated effect on growth of the policy tightening in August and disruption in credit markets in the past few weeks. The latter effect was seen to occur most directly via the housing market, through lower lending for construction and associated feedback effects. This forecast assumed that conditions in credit markets would start to improve in the near future, though credit spreads would remain higher than they had been in the first half of this year.

An alternative scenario was also prepared to assess the effect on the forecasts of a protracted credit crisis around the world and in Australia. The purpose was to provide illustrative rather than precise magnitudes of the possible effects if the recent problems in financial markets were sustained. With the credit disruption a worldwide event, world growth was assumed to be 2 percentage points lower over the forecast period. The assumed tightening in the global credit market would lead to a reduction in capital inflows to Australia and a lowering of the current account deficit, which would require a substantial depreciation of the exchange rate. As a consequence, relative to the central forecast, non-farm GDP growth in Australia was estimated to be 1½ percentage points lower: a larger fall in domestic spending would be cushioned by the effect of the lower exchange rate on the competitiveness of exporters and import-competing industries.

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The weaker economy would result in a rise in unemployment and a fall in wage growth. Taking account of the reduced pass-through of exchange rate depreciations to inflation in recent years, the assumed exchange rate depreciation would nonetheless boost inflation above the central forecast in the short term, but the slowing in demand and lower level of resource utilisation would see underlying inflation declining by the end of the forecast period.

Updated forecasts for output and inflation, which would incorporate the latest national accounts data and other recent developments, would be prepared for the next meeting.

### **International Economic Conditions**

The discussion of the world economy provided Board members with an update of conditions prior to the emergence of the recent problems in credit markets. The story was one of strength in most regions, based on the June quarter national accounts where they were available. Growth in Australia's trading partners was above 5 per cent for the year to the June quarter, which was near the highest rates seen over the past 15 years, and it appeared to be firming in the period for which data were available. Members noted that growth in output in India had been very strong over the past year and that it had now stepped up to be more than 9 per cent per annum.

In the United States, the June quarter national accounts, which reported growth of 0.8 per cent in the quarter, suggested that growth outside the housing sector was holding up reasonably well. The question remained about the extent to which the current weakness in housing activity, including in the secondary market, would spread to other parts of the economy. Indicators for housing construction up to July had remained very weak and were likely to deteriorate further as the credit disruption took its effect. The stock of unsold houses was being worked off, but this process had a long way to run and it was too soon to tell whether or not the cycle in new home sales had reached a trough.

House prices in the United States had begun to level out or were falling, according to three key measures. Members were informed that the most accurate indicator of current trends in house prices was the Case-Shiller series, which was a monthly repeat-sales index derived from sales of houses in the 20 largest cities. This series suggested that house prices across the United States peaked in mid 2006 and had fallen noticeably over the past year.

### **Considerations for Monetary Policy**

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

In discussing the recommendation, Board members observed that macroeconomic conditions in the world economy and Australia were at least as strong as in the previous month, when policy was tightened. Recent data for the Australian economy continued to suggest a robust pace of expansion, with output rising faster than trend and capacity utilisation and confidence high. However, downside risks to the United States economy had increased as a result of the ongoing weakness of the housing sector there.

Members noted that there were stresses arising from the turbulence in global financial markets as participants had struggled during recent weeks to re-price risk in the face of heightened uncertainty. Although these stresses were not always visible to those not directly involved in credit markets, the economic effects were potentially significant. Short-term wholesale funding costs for financial institutions had risen, including for Australian entities, and some segments of the capital markets

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were effectively closed. The higher cost of funding faced by these institutions, if sustained, would at some point be passed on to indicator lending rates. In the absence of offsetting developments, this factor, together with the heightened risk of slower world growth, would exert some additional restraint on demand, and hence inflation, in Australia.

While the strength of the underlying economy was seen by members as possibly requiring a further monetary policy tightening to prevent inflation from rising above the target range, the financial developments over the past month could result in a tightening of financial conditions independently of movements in the cash rate. Under those circumstances, members judged that a stable policy setting was appropriate for the time being.

## **The Decision**

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



Chairman  
2 October 2007