RBA's low-rate campaign key to house price boom

Reserve Bank of Australia Governor Philip Lowe is considering cutting the cash rate for the first time since 2016. Picture: AAP

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Surging house prices in Australia over the past decade were caused mainly by the Reserve Bank's campaign to slash the official interest rate to record low levels, according to a groundbreaking study by the central bank.

The conclusion, reached in a new paper by senior RBA economists Peter Tulip and Trent Saunders, comes as RBA governor Philip Lowe considers cutting the cash rate for the first time since 2016 as economic growth falters and reinforces evidence about the effectiveness of the central bank's interest rate lever as a means to kickstart the economy.

The researchers also warned of a "worst-case scenario" event, where house prices would fall by 30 per cent — mirroring the experience of Ireland, Spain and the US during the global financial crisis — if the RBA sat on the sidelines when sentiment on house prices declines, as happened during the GFC.

When "expected capital appreciation declines 2.5 percentage points … housing prices … take a long time to adjust, falling gradually, but substantially, to be one-third lower after five years," the paper said. "This scenario is extremely unlikely: nothing like it has happened in Australia before. However, in scale and duration, it resembles the largest housing collapses seen during the global financial crisis (in Ireland, Spain, US), so is relevant as a worst-case scenario to be guarded against."

In a newly constructed model of the Australian housing market that examines the interaction between interest rates, property prices, construction, vacancies and rents, the RBA has also found that cutting rates has a "large and highly significant" effect on driving construction rates, mainly by encouraging builders to take advantage of rising property prices.

It found that, all else being equal, a 1 per cent drop in interest rates would, over the long run, boost house prices by 17 per cent. The cash rate has been slashed from 4.75 per cent throughout most of 2011 to its current record-low level of 1.5 per cent as the central bank attempted to offset the end of the mining boom and encourage activity in the housing and consumption sector.

Over the five years to the end of 2017, nationwide housing prices rose by almost 50 per cent. Although property prices have tumbled by about 10 per cent since then, Sydney houses are still 75 per cent higher compared with levels a decade earlier, while in Melbourne, they are 70 per cent higher.

The authors also appear to have rebuked Dr Lowe, citing anecdotal evidence that tightened lending standards and banks unwilling to sell larger loans "seems to be important in the decline in house prices in 2018".

The RBA governor said last week that an overdue increase in supply of new properties was causing prices to fall.

The timing of the paper, which was discussed at the RBA's March board meeting last week, coincides with a growing consensus among market analysts that official rates will be cut twice this year, after the economy stalled at the end of last year, sliding into a recession on a per capita basis.

Mr Tulip and Mr Saunders argue that the economy is stimulated not by the overall level of the cash rate, but by cuts to interest rates, mainly through higher rates of construction and higher house prices, which reinforce one another. "The strong and clear response of residential construction to interest rates is evidence of the potency of monetary policy. It contrasts with the weak and imprecise response of other components of GDP," the authors said.

“When the price of established housing increases relative to the cost of new housing, the incentive to build increases.” According to the model, every 1 per cent rise in the number of houses lowers the cost of housing by 2.5 per cent.

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