

9 October 2003

Productivity Commission
Collins Street East
Melbourne

Dear Sirs/Madams

Nominal Interest Rates

Further to my previous submission, the following provides some background on some factors affecting nominal (and real) mortgage interest rates, an important factor affecting the price of houses and housing affordability.

The decline in interest rates in the early to mid-1990s was associated with both lower inflation and a structural decline in interest rate margins on mortgage lending over this period. In more recent years, there has been relative stability in net interest margins on mortgage lending.

The decline in interest rates in the early to mid-1990s had a positive effect on housing prices up to 1997 at least. However, on October 8, 1997, the RBA's Assistant Governor, Mr. G.R. Stevens, asked the question: "Will house price inflation, and asset price inflation generally, be as high in future as it was in the 1980s (or even the recent past)?" Stevens went on to say "The answer to (this) question is surely no". In other words, Stevens believed that the effects on housing prices associated with the structural decline in mortgage interest rates and lower inflation had already largely flowed through to housing prices by 1997.

Nevertheless, it is important to examine the reasons for the structural decline in interest margins on mortgage lending in the early to mid-1990s. This is because this structural decline may, potentially, reverse to some extent in the future. The structural decline in housing mortgage interest margins in the early to mid-1990s was largely due to:

- The entry of mortgage managers. These new lenders were able to securitise mortgage assets to fund their lending at competitive rates. They were also able to pass on a low cost structure (e.g. no branches) in the form of low interest rates.
- The decline in prudential risk weighted capital requirements for deposit taking institutions for loans secured by residential property. This allowed interest rates to fall while preserving return on capital.
- Productivity gains of lenders.

The decline in government and semi-government debt reduced the availability of high quality debt securities to superannuation funds, fund managers, insurers and foreigners.

This had a positive effect on demand for securitised mortgage assets and drove down interest rates on such assets.

In the late 1990s, banks became more active in securitising housing loans, and this assisted them in funding very rapid growth in housing lending. However, it appears that banks have not utilized securitisation to a significant extent because banks can fund loans competitively using their own balance sheet. Indeed, Commonwealth Bank reduced its reliance on securitisation of housing loan assets between June 30, 2002 and June 30, 2003.

Banks have been fairly successful in retaining market share in housing lending markets in recent years.

Economic activity in Australia has been bolstered by low real interest rates, rising housing prices and low or negative household savings. There are concerns that the rise in household debt will adversely affect household consumption spending and economic activity going forward. Moreover, any significant decline in housing prices and household wealth would have a similar effect in the future. But, the major concern is that a decline in housing prices could be accompanied by a recession or a rise in interest rates. This combination may also cause financial instability (and potentially the failure of a financial institution).

In August 2003, the Governor of the RBA, Ian Macfarlane, told the House of Representatives Standing Committee on Economics, Finance and Public Administration "... if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing – the credit driven house spiral – also continues over the 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession". A severe recession would almost certainly be accompanied by a fall in housing prices (as it was in the early 1990s).

If the scenario put forward by MacFarlane were to eventuate, this must result in a significant increase in housing mortgage defaults. Governments may have to significantly increase spending on welfare and/or on economic stimulatory packages. This would drive up government debt (as has happened in Japan) and potentially crowd out securitized mortgage assets.

If there is a significant increase in housing mortgage defaults (and such a scenario may not be isolated to Australia), it could contribute to the failure of financial institutions. It would also cause investors to reassess their investment in mortgage backed securities. Deposit taking institutions may need to raise deposit interest rates and, to preserve profitability, raise interest rates.

Any significant increase in mortgage defaults may cause regulators to review the capital weighting for loans secured by housing.

Any significant increase in housing loan defaults would also require significant increase in resources devoted by mortgage lenders to loan administration and recovery. Mortgage lenders would also reassess their lending practices. This would drive up lending costs and, at the margin, interest rates.

The pricing of mortgage interest rates may not currently reflect all the risks. While the Governor of the Reserve Bank concedes that it is more risky to borrow (and presumably to lend) for housing investment compared to owner occupied housing, there is no premium charged for investor loans (prior to 1996 the margin was at least 1% and prior to 1990 likely more).

Central Banks Role in Relation to Housing Prices/Housing Debt

Way back in 1997 at least some staff at the RBA had concerns about the rise in mortgage lending and housing prices. Mr. C. Kent and Mr. P. Lowe of the RBA's Economic Research Department presented a Research Discussion Paper in October 1997 which analysed the role of monetary policy in responding to asset prices bubbles (and particularly in assets used as collateral, such as housing). Kent and Lowe concluded that there may be circumstances where monetary policy should be tightened in response to an emerging asset-price bubble. Similar conclusions have been reached by other reputable economics (including at the Bank of International Settlements).

Six years later (in mid-2003), the RBA held a conference on this topic, which included presentations made by overseas economists. However, consideration of the views of economists in other countries on any role for central banks in responding to asset-price bubbles needs to be tempered by a few realities. Foremost, there are differences in the circumstances prevailing in their countries relative to Australia. For example, while there are concerns about housing price growth in the United States, housing prices in the US have not increased to the same extent as they have in Australia. The US mortgage market is very different to Australia's (refer to prior submission). In general, households the world over do not leverage against shares to the same extent as they do against housing property.

Australia's ratio of household debt to disposable income has increased at a very fast rate compared to other advanced countries, which indicates that for households with debt the ratio is very high in Australia. Back in 1997, the RBA's Assistant Governor, Mr. G.R. Stevens, said that low interest rates had allowed more low income earners to participate in home ownership (the Commonwealth's first home loan subsidy probably enticed more low income earners into the market). ABS data indicates that in 1998-99 housing debts were high for Australian households on low incomes. This may indicate that Australia has a relatively high proportion of low income earners with high debts, compared to other countries. Any comparison with the UK of debt levels would need to take into account

the high level of public and community housing catering for low income earners in that country (and relatively low level of investor housing in the UK).

Both the Federal Reserve and the Bank of England's monetary policy committees' publish Board Minutes. In Australia, it is time for the market to find out how the various board members of the RBA are voting in relation to official interest rates and why.

Previous submissions provide further information on this topic.

Yours faithfully

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