

STATEMENT ON MONETARY POLICY

February 2008

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The first chapter of this *Statement* is provided below. The [complete *Statement*](#) can be viewed as a 619K PDF file.

Introduction

The Australian economy has remained robust in the recent period, notwithstanding a more difficult international environment. Domestic demand and activity have remained strong and capacity usage is high after a long period of economic expansion. These conditions have been associated with a rise in inflation. Hence Australian monetary policy has had to take into account sharply contrasting domestic and international developments.

The global economic situation in recent months has been marked by ongoing turbulence in financial markets, reflected most obviously in a decline in world equity prices. The primary drivers have been the ongoing write-downs of credit exposures by major global financial institutions and increased concerns about the US and global economic outlook. Equity markets in the major industrial economies have fallen back to around their levels at the beginning of 2007, as has the Australian market. Emerging stock markets, which initially had been relatively resilient, have also experienced declines.

In addition to these equity market developments, the turmoil in global credit markets that began in the middle of last year has continued. There have been a number of aspects to this, including a general widening of credit spreads and continuing difficulty for private borrowers in accessing capital markets. Strains in money markets around the world reached a peak in September and again in mid December, with the latter reflecting concerns about funding over the year end. Since mid December these strains have eased, but money market term funding costs remain significantly higher than they were before the turmoil began. Central banks have acted to supply liquidity as needed. The RBA increased exchange settlement balances to record levels at the end of the year, but has since wound back liquidity as conditions calmed, though both settlement balances and money market spreads have settled at higher levels than before the turmoil.

The deterioration in financial market sentiment has been associated with a weakening in the outlook for global economic growth. The US economy posted only modest growth in the December quarter and most observers have revised down their expectations for 2008, with some forecasting a US recession. Labour market conditions have been softening over recent months and the housing sector is still very weak, with the fall-out from the sub-prime crisis likely to remain a dampening factor for a while yet. Growth in the euro area and Japan is also slowing.

The extent to which the weakness in the major industrial economies will affect the developing world is still unclear. At this stage, conditions in China, India and the smaller east Asian economies remain strong. In China, GDP grew by 11 per cent over the year to the December quarter. While Chinese export growth has moderated, domestic spending is expanding rapidly. In the rest of east Asia, production and export growth generally strengthened through most of 2007. Overall, the recent run of indicators seems consistent with the view that global growth is slowing to a pace somewhat below trend, with significant weakness in the major industrial economies but relatively strong growth in the developing world. Despite the weaker global conditions, inflation remains a source of concern in a number of countries.

Some central banks have responded to the weaker conditions in their economies by reducing their policy interest rates. In the United States, the Federal Reserve has cut the federal funds rate by 150 basis points in the past two months. A significant fiscal stimulus has also been proposed and is likely to take effect in the months ahead. Interest rates in the UK and Canada have also been reduced a little. But other central banks, including the ECB, the People's Bank of China and a number of emerging market central banks, while acknowledging the increased downside risks to growth, remain concerned about inflation pressures and have left policy unchanged or have tightened. In Australia, financial market expectations about monetary policy have fluctuated over recent months, though following the release of the December quarter CPI, markets largely anticipated the February increase in the cash rate.

Global commodity prices have generally stayed high in the recent period, and this continues to boost incomes and spending in Australia. Rural commodity prices have picked up over the past year. While base metals prices have dropped back from the peaks they reached in mid 2007, they are still high relative to their average levels over the past few years. Conditions in coal and iron ore markets have tightened further, and most analysts have revised up their forecasts for contract prices of those commodities in 2008. Based on these developments, the prospects are that Australia's terms of trade will rise further this year, after the sharp increases already seen over the past four years.

The performance of the Australian economy has to date remained robust. The latest national accounts showed growth of more than 4 per cent over the year to the September quarter, with domestic demand expanding by 5½ per cent, well in excess of the trend growth in the economy's productive capacity. Both the private and public sectors made significant contributions to the growth in spending over the year. Consumer demand has been driven by rapid growth in household incomes, which in turn has reflected rising employment and real wages as well as cuts in income taxes. Business investment spending has also grown at a fast pace. More recent indicators suggest that the strength of domestic demand continued in the December quarter, although the pace of output growth may have moderated as more of the demand was met by imports.

With demand still growing strongly after a long period of expansion, there have been persistent signs that productive capacity is stretched. Business surveys have for some time been indicating both high rates of capacity utilisation and high levels of concern about labour scarcity. The unemployment rate in recent months has remained around a 30-year low and the job vacancy rate has increased further. The high levels of business investment now underway will undoubtedly assist in alleviating bottlenecks over time and hence adding to the growth of the economy's productive potential. Nonetheless, with the economy having grown at an above average pace last year, capacity pressures were probably increasing during that time.

Financial conditions facing household and business borrowers in Australia have become more restrictive in the period since the middle of last year, reflecting the combination of higher interest rates, reduced access to capital markets and, for some borrowers, tighter credit standards. In addition to passing on the recent increases in the cash rate, lenders have raised the interest rates on their loan products in response to higher wholesale funding costs. It remains to be seen how far funding difficulties in wholesale markets will curtail the ability of lenders to provide credit to households and businesses. While the major banks have been able to continue to access funding broadly in line with their pre-crisis experience, albeit at higher cost, other institutions have had more difficulty. Consequently, a number of the smaller players have sharply scaled back their lending. To date, the indications from housing loan approvals suggest that the major banks have increased their lending to an extent that has broadly offset the contraction from their competitors. For the business sector, there has been a marked contraction in access to funding in the capital markets but, to date, lending by banks has grown strongly to fill the gap.

The tighter financial conditions prevailing since the middle of last year seem to have had a modest restraining influence on household borrowing, though the effect on businesses has been less clear. Housing-related credit has expanded at an average rate of around 0.8 per cent a month recently, which is at the lower end of the range in which it has fluctuated over recent years. At this stage, there is little sign of any dampening effect on the market for established houses. Lending to businesses has remained strong, expanding by 24 per cent over the year to December, its fastest pace since the late 1980s. Even allowing for the sharply reduced borrowing by businesses on capital markets in recent months, the growth of total business debt has nonetheless remained very rapid, at a rate of 19 per cent over the year, noticeably faster than in the preceding period.

The December quarter consumer price index provided further evidence of a pick-up in Australia's inflation rate. The CPI rose by 0.9 per cent in the quarter, lifting the year-ended rate to 3 per cent. Temporary factors held down the CPI increase in net terms over the year, most notably falls in fruit prices and a recent change to the child-care rebate, while petrol price fluctuations have also affected the recent quarterly outcomes. Estimates of underlying inflation which smooth out these volatile influences suggest an underlying rate of around 1 per cent in the December quarter and 3½ per cent over the year.

A number of factors are likely to have contributed to the pick-up in underlying inflation over recent quarters. As noted, domestic demand was strong in 2007 and constraints on productive capacity have persisted for some time. Significant rises in the prices of oil and other raw materials in world markets over the past couple of years have added to business input costs, though there has been a partly offsetting influence from the appreciation of the Australian dollar. Wage pressures until now have been mostly confined to the mining and construction industries. Nonetheless, labour market conditions are tight, and there is some evidence of higher growth in aggregate wages in the most recent period. In particular, while the wage price index has continued to show a relatively stable rate of wage inflation, the average earnings measure, which captures a broader range of labour costs, has picked up appreciably over the latest year. Measures of inflation expectations have also been picking up gradually in recent quarters.

In the short term, inflation as measured on a year-ended basis is likely to increase further, reflecting in part the quarterly pattern of price increases that have already occurred. Given the current strength of domestic demand and pressures on capacity, a significant moderation in demand will be needed if inflation is to be satisfactorily reduced over time. There are a number of forces at work that could contribute to such an outcome, though the extent of the downward pressure they will exert on inflation is uncertain. The level of interest rates has been lifted to a position that is on the restrictive side of neutral, reflecting increases in both the cash rate and lending rates. The deterioration in global growth can also be expected to dampen demand and activity in Australia. On the supply side, the high level of business investment will help to raise the growth of the economy's productive potential over time. Taking into account these factors, including the Board's decision to increase the cash rate in February, inflation is forecast to decline gradually from late this year, but would still be around 3 per cent in two years time.

The situation in the global economy and financial markets remains a major source of uncertainty for this outlook. It is possible that there will be a sharper downturn in the world economy than is currently forecast, and there is also a risk that tighter credit supply could constrain demand and activity in Australia to a greater extent than is assumed. Should those risks eventuate, inflation would fall more quickly than is currently forecast. On the other hand, domestic demand has to date shown considerable momentum, and there are further income gains from the terms of trade and other factors ahead. There thus remains a risk under the current monetary policy setting that demand does not moderate sufficiently to achieve the forecast reduction in inflation. A further risk is the possibility that inflation expectations could rise, which would make the reduction in inflation more difficult to achieve.

On the current outlook, then, and allowing for the inevitable uncertainties in forecasting, the risk of inflation remaining uncomfortably high for some time is considerable. Absent a further shift in economic risks to the downside, therefore, monetary policy is likely to need to be tighter in the period ahead.

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