SURGING HOUSE PRICES: RATE HIKES THE ANSWER?

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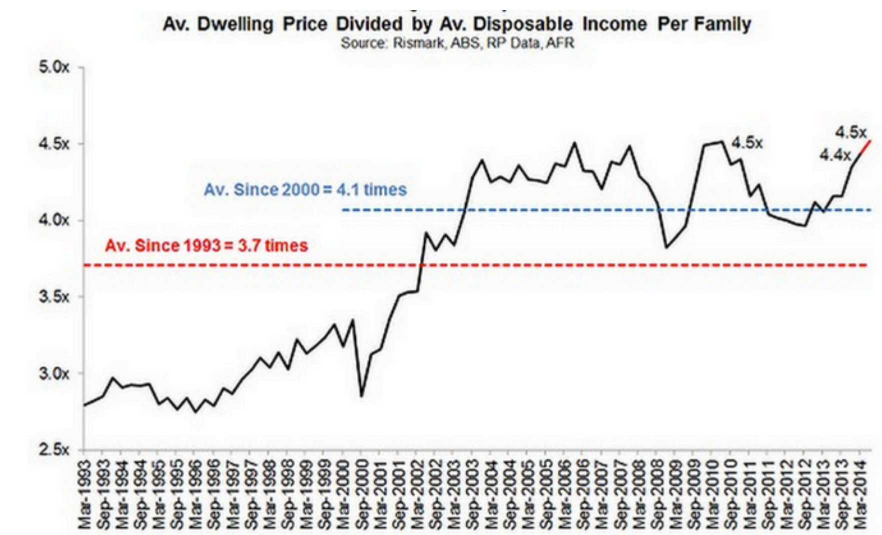
The RBA's decision to slash the cash rate to a record low of 2.5% in August 2013 has induced the emergence of a housing bubble in Australia. Australia's housing prices have surged 11.89% according to RP Data-Rismark Daily Home Value Index, which threatens housing affordability as dwelling prices equate to approximately 4.5x of disposable income, as shown in the diagram. The economy should not depend on the housing market to fuel economic growth because it risks a housing bubble burst that is detrimental to the economy and may have global ramifications. Given suggestions of a housing bubble, the RBA may implement monetary policy to manage the economy.

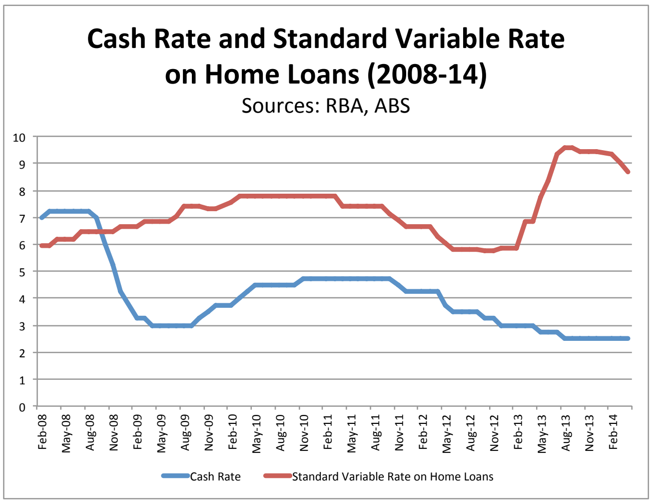


KEY DRIVERS OF THE HOUSING BUBBLE

The upward spiral in housing prices has been significantly fueled by the lowest average standard variable home loan rate since 2009, as shown in the diagram, making borrowing more affordable and encouraging dwelling approvals. Restrictions on housing supply and a strong population growth of 407,000 since June 2012 according to the ABS has also driven demand for housing, which experts believe is currently overvalued by at least 10%. Other factors including expectations of capital gain, negative gearing and first time homebuyer grants have also contributed to the increase in dwelling prices. Although it cannot be claimed that a housing bubble exists due to strong demand, after borrowing costs normalize housing affordability and a potential drop is dwelling prices will be detrimental to the economy as households respond by rapidly increasing savings.

TIGHT MONETARY POLICY

In order to tackle the rising housing prices, the RBA may choose to tighten monetary policy in an attempt to normalize borrowings costs and discourage further increases in home loans. The RBA sell securities to put upward pressure on the cash rate, forcing banks to increase their mortgage rates, which will discourage households from borrowing excessive amounts and reduce the expectations of capital gain. Once demand for housing subsides, housing prices will fall and promote housing affordability.



RATE HIKES THE ANSWER?

Considering the current Australian economy, increasing the cash rate may cause more harm to the economy than an inflating housing bubble. Due to the tight budgets for fiscal 2014-15, cuts on government spending to return budget to surplus are expected to shed 0.5% off GDP growth. Following the end of the mining boom, commodity prices have begun softening and Chinese investment in Australia has slipped 10% from 2012. Although the retail sales have increased 4.6% over the past year, the strengthening housing and retail sector are still insufficient to fill the void from fading mining investments.

The RBA aims to support economic recovery and transition from mining activities to non-mining activities with low interest rates. A rate hike will not only inhibit economic recovery but also drive up the dollar, which is undesirable to exporters. Since inflation has only risen 2.9%, below economists' expectations, the RBA may maintain the low interest rate for an extended period of time.

THE VERDICT

The consequences of increasing and decreasing the cash rate on the Australian economy make it difficult to ascertain how the RBA should act to manage the economy. Despite a strong decline in housing affordability, the RBA should prioritize economic recovery because the housing market is still supported by strong demand for housing, which will prevent a housing bubble burst. Therefore, in the short-term the RBA should maintain the current cash rate to support the economy's transition and in the long-term, perhaps by 2015, once the economy has gained momentum begin raising the cash rate to moderate housing prices.