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

SYDNEY, 6 FEBRUARY 2007

Present

GR Stevens (Chairman), KR Henry AC, JR Broadbent AO, RC Corbett AM, DG McGauchie AO, WJ McKibbin, HM Morgan AC

R Battellino, ML Edey

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

Minutes

The minutes of the meeting held on 5 December 2006 were approved.

Board Member

- KR Henry AC

Members congratulated Dr Henry on being awarded an AC in the 2007 Australia Day Honours List.

International Conditions

Discussion of international economic conditions commenced with an assessment of the momentum of growth of the US economy. While the US economy had been widely expected to slow to a below-trend pace, GDP figures for the December quarter and other recent indicators were relatively strong and suggested that there had been no significant slowing in overall growth over the past two years. In fact, GDP growth of 3½ per cent through 2006 remained slightly above trend and this could be a source of inflationary risk, which had been of concern to the Fed given the high level of resource utilisation in the economy.

In the housing sector, starts had begun to stabilise after a fall of over 25 per cent. However, it was too soon to determine whether more falls were likely given the current conditions of oversupply, and whether the sharp slowing in housing construction during 2006 would spread to other parts of the economy and dampen activity. At this stage, it appeared that growth in other sectors had remained relatively immune to conditions in the housing sector, and this suggested a lessening in the downside risks to prospects for growth. Inflation figures had indicated an easing in core inflation in recent months, from just below 3 per cent per annum to 2.6 per cent over the course of 2006. Headline inflation had been volatile, reflecting movements in oil prices, which had a large effect on gasoline prices in the CPI.

Growth in Japanese GDP in the September quarter had been revised from 2.7 per cent to 1.7 per cent. There had been no particular reason to explain the sharp downward revision, and the cyclical pattern of growth over the past couple of years had remained intact. The Tankan business survey continued to indicate strengthening conditions and suggested that the current expansion was continuing at a moderate pace.

In China, GDP growth through 2006 was above 10 per cent. This had been the fourth consecutive year of growth around that fast pace. In other parts of east Asia, the maturing of economies implied that growth rates were now cycling around a lower trend rate; GDP in Korea had increased by 4 per cent through 2006.

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In Europe, the only country for which December quarter GDP figures were available was the UK. These data indicated a strong final quarter of growth in 2006 and GDP had increased by 3 per cent over the year.

Looking at the world economy as a whole, growth in 2006 was likely to have been 5¼ per cent, which was well above average. While growth was forecast to slow to 4¾ per cent in 2007, if realised this would be the fifth consecutive year of growth above the 30-year average; these forecasts did not yet incorporate the higher-than-expected US December quarter GDP figures.

The crude oil price had fallen sharply during the first half of January, to just above US\$50 per barrel, but over recent weeks it had increased towards US\$60 per barrel. The supply disruptions, security concerns in the Middle East and speculative excesses that had led to a peak in the oil price of above US\$70 per barrel during the middle of 2006 had since been unwinding.

Domestic Conditions

GDP growth in the September quarter was 0.3 per cent. Members were informed that this differed from the estimate provided to the Board at the previous meeting, for growth of around ½ per cent, because stock-building had been lower than expected. Year-ended GDP growth of 2.2 per cent indicated that growth in the past few years had been cycling around a lower average than in the 1990s. With the drought affecting overall GDP growth, the non-farm economy had grown by 2.6 per cent over the year to the September quarter.

Members noted that a range of important questions arose from assessments of the true trend in productivity in the Australian economy, including those relating to potential growth and living standards. The latest national accounts indicated that productivity growth had been weak in recent years, with this evident from both aggregate and disaggregated sectoral data. Similar trends had been seen, though to a lesser extent, in the US and Canada, which also had puzzling strength in employment in the context of apparently weak productivity growth. The ABS was undertaking an internal inquiry into whether the national accounts have underestimated GDP in the past year or so, but it would be some time before the puzzles in the data were resolved.

Turning to the regular assessment of the flow of data since the previous meeting, retail sales had increased by just over 6 per cent through 2006. Annual growth in sales by large retailers had been higher than that for small retailers for most of the year, and steady at over 6 per cent. Growth in overall consumption had been supported by good growth in real disposable household income, which had been a bit below 4 per cent over the year to the September quarter.

In the housing sector, there had been little change in total building approvals in recent months and the downturn appeared to have troughed. A modest uptrend in residential building activity in the year ahead was expected, as approvals were running below underlying demand and the rental market was tightening, as seen by low and declining vacancy rates throughout the country. In addition, rents were rising, by just below 4 per cent per annum according to the CPI, and by 8 per cent for newly tenanted dwellings according to a measure compiled by the Real Estate Institute. The latter data revealed that Brisbane and Perth appeared to have the most severe shortages of rental accommodation, with rents for newly tenanted dwellings in those cities rising by well over 10 per cent per annum.

Business investment slowed sharply during 2006, to growth of around 5 per cent over the year to the September quarter, which followed rapid growth of 10–20 per cent per annum since 2002. Despite lower growth in the recent period, and the prospect of slower growth in domestic demand as a consequence, the level of investment as a share of GDP remained high, which would be adding

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to the capital stock. Business credit growth had slowed a little recently, but remained in the 15–20 per cent range, as businesses geared up after a long period of noticeably slower growth in borrowing.

Exports were estimated to have increased only moderately in volume terms in the December quarter, and by around 5 per cent over the year. Iron ore exports had increased steadily over the past few years, while coal exports had been relatively flat, with various infrastructure bottlenecks constraining growth. Oil exports had been on a falling trend until recently, but the opening of a new field had led to a pick-up in oil exports from mid 2006. Export receipts had increased more rapidly than volumes over the past few years given rising commodity prices. Import volumes were estimated to have risen strongly in the December quarter, and by around 10 per cent over the year. The estimates for growth in exports and imports in the December quarter implied that international trade would subtract significantly from output growth in the quarter, but the strength of imports suggested that there had been a pick-up in domestic demand towards the end of the year.

In the labour market, employment growth had been strong in both November and December, with growth of 3 per cent through 2006. The strong employment growth contrasted with the growth of GDP of 2.2 per cent over the year to the September quarter. As these two indicators provided opposing signals about the momentum of the economy, for the time being they needed to be treated carefully, with each signal interpreted on its merits, including how it tied in with other indicators. The unemployment rate was 4.6 per cent at the end of 2006, a 30-year low, and the participation rate had risen noticeably over the course of the year. In a further sign of tightness in the labour market, job vacancies had increased to 1.5 per cent of the labour force, which was the highest rate since the 1970s.

The CPI indicated that prices fell by 0.1 per cent in the December quarter and year-ended inflation declined to 3.3 per cent. The easing in inflation pressures had been expected with petrol and banana prices both falling sharply in the quarter. In underlying terms, inflation had increased from 2½ per cent at the end of 2005 to around 3 per cent in the September quarter 2006, where it had remained in the final quarter of the year. On a quarterly basis, underlying inflation peaked at 0.9 per cent in the June quarter and had slowed to 0.5 per cent in the December quarter. Price rises were less common than price falls in the December quarter: around 40 per cent of the items in the CPI by weight rose by more than 2.5 per cent in the quarter, compared with over 60 per cent around mid 2006. While input price pressures remained high, the staff forecast was for underlying inflation to decline gradually to 2¾ per cent over the coming year.

Financial Markets and the Bank's Operations

The past year was favourable for financial markets, with strong rises in share prices, low bond yields, tight credit spreads and generally low volatility. These developments reflected the healthy state of the world economy. However, some signs of increased risk-taking in financial markets had begun to emerge. While this was not threatening at present, its continuation could pose risks. In particular, most countries had experienced a large increase in mergers and acquisitions activity, notably leveraged buy-outs. Developments in China also needed to be monitored as the authorities were struggling to offset the domestic liquidity effects of their massive intervention in the foreign exchange market.

Turning to individual markets, share prices in the US rose by around 15 per cent in 2006, which was the fourth consecutive year of strong returns. This rise took the market to within 5 per cent of the peak in 2000. Share markets in other developed countries had also been strong in 2006, apart from Japan, where the market had been relatively flat following a very strong year in 2005. Emerging market share prices, particularly in Latin America, had been even stronger than those in the major

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countries. The strength was the result of a combination of improving economic conditions and a general increase in risk appetite in global markets. The fact that volatility in share markets in recent years had been about half its long-run average was encouraging investors to move into some risky assets.

Bond yields had risen slightly over the past year or so, but remained low by historical standards. In the English-speaking countries and most of Asia, longer-term yields were lower than the respective cash rates, i.e. yield curves were inverted. This was a result of strong demand for bonds, including by Asian and Middle Eastern central banks. In the US, bond yields had not changed in net terms since mid 2004, though the Fed funds rate had risen significantly over that period.

Credit spreads on non-government bonds had continued to tighten, as a result of the search for yield and increased risk appetite. This had occurred against a backdrop of very low default rates on speculative debt; despite the narrowing, spreads were such that investors were being adequately compensated as long as these low levels of defaults continued. In previous cycles, however, default rates on low-rated debt had increased to around 10–13 per cent when economic conditions deteriorated, well above current rates.

Central banks had increased cash rates during 2006. In the US, the Fed had restored the Fed funds rate to 5¼ per cent, which is a relatively normal level, and the economy was growing at a moderate pace. Although markets through the second half of 2006 had been expecting significant easing by the Fed during 2007, at present no change in the funds rate was expected over the next six months. The ECB still had the cash rate a little below normal, and markets expected some further tightening in the next few months. Short-term interest rates in Japan were still close to zero and continued to provide a source of cheap funding for global markets.

The US dollar fell in 2006 following a rise in 2005, but in net terms had shown little change over the past two years, and was about 25 per cent below its peak in 2002.

The yen had been very weak in recent years, and was one of the few currencies that fell against the US dollar. Since its peak in the mid 1990s, the yen had fallen by about 40 per cent, measured in real trade-weighted terms.

The exchange rate of the Chinese currency increased by 3 per cent against the US dollar in 2006. However, as this was less than the extent of the fall in the US dollar against other currencies, in trade-weighted terms the Chinese currency remained low. The Chinese authorities had been purchasing US\$20–30 billion per month of foreign exchange to prevent the exchange rate from rising, which had led to problems in the domestic financial system, including a sharp rise in liquidity and rising prices of shares and other assets. The Chinese share market rose by 150 per cent in 2006, with most of the rise occurring in the second half of the year.

During 2006, foreign reserves accumulation by Middle Eastern central banks, which mostly manage fixed exchange rates, was almost as large as the accumulation by the People's Bank of China. Other countries in Asia also increased their accumulation of reserves in 2006.

In Thailand, a range of measures were recently announced to try to prevent capital inflow and encourage capital outflow, in order to stop the exchange rate from rising. The main effect had been on the share market, which fell sharply late in 2006.

Share prices in Australia rose by about 20 per cent in 2006. As was the case in several other countries, this was the fourth consecutive year of strong returns. While resource shares were flat overall in 2006, share prices in other sectors rose. Over the longer term, share prices in Australia

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had been more stable than in the US, particularly around the turn of the century, where the US experienced a boom and bust period. Recent rises in share prices in both countries had been supported by higher profits, and price-earnings ratios had, if anything, fallen.

The strength in profits in Australia in recent years had surprised company analysts, who have had to revise up their profit estimates through the course of most years. Some easing in resource sector profits had meant that forecasts for profits in the current financial year were no longer being revised up, but forecasts for 2007/08 were still rising, with the current average forecast for 8 per cent profit growth.

Mergers and acquisitions activity in Australia had been increasing, and involved 10 per cent of the share market in 2006, which was the highest since 2001 and about twice the average rate. Within this, leveraged buy-out activity was particularly strong, as it was in several other countries. The increase in the level of these activities was being driven by the low cost of debt and high return on equity. The market response to the increase in leveraged buy-out activity had been a sharp increase in the spreads on target companies' debt, because of the associated increase in gearing and reduction in credit quality.

Turning to the Australian money market, earlier in the year markets had been pricing the probability of a tightening in monetary policy at the February Board meeting at 50 per cent. However, this expectation largely dissipated following release of the lower-than-expected CPI data for the December quarter.

Banks' lending rates for housing had increased following the November tightening, and it appeared that the incidence of discounting had stabilised. Virtually all borrowers were now paying less than the indicator rate.

The Australian dollar had risen late last year and early in 2007, towards the top of its range for the past three years, but fell back following the CPI data. The Australian dollar was now 10 per cent above its long-run average in terms of both the US dollar and the trade-weighted index. Overall, the exchange rate had been very stable, with the range in the TWI in 2006 the second lowest on record. The Australian dollar had increased by about 50 per cent against the yen over the past five years, to its highest level since prior to the Asian financial crisis.

With the higher exchange rate, the Bank had stepped up slightly the rate at which it had been buying foreign exchange, to around \$200 million per month.

Considerations for Monetary Policy

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

The data on the US economy in the past couple of months suggested that growth had remained above trend and the downside risks had eased. Overall, the world economy was expected to grow a little more slowly in 2007 than in 2006, but still at an above-average pace. While growth of the Australian economy was well below trend up to the September quarter, and had been adversely affected by the drought, conditions in the labour market were healthy and aggregate income continued to be supported by high commodity prices. The high level of capacity utilisation had led to a pick-up in inflationary pressures earlier in the year.

The CPI data for the December quarter were below expectations and suggested that underlying inflation had been contained to around 3 per cent over the year. Importantly, underlying inflation was lower in the second half of 2006 than in the first half. The latest information on economic

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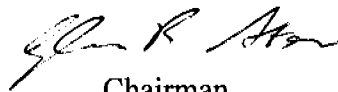
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activity and producer and consumer prices gave Board members a little more confidence in the forecast, first enunciated following the November policy tightening, that underlying inflation would decline to around 2¾ per cent over the next year or so.

While members noted that the most likely outlook for inflation would be for it to be consistent with the target of 2–3 per cent, they were still wary of possible inflation risks. Although the forecast for output growth in the year ahead had been lowered slightly, capacity utilisation remained high, which implied there was still some risk that the inflation pressure evident in much of 2006 could re-emerge if demand proved to be stronger than expected. Despite the well-behaved nature of wages growth to date, reports of strengthening wage pressures in an environment of an apparent slowing of productivity growth also posed a possible inflationary risk. This meant that it was appropriate for the monetary policy stance to remain mildly restrictive, but members did not see a case for a further tightening at present. The Board decided to leave the cash rate steady, but would monitor incoming data and adjust policy as necessary to ensure that inflation remained satisfactorily contained in the medium term.

The Decision

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



Chairman
6 March 2007