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

Sydney - 4 November 2014

Members Present

Glenn Stevens (Governor and Chair), Philip Lowe (Deputy Governor), John Akehurst, Roger Corbett AO, John Edwards, Kathryn Fagg, Martin Parkinson PSM (Secretary to the Treasury), Heather Ridout AO, Catherine Tanna

Others Present

Guy Debelle (Assistant Governor, Financial Markets), Christopher Kent (Assistant Governor, Economic), Alexandra Heath (Head, Economic Analysis Department), Anthony Dickman (Secretary), Peter Stebbing (Deputy Secretary)

International Economic Conditions

Members began their discussion of the world economy with the observation that the growth of Australia's major trading partners had been a little below its long-run average pace in the June quarter, mainly as a result of the sharp decline in Japanese GDP. More recent data had suggested a pick-up in trading partner growth in the September quarter. Commodity prices had declined further over the past month, with **oil** prices recording a noticeable fall.

Chinese GDP growth had been steady in the September quarter and close to the authorities' target of 7.5 per cent for 2014. Members noted that the composition of growth had continued to shift in a manner consistent with **China**'s transition to a more balanced growth model; investment growth had eased further while consumption growth had been steady, and the service sector had continued to record slightly stronger growth than the manufacturing sector. Members observed that housing prices in **China** had fallen further in September and that the authorities had introduced targeted policies to ease financing conditions for home **purchases** and **property** development. Overall growth in total social financing had eased further following an earlier tightening of policies intended to put financing on a more sustainable footing.

In Japan, activity looked to have increased modestly in the September quarter, following a sharp decline in output after the consumption tax increase in April, with indicators suggesting that consumption had picked up in recent months. Members judged that it was too early to assess the impact of temporary fiscal measures designed to support growth following the consumption tax increase. Overall, indicators of business conditions had improved and the labour market had continued to tighten. Output in the rest of east Asia appeared to have been growing at around its average pace of recent years, supported by stronger domestic demand.

The US economy had grown at an above-trend pace in the September quarter. Business investment had picked up noticeably and the unemployment rate had declined further, although other measures of labour market slack had not improved to the same extent. After picking up earlier in 2014, inflation was about ½ percentage point below the 2 per cent goal set by the Federal Open Market Committee (FOMC). Meanwhile, wage growth had increased over the past six months.

The recovery in the euro area remained fragile. Despite declining a little over 2014, the unemployment rate remained high and inflation continued to be well below the target of the European Central Bank (ECB) of close to, but below, 2 per cent.

Commodity prices overall had declined slightly over the past month. An ongoing expansion in global supply and easing of growth in **Chinese** steel production had put further downward pressure on **iron ore** prices of late, while rising **oil** supplies - particularly from the United States - had led to a sharp fall in **oil** prices. Members observed that this would support output growth in **energy**-importing economies.

Domestic Economic Conditions

At the start of their review of the domestic economy and the economic outlook, members noted that the data available for the September quarter indicated that activity had grown a little below average, with the composition of growth remaining similar to that seen in the first half of 2014.

Resource exports had continued to grow strongly in the September quarter and were expected to be boosted over the next year or so by a further expansion in **iron ore** production, despite much lower prices, and a gradual ramping up of production of liquefied natural gas. **Coal** production was expected to be sustained at a high level even though a few smaller, higher-cost mines had closed in response to lower **coal** prices. **Mining** investment was expected to continue to decline for some time, with current projects being completed and only a few new projects under consideration.

Low interest rates and ongoing population growth were expected to continue to support growth in both housing activity and the established housing market. Growth in dwelling investment had remained strong and this was expected to continue in coming quarters, based on building approvals and other forward-looking indicators. Housing price growth had slowed from the rapid pace of late last year, but was still high in Sydney and Melbourne. While growth in housing credit for owner-occupiers was only a little above that of income, credit extended to investors had continued to grow at a noticeably faster rate.

Members noted that the strength in the housing market was expected to give some support to household consumption in the near term as rising housing valuations allowed some credit-constrained home owners to bring forward their consumption. The pick-up in retail sales in the September quarter and stronger growth in retail sales in those states with more rapid housing price growth was consistent with this view. However, members also observed that expectations of low income growth would be likely to weigh somewhat on consumption, which was expected to continue growing at a moderate pace in the near term before strengthening over 2016.

Survey measures of business confidence and conditions, along with measures of capacity utilisation, had been close to or above average long-run levels. However, non-**mining** business investment had remained subdued and liaison continued to suggest reluctance on the part of firms to undertake significant new investment projects until they experienced a sustained improvement in demand. Notwithstanding a substantial pipeline of non-**residential** building work yet to be done, non-**residential** building approvals had declined over the past year. Fiscal consolidation at all levels of government was also expected to weigh on aggregate growth in the period ahead.

The forces underpinning the outlook for domestic activity were much as they had been for some time. **Mining** investment was expected to decline sharply and resource exports were expected to grow strongly as the transition from the investment to the production phase of the **mining** boom continued. Members noted that non-**mining** business investment was not being impeded by the price and availability of finance. Overall, the forecast for output had not materially changed. GDP growth was still expected to be below trend over 2014/15, before gradually picking up to an above-trend pace towards the end of 2016.

Conditions in the labour market had remained subdued, with members noting that the latest vintage of the labour force survey data, which was released by the ABS during the meeting, showed a small rise in the unemployment rate over the previous six months and employment growth somewhat below the pace of population growth. Forward-looking indicators were at levels consistent with modest employment growth in coming months.

Inflation had declined in the September quarter, after earlier strong results. The year-ended rate of consumer price inflation declined to 2.3 per cent from 3.0 per cent previously. While acknowledging that the removal of the price on carbon had been an important factor behind lower CPI inflation in the September quarter, members noted that the effect on underlying inflation, which had declined to ½ per cent in the quarter and 2½ per cent over the past year, was much smaller.

Members observed that the fall recorded in tradables inflation in the September quarter had been a little surprising, given that it had been increasing in year-ended terms over the previous year, reflecting the depreciation of the exchange rate over the preceding 18 months or so. But they also noted that tradables inflation was quite volatile on a quarterly basis and that some of the most recent fall could be attributed to discounting of clothing and footwear prices to clear winter stocks built up during the period of unusually warm winter weather. Non-tradables inflation over the past year remained below its average over recent years and was little changed from the June quarter, abstracting from the effect of the repeal of the carbon price on utility prices. It was clear that lower wage growth had flowed through to the prices of many services, especially market services, while inflation in new dwelling costs had increased, consistent with the strength of activity in the housing market.

The outlook for inflation had been revised up slightly in response to the depreciation of the exchange rate during October. The cumulative effect of the exchange rate depreciation since early 2013 was expected to add a little under ½ percentage point to underlying inflation in each year over the forecast period. Nevertheless, domestic inflationary pressures were generally expected to remain subdued given spare capacity in labour and product markets. As a result, underlying inflation was expected to remain consistent with the target over the forecast period.

Financial Markets

Members observed that volatility in global financial markets had increased through October, with market positioning and dynamics amplifying the effect of increased investor concern about the outlook for global growth.

As expected, the US Federal Reserve ended its asset **purchase** program at its October meeting. The Federal Reserve's balance sheet stood at US$4.5 trillion, having increased by US$1.7 trillion during the third round of quantitative easing. Market pricing implied that the first increase in the federal funds rate would occur around October 2015, even though recent commentary by FOMC members suggested that mid 2015 was the most likely period when official rates would start to be increased. In contrast, market pricing suggested that expectations for future policy rate increases by the Bank of England and the Reserve Bank of New Zealand had been pushed further out over the course of the past month.

The Bank of Japan (BoJ) surprised financial markets late in October with its announcement of a further easing in monetary policy. Japanese **equity** prices in particular had risen strongly following the announcement, in which the BoJ had outlined plans to make additional asset **purchases** to increase the money base further, with monthly **purchases** of Japanese government **bonds** and other assets expected to be around US$60 **billion**. Members noted that this compared with a previous peak in monthly asset **purchases** by the Federal Reserve of around US$85 **billion**. The BoJ had stressed that the present move had been pre-emptive and sought to ensure that the previous modest rise in inflation expectations in the Japanese economy did not dissipate. At the same time, Japan's Government Pension Investment Fund (GPIF) announced a reduction in its target allocation for domestic **bonds**, together with significant increases in the corresponding target allocations to domestic and foreign equities and foreign **bonds**. Members noted the potential for these policy actions to increase the size of capital outflows from Japan in pursuit of more attractive yields on various assets in Australia (along with other destinations). Such flows could hold the Australian dollar at a higher level than economic fundamentals would imply.

The ECB commenced its covered bond **purchase** program in October. Members noted that after declining over the past couple of years by around 1 trillion, the ECB's balance sheet was subsequently expected to increase to around its earlier peak, through the ECB undertaking a combination of asset **purchases** and targeted longer-term refinancing **operations**. Italian and Spanish banks remained the largest borrowers of funds from the ECB - accounting for around two-thirds of outstanding lending. Members noted that the ECB's assessment of the asset quality of the euro area banking system had been released during the month.

US sovereign bond yields fell a little further over October, notwithstanding considerable variation within the month. On 15 October, yields traded over the widest intraday range (37 basis points) since 2011, as leveraged participants in this market unwound positions in other financial instruments. Australian bond yields also declined over the past month, generally tracking the moves in US Treasuries.

Share prices in the advanced economies fell sharply early in October, reflecting concerns about global growth, but had generally recovered those losses by the end of the month, with share prices in both the United States and Japan reaching multi-year highs. Members noted that Japanese **equity** prices had risen by nearly 5 per cent on the last day of October in response to the unexpected further easing in the BoJ's monetary policy. Australian **equity** prices had also risen over the past month, outperforming most other markets, with stocks in the finance sector rebounding in particular.

The major movement in foreign exchange markets had been the depreciation of the Japanese yen following the policy announcement by the BoJ and the announcement by GPIF. Other exchange rates had been little changed, with the notable exception of the Russian rouble, which depreciated by a further 9 per cent against the US dollar over the month to be more than 20 per cent below its recent peak in late June. While the Russian central bank had undertaken significant intervention to limit the exchange rate depreciation, its foreign currency reserves remained sizeable.

After having depreciated noticeably in September, the Australian dollar was little changed against the US dollar in October. The Australian dollar had appreciated by 4 per cent against the Japanese yen, which has a 13 per cent weight in the trade-weighted basket. In trade-weighted terms, the Australian dollar ended the month higher than in January 2014, notwithstanding the significant declines in key commodity prices since then.

Members concluded their discussion of financial markets with the observation that Australian lending rates on the stock of outstanding housing and business loans were continuing to edge lower, while domestic financial markets expected the **Board** to leave the cash rate unchanged at the November meeting.

Considerations for Monetary Policy

The outlook for the global economy had been little changed, with the growth of Australia's major trading partners forecast to be a little above average in 2014 and 2015. While members judged that the risks for the global economy were roughly balanced, they acknowledged that there was considerable uncertainty related to the outlook for the **Chinese property** market and the broader implications for the **Chinese** economy. Commodity prices had declined noticeably over the year to date, although they remained high in historical terms.

Domestically, economic activity over recent months appeared to have continued growing at a moderate pace. The forces underpinning the outlook for domestic activity were much as they had been for some time and the forecasts had not materially changed; GDP growth was still expected to be below trend over 2014/15, before gradually picking up to an above-trend pace towards the end of 2016.

Very low interest rates continued to support activity in the housing market and this was expected to spur activity in other areas of the economy through the usual channels. Members noted that growth in housing credit extended to investors in housing had continued to grow at a noticeably faster rate than credit to owner-occupiers.

Labour market conditions had remained subdued and it was likely to be some time before unemployment declined consistently. Spare capacity in labour and product markets was likely to continue to limit domestic inflationary pressures, ensuring that the inflation outlook remained consistent with the target notwithstanding some temporary upward pressure from the depreciation of the exchange rate since early in 2013. Despite the recent depreciation of the exchange rate, the Australian dollar remained above most estimates of its fundamental value, particularly given the further declines in key commodity prices over the course of the year to date. As a result, the exchange rate was offering less assistance than would normally be expected in achieving balanced growth in the economy.

In their assessment and given the information available, the **Board** judged that the current accommodative stance of monetary policy continued to be appropriate to foster sustainable growth in demand and inflation outcomes consistent with the target over the period ahead. Members considered that the most prudent course was likely to be a period of stability in interest rates.

The Decision

The **Board** decided to leave the cash rate unchanged at 2.5 per cent.

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