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

SYDNEY, 3 JULY 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, DW Orsmond

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

Minutes

The minutes of the meeting held on 5 June 2007 were approved.

Board Member

- HM Morgan AC

The Governor noted that this was Mr Morgan's final meeting after a combined period of almost 14 years covering four terms, with his first beginning some 26 years ago. Throughout his period as a Board member, he made an outstanding contribution as a consistent and forceful advocate for sound monetary policy. His extensive commercial experience and specialised knowledge had been of great value to the Board's deliberations and was highly appreciated by the five Governors with whom he had worked. Members wished him well in the future.

Domestic Economic Conditions

Board members commenced their discussion of the domestic economy by reviewing the national accounts for the March quarter, which were released the day following the previous Board meeting. Growth in both aggregate and non-farm output had been higher than expected. Following the strong outcome in the December quarter and upward revisions to earlier periods, and a smaller fall in farm output in the March quarter than had been expected, GDP growth over the year to the March quarter was 3.8 per cent. Non-farm output increased by 4.6 per cent over the year, with strength in most major components in the most recent quarter.

Domestic demand growth over the year to the March quarter had been 4¼ per cent, which was firm but lower than in recent years, and the gap between demand and output had narrowed. The composition of spending had changed in the past two years; initially, investment had picked up as the pace of consumption and dwelling activity had slowed but, more recently, these trends had started to reverse.

Members were informed that, in the staff's judgment, part of the recent strength in the national accounts was likely to be payback from weakness earlier in 2006 and that the pace of growth from the June quarter onwards would probably ease. It was noted that the quarterly pattern of growth presented by the national accounts was subject to measurement error and subsequent revision, and that in the past year or so these data may have exaggerated both the slowing and then the pick-up in growth. Survey measures of business conditions and labour market data suggested that the pace of growth had varied by less than indicated in the national accounts.

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The stronger growth in output implied an increase in the rate of growth of productivity, which was measured at a little above 2 per cent over the year to the March quarter, compared with the longer-run average of around 1¾ per cent. The higher rate of productivity growth was a consequence of the figures for GDP growth and employment growth coming more into line, following a period where employment growth had been considerably more rapid than output growth. Looking at longer-run movements in productivity growth, members discussed the possible reasons for the higher growth in the second half of the 1990s relative to earlier periods. One explanation was the possibility that it had taken a long time for the effects of the microeconomic reform measures that had been introduced from the early 1980s to permeate through the economy and thereby show up in data on activity.

Turning to the regular data releases over the past month, it was noted that there had been no new retail sales figures following the modest increase reported for April, though information from the Bank's liaison contacts had suggested firm trading conditions recently. Motor vehicle sales had fallen a little in April and May, though this had followed a strong March quarter.

Strength in consumer spending in recent months had been supported by rapid growth in household disposable income, which had increased in real terms by around 2 per cent in the March quarter and 6 per cent over the year. The income growth had been underpinned by strong labour market income growth and increases in earnings on household financial assets.

In the housing sector, the cyclical downturn had been mild by past standards and some of the leading indicators of activity were starting to pick up somewhat. The current supply of 12 000 dwellings per month, judging from data on private building approvals, was below estimates of underlying demand of around 15 000 per month, with the growing excess demand expected to underpin prospects for future growth in housing construction activity. Members commented that there was some doubt as to whether there was the capacity to increase housing construction further given the demand on resources for non-residential construction, which was running at a high level, and by state government plans to increase public infrastructure spending.

House prices had increased in the past few months in all the capital cities except Perth, where they had levelled out after rapid rises over the past few years. The increase in most cities was concentrated in the most expensive suburbs; in Sydney, however, prices were rising only in suburbs in the middle of the price distribution, with the top end flat and prices in the cheapest suburbs still flat or falling. There were some signs of increasing mortgage arrears, which implied that the housing correction was continuing in some parts of the largest cities.

Looking at credit growth, while housing loan approvals and lending credit growth had increased a little in recent months, the rate for both series was below that seen in recent years. Business credit, on the other hand, was rising at an annual rate of close to 20 per cent over the six months to May, the fastest in almost two decades. Members discussed whether it was appropriate to characterise policy settings as 'mildly restrictive', agreeing that it was. The Governor undertook to have a further analysis for the next meeting.

Business investment had increased by about 4 per cent over the year to the March quarter (excluding the effect of the reclassification of Telstra from the public to the private sector in the March quarter). Although this was well below the average rate of growth of 15 per cent in the previous four years, the current share of investment in GDP was high and this implied growth of the net capital stock of around 6 per cent per annum.

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In the external sector, annual growth in export volumes was strong at about 7 per cent in all components in the March quarter except rural exports, which fell because of the drought. Import volumes rose sharply in both the December and March quarters because of strong growth in domestic demand.

The current account deficit had fluctuated between 5 and 6 per cent of GDP in the past few years, with the latest observation a little below 6 per cent. Over this period the trade deficit had narrowed, reflecting the rising terms of trade and pick-up in export volumes, but this had been offset by a widening in the net income deficit, which had left the current account deficit broadly stable as a share of GDP. The widening in the net income deficit had arisen because of higher interest payments on foreign debt and higher dividend transfers abroad; as these payments were typically reinvested in Australia, they were also recorded in the balance of payments statistics as inflows on the financial account.

The terms of trade were estimated to have increased by about 2 per cent in the June quarter, following a rise of 1 per cent in the March quarter. Base metals prices had fallen back in the past few months from very high levels, with this mainly reflecting the trend in nickel prices. The latest expectations for next year's price increases for bulk commodity contracts had been revised up for both iron ore and coking coal.

Oil prices had risen over the past month, to around US\$70 per barrel for WTI crude. Members discussed the relationship between WTI and Malaysian (Tapis) crude prices, noting that the former was the global benchmark while the latter was the relevant benchmark for the Asia-Pacific region and Australian petrol prices. The price of Tapis crude had been high, and this had been an important contributor to higher domestic petrol prices in Australia. The margin between WTI and Tapis crude prices had widened a few months ago, reflecting refining capacity outages in the US that had reduced the demand for WTI crude, though some of this was in the process of being reversed.

Rural output was expected to bounce back strongly in 2007/08, following the breaking of the drought. The latest projections from the Australian Bureau of Agricultural and Resource Economics suggested that growth of 130 per cent would take winter crop production above the average of the five years preceding the most recent drought. Although the eastern states had benefited from widespread rainfall providing a good start to the winter cropping season, members commented that the projections may be optimistic given the poor conditions in Western Australia and the likely cut-backs to water allocations from the Murray-Darling system.

Labour market conditions were again strong in May. Year-ended growth in employment of over 3 per cent was coupled with a fall in the unemployment rate to 4.2 per cent, which was the lowest level since 1974, and a rise in the participation rate to its highest in at least 60 years. A rising employment-to-population ratio, coupled with population growth (including higher migration), had driven overall employment growth in recent years. Members noted that growth in the working age population was expected to peak in the next year or so.

International Economic Conditions

The outlook for the world economy had remained favourable since the previous Board meeting. Consensus forecasts for growth in 2007 and 2008 had been revised up noticeably since earlier in the year. The outlook for the G7 economies was relatively stable, with a forecast slowing in the US

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offset by upward revisions to the outlook for the euro area and Japan. China and other emerging economies were expected to grow faster in both years.

In the US, the latest data suggested little change in current conditions. Housing permits and starts were around one-third below their peaks. The lower level of activity was leading to some reduction in excess housing stocks, but this was a gradual process and the weaker conditions in the housing sector were likely to last longer than previously expected. However, other indicators of activity and spending in the economy had remained quite solid.

In other countries, conditions were broadly similar to those presented to the Board at the previous meeting. Business sentiment in Japan had remained steady at relatively high levels. Industrial production in China was continuing to increase at a fast pace, while production and export growth in east Asian economies had slowed over the past six months, having been adversely affected by the slowing in the US. The latest data for the euro area suggested that growth had moderated but remained relatively firm, and sentiment among businesses and consumers had remained high.

Outlook for the Australian Economy

The near-term outlook for the Australian economy was for the pace of quarterly growth in demand and output to be lower than the rapid pace seen in the December and March quarters, with non-farm GDP expected to grow at an annualised rate of about 3¼ per cent over the two-year horizon, which was somewhat above trend. Growth in total GDP would be higher next year as it would be boosted by the expected bounce-back in farm output in 2007/08, but thereafter was expected to be at around the same rate as non-farm GDP growth.

The past couple of quarterly outturns for underlying inflation had been lower than expected, with a year-ended rate of about 2½ per cent expected for the June quarter. Pending a review of the forecast for inflation to be undertaken following receipt of the June quarter CPI in late July, the outlook was for underlying inflation to rise slightly towards 2¾ per cent by the end of the forecast period. The increase was expected to be driven by current and forecast strong demand pressures and high levels of capacity utilisation, including in the labour market, though members noted that wages growth had been relatively stable in the period up to the March quarter. A sizeable increase in the headline CPI was expected for the June quarter, given recent higher petrol prices, but this would nonetheless be lower than the figure a year earlier, which had spiked up following the effect of Cyclone Larry on banana prices. This implied that the year-ended rate of CPI inflation would drop to around, or a bit below, 2 per cent in the June and September quarters, after which it was expected gradually to reach the same rate as that for underlying inflation.

Financial Markets

In the major economies, monetary policy had not changed in the US and in Japan. The European Central Bank had tightened policy in June, as expected, and a further tightening was expected later in the year. In other countries, policy rates were raised in Switzerland, Sweden and New Zealand. The Bank of England, and possibly the Bank of Canada, were expected to tighten policy at their next meetings.

Members noted that there had been a noticeable change in market expectations about future Fed policy moves over recent months. Expectations of an easing, which had persisted for much of the past year, had recently dissipated, and no change in the Fed policy rate was now expected before the

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end of the year. To that extent, markets now appeared to be more in line with Fed thinking. Over the past year, Fed commentary had generally expressed concerns about inflation.

As a consequence of the market's reassessment of the outlook for short-term interest rates, longer-term bond yields had increased further over the past month. While US bond yields had risen by as much as 60 basis points at one stage during the month, by the end of June the net rise was only 15 basis points, to around 5 per cent. While there had been much media and market commentary during the past month about the significance of these moves, members noted that they were considerably smaller than those in some earlier episodes, for example in 1994. Members concluded that the recent rise in yields reflected a less pessimistic assessment of prospects for the real economy rather than higher inflation expectations, which had remained relatively stable.

Yields on lower-rated US debt instruments had risen more than those on government bonds, indicating a widening in corporate spreads. Spreads on emerging market debt, however, had not widened.

New data on mortgage delinquencies in the US for the March quarter showed a rise to about 14 per cent for sub-prime loans, but there had been little change in the proportion of prime loans that were delinquent; this remained low. Rising sub-prime delinquencies were reflected also in the foreclosure rate, which had risen in recent months and was expected to rise further. There had also been a tightening of credit standards in mortgage lending to individuals, particularly for the sub-prime component, according to a survey by the Fed.

The current problems in the US sub-prime mortgage market had led to significant falls in the share prices of sub-prime lenders. Members discussed the effect of the problems in the sub-prime market on Bear Stearns, which had occasioned much commentary in the financial media of late. The Bear Stearns share price had fallen somewhat and its reputation had been damaged as a consequence of its involvement in, and support of, two highly leveraged funds which had incurred large losses by investing in the sub-prime market.

While it was too early to judge the broader significance of these developments, it was noted that a number of debt raisings by leveraged firms had been withdrawn, due to lack of investor demand. Members agreed some tightening in credit conditions was, on balance, a healthy development.

Turning to share markets generally, rising bond yields had led to a soft month for global share markets. However, emerging markets had seen another strong month, though the Chinese market had been volatile. In Australia, the share market had fallen slightly after 10 consecutive monthly increases and was still one of the strongest markets around the world for the year to date. Resource share prices in particular had been strong, supporting an increase in the overall market of 24 per cent over the past financial year. Mergers and acquisitions activity among listed Australian entities had remained strong, though this could be affected by tightening credit standards in due course.

In foreign exchange markets, the yen had continued to depreciate, particularly against the euro, with the fall driven by the effect of carry trades and capital outflows associated with investment abroad by Japanese households. Despite Japan's economic upswing in the past few years, the yen had depreciated substantially in both nominal and real effective terms.

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The NZ dollar had recorded a post-float high against the US dollar in June, as New Zealand had been the recipient of funds associated with carry trades. The RBNZ had intervened in the foreign exchange market following a sharp rise in the NZ dollar in New York trading early in June. This had had an immediate effect in producing a fall in the exchange rate and injecting some two-way risk in the exchange rate, but the currency had subsequently appreciated again. There had been several more episodes of intervention later in the month.

Members were briefed on financial conditions in New Zealand in some detail. The RBNZ had been tightening monetary policy for some time, but this had been slow to flow through to longer-term mortgage rates because of large capital inflows into the New Zealand bond market. As fixed-rate mortgages were more prevalent than variable mortgage rates in that country, this had blunted the impact of monetary policy, at least in relation to housing. It appeared that rising bond yields over the past month may finally have started to deliver the tightening sought by the central bank. Members noted that, to date, house prices in New Zealand had continued to rise strongly in the face of tighter monetary policy, but house building had slowed.

The Australian dollar had appreciated further over the past month, to be higher against all currencies in the trade-weighted basket except the NZ dollar. New multi-year highs had been reached against the US dollar and yen, and in trade-weighted terms, during June. Over the past year, the Australian dollar had risen by about 10 per cent overall, though it had depreciated against the NZ dollar. Compared with its post-float average, the dollar was high relative to the US dollar and Asian currencies, around average against European currencies, the pound and Canadian dollar, and below average against the NZ dollar. Measured in terms of the TWI, it was about 20 per cent above the post-float average.

Market expectations were for no change in monetary policy in Australia in July, but the stronger data for economic activity in the past month had pushed up expectations of a policy tightening by the end of the year.

Considerations for Monetary Policy

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

In discussing the recommendation, Board members noted that the outlook for the world economy remained favourable. There were some dampening factors affecting the outlook for the US economy, but these had had little effect elsewhere thus far, and global economic growth was expected to continue at an above-average pace next year.

On the domestic economy, members noted that the strength exhibited in the recent national accounts probably exaggerated the lift in growth. Nonetheless, it was clear from the assessment of all recent data that there had been some strengthening in demand and activity. This was reflected in the revised forecasts by the staff, which showed higher growth in GDP in the coming year. No new price or wage data had been received during the past month. In short, the economic configuration facing the Board continued to be strong demand and output, declining unemployment, steady wages and moderating inflation. The forces that produced this favourable combination of events were still not clear. A key issue was whether they were the result of the economy's capacity having expanded to a greater extent than earlier indicated. The prices data for the June quarter, scheduled for release in late July, would be a key piece of information in assessing the relative expansion of demand and supply.

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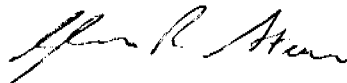
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For the present, the staff forecast continued to point to inflation rising to 2¼ per cent in 2008, owing to strength in activity and labour market tightness. The recent strength in activity suggested that the upside risks to this forecast may have increased, though the appreciation of the exchange rate would be a dampening factor. It also remained the case that any pick-up in inflation would start from a lower base than expected six months earlier.

Taking all these considerations into account, members believed that tighter policy could well be needed before long. But, on balance, they judged the current mildly restrictive stance of monetary policy should be maintained for the time being, pending further information on inflation, which would be available at the August meeting.

The Decision

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



Chairman
7 August 2007