PREAMBLE

This is my third submission to the First Home Ownership Affordability Inquiry. My first submission to the Inquiry highlighted the need for the Productivity Commission to look into the role played by monetary policy in the decline in first home ownership affordability. This submission provides some detailed background information about monetary policy.

The Reserve Bank of Australia states that "interest rates affect economic activity via" … (my emphasis)…"a number of mechanisms. They can affect savings and investment behavior, the spending patterns of households, the supply of credit, asset prices and the exchange rate, all of which affect the level of aggregate demand". In other words, monetary policy can affect economic activity through its effect on asset prices, credit and savings.

1. Expansionary Monetary Policy

Monetary policy has set interest rates at a level which has stimulated credit growth and housing prices and reduced the incentive for households to save.

The Governor of the RBA, Ian Macfarlane, has said that much of the growth in housing credit was a once-off event; arising from a lower inflation and interest rate environment and changes brought about by financial innovation and deregulation.

But a close examination reveals a quite different reason for the rapid rise in housing credit and housing prices: interest rates were cut in the face of higher inflation. I will explain this conclusion by analysing what has happened since 1995-96 when:

1. real interest rates were higher;
2. housing credit growth was lower;
3. households saved more; and
4. growth in housing prices was lower.

a) Inflation

The inflation rate, as measured by the increase in the CPI, averaged 1.3% between 1995-96 and 1998-99. The inflation rate then increased significantly to average 3.7% between 1999-2000 and 2002-03 (and was 2.7% in the 2002-03 year). Housing credit growth (and housing prices) actually started to pick up dramatically when inflation began to rise in 1999. Borrowers learn to love inflation because it reduces the real value of their debts. By way of illustration, a $100,000 loan in June 1999 is worth $86,550 in June 2003 prices (discounted by the CPI – All Groups).

b) Interest Rates

The RBA's cash rate is the benchmark for other short term interest rates, and variable home loan interest rates have followed the RBA's cash rate very closely. There was little, if any, other influence on variable home loan rates. So, the difference between the RBA's

cash rate and the standard variable home loan interest rate for mortgage managers in 2002-03 was exactly the same as it was in 1995-96 (1.6%).

The RBA's real cash rate (i.e. after CPI inflation) averaged around 4.9% in the three years to June 1998. But the real cash rate gradually fell away to average -0.2% in 2000-01 (due at least partly to effects of the GST), before gradually increasing to 2.1% in 2002-03. But, the fall away in the real cash rate has made saving much less attractive and borrowing much more so. The result has been a large rise housing prices, which has also promoted speculative and other buying activity aimed at getting into the market "before it is too late".

The RBA has been fully aware of its role in the housing price explosion. And at one stage, it looked as though the RBA would reverse monetary policy's stimulatory role. In May 2002, the RBA announced a move away from an "expansionary" monetary policy setting toward a more "neutral" setting (i.e. a policy that would make it more attractive for households to save). This move was, in the words of Macfarlane "to get interest rates back up to normal". But the move to "normal" interest rates was abandoned within a month or two, due to the onset of global economic weakness – so the expansionary setting remained in place. And the housing market responded with a vengeance in 2002-03 – with housing prices in capital cities up an average 18.1% and housing credit up 21.4%. In August 2003, the RBA released data showing that household credit in Australia had grown by 19.6% in the latest year - the highest rate of growth among the 12 countries it measured (Spain ranked second place with 12.7% growth). And the household savings rate in Australia was actually <u>negative</u> in 2002-03. The RBA's policy helped domestic demand in Australia surge in 2002-03, which offset external weakness.

In summary, the RBA has pursued a monetary policy that has increased housing prices. What the Governor of the RBA calls "open-mouth policy" (i.e. public warnings about prices and debts) has been an attempt to counteract the stimulating effects that monetary policy has had on housing prices and housing credit.

c) Deregulation

Deregulation of the financial system in the 1980s promoted the emergence of mortgage managers and this helped drive down the banks' home loan interest rates. But the interest rate differential between banks' and mortgage managers' variable home loan interest rates had largely disappeared by February 1997 (when the differential was only 0.15%). The fact is the fall in the RBA's cash rate was <u>the</u> factor driving down housing loan variable interest rates between 1995-96 and 2002-03.

Deregulation of the financial system has contributed to a relaxation of lending standards and this must have contributed to some of the growth in housing debt (and housing prices). But the relaxation of lending standards has been met with concerns, including those of the Australian Prudential Regulation Authority. My first submission to the Inquiry listed some of the ways lending standards have been relaxed in recent years.

2. Monetary Policy Objectives and Outcomes

The following is a discussion about how institutionalised factors may have affected the conduct of monetary policy in Australia.

The RBA's objectives are set out in legislation, but in 1996 these objectives were narrowly construed by agreement between Macfarlane and the federal Treasurer, Peter Costello. This agreement requires monetary policy to be set to maintain consumer price inflation between 2-3 per cent over the cycle (in practice a year or two) and, provided that objective is met, 'to encourage strong and sustainable growth in the economy'. The Chief Economist of the ANZ Bank, Saul Eslake, believes that this means the RBA has "no mandate from the government to target asset prices inflation" (AFR Opinion July 30, 2003).

It is possible that some external members of the RBA Board may have stymied an effort by Macfarlane to return monetary policy to "neutral" or to specifically address housing asset-debt inflation. It was reported that the federal Treasury Secretary, a member of the Reserve Bank Board, was at odds with Macfarlane and had pushed for a lower cash rate in recent months. Macfarlane has recently pointed to the role of government policies, such as tax policy, in addressing the housing price/debt problem.

The Deputy Governor of the RBA, Glenn Stevens, believes that it would be a "retrograde step … (for the RBA)… to be perceived as walking away from a (monetary policy) framework which has for a decade produced good results, in favour of some explicit pursuit of asset prices per se". Nevertheless, Stevens has indicated that "a case might be made, on rare occasions, to adopt a policy of 'least regret' so far as asset prices are concerned if financial and macroeconomic stability were thought to be at risk".

Stevens has also suggested that monetary policy's inflation targeting framework would allow scope for responding to concerns about asset prices, provided the RBA is "prepared to adopt a sufficiently long-time horizon". But such an approach would seem to require Macfarlane and Costello to renegotiate their agreement.

But discussions about new monetary policy frameworks to address asset prices look like a smoke screen. The fact is the RBA planned to move toward a "neutral" monetary policy back in May 2002 and, if this policy had of been fully implemented, it would have addressed the housing price-debt bubble. And back in May 2002 there was no indication of any move by the RBA away from its existing inflation targeting framework.

The RBA has pointed out that the rise in household debt has made household spending, which accounts for as much as two-thirds of the economy, significantly more sensitive to economic conditions. The RBA's fear is that, with high household debt, an economic shock could drive the economy into a deep recession and cause significant financial distress.

But it may not take an economic shock household debt to start weighing down on the economy. Much of the growth in household credit has been funded by foreign debt.

When households decide that enough is enough and start paying down debt, as they eventually must, a vast pool of funds will start flowing back to foreign lenders.

If any of the adverse implications that the RBA has associated with rising housing credit come to pass, the RBA must come in for its fair share of criticism.

Conclusion

Housing affordability, housing prices and housing debt have fallen through cracks in public policy. Hopefully, the Productivity Commission can recommend policies that will address these issues.

Table: Real Interest Rates, Housing Credit, Household Savings, and Housing Prices

	RBA Real Cash Rate	Growth in Housing Credit	H'Hold Savings Rate	Increase in Housing Prices
1995-96	4.4	10.1	4.7	
1996-97	6.1	8.8	5.4	
1997-98	4.3	9.8	2.3	
1998-99	3.8	10.6	2.0	6.2
1999-00	2.1	15.0	2.1	9.1
2000-01	-0.2	13.6	3.3	7.4
2001-02	1.7	19.2	2.2	16.5
2002-03	2.1	21.2	-0.6	18.1

Notes: 1. Real cash rate is the RBA cash rate (Source: RBA) minus the % change in the CPI all groups (source: RBA). 2. Growth in housing credit obtained from RBA published data. 3. Household savings rate derived from RBA's GDP data, except for 2002-03 (estimate). 4. Increase in Housing Prices obtained from ABS.