



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

Sydney - 6 October 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, Warwick McKibbin

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

Others Present

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

International Economic Conditions

Data becoming available over the past month had continued to indicate a gradual improvement in conditions in the global economy. Global forecasts had been revised up, with the recent IMF forecasts showing a modest upward revision for 2009 and a significant upward revision for 2010. World growth in 2010 (based on purchasing power parity weights) was now forecast at 3.1 per cent, up from 1.9 per cent in April. Although growth in the G7 economies was forecast to be relatively weak, the rest of the world was forecast to grow at over 4 per cent, with growth significantly higher than this in some countries in Asia, most notably China. Overall, growth in Australia's major trading partners in 2010 was forecast by the IMF at around 3¼ per cent, which was close to trend.

Members discussed the drivers and expected durability of the recovery that was under way. Part of the recent improvement in demand and production had been due to fiscal incentives to buy cars and other durable goods, and it remained to be seen what would transpire following the expiry of some of these schemes. The inventory cycle was also contributing temporarily to growth in a number of countries. Where that had occurred, a durable recovery would require sustained growth in private demand. In the emerging economies, there would have to be reduced reliance on external demand and greater efforts to foster domestic-led growth.

Consumer sentiment had fallen to very low levels in early 2009 in some of the large advanced economies. Sentiment had since recovered somewhat, which would be helpful in encouraging demand, but it remained well below long-run average levels in many economies. In Australia, the fall had been less pronounced and the recovery had taken consumer confidence measures to well-above-average levels.

The data for the Chinese economy suggested solid growth in August after an easing in some indicators in July. GDP growth was expected to be quite strong for the September quarter, although not as rapid as in the June quarter. Monthly growth in credit had remained below the very strong pace seen earlier in the year, but there were indications of a pick-up in growth in lending to households, partly reflecting policy measures. Elsewhere in Asia, there had been a pause in the recovery in exports and industrial production in August in a number of economies, although some early data for September suggested that growth was continuing.

Data for the US economy had been mixed, but prospects appeared to be gradually improving. The most recent labour market data had been weaker than expected, but household consumption spending had risen over the three months to August, even after accounting for the policy-induced boost in spending on cars. The inventory cycle had subtracted significantly from GDP growth up to now, but this could be expected to end soon, providing a near-term boost to growth.

Members discussed trends in global consumer price inflation. The earlier falls in the price of oil had resulted in negative year-ended headline inflation rates in many countries. Measures of core inflation had also drifted downwards, and were now a little below medium-term targets in a number of the advanced economies. In China and some Asian economies, even core inflation had recently been negative but it appeared that the decline might have mostly run its course.

Domestic Economic Conditions

Members reviewed the June quarter national accounts, which had been released the day after the previous Board meeting. Based on the average of the three measures, GDP was estimated to have grown by around 1 per cent in the first half of the year, which was stronger than had been expected earlier in the year and better than in many other economies. Outcomes for exports, business investment and household consumption had all been materially stronger than expected. Nevertheless, members noted that the fall in the terms of trade over the past year had resulted in a fall in Australia's real gross domestic income.

The more recent data had suggested that the economy was continuing to expand. Business surveys showed confidence at high levels and business conditions a little above average levels. Survey measures of capacity utilisation showed a slight pick-up relative to earlier in the year.

Household spending appeared to have remained relatively resilient, consistent with the high level of consumer sentiment. Retail spending increased in August after falls in the previous two months. Liaison suggested that motor vehicle spending by households had also been quite strong. Housing markets were quite buoyant, with dwelling prices estimated to have risen by around 2 per cent in August. Prices had increased in all the major capitals and in both higher- and lower-price suburbs. Data from private-sector providers suggested that nationwide prices were now above the earlier peaks seen late in 2007 and early in 2008.

Members discussed the extent to which the growth in the economy had been affected by fiscal policy measures. Staff estimates suggested that the impact of fiscal policy (including payments to households and other ongoing programs) on GDP growth was likely to have peaked in the June quarter and was now gradually declining.

There were divergent trends in activity in the construction sector. Building approvals for houses had risen significantly since late 2008, and there had also been some growth in approvals for low-rise medium-density housing. However, approvals for higher-rise apartments were very weak, partly reflecting financing problems. Members noted that, given the strong population growth, the current rate of housing construction meant that the average household size was increasing. In the non-residential sector there had been a sharp increase in approvals in the education sector, but approvals for other types of construction remained low.

Housing loan approvals in recent months had been well above the lows seen in 2008. However, growth in housing credit had not picked up much, implying that net repayments had risen. This probably reflected the fact that many households with home loans had not sought to lower their monthly payments when mortgage rates had fallen and had instead paid down their loan balances ahead of schedule. This would reduce the vulnerability of that part of the household sector to rising mortgage rates.

The pace of deterioration in the labour market had slowed substantially; the unemployment rate had been steady for several months and the earlier significant fall in hours worked appeared to be easing. Surveys suggested that households were no longer expecting a sharp rise in unemployment. Liaison with businesses indicated that the extreme caution in hiring plans earlier in the year was gradually being unwound. Measures of advertised job vacancies had also started to rise, albeit from levels well below earlier peaks.

Exports of coal and iron ore were estimated to have risen significantly in the September quarter. Steel production outside of China had now grown by around 20 per cent, after a very sharp fall late in 2008. Production in China had been quicker to recover, after a smaller fall. However, with steel prices falling, the Chinese authorities were now taking measures to slow growth by closing down some smaller mills. Spot iron ore prices remained well above the levels that had been set in contracts with the Japanese and Korean mills earlier in the year.

Members discussed the long-term outlook for the resources sector. Mining investment had grown strongly in recent years; as a share of GDP, it was currently well above the peaks in earlier resources booms. This was likely to rise further in coming years, reflecting growth in the LNG sector and ongoing strong investment in the coal and iron ore sectors. This would be positive for the economy as a whole, but would present challenges for some sectors as it would require a significant reallocation of resources in the economy.

Members also discussed the latest staff forecasts and the risks around the outlook. The forecasts assumed a rise in the cash rate over the year ahead. Growth was now expected to be around trend in 2010 and subsequently to strengthen somewhat. Inflation was expected to decline in the near term, reflecting both the current level of spare capacity in the economy and the recent relatively slow growth in labour costs. However, the forecast trough in inflation was not as low as previously expected, and by 2011 inflation could be rising again.

Financial Markets

Members noted that the general improvement in conditions in financial markets had led some central banks to announce termination dates for arrangements introduced to support markets at the height of the financial crisis a year ago. This included the cessation of the guarantee on money market mutual funds in the US and a winding back of the Federal Reserve's term auction facility and the US dollar swap facility. Most central banks had continued to leave their policy rates unchanged over the past month and the market pricing suggested that policy rates in the major economies were expected to remain at current levels for some time yet.

Money market spreads had fallen to low levels in the major markets and also in Australia, where they were now only a little above pre-crisis levels. Members noted that the longer-dated repurchase agreements entered into by the Reserve Bank at the height of the crisis were now maturing, and as a result there had been a marked decline in the average maturity of the Bank's outstanding repurchase agreements.

Government bond yields had been little changed over the past month, despite concerns in some quarters about the large amount of issuance in several major countries. Bond yields in Australia had tended to decline slightly. There had been very strong demand for the \$4 billion of indexed bonds issued by the Australian Office of Financial Management (AOFM) late in September. This was the first issuance of indexed bonds since 2003.

Members were informed that the issuance of government-guaranteed bonds globally was relatively low in September. Australian institutions had accounted for about a third of global guaranteed issuance in the past three months. Members noted that guarantee schemes were being significantly curtailed or modified in several countries. In the United States, the Federal Deposit Insurance Corporation had announced the end of the program in its current form at the end of October, with a possible six-month extension, at a high fee, for institutions that were unable to issue unguaranteed debt or had difficulty rolling over maturing debt.

The share of unguaranteed bonds issued by Australian banks in September had risen to almost half of their total issuance, compared with 5 per cent in the March quarter and a third of their total issuance in the June quarter. The major banks' issuance in the local market was entirely unguaranteed, but they had issued both guaranteed and unguaranteed paper offshore. The foreign-owned banks operating in Australia had continued to issue a sizeable volume of guaranteed paper. These changing issuance patterns had reflected pricing incentives, with it now being cheaper for the major banks to issue unguaranteed bonds domestically than guaranteed bonds.

Conditions in Australian securitised markets had improved noticeably in the past month; for the first time in a year, there was a successful issue of residential mortgage-backed securities (RMBS) without the support of the AOFM. The continuing decline in the outstanding stock of RMBS had seen spreads in the secondary market decline considerably, such that investors were now seeking new issues at prices that were economic for the issuers.

Global share markets had risen slightly over the past month, to be more than 50 per cent above the trough in March, though share prices were still around a third below the recent peaks. Forward price-earnings ratios were now generally around the long-run average. The Australian share market had experienced similar movements to markets elsewhere over the past month, with financial stocks generally performing better than other sectors. Members noted that there had been a particularly strong rise in banks' share prices in several countries since the trough, notably Australia and Canada.

The high level of equity raisings in the September quarter in Australia had led to a marked reduction in corporate gearing ratios, which were now down to around 65 per cent. For some highly leveraged corporates, asset write-downs had limited the effect of the equity raisings on their gearing ratios.

Turning to foreign exchange markets, the US dollar had depreciated by 15 per cent since its recent peak in March, falling against almost all the currencies in its trade-weighted basket. A notable exception had been the pound sterling, which had fallen further against many currencies. The depreciation of the US dollar had unwound two-thirds of its appreciation that had occurred since the trough in March 2008.

The Australian dollar had continued to appreciate over the past month, reaching a 14-month high against the US dollar; on a trade-weighted basis it was about 8 per cent higher over the past year. The appreciation of the Australian dollar in recent months had reflected the generally improving sentiment in financial markets, the relative outperformance of the Australian economy and the strength of commodity prices.

Members discussed trends in capital flows. They noted that net inflows of portfolio equity capital had accounted for a significant share of private capital inflows to Australia since the December quarter 2008, in contrast to earlier periods in which debt capital inflows predominated.

Domestically, banks had continued to compete aggressively for deposit funding. While this had placed upward pressure on funding costs, the effect on banks' overall funding costs had been approximately offset by the contraction in spreads.

Considerations for Monetary Policy

Overall, the information becoming available over the past month had provided further evidence that the outlook for the domestic and global economies was continuing to improve.

Data on the global economy suggested that prospects for all the major regions of the world were improving, though some more noticeably than others. The recovery in the advanced economies was relatively subdued, and was expected to remain so owing to on-going balance sheet adjustments following the past couple of years of financial difficulties. The Asian economies, on the other hand, had picked up strongly over the past six months and the outlook was quite positive. Overall, growth in Australia's major trading partners over the forecast period was expected to be relatively close to trend.

Conditions in the domestic economy had for some time been noticeably stronger than had earlier been expected. Growth forecasts were tending to be revised up. Measures of both household and business confidence had recovered, household spending had remained relatively resilient, house-building activity was in the process of picking up and the risks of a sharp contraction in business investment had receded noticeably. The impact of public-sector spending on infrastructure was starting to become apparent. Absent further setbacks, GDP growth could be close to trend through 2010. Inflation was likely to decline in the near term but probably not fall as far as earlier expected. At its previous two meetings, the Board had noted the improvement in the economy and had agreed that, if prospects for the economy continued to strengthen, in due course there would be a need to adopt a less expansionary policy stance. The question facing the Board was whether the continued picture of improving conditions and prospects over the past month meant that the point had now been reached where the cash rate should be increased.

Members discussed the risks that a move at this meeting would be premature. Key among them was that economic prospects for most of the developed world were still uncertain and the possibility of another downturn in some countries could not be ruled out. While such an outcome would no doubt be detrimental to confidence, including in Australia, members noted that prospects for Australia were being affected significantly by developments in the Asian region, which was doing relatively well despite weakness in the advanced economies. Members also noted that a sizeable gap had opened up between the performance of Australia and other developed economies, and the Board had to be mindful of local conditions in setting policy.

Members noted that there was still a possibility that the recent strength in the domestic economy had been largely due to the greater-than-expected impact of the fiscal stimulus, which left open the attendant risk that activity might slow as that stimulus faded. It was also likely that the appreciation of the exchange rate would act as a contractionary influence on activity and help contain inflation. These considerations weighed in favour of keeping the current policy setting for a while longer so as to evaluate further data.

On the other hand, members judged that, compared with previous meetings, the risks in waiting had increased. In particular, underlying inflation was still, on the latest data, above the target and, while current forecasts suggested it would fall in the coming year, the expected trough in inflation was significantly higher than earlier thought. Keeping interest rates at very low levels for an extended period could therefore threaten the achievement of the inflation target over the medium term. More generally, very expansionary policy could result in the build-up of other imbalances in the economy, which would ultimately be detrimental to economic growth.

Overall, members concluded that, while downside risks to the domestic economy could not be ruled out, they had diminished significantly over recent months. This meant that the balance of risks was now such that the current very expansionary setting of policy was no longer necessary, and possibly imprudent. The Board therefore decided in favour of raising the cash rate.

The Decision

The Board decided to raise the cash rate by 0.25 percentage points to 3.25 per cent, effective 7 October.

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