Submission to Senate Select Committee

On Housing Affordability in Australia

Department of the Senate

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Table of Contents

1. Preamble

The Reserve Bank of Australia (RBA) is charged with the responsibility of maintaining price stability in Australia. Currently price stability is defined as maintaining price increases in a target range of 2-3 per cent per annum as measured by the Consumer Price Index (CPI).

It is my view that use of the CPI in its current structure as the appropriate measure for inflation and the setting of monetary policy <u>is flawed,</u> and it is these flaws that have lead to the massive increase in house prices, household debt and the resultant housing affordability crisis in Australia that we have today.

It is also my contention that this misguided approach to monetary policy has lead to a massive redistribution in wealth away from poor and middle income earners to the asset rich, wealthy Australians and that this problem has the potential to cause major social issues going forward, particularly for the younger generation (I am 53 years of age).

Thus any policies that seek to address housing affordability in Australia **<u>MUST</u>** include a review of the RBA's approach to managing monetary policy.

Note that throughout this submission unless specifically stated housing prices refers to the combined value of land and residence (i.e. the amount the consumer actually pays) rather than the more narrow definition of the cost of the residence (excluding land). This important distinction will become more apparent later in this submission.

2. Theoretical Economic Framework for my Submission

In order to understand my analysis and findings it is important that I provide a brief theoretical synopsis of a modern economy.

In brief, a modern economy consists of what we call the economic sphere and the financial sphere. The economic sphere consists of the real economy of the traded goods and services sector, and therefore includes basic elements such as consumption, investment and government expenditure. Not surprisingly the financial sphere focuses on the banking and financial systems, including money supply and the provision of credit. Up until recently the financial sphere has been dominated by the banks but in more recent times it has been joined by a host of other institutions including mortgage brokers, hedge funds and the like.

Ideally activity in the financial sphere should be synergistic with movements in the economic sphere and visa versa.

Why is it important to differentiate between the two spheres as it relates to housing affordability? There are two key reasons:

- Firstly because almost all of the discussion in relation to potential solutions to housing affordability relate to the economic sphere. In particular they are generally focused on supply-side solutions which focus on increasing the supply of available land and on delivering cheaper, higher density housing;
- This single focus on the supply side completely misses one of the main drivers of housing price increases, namely from the financial sphere the plentiful supply of cheap credit via by the RBA and other central banks of the world. It has been this laxness in the financial sphere that has driven up asset prices in Australia and elsewhere including residential and commercial property as well as share prices.

As we shall see in the following sections the CPI picks up only activity in the economic sphere, and thus misses any price increases in asset prices (including houses) which are driven by policy looseness in the financial sphere.

3. What is Inflation?

In technical economic terms inflation is defined as ***an increase in the volume (supply) of money and credit*** relative to the supply available goods and services.

Inflation and deflation are monetary phenomena. Thus significant increases in the supply of money (and credit) will result in increases in demand (relative to the availability of supply of assets and goods) which directly translates to increases in asset and other prices.

This increase in money and credit (in layman's terms "DEBT") has lead directly to increases in the prices of residential and commercial property prices in Australia and elsewhere as well as in global terms to the commodities boom. It has also led to the massive financial mania which is currently de-leveraging with adverse results in the global financial system.

Credit expansion (i.e. inflation) has 2 components, namely:

(a) the general willingness / ability to lend and borrow; and

(b) the general ability of borrowers to pay interest and principal.

In turn these factors are impacted by the psychology of lenders / investors as well as the ability to ramp up productive capacity.

4. Other "Inflation" Measures

Economists use a number of other "inflation" measures to describe inflation. These include the Consumer Price Index (CPI), Asset Price Inflation, Wage Inflation and Materials Inflation. Whilst these are useful in various sets of analysis they only measure certain aspects and symptoms of inflation, but according to economic theory they don't measure the underlying cause of inflation, which is always a monetary phenomenon.

4.1 The Consumer Price Index

The Australian CPI is specifically designed to provide a ***general measure of price inflation for the household sector as a whole***. (i.e. it measures changes over time in the prices of consumer goods and services acquired by Australian households). The CPI measures the changes in the price of a fixed basket of goods and services acquired by household consumers. The objective of the CPI is to obtain a measure of price inflation facing households as consumers.

The CPI is useful when a general measure of inflation is required. It is the most widely used price measure as an input into general economic and monetary policy. It is also used to index things such as various pension and superannuation payments as well as rents.

The CPI measures price changes relating to the spending patterns of all metropolitan private households. Thus the CPI measures price movements (i.e. percentage changes) and not actual price levels.

The Australian Bureau of Statistics (ABS) uses a top down / bottom up approach in developing the CPI. At the highest level is the "all groups" which naturally contains all the groups, subgroups and expenditure classes. This is further broken down into groups, subgroups, and Expenditure Classes which are groups of similar goods or services e.g.

- Group = Food
- Sub-group = Dairy and related products
- Expenditure classes = Milk, cheese, ice cream and other dairy products.
- Elementary aggregates – these are the basic building blocks of the CPI. Each elementary aggregate contains several prices for a particular good or service.

In the 15th series CPI there are 11 major groups. The following table shows the weighting pattern for the CPI as at June Quarter 2005 as well as for the 14th series (as at June quarter 2000).

Major Groups	14th Series Weighting (By value)	15th Series Weighting (By value)
Food	17.7	15.4
Alcohol and tobacco	7.4	6.8
Clothing and footwear	5.2	3.9
Housing	19.8	19.5
Household contents and services	8.1	9.6
Health	4.7	4.7
Transportation	15.3	13.1
Communication	2.9	3.3
Recreation	12.3	11.6
Education	2.7	2.7
Finance & Insurance Services		9.3
Miscellaneous	4	
TOTAL	100.0	100.0

The weights reflect relative expenditures of the CPI population group as a whole and not those of any particular type and size of household. As such the weights reflect expenditures of households on average rather than an average household.

Of particular interest to this submission is the major group related to Housing. The ABS describes the category as follows:

> ***Housing*** – conceptually the Housing group includes all expenses relating to rents, utility services, purchase and maintenance of dwellings and other expenditure on shelter-related goods and services. Examples of items priced include:
>
> - Rents – rent paid to private and government landlords, including public housing and Defence Housing Authority
> - Utilities – electricity, gas and other household fuels, water and sewerage,
> - Other Housing
> - House purchase – *new* homes ***(excluding land)*** and major improvements to existing homes, and fixed appliances such as hot water systems and dishwashers
> - Property rates and charges
> - House repairs and maintenance

Pricing of house purchases is limited to transactions in newly constructed owner-occupied houses and is conducted monthly. A sample of project home builders is approached to obtain prices for a number of specified types and models of project homes. Extensions and renovations form part of this expenditure class. However no prices specifically relating to thee activities are collected as the costs are assumed to move similarly to new house building costs.

5. Shortcomings of Using the CPI When Setting Monetary Policy

There are a number of major shortcomings when it comes to using the CPI as the sole tool when setting monetary policy, particularly as it relates to its impact on Housing Affordability.

- Firstly the CPI excludes the largest element of movement in house prices, namely the cost of land as well as changes in the price of established housing. Studies (Schiller from the US) have shown that it is the price of land that varies the most in periods of rapid price changes. This is evidenced by the absurdity of house prices in places like Canberra, Mackay, Broome, Cairns and other regional areas rising up to and in some cases exceeding $500,000. As we all fly over Australia it becomes pretty apparent that Australian doesn't have a shortage of land. And yet the price of land has escalated to exorbitant and unaffordable levels.
- Secondly there are a number of major factors, both domestic and overseas, that can have a major impact on the price of consumer goods and services. In fact it has been argued (Gary Schilling & Co) that over the past 25 years the world has been in a major disinflationary trend, lead by globalisation, mass retailing, technology-enabled productivity improvements and de-regulation. These structural changes would have kept the CPI down irrespective of what the central banks have done. Because of this disinflationary environment the RBA and other central banks have massively ramped up credit growth which has fed directly into asset price inflation, including housing.

  It is this ***debt-fuelled binge*** that has had a major impact on the current housing affordability problems currently being experienced in Australia and elsewhere. Without this massive financial stimulus it is quite likely that the CPI could have dipped below zero which would have had positive impacts on real wages and the cost of living. For example if the Chinese and other economies can produce goods at cheaper prices why shouldn't consumers be able to take advantage of this as this increases the standard of living of average wage earners without feeding into the need for wage increases.

- Thirdly the current increase in the CPI is being fuelled largely by increases in world-wide commodity prices which are largely outside the control of the RBA.

- The failure to call asset / housing price inflation for what it is has lead to major distortions in investment and consumer expectations. For example many Australians seem to be over-investing and over-capitalising in housing on the basis of continually rising house prices, rather than the economy investing in productive capacity in areas like factories, plant, equipment and infrastructure. Real wealth and jobs are not generated by loose financial policy inflating asset prices but rather by increasing productive capacity in the real economy.

  Similarly over the past 2 decades there has developed an almost religious fervor about expectations for future increases in house prices. This has been fed by vested interests including the banks, property industries, the media, and all levels of Government. Who can forget those brain-deadening TV shows such as Hot Property, Auction Squad, the Block etc? They all fed into the manias that lead to credit-fuelled, massive increases in housing price increases. And unfortunately this has lead directly to the housing affordability crisis.

  The RBA's actions of not addressing house price inflation have now led to expectations of ever-increasing house prices in both real and nominal terms. Parodying a term the US Federal Reserve Board is fond of using: ***Inflationary expectations in Australia are NOT well-anchored*** (as it relates to housing prices) and this is clearly as a result of RBA failure in terms of maintaining price stability (in a broader context).

6. Winners and Losers from House Price Inflation

Rapid house price increases are a zero-sum game. Thus, for every winner there has got to be a loser.

The winners of the massive inflation of housing prices over the past two decades generally include the “big-end of town”, aided and abetted by government at all levels. The winners have included:

- The banks, mortgage brokers and other financial institutions – the banks have been major winners as the credit-fuelled binge has inflated their balance sheets far in excess of the increase in the CPI. Many people are so indebted to the banks that they go off to work each week just to repay the banks. This is a modern form of serfdom where the populace has become indentured to the banks. And all of this with the blessing of successive Federal Governments and the RBA. It is no co-incidence that many in the Economics profession have been cheer-leaders for this debt-fuelled binge as many of them are employed by Government and the banks.

  As an example of the change in mentality in relation to debt and house prices, where I am currently working, a real estate agent (partnering with a financial institution) has a sign in the window saying “Put the lazy equity in your house to work through home equity loans”. Why have the tried and tested ways of the past where it was deemed prudent financial management to build up equity in your house been swept away so quickly in recent times? The answer clearly lies in financial deregulation and the banks and financial institutions being interested only in having their customers increase their debt to extreme levels so that bank profits can continue to soar to ever-increasing levels;

- The property Industry, including developers, construction companies, real estate agents. This group clearly has a vested interest to see the merry-go-round continue;
- Those people in the market many years ago;
- The wealthy – this group benefits because they have much of their wealth tied up in financial and property assets. Thus massive asset price inflation results in an increase in their relative wealth, thus resulting in a massive transfer of wealth from low and middle Australia to the upper class;
- Speculators – those people who have speculated in real estate or who have taken advantage of house price inflation through negative gearing strategies;
- The media – the print and electronic media have been handsome winners with the debt-fuelled housing binge. The print media obviously gains through increased real estate and financial institution advertising. Who hasn't seen the front page headlines crowing about which suburbs have seen the greatest increase in prices and what your house is now really worth.

  If the print media had been honest in their reporting what they would have said is "*RBA-endorsed house price inflation is rampant, putting the price of housing beyond the reach of ordinary Australians and the RBA does nothing to prevent it*". It is a sad indictment of the quality of our financial journalism, even in supposedly reputable newspapers, that few stories have emerged until recently to analyse what has been happening with asset price inflation. The electronic media has been equally bad, if not worse, in fuelling the house price inflation through their mindless "reality" shows. As I noted earlier inflationary expectations are not well-anchored. In fact only in the last couple of days a well-known property consulting firm forecast that house prices would increase by a further 40-50% ONCE interest rates come down. So clearly interest rates have a major impact on property prices and inflationary expectations remain strong;
- All levels of government – All levels of government benefit as a result of inflation, because inflation is in effect a stealth tax. And rapid house price

inflation is a marvelous stealth tax. For example the State governments are allowed to support their profligate spending by being major beneficiaries of rampant house price inflation through their reliance on land taxes, stamp duties and GST revenues. The Federal government has also benefited through an increased tax take related to corporate taxes. Finally local government benefits as much of their rates base is tied to property values.

Unfortunately the losers have little or no voice in academia, the media or government so they suffer in silence. The losers include:

- The younger generation who have little chance of entering the housing market other than by taking on extreme levels of debt;
- Those in the rental market who are now being squeezed as the result of years of rampant house price inflation that is now starting to flow through into rents. For many years rents increased at a slower rate than house prices, but this is now reversing. The sharp rental increases are clearly as a result of earlier rampant house price inflation;
- People who save – many people have been affected by investing conservatively rather than going into significant debt. These people have had their savings decimated in real terms as a result of the rampant asset price inflation, particularly housing;
- Retirees and those on fixed incomes; and
- Lower and middle income Australians who have been hit by being forced into higher and higher debt levels just to enter the housing market. ***The underlying problem for these people is not with interest rates. The problem is with the underlying level of debt.*** People could handle reasonable increases in interest rates if their debt levels weren't so horrendous. Unfortunately by pumping up the money supply to suppress the price of money i.e. interest rates, the RBA has encouraged debt levels to get to extreme and dangerous levels and in so doing they have doomed many people to either mortgage stress, a lower level standard of living or in may cases bankruptcy.

- The level of foreign debt has been exacerbated by the large run-up in foreign debt which has arisen as result of banks going offshore to fund the growth in their balance sheets as a result of an inadequate domestic savings. This is evidenced by the declining savings rates in Australia in recent years.

7. The Facts (Statistical Analysis)

I have included below a summary of analysis that I have undertaken in this area. The underlying statistics are included in an attached spreadsheet. Most of the data has been sourced from official RBA and ABS statistics and generally covers the period from 1990 to mid-2007. Unfortunately I have not had access to a vast array of public or private data on house prices. I believe access to this data would further re-enforce the findings of my submission.

1. Increase in CPI (Source ABS)

From the period June 1990 to March 2007 the CPI has increased has increased from 102.5 to 155.6, an overall increase of about 55%. The table below shows the percentage increase in the key categories over that time:

- Food + 69.9%
- Alcohol & Tobacco + 141.6%
- Clothing & Footwear + 7.7%
- Housing + 34.2% (as measured by the CPI – not by increase in house price inflation)
- Household Contents & Services + 23.6%
- Health +125.7%
- Transportation + 55.8%
- Communication + 11.0%
- Recreation + 33.9%
- Education + 170.9%

These figures highlight the following:

(a) the prices of goods and services impacted by disinflationary forces mentioned earlier and over which the RBA has little or no control (i.e. clothing and footwear, household contents and services, recreation and communication) have shown relatively small increases in prices;

(b) the measure for housing (which is used to influence monetary policy) grossly understates the increase of housing price inflation as measured by the increase in residential house prices (i.e. the true cost of house price inflation);

(c) those areas that are impacted by domestic factors including domestic wages and taxes have shown the greatest increase (e.g. health, education, alcohol and tobacco).

2. Real Gross Domestic Product (GDP)

Real GDP appears to have grown by about 66.4% over the period June 1990 to June 2006.

3. Average Weekly Earnings

The total average weekly earnings for all employees have increased by a total of 77.3% for the period November 1990 (estimate) to November 2006, which is marginally above the increase in CPI for the same period. Full-time adult total earnings have increased by 89.2%.

4. M3 Monetary Aggregates

M3 is a very commonly used measure of money supply in Economics. It include currency in circulation, current deposits with banks, other deposits with banks as well as deposits with non-bank deposit institutions. Whilst there is some debate in academic circles as to its usefulness in monetary policy I believe it does have some value and can at least be an indicator as the looseness / tightness of monetary policy settings.

M3 has increased by almost 300% (+287.2%) during the period June 1990 to May 2007. This large increase in M3 fed into asset price inflation, including house prices, and this has had a major impact on housing affordability in Australia.

5. Lending and Credit aggregates

The last two decades have seen a significant increase in lending aggregates, which have resulted in massive increases in consumer and household debt levels. This is highlighted in the following table which shows the growth in selected lending and credit aggregates for the period June 1990 to April 2007.

- Credit (including securitizations) + 468% (from $338 billion to $1,583 bn)

Of which

- Housing (including securitizations) + 1,083% (from $74.8 bn to $ 849.4 bn)
- Other personal (including securitizations) + 310% (from $44.6 billion to $138.2 bn)
- Business (including securitizations) +277% (from $215 bn to $595.5 bn)

This clearly highlights the massive increase in lending for housing which has far outstripped lending for business. And yet it is business that generates wealth in the long-run, not passive investment such as housing that has been inflated by easy monetary policy.

6. Bank Assets

The following table highlights the significant increase in loans and advances going to housing vis-à-vis other lending categories for the period June 1990 to April 2007.

- Residential + 962% (from $62.7 bn to $602.7 bn)
- Personal + 338% (from $29.7 bn to $ 100.3 bn)
- Commercial + 491% (from $96.9 bn to $476.1 bn)
- Other assets +610% (from $68.7 bn to $418.7 bn)

Bank assets have increased by 530% over the period June 1900 to current. No wonder bank shares have increased as a share of the stock market over this period. Similarly it is no surprise that banks have put a great deal of effort into lobbying and supporting financial deregulation. For their shareholders that has been their job. But Government has a wider role to play. And that is to balance corporate and social interests. And the Federal Government and the RBA have allowed those competing interests to get completely out of whack to the disadvantage of ordinary families and the next generation. Surely the Federal Government has a greater interest than protecting the interests of the wealthy few.

7. Household Finances – Selected Ratios

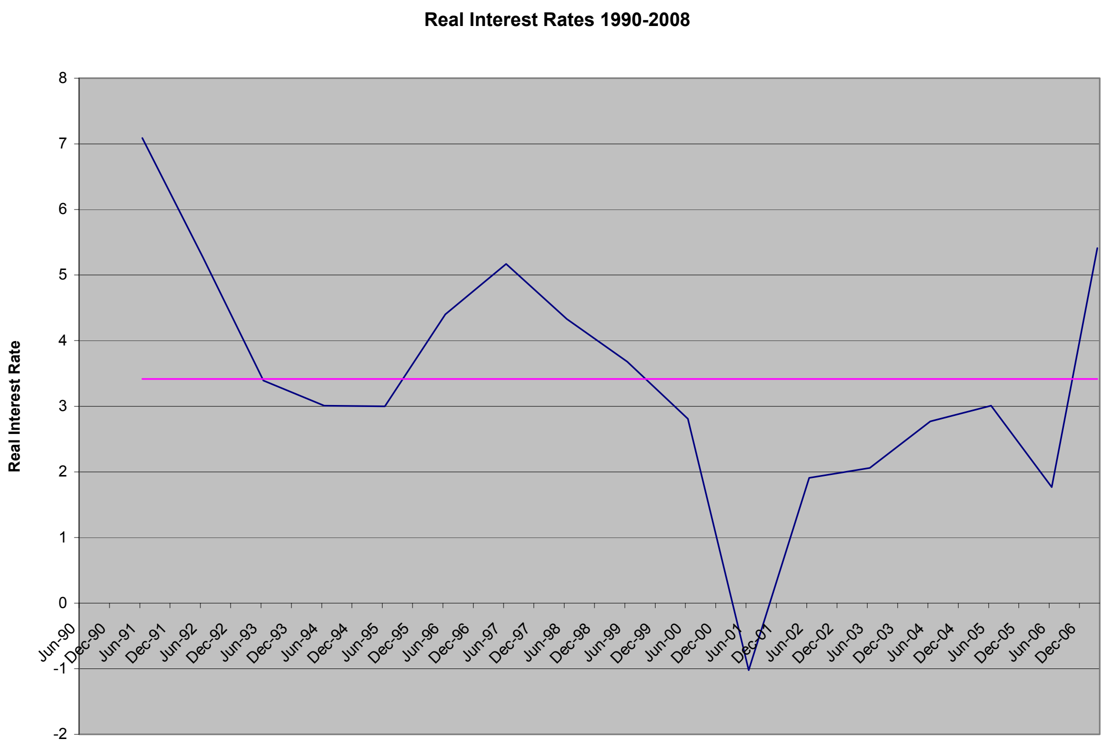
The following table highlights the impact that this increase in debt has had on selected ratios of household finances for the period June 1990 to March 2007.

Ratio	June 1990	Dec 2006
Debt to Assets	8.5%	17.3%
Housing debt to housing assets	10.8%	26.1%
Debt to disposable income	46.7%	158.1%
Total assets to disposable income	468.1%	805.2%
Interest payments to disposable income (total)	8.9%	11.7%
Interest payments to disposable income (housing component only)	5.8%	9.3%
Household savings ratio (Source from GDP statistics)	+3.5%	-1.4%

These clearly show debt has increased as a proportion of assets, debt servicing has increased and the savings ratio has decreased. These are not signs of a well-balanced, sustainable economy. These figures are particularly disconcerting as they are based on lower interest rates. These ratios will surely worsen over the coming months as debt and interest levels rise and house prices potentially fall.

8. Cheap Credit

The following graph shows real interest rates for the period June 1990 to current. It has been calculated by discounting interest rates by the relevant CPI.



The graph clearly shows that interest rates have been their medium term average for the last 8-10 years and actually fell below zero in real terms for a short period of time. In effect the RBA was begging people to borrow and this has led to a debt binge and the increase in housing prices, thus exacerbating the housing affordability crises.

9. Other Key Housing Affordability Statistics

Lack of access to key housing price figures has currently prevented me from including these with any degree of accuracy. These key statistics would include the traditional measures of housing affordability, namely:

- Rent to house prices; and
- Medium wages to medium house prices

I believe these figures would substantiate the remainder of the data. More importantly I believe these basic statistics should play a much greater role in formulating monetary policy in the future. Interest rates have a much greater part to play in determining these ratios than the cost of food and electronic goods. Moreover the policy must be to keep these statistics in line with long-term historical bands so that debt levels and house prices don't get out of sync.

8. Conclusions

I draw the following conclusions from this analysis:

1. Housing price affordability is not just a supply-sided issue related to the economic sphere. Whilst admittedly supply-side constraints are part of the cause and therefore will be part of the solution an equally if not more important cause of housing price un-affordability relates to flaws in the Monetary Policy Framework adopted by the Federal Government and the RBA.
2. Bank assets (in other words – indebtedness in the residential and business community) has increased by 530% over the period June 1900 to current vis-à-vis growth in real GDP of 66.4% over the same period. It seems that the RBA has been grossly inflating debt which has lead to major asset inflation because of the disinflationary forces occurring in the real economy. Unfortunately because of major inflationary pressures in many countries including China, India, the Middle East and Europe this structural advantage is unwinding. Unfortunately consumers are still left with the debt.
3. The definition of price stability as used by the RBA and the Federal Government is too narrow as it does not focus on the key causes of "inflation" i.e. increases in the money supply and credit. As a result the RBA does not include in its calculations increases in the price of real estate and this has lead to monetary policy being too loose for far too long. This in large part contributed to excess demand for housing and thus to increasing house prices, resulting in our housing affordability crisis.
4. Money supply has far outstripped growth in the real economy (as measured by real GDP). This allowed the RBA to stoke the fires of asset price inflation through a vast excess of liquidity.
5. The problem of housing affordability is not per se the level of interest rates. The problem is the massive increases in recent years in the underlying levels of debt.
6. The horse has bolted and in effect the price of housing has got completely out of touch with the ability of people to be able to comfortably make their

repayments. ***The solution does not lie in reducing interest rates*** as all this will do is drive house prices up to even more un-affordable levels as people take on ever-increasing levels of debt. Instead the solution lies in stabilizing house prices for a long period of time and getting debt levels down to more manageable levels.

7. Expectations have built up in the community for ever-increasing increases in housing prices (or in more blunt terms relentless house price inflation). These expectations have driven people's retirement, saving and investment plans and therefore it will take a period of sustained house price stability to eliminate these expectations. The Federal Government and the RBA must change their policy and state that they will be targeting house prices as part of their war on inflation.
8. Because the price of housing has got so far out of line with wages and the ability to repay, house prices must come down in both nominal and real terms. This adjustment can occur in two ways. Firstly it can take place as it is currently occurring in the United States with house prices falling up to 10% already (more in grossly over-inflated areas) with another 15% to go, or alternatively it can occur through an extended period of stagnant house prices for many years. Whichever way the adjustment, it will be painful for many. However allowing housing prices to continue as they have over the past 2 decades is criminal and negligent, and will continue to disenfranchise a far greater number of people and lead to an even greater level of poverty and re-distribution of wealth to the well-off.
9. In changing policy the Federal Government will be taking on some very powerful stakeholder groups who have access to vast intellectual and financial resources and who have the ability to develop plausible arguments towards their own interests by swaying public and political opinion. Unfortunately there have not been sufficient alternative arguments to counter the massive PR campaign run by these self-interested groups in the past. Interestingly one of these groups is likely to be the RBA itself as it will have to admit to serious past policy errors in the targeting of price stability. It is

disingenuous of the RBA and Federal Government not to include in their definition of “price stability” what is generally regarded as most people’s largest asset and at least to try and maintain price stability rather than inflate the cost of housing out of reach of everyday Australians without putting them into hock to the banks for the rest of their lives.

10. The Federal Government must take the lead in terms of including housing price inflation in their attack on inflation. House price inflation, like all other forms of inflation, is a stealth tax and a silent killer which is making many people’s lives miserable as they battle with ever-increasing levels of debt.
11. The vast majority of commentators, including politicians of both sides of parliament (including the current and former Treasurers), bank economists, financial journalists, business people, the media and the public at large have a misunderstanding of the concept of inflation. The CPI is but only one measure of inflation but it is not the main one. Inflation is, and has always been a monetary issue and it is the profligate increases in money and credit that fuel debt-based spending and manias. The enquiry should seek to re-focus stakeholders attention on the underlying cause of inflation and not just the symptoms.

9. The Solution

The solution to housing affordability must include supply-side effects (as will be highlighted by many other groups making submissions) but more importantly by attacking the underlying cause of house price inflation, namely through changes to the management of monetary policy within Australia.

In particular the answer quite simply is for the RBA to do its job and maintain price stability, not just consumer prices for which it has little influence but also more importantly in relation to asset prices, particularly residential property prices (note this includes both land and residence and not just the residence itself).
The Federal Government should expand the definition of “price stability” to include targets for house price increases. Unfortunately this will likely require a period of sustained higher interest rates. However the Government and the RBA must break the consumer, media, bank and property industry expectations of ever-increasing house prices. This will take a great deal of leadership but it is necessary as it is the only way that the Government will be able to bring house prices back into the realm of being affordable without putting people into massive debt traps where they become indentured to the banks for the remainder of their natural lives.
The Government needs to govern for all Australians, not just for the large institutions.