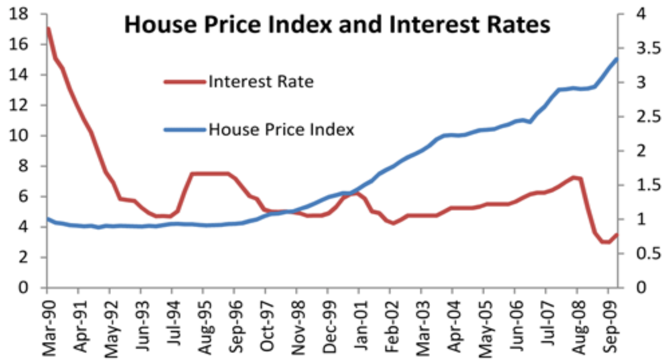
Given suggestions of a housing bubble, how should monetary policy be used to manage the economy?

The belief that the cash rate will remain at a historical low of 2.5% for the majority of 2014 is based on the fundamental interpretation of the inevitable end to the mining boom and the negative effect it carries after. Falling GDP, rising unemployment rates and declining terms of trade to just name a few.

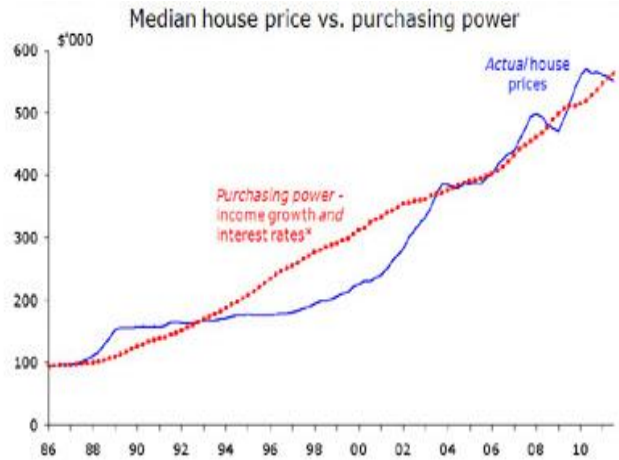
Whilst it may appear that the historical low interest rate acts as a lagging indicator in response to the declining mining industry and the 'prevention of a recession' (Glenn Stevens 2013) and having a negative effect, it may also be viewed as a leading indicator or a catalyst to the increase in demand for housing.



With low interest rates driving the expansion in asset prices, speculators enter the market, believing that greater profits can be generated through investments in housing markets as opposed to bank deposits. Whilst this basic concept further cements the theory of prices rising as a result from excess demand, it is only temporary as demand either decreases or stagnates at the same time supply increases, leading to a decrease in property pricing. This concept is known as a housing bubble.

The creation of a housing bubble is purely and only driven by the basic economic concept of demand and supply. Property assets can be sold for record high prices because more potential buyers are able to fund the mortgage it carries, and hence the increase in demand. Yet however, does this housing price spike really follow the concept of finance, or is it just filled with what a 'bubble' is filled with, nothing-just plain air? And if this is the case, how much longer will the 'bubble' expand before it reaches its maximum point?

Based on history, the concept of a housing boom is inevitable and will last much longer than forecasted by individuals. The analogy of an owner taking the dog for a walk is perfectly mirrored in with this situation. The dog would start sprinting off, leaving his/her owner behind. When it felt it had gone too far, it would track back and the whole cycle starts again. Whilst this basic analogy is widely used America with the dog representing the Dow Jones Index and the owner being the American economy, it can also mirror the relationship between wages and median house price. Assuming wages rises in accordance to a positive CPI, the median house price will tend to follow a trend of rising for 5 years and declining for 2 years.



As such, it is clear to see that even though if a 'housing bubble' does not follow the basic fundamentals of finance, a new 'bubble' will be formed following a 'bust' of another. Therefore, rather than having the decision of altering the cash rate centered around the housing market, monetary policy should have their central focus on the inevitable end of the mining boom and the consequences it carries.

The mining sector accounts for 59% of Australia's exports and contributes 10% towards the nation's GDP. As such, declines in the mining sector will lead to substantial negative impacts on Australia's overall GDP growth and unemployment figures.

On present indicators, it may seem likely that Australia will experience 'a period of stability in interest rates' (Glenn Stevens April 2014), yet should the rates be raised, the central focus should be diverted towards the overall nation's impact on the decline in Australia's primary exporting sector rather than the housing market. RBA's main goal is to maintain a sustainable economy where GDP continues to grow each year alongside CPI. It is indeed true that the RBA needs to ensure that housing prices do not reach too high, yet they need to assess other general economic indicators. It is only when they return with positive indications that the RBA should slowly raise the cash rate in order to achieve a so-called 'soft landing' for the housing market.