RESERVE BANK OF AUSTRALIA

Reserve Bank of Australia
Minutes of the Monetary Policy Meeting of the Board

Sydney - 1 September 2009

Members Present

Glenn Stevens (Chairman and Governor), Ric Battellino (Deputy Governor), Ken Henry AC (Secretary to the Treasury), John Akehurst, Jillian Broadbent AO, Roger Corbett AO, Graham Kraehe AO, Donald McGauchie AO, Warwick McKibbin

Others Present

Guy Debelle (Assistant Governor, Financial Markets), Malcolm Edey (Assistant Governor, Financial System), Philip Lowe (Assistant Governor, Economic), Tony Richards (Head, Economic Analysis Department), Anthony Dickman (Acting Secretary)

International Economic Conditions

Overall, the data available over the past month had indicated a continued consolidation in the global economy. Data for June quarter GDP were now available for most economies and showed that growth in the Asian region had been much stronger than elsewhere. However, there had been some upside surprises in other countries, including positive growth in France and Germany in the quarter. Industrial production in a number of countries had been boosted by incentives for the purchase of cars and other durable goods. There was therefore a question about the sustainability of the recovery, in particular whether the growth that had been seen was largely a one-off effect of stimulus measures or if there was also a fundamental improvement.

Members discussed the divergence that was being seen in different parts of the global economy. In recent years, there had been much discussion about the desirability of stronger demand growth in Asian economies and this was now occurring. To the extent that Asia continued to grow more strongly than elsewhere, this would be positive for the Australian economy, with Australia's largest export destinations now in Asia.

Members were briefed on the recent data for the Chinese economy, which had been somewhat mixed. Car sales had risen very sharply and export volumes had also been growing, including recently to the United States and Europe. However, growth in industrial production, fixed asset investment and credit was estimated to have slowed. Members also discussed trends in the Chinese steel industry, including what evidence was available on the build-up of inventories of iron ore and steel. Overall, members observed that some slowing in the Chinese economy relative to the rapid pace in the June quarter had been inevitable but that the longer-term prospects were strong.

Developments elsewhere in Asia indicated that growth was continuing to recover. India had recorded two quarters of solid growth in the first half of 2009, boosted by an easing of both fiscal and monetary policy. In South Korea, industrial production had grown by nearly 30 per cent since the start of the year and was now back to its previous peak. There had been a particularly strong recovery in production of electronic components, some of which were exported to China for assembly. The Japanese economy was also doing better than earlier expected, though part of the growth in the June quarter was accounted for by measures to boost sales of cars and household appliances. Nevertheless, there was a significant amount of spare capacity, with Japanese output 7½ per cent below its peak and the unemployment rate, at 5.7 per cent in July, at the highest level in the five decades for which there were comparable data.

The data for the United States indicated that the pace of deterioration in the labour market was easing. However, household spending had shown essentially no growth so far this year, and the household saving rate had risen. The US economy was expected to grow in the September quarter, after contracting by 4 per cent over the previous year.

Members were briefed on global trends in credit growth and housing markets. Developments in business credit had been fairly similar across countries, with falls in 2009 in a number of advanced economies as companies reduced debt levels in an environment of tighter credit standards by lenders. In relation to housing markets, members observed that in countries that had experienced better economic outcomes and/or fewer financial sector problems (e.g. China, Canada, Norway and Australia), house prices now appeared to be rising quite solidly and were above or around earlier peaks. Even in the US and UK, which had earlier experienced significant falls in house prices, there had been some up-ticks recently.

Domestic Economic Conditions

The flow of information on the Australian economy over the past month had been mostly positive. The staff's expectation was that GDP data for the June quarter, due to be released the day after the meeting, would show a moderate increase in output, with growth in household consumption, business investment, public spending and exports.

Measures of sentiment had continued to strengthen. Consumer sentiment had risen sharply over the three months to August. Liaison with retailers suggested that household spending had softened somewhat in July but had been better in August.

Measures of business confidence and business sentiment had also risen to be modestly above average. The data for business investment in the June quarter indicated a strong rise in spending on plant and equipment, with a sharp increase in spending on a wide range of capital goods, including cars. However, this mostly reflected the bringing forward of spending to qualify for tax allowances. Car sales had subsequently fallen in July. Building construction had fallen sharply in the June quarter, but engineering construction had risen strongly.

Members discussed the broader outlook for investment, which – as a share of GDP – was around the highest levels in the 50-year history of the national accounts. The capital expenditure survey pointed to some near-term weakness in private investment, though less than expected earlier in the year. Developments in the resources sector, especially for LNG, pointed to significant strength in the medium term. Public investment would increase because of the fiscal stimulus packages and state government infrastructure plans. Members also discussed the trend in dwelling investment. They noted that even though the number of new dwellings completed had been lower in recent years, dwelling investment as a share of GDP had held up, due to the trend towards larger and higher-quality homes and an increase in the share of alterations and additions.

Business credit data showed a further fall in July, but there were some tentative signs of a slowing in the rate of decline. Equity raisings had remained strong. The most recent profits data showed a pick-up in the non-mining sector in the June quarter, but mining profits had declined following earlier falls in commodity prices.

The data for June quarter export volumes showed most categories were growing or holding up reasonably well. Manufacturing exports were the exception, and had fallen broadly in line with the falls seen in many other countries. On average, commodity prices had been broadly steady since the last meeting. Iron ore spot prices had weakened over the previous couple of weeks, although they remained above the contract prices agreed with Japanese and Korean steel mills.

The most recent monthly labour market data continued to suggest that the deterioration in the numbers employed and in unemployment had been less than feared earlier in the year. There had been a noticeable increase in flexibility in hours worked. Members noted that this had been beneficial for firms, employees and the broader economy.

The wage price index showed a significant moderation in private-sector wage growth over the first half of the year, although public-sector wage growth had not slowed much. The slowing in private-sector wage growth was consistent with reports that some companies had implemented wage freezes, and members judged that it would be helpful in minimising job losses and in exerting some downward pressure on underlying inflation from the current elevated levels.

Financial Markets

Sentiment in financial markets had generally consolidated further over the previous month.

Spreads in money markets had narrowed further, gradually returning towards more normal levels. There had been no significant changes in monetary policy in the major economies, although the Bank of England had expanded its asset purchase program.

Issuance in global bond markets had been subdued in August, mostly reflecting the northern summer holidays, and there had been a very significant drop-off in issuance of government−guaranteed debt. Members noted that recent guaranteed issuance in the Australian market had mostly been by branches and subsidiaries of foreign banks. The major banks had raised some longer-term offshore unguaranteed debt at a yield that was only slightly above the all-in cost of a guaranteed issue.

There were some favourable signs in the Australian residential mortgage-backed securities market. The gap between secondary market yields and primary market yields was continuing to close, such that the prospect of issuance without the support of the Australian Office of Financial Management was increasing.

Equity markets had mostly strengthened over the past month, with China a notable exception. Chinese equities had fallen significantly from their recent peak, with concerns over the rapid credit expansion and its possible curtailment contributing to significant volatility, which had spilt over to other markets on occasion.

The Australian equity market had risen, especially financial sector stocks. Although underlying profits of Australian companies had fallen significantly, recent earnings reports had mostly met or exceeded analyst expectations. Issuance of new equity had been running very strongly in the quarter to date.

Turning to banks’ funding, members noted that there had been a continuation of the strong competition for deposits. Together with an increase in term interest rates, which were rising because of expectations of monetary tightening, this was contributing to an increase in bank funding costs. Banks had raised interest rates on their fixed-rate lending and members noted there was market speculation that variable mortgage rates might also be increased. Average business lending rates had risen slightly, as banks continued to adjust customer risk margins upwards as loan facilities were renewed.

Financial System

Members were briefed on the Bank’s half-yearly assessment of the financial system. The discussion focused on the improvement in conditions in the global financial sector over the past six months; the resilience of the Australian financial system; improvements in sentiment among Australian households and businesses; and developments in regulation of the financial sector.

Members noted that the extreme risk aversion prevailing in global markets in the wake of the Lehman Brothers collapse last year had dissipated. Investors had become more confident, which was evident in a bounce-back in global equity prices. The recovery in share prices had been proportionately larger for banks than the broader equity market. There had been similarities in the performance of the Australian equity market.

Members observed that financial conditions in some key countries remained challenging, as macroeconomic conditions continued to weigh on loan quality. Commercial property seemed to be a key point of weakness in several countries.

Members noted that the Australian financial system had continued to perform relatively strongly. Although loan impairments were rising, mainly relating to business lending, the large Australian banks had reported solid profits for the latest half-year, as they had throughout the period of the financial crisis. The banks remained well capitalised, and had strengthened their positions further with additional raisings during the past year. With investor risk appetite returning, banks had been increasingly willing to tap markets on their own credit standing and without the support of the government guarantee in the past couple of months.

Members discussed overall lending standards, which had clearly tightened since the start of the crisis. They noted that while larger companies had been reducing debt and banks had reduced exposures, credit remained available to high-quality borrowers, albeit at higher spreads. Although commercial property was currently the largest component of non-performing assets, the construction cycle had not been as pronounced as in the late 1980s. This suggested that there was a smaller amount of overbuilding in the market, including in Perth and Brisbane, where the largest falls in commercial capital values had been seen to date.

In the non-financial sector, members noted that sentiment among Australian households and businesses had improved significantly. Many firms were still trying to strengthen their balance sheets by reducing debt and raising equity. For households, net worth had fallen during the past year but the latest figures showed it was now recovering, reflecting higher prices for both shares and houses. Members observed that household interest payments as a share of disposable income had fallen substantially and that household borrowing was growing at a moderate rate.

On regulatory developments, members noted the ongoing debate in various international fora. Details on possible changes to regulations covering bank capital and other standards were still being worked out, but were likely to result in higher capital and liquidity requirements around the world.

Considerations for Monetary Policy

The information presented to members showed that the situation in the global economy was continuing to improve. Of most significance to Australia, the Asian region had recorded strong growth in the June quarter. While this had been largely driven by domestic demand in these economies, reflecting strong economic stimulus, there were also recent signs of a pick-up in their exports. Outside Asia, most economies had experienced another fall in GDP in the June quarter, though more recent information suggested that the majority of these economies were now approaching a turning point.

An important question for members was whether the global economic improvement would be sustained, or whether it was mainly a reflection of the strong macroeconomic stimulus that had been applied over the past year and might in due course fade. Members were also conscious that, even though financial market conditions had improved significantly and debt markets were beginning to function again, banks, corporates and households in many countries still faced significant balance sheet adjustments. This too could serve to limit growth.

Members concluded on balance that the global economy was most likely on a sustained, if modest, recovery path, though it was still too soon to be confident of this assessment.

Members noted that indicators of the domestic economy over the past month had again been better than expected. GDP figures due to be published the next day would most likely show that a moderate rise in output had occurred in the June quarter, which meant that the slowdown in GDP had been significantly less than forecast earlier in the year. Consumption, investment and exports had all shown unexpected resilience. Measures of confidence of both households and businesses had recovered strongly.

Members noted that it was hard to disentangle the contribution that Asian demand, fiscal stimulus and easier monetary policy had each made to the better-than-expected outcomes. There were signs that some of the unexpected strength in investment in the June quarter owed to the pull-forward of spending to qualify for tax concessions that ended in June, but investment plans for the year ahead had also been revised up. Information from liaison suggested that household spending might be holding up reasonably well even several months after the government payments had ended. There were some signs that Chinese demand for resources had not continued at the exceptional pace of the June quarter, but liaison with resources companies suggested that they were very confident about medium-term prospects.

Members also noted that business credit was still very weak and that borrowers were facing tight credit conditions and rising borrowing costs as banks continued to review risk margins as lending facilities were renewed. For some sectors, particularly those related to property, this was likely to continue to be a brake on economic activity in the near term. The rise in market yields, in expectation of a monetary tightening, was also adding to borrowing costs.

Members were reassured by the clear signs of wage moderation in the economy, as this would help to contain inflation in the near term. Nonetheless, with underlying inflation still relatively high on the latest reading and economic activity substantially stronger than expected, members were conscious of the need to balance the task of controlling inflation over the medium term with that of supporting economic recovery.

At the previous meeting, members had agreed that if the economy continued to evolve as in the latest forecasts, the Bank would in due course need to adopt a less expansionary policy stance. The information at this meeting suggested that economic conditions were indeed evolving broadly in that way. Nonetheless, some uncertainty remained about the outlook both abroad and at home.

As at the previous meeting, members noted that the policy decision in the near term involved balancing the risk of over−staying an accommodative stance, and that of prematurely tightening and adversely affecting confidence and demand.

The meeting concluded that the balance was best struck by leaving the cash rate unchanged for the time being, pending further evaluation of incoming information at future meetings.

The Decision

The Board decided to leave the cash rate unchanged at 3.0 per cent.