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An Interesting Dilemma

Australia's well-recognised love affair with home ownership has been the subject of considerable debate over recent months, as real estate values continue to soar, and housing-related debt levels grow rapidly. State and Commonwealth Governments have traded accusations of blame, and the Productivity Commission has now been asked to find out what is causing the boom.

The Reserve Bank Board, as well, has been heavily focussed on the issue - if commentators are to be believed. The understanding is that recent official interest rate decisions have been heavily influenced by conditions in the housing market.

Whether the state of the Australian housing market is the business of the Reserve Bank is an interesting question. It is especially interesting to farmers, who may become collateral damage in efforts to cool the housing boom.

For the past few months, considerable speculation has surrounded the monthly meetings of the Board of the Reserve Bank of Australia (RBA). Some commentators have proposed that the RBA should reduce official Australian interest rates as a means of stimulating the Australian economy, especially given the uncertain global economic climate, and the disparity between Australian and US interest rates.

Easing Australian interest rates is additionally assumed likely to slow or reverse the appreciation of the Australian dollar exchange rate, thereby stimulating exports.

At the same time, however, Australian household debt and housing-related credit have been growing at a rapid rate which many, including the RBA, consider unsustainable and which would only be exacerbated by any reduction in interest rates.

Reconciling these divergent economic pressures in a decision about official interest rates is obviously an almost impossible challenge.

It is also not the role of the Reserve Bank Board, except in an indirect sense. Section 10(2) of the Reserve Bank Act (1959) provides the RBA with a broad responsibility to implement monetary policy in a manner that best contributes to the stability of the Australian currency, the maintenance of full employment and the economic prosperity and welfare of Australia.

However since 1993, these objectives have found practical expression in a target for consumer price inflation, of 2-3 per cent per annum. Monetary policy aims to achieve this over the medium term and, subject to that, to encourage the strong and sustainable growth in the economy. This objective was recently reaffirmed in a statement on the conduct of monetary policy jointly issued by the Reserve Bank and the Government.[1]

Notwithstanding questions about how broadly the RBA's role extends in managing the economy, a number of significant questions arise as a result of this debate. The first concerns the likely impact of monetary policy decisions on other factors such as exchange rates. A second and related question is whether there are other, more targeted policy measures that would be more appropriate to manage the economy in the current economic climate.

Interest and Exchange Rate Relationships

There is a general assumption in a small and open economy such as Australia that decreasing official interest rates relative to those of major trading partners will make Australia less attractive to foreign capital, reducing demand for Australian dollars and thereby reducing the exchange rate of the Australian dollar relative to other currencies. While such relationships generally operate in the longer term – all other things being equal – it is apparent that there is no guarantee a weaker $A would necessarily be the immediate result if interest rates were lowered in Australia.

Figure 1 shows historical movements in the exchange rate of the $A against the $US since 1985, charted against the nominal differential between Australian and US official interest rates. This shows there is no

[1] RBA (2003) "Second statement on the conduct of monetary policy". Statement jointly issued by the Reserve Bank and the Treasurer. www.rba.gov.au

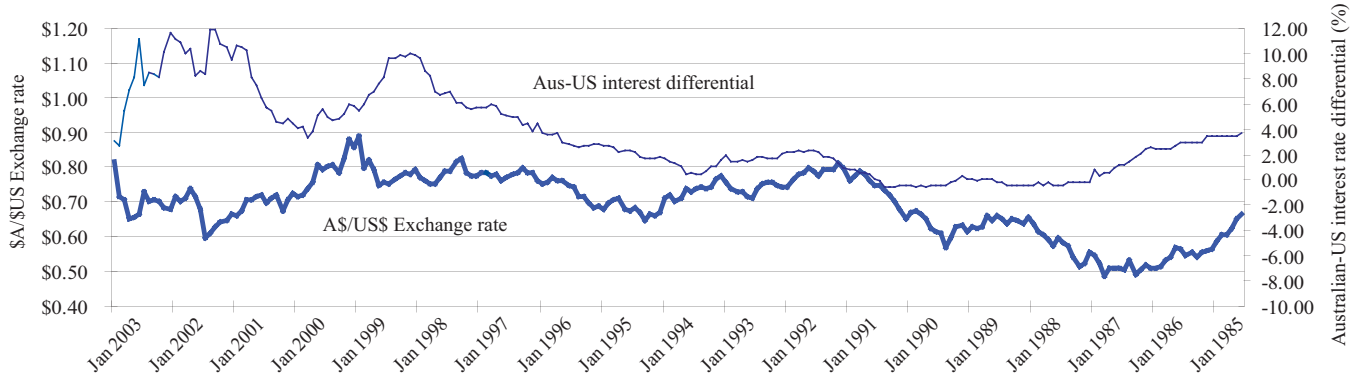

Figure 1 Comparison of Australian/US interest rate differentials and exchange rates.

obvious immediate relationship between interest rate differentials and exchange rates. There have been periods when Australian interest rates have been almost 10% above US rates (in 1987 and again in 1990) yet the $A has been relatively weak against the $US. Conversely, the reverse has applied at other times, such as the period between 1993 and 1997.

There has been considerable research carried out to attempt to model relationships between monetary policy and exchange rates. Most of this research has focussed on the lag between policy changes and their impact on the economy – often referred to as the transmission process. The research has also attempted to quantify the impacts of other factors on any relationship between these.

A general conclusion of much of the research has been that economists have not yet been able to come up with robust models that adequately predict how exchange rates will respond to other changes in the economy. As a recent review of the subject highlighted, "*The reality of floating exchange rates has been far different from what had been predicted. Exchange rates have been very volatile, much more than the underlying fundamentals.*"[2] The review continued "*The combination of excess volatility and exchange rate misalignment has led to a widespread failure of econometric tests of empirical models of exchange rates.*" The author was more hopeful that longer-run relationships between economic factors and exchange rates would be able to be predicted with more certainty, but conceded that reliable models may take some time to complete.

This is not to say that there would be no impact on exchange rates arising from adjustments to monetary policy, but that the results are not necessarily easy to predict. This is perhaps understandable, given the range of different factors thought likely to be involved. Among those listed include unobservable variables like expectations and business confidence, differences between short and long-term interest rates, Government expenditure and taxation decisions, technological changes, stages of the business cycle when policy changes are made, and even the fact that monetary policy decisions are typically made on the basis of future expectations, rather than confirmed trends in the economy.[3]

It is also apparent that relationships between domestic monetary policy and exchange rates are not simple cause and effect relationships. For example, a sudden decline in economic prospects in overseas countries at a time of strong economic performance in Australia's domestic economy would be likely to result in an appreciation of the Australian dollar as overseas investors sought increased exposure in Australia.

As the Reserve Bank noted in its recent quarterly statement[4], the strong rise in the Australian currency over the first six months of 2003 was likely driven by overseas investors chasing yields in the more stable Australian economy as the US economy slowed and international sharemarkets weakened.

However in recent weeks, more positive signals emerging in the US economy have resulted in investors positioning themselves to benefit from growth opportunities in the US, and as a result upward pressure has eased on the Australian dollar, and it has fallen about 4% from its recent month's highs. None of these exchange rate changes have been as a result of monetary policy changes in Australia, which again highlights the complexity of the relationship between monetary policy and exchange rates – as economic modellers have noted.

Other Policy Avenues Available to Government

In a general sense, the main issues of current concern in relation to the Australian economy appear to be the potential for a sustained downturn internationally to have a negative impact on Australia, and the potential outcome of the current significant boom in Australian household and housing related credit, which is seen as a driver of strong growth housing prices

On the first issue, the recent quarterly economic statement by the Reserve Bank suggested the international outlook is now slightly more positive than it has been in the recent

[2]Husted (1999) Exchange rates and fundamentals i the short and long runs. *Australian Economic Review,* 32(2) June 1999

[3]Edey and Romalis (1996) Issues in modelling monetary policy. Research Discussion Paper 9604. Reserve Bank of Australia. www.rba.gov.au

[4]Reserve Bank of Australia (2003) statement on monetary policy. August 2003

past. Indicators of this improvement include stronger than expected US GDP growth, a rise in US industrial production and capital goods orders, and improvements in business sentiment. In addition, equity prices have increased to be around 20% above recent troughs in international markets.

The boom in housing prices and the related growth in household credit is a phenomena that has gained increasing attention over recent months, both from the Reserve Bank but also more generally. The RBA has reported that household credit grew at an annualised rate of 23% for the June 2003 quarter, and lending for investment housing expanded at an annualised rate of 34% for the quarter. This growth is considered unsustainable, and there has been considerable talk about a housing "bubble" and the potential impact that the inevitable bursting of that bubble may have on the rest of the economy. In particular the impact is likely to be felt due to a significant contraction in household expenditure, as over-extended borrowers cut spending in order to continue to meet mortgage repayments.

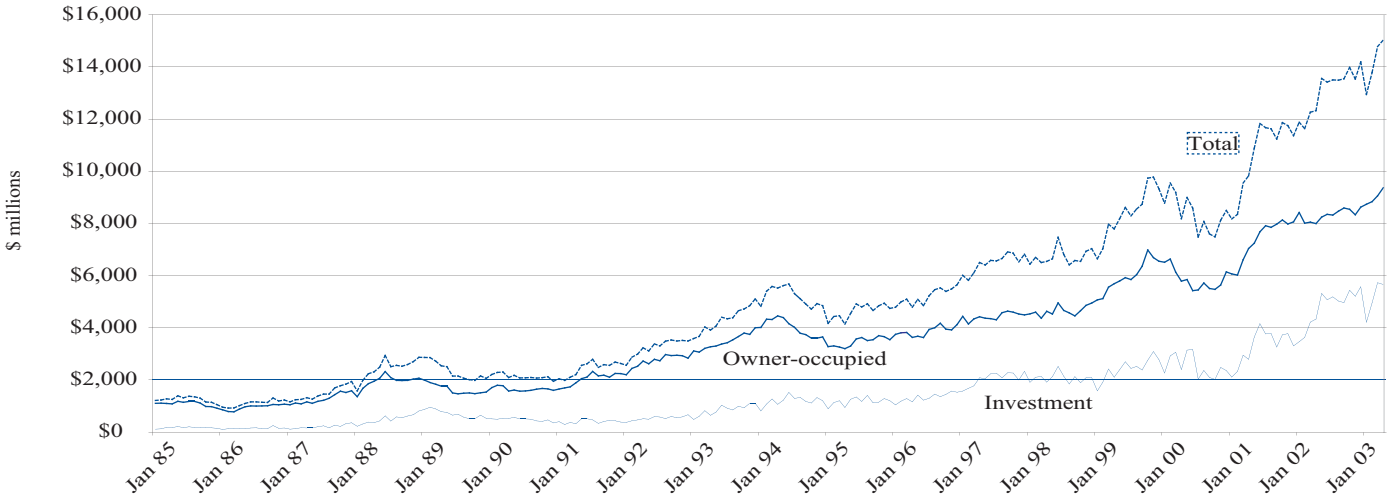

Figure 2 Housing lending committments - all lenders.

The extent of the housing boom can be gauged from a range of statistics. Over the five year period to July, 2002 housing prices have increased at a rate of over 9% per annum, with an increase of 17% during 2001/02. There is no evidence of this rate of increase slowing during 2003. While increases such as this are likely to be driven by both supply and demand pressures, there are a number of significant policy settings and changes by Government over recent years that seem likely to have significantly contributed to the demand driving this increase.

The First Home Owners' Grant Scheme was introduced in July, 2000, to compensate first home buyers for the increases in building and housing costs associated with the introduction of the GST. It was initially a non-means tested grant of $7,000 for first-home purchasers, and was augmented in March 2001 with an additional grant of $7,000 for purchasers or builders of new homes. This was subsequently reduced to $3,000 at the end of 2001. The additional grant was designed to assist the housing industry through the post-GST slump in building that occurred as a result of the rush to beat the GST in the first half of 2000.

While the additional grant for purchasers of new homes is no longer available, the $7,000 grant for First Home Owners continues. To date, it is estimated that some $3.8 billion has been paid to over 400,000 first home buyers.

The initial justification for the scheme was as a stimulus for the housing industry in the post-GST period. However, the continuation of the grant – which is not means tested or limited to purchasers of houses up to a certain value – seems impossible to justify in the light of the current boom in house prices. Logic dictates that over time, potential purchasers will simply factor the additional $7,000 grant into the amount they are prepared to pay for a house, adding further upward pressure to house prices and exacerbating the boom. Given that Australia already has very high home ownership rates by international standards, the rationale for encouraging even more buyers into the housing market simply does not exist.

Longer-term, several significant taxation policies have also contributed to the current boom. While these measures have been in place for some time and have not triggered the current situation, their existence is likely to have added considerable impetus to housing price trends when the outlook for other investment options –such as the sharemarket – have not been positive.

Most significant of these is probably the capital gains tax exemption that applies to owner-occupied housing on areas of land of less than 2 hectares. This exemption has applied since the introduction of Capital Gains Tax in 1985, and confers a significant advantage on housing investment compared with other investments. The advantage has been somewhat reduced by the changes to Capital Gains Tax introduced in 1999, but is still significant.

Research conducted in 2003[5] estimated that the national real value of the capital gains tax exemption for owner-occupied housing for the 2001 year was $13 billion, equivalent to 1% of GDP. This was $2,600 per household, an amount that would have been even greater in 2002 and 2003.

[5]Yates (2002) A distributional analysis of the impact of indirect housing assistance. Australian Housing and Urban research Institute report. April 2003

The research also examined the distribution of these benefits to different households. It found that people in the lowest income categories received little or no benefits from these policies, whereas the size of the received benefits for those in the highest income bracket was three to six times as great as the benefits received by middle-income earners. The report concluded that *"those who benefit most from these (policies) are high-income households who live in high value dwellings and have little housing debt."*

A third issue that significantly advantages those with high incomes investment in housing is the ability to negative gear the losses made on an investment property against tax that would have been paid on other income. It was recently estimated[6] that 54% of those owning rental housing during 1999-2000 claimed to be operating at a loss, enabling them to write off their entire rental income against tax, and another $3 billion against other income. In 2001, it was reported that 1.3 million taxpayers reported rental income of $12.6 billion, but with negative gearing the deductions claimed were $13.3 billion.[7]

The Reserve Bank[8] notes that since October 2000, monthly loan approvals for housing investment purposes have risen by 113%, compared with a 48% increase in loan approvals for owner-occupiers. Given that average rental returns are currently at a twenty year low and are estimated at close to 4%, the reasons for such high growth in investment housing are clearly not yield, but potential capital gain linked to the ability to negatively gear other income.

The ability to negatively gear investment housing losses clearly provides a significant incentive to invest in housing – especially for taxpayers on high incomes who incur high rates of marginal tax. In contrast, the taxation rules for the same individual investing in a farm only allow operating losses to be offset against future farm income, not off-farm income – and only where the investor has gained primary producer status by passing tests concerning the viability of the business. Applying a rule such as this to housing investment seems more logical, and would remove some of the incentive to invest in housing in contrast to other investment options.

Does the Housing Boom Matter for Farmers?

While the housing and related housing credit boom is obviously a concern for Government, it could be argued that it should be of little concern for the farm sector.

This ignores the reality, however, that for an export-dependent sector such as agriculture, interest rates and exchange rates have a vital impact on competitiveness in international markets. For example, ABARE[9] has estimated that a 1% appreciation of the $A against the $US results in an average decline in Australian broadacre farm cash incomes of $1,230 per farm, a total of $84 million. Similarly, a 1% increase in interest rates costs the average broadacre farmer an additional $1,790, or a total of $122 million. Including intensive agriculture in these figures would make them even more significant. At the current US/Australian interest rate differentials, Australian broadacre farmers are at an average disadvantage of $6,700 in interest payments compared to a US farmer carrying the same amount of debt.

For this reason, it is not in the interests of farmers or other major exporters such as the mineral sector, to have Australian interest rates (and probably exchange rates) increased or maintained at artificially high levels in an attempt to dampen the boom in the housing sector. Agriculture accounts for 22% of Australia's exports of goods and services, and mining 36%. It really would be a case of killing the goose that laid the golden egg if both these sectors are disadvantaged by Reserve Bank interest rate decisions that are focussed mainly on outcomes in the housing sector.

This is especially so when there are obvious policy options available for the Commonwealth Government that would be likely to generate a much more targeted response in the housing sector than would blunt monetary policy decisions.

Discontinuing the First Home Owners' Grant, limiting the Capital Gains Tax exemption on owner occupied housing and restricting the extent to which negative gearing can be utilised for investment properties are all options which in isolation or in combination would dampen the attractiveness of investment in housing, without also disadvantaging the rest of the economy. These decisions would require a degree of political courage, but in the longer term would level the investment playing field and ensure more balanced investment decision-making, rather than further encouraging Australians to over-invest in real estate.

Utilising these policy options would also enable the Reserve Bank to remain focussed on its appropriate role, rather than being forced into becoming the quasi-manager of the entire economy.

COMMENTS CONTAINED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE AT TIME OF PUBLICATION.

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[6] Colebatch (2003) "Why Costello should scrap negative gearing." The Age, July 8, 2003

[7] Harley (2003) "How negative is gearing?" Australian Financial Review. July 7, 2003

[8] RBA (2002) "Recent developments in housing: Prices, finances and investor attitudes." Reserve Bank Bulletin, July 2002

[9] ABARE (2002) "Impacts of a depreciation of the $US on Australian commodities." Australian Commodities (9)3. September 2002.