HD **TEXT - Minutes from Reserve Bank of Australia June 3 board meeting**

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Glenn Stevens (Chairman and Governor), 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

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

International Economic Conditions

The global data released over the past month suggested that the pace of growth in Australia's major trading partners had remained close to its long-run average. In China, growth in a range of key indicators had been running at a somewhat slower pace than over the course of 2013, with outcomes having been a little mixed of late. Growth in industrial production increased a touch in March and April, and PMIs picked up in May, while, in contrast, a range of other indicators, including various measures of freight, had shown more moderate growth than in 2013. The slower growth in residential investment was consistent with the broad-based decline in residential property inflation and transaction volumes over recent months. While there had been a number of reports that the extent of overbuilding had been greater in smaller cities, the decline in price inflation and downturn in sales were larger in the biggest cities, which had earlier experienced a more pronounced increase in prices and sales.

In Japan, GDP picked up sharply in the March quarter, driven in large part by a strong increase in consumption ahead of the rise in the consumption tax from the start of April, although business investment was also stronger. Preliminary indicators suggested that household expenditure fell back subsequently, as had been expected. In Thailand, GDP declined sharply in response to political unrest. In the rest of east Asia, GDP growth moderated slightly in the March quarter from the strong pace seen in the December quarter; taking the two quarters together, growth was around its longer-run average pace. More timely indicators suggested that this had continued over recent months. Members noted that economic conditions in India remained subdued but with potential for stronger growth if structural reforms were pursued.

Recent data suggested that the US economy was growing at a moderate pace. GDP recorded a small decline in the March quarter, in large part reflecting the unusually severe winter weather. More recent indicators had been stronger and forward-looking indicators of business investment pointed to further growth.

The gradual recovery in the euro area economy had continued through the year to date. Indicators of economic activity had improved of late and measures of household and business confidence were around their average levels. Business credit, however, had continued to decline, reflecting a combination of weak demand for, and constrained supply of, loans. Members noted that large corporations were raising funds through bond issuance but smaller businesses were not able to access this source of finance.

Iron ore prices fell further over the past month, in part reflecting softer conditions in the Chinese steel market but also in response to the increase in iron ore production capacity globally. Other commodity prices were little changed overall, with coal prices relatively stable, rural prices declining a little and base metals prices slightly higher. Members noted that at current prices most iron ore production in Australia was thought to be profitable, but that some iron ore producers in other countries were likely to have begun to incur losses.

Domestic Economic Conditions

The wage price index rose by 0.7 per cent in the March quarter and by 2.6 per cent over the year. The year-ended pace of wage growth was 1 percentage point below its long-run average and around the slowest pace in the 17-year history of this series. Members noted that the decline in wage growth over the past 18 months or so was consistent with the increase in the unemployment rate over the same period. Business surveys and liaison suggested that wage pressures were likely to remain constrained over the year ahead.

The labour market had shown some signs of improvement. In April, employment increased to be almost 1 per cent higher since the end of 2013 and the unemployment rate remained steady. Forward-looking indicators had improved over the past year but remained at low levels, consistent with relatively moderate growth in employment over coming months.

The 2014/15 federal budget estimated that the deficit would narrow by slightly more over the next two years than estimated in the 2013/14 Mid-year Economic and Fiscal Outlook. Members observed that the change in the budget position over the next couple of years was forecast to proceed at a similar rate to earlier episodes of fiscal consolidation. Beyond that horizon, the budget implied a more substantial fiscal consolidation than had earlier been projected.

Household consumption spending had continued to increase, with growth in the volume of retail sales in the March quarter around the same strong pace as in the December quarter. Following strong growth in January, growth of the nominal value of sales had slowed over the three months to April, and the Bank's retail liaison suggested that growth had moderated further in May. Measures of consumer sentiment had fallen sharply over the past month and were now below their long-run average levels. However, it was noted that while low-frequency movements in confidence measures had been broadly associated with trends in consumption spending, there was little evidence from the historical record that high-frequency movements carried much predictive content.

A range of indicators of housing construction confirmed that a significant recovery was underway. **Residential** work done picked up strongly in the March quarter. Forward-looking indicators of new dwelling investment were at high levels relative to recent years, although building approvals had declined in recent months. In the established housing market, dwelling price growth had eased from the rapid pace seen in 2013 and auction clearance rates in Sydney and Melbourne had declined from the high rates that prevailed during much of 2013.

Resource exports grew very strongly in the March quarter. **Iron ore** exports had continued to grow in April, while **coal** exports had declined somewhat. Private non-**residential** building approvals had continued to trend lower, although the high level of work yet to be done was likely to sustain construction activity for some time. The ABS capital expenditure survey for the March quarter suggested that **mining** investment fell in the quarter, while non-**mining** business investment appeared to have increased a little. Looking ahead, firms' investment intentions implied that **mining** investment would fall quite sharply over the course of 2014/15, but the same survey pointed to a modest increase in non-**mining** investment over this period. Surveys of business conditions and confidence in April remained around their long-run average levels. In the Bank's liaison, non-**mining** firms continued to report a reluctance to commit to significant new investment projects until they saw a sustained improvement in demand conditions.

Members noted that the March quarter national accounts were scheduled to be released the day after the **Board** meeting. GDP was expected to have grown at an above-average pace in the quarter, led by a large increase in resource exports. Dwelling investment had shown signs of improvement. **Mining** investment looked to have declined while growth in public spending was likely to have been subdued.

Financial Markets

With financial markets continuing to be characterised by markedly low volatility, the main focus over the past month had been the outlook for monetary policy set by the European Central Bank (ECB). At its meeting in early May, ECB President Draghi had emphasised that the ECB Governing Council was dissatisfied with the subdued outlook for inflation and would take action if necessary at its meeting in early June. Likely actions to be considered included a further reduction in policy rates - which would reduce the ECB deposit rate to below zero - as well as long-term refinancing **operations** aimed specifically at supporting small and medium-sized businesses. Over the past month, market expectations for the future path of the ECB policy rate had shifted down by around 10-20 basis points.

The US Federal Reserve was widely expected to continue reducing its asset **purchases** by US$10 **billion** at each policy meeting, until such **purchases** end later this year. Market expectations for the future federal funds rate had also declined modestly over the past month.

The decline in sovereign bond yields was another feature of financial market developments in May, with yields in the major markets around 60 basis points lower than at the start of the year. Reasons for lower yields cited by commentators included market expectations of lower long-term real rates worldwide and heightened demand for sovereign **bonds** from pension funds and banks. Members noted that most of the posited explanations had emerged after bond yields had actually declined.

Yields on longer-term government **bonds** in Australia had fallen by a similar amount to those in the major markets. The Australian Government's budget had little effect on financial markets, with sales of Commonwealth Government Securities (CGS) continuing to be well received. Interest rate spreads between CGS and state government debt had also remained at around their lowest levels since 2007, as had spreads on investment grade corporate **bonds** both in Australia and elsewhere.

Government bond yields in emerging markets had also declined further from their peaks earlier in the year. Election outcomes in India and Indonesia

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