John P. McAuley, M Ec (Macq), B Ec (Adel)
AFIA, AAIB, AACA, AICS, JP

Mr J Hawkins, Secretary FAX 02 6277 5719

SUBMISSION TO THE SENATE SELECT COMMITTEE ON HOUSING AFFORDABILITY IN AUSTRALIA

1 I wish to address one of the two components of "Housing Affordability", namely, A. the inadequacy of the physical volume and therefore, the costliness of housing, rather than B. the comparison with incomes.

2 The consequential "unaffordability" of housing is often described as resulting in mortgage-stress and this is the aspect which concerns my submission. Since mortgage-stress is presently of significant proportions, its effect is felt on existing borrowers and potential borrowers alike.

3 The stress is largely reflective of increases in bank borrowing rates initiated by Reserve Bank policy decisions made in implementing Australia's Monetary Policy in the so-called fight against inflation.

4 My major argument is that this particular aspect of Monetary Policy is quite absurd. and I have described this in some detail in my Attachments of 27.3.08 and 28.3.08. I suggest that it is unnecessary, unfair, and counterproductive that "Existing" housing borrowers should have their bank borrowing rates increased as a result of these policy-initiated decisions principally because:

:1 These borrowers are Not currently adding to inflationary spending pressure at the time of the decisions; their loan repayments would be in fact, have been Reducing the pressure; a tax on the community generally, would be fairer, if that is to be the criterion;

:2 Transferring the increase in the housing interest on 'existing' bank borrowers would simply add to the trading banks' capacity to create further Credit, adding to the already excessive inflationary expenditure and thereby Negating the very purpose of the policy decision to increase borrowing rates.

.The present system overlooks the basics of inflation, ie that inflationary expenditure has to be financed, that to curb inflation, the financial sources have to be curbed, and that increasing "innocent" existing bank borrowers' interest rates as under present Monetary Policy, is unnecessary, unfair and counterproductive.

Other aspects are discussed in the attachments.

J. McAuley
JP McAuley 3.4.08

FIGHTING INFLATION FAIRLY

Australia prides itself on having an independent central bank(RBA) in charge of its Monetary Policy (MP) and in fighting inflation as top priority.

In reality, our MP has no clout.

Policy stems, not from the RBA's worthy statutory obligations, but from a deplorable 2003 Statement signed by Treasurer Costello and the RBA Governor. The RBA fights consumer price inflation beyond an "underlying" 2-3% range, by increasing the variable interest cost of borrowing from banks.

Measuring the "underlying" CPI rate is not transparent. For a while, excluding "volatile" items from the CPI was a sufficient guide for the RBA. Latterly, the Weighted Median and the Trimmed Mean seem favoured but appear to guarantee 'rising' interest rates to the next election and for years ahead (whilst globally, rates may continue downwards!).

A MP of indefinitely rising interest rates is deplorable for these reasons::
1. Results are Unpredictable in respect of activity and unemployment; and are incompatible with the RBA's statutory obligations;

2 Unfair for 'old/existing' borrowers with loan balances still outstanding, because (any re-draws aside), these borrowers do Not add currently to excessively inflationary expenditure but to the contrary, may themselves be caused unfair "mortgage-stress" ;

3 Inflationary, because the transfers to banks of the higher interest from the mortgage-stressed "old" borrowers, Adds to the banks' credit-creation capacity, multiplying, not reducing the inflationary pressure as initially intended;

4 Continues the housing-unaffordability regime of recent past years, by keeping the lid firmly on the CPI and wages, whilst ignoring the RBA's statutory objective of "prosperity and welfare of the people of Australia", and allowing Unchecked, rampant inflation for real estate, productive infrastructure and shares, and countenancing lack of housing affordability.

RBA-initiated interest increases should apply only to New Loans, with the higher interest received by the banks, to be gauged to about equal the higher interest the banks ought then pay, on New and renewed Deposits with banks (so that the deterrent to borrowing should offset the encouragement to saving, leaving no net benefit to banks from a policy movement).

Instead, the RBA's MP should require the volumes and directions of new bank loans to be compatible with the RBA's projections of what is needed to avoid inflationary expenditure pressure. To implement this MP, the RBA should communicate monthly to the banks, its "ideal" volume of new loan Targets.

As a result, the banks with relatively excessive new loan levels should be penalized with interest, the total amount of which would be shared proportionately amongst the banks with more restrained levels.

Separate, more generous targets could apply to loans of a purpose-category considered by the RBA to be especially in the current national interest, such as loans for small, medium and rental housing, for small businesses without alternative funding sources, skills-training and productive infrastructure.

This would mean a constructive MP. The RBA would continuously encourage by penalties and incentives, the volumes and directions of new loans to be consistent with non-inflationary expenditure pressure. This would replace fighting inflation by mortgage-stress and reducing employment in breach of RBA statutory obligations to maintain "full-employment" and "prosperity and welfare". .

To "fight" inflation seriously, the RBA MP must attack the funding sources of inflation, and not let the banks finance consumption to the point of extravagance, rather than the legitimate housing and family formation needs of future generations and their other productive capacity requirements.

HOW MORTGAGE-STRESS FUELS, NOT FIGHTS INFLATION

Australia's Monetary Policy (MP) is a nonsense.

The sole weapon of MP is for the Reserve Bank of Aust. (RBA) to raise bank borrowing interest rates when the underlying CPI growth exceeds 3% pa. This not only causes unfair and unnecessary mortgage-stress, but may seriously weaken economic growth and actually exacerbate inflation.

The practice also overlooks prohibitive inflation on items not (fully) covered in the CPI, eg housing and productive infrastructure. This concentration on CPI alone,seems incompatible with the RBA's wider statutory obligation under s 10 of its Act,to "contribute to ...the economic prosperity and welfare of the people of Australia" (which covers more than the CPI).

Under a ridiculous Statement in 2003 signed by Treasurer Costello and the RBA Governor, the RBA is required to fight consumer price inflation beyond an "underlying" 2-3% range, by increasing to the public, the cost of borrowing from banks on variable interest loans.

The consequences of this policy on employment and activity are unpredictable and indeterminate. There is no evidence that such an indiscriminant interest rise will restore a CPI inflation to an acceptable 2-3% level. How much unemployment is needed to achieve this, is another unknown.

Moreover, the practice is to extend the variable interest rate rise beyond 'new' bank loan approvals (and re-draws) where the extra expenditure could conceivably contribute to inflationary pressure), into the "mortgage-stress" area of 'past/existing' borrowers with housing or business loan balances still outstanding. 'Current' expenditure from the latter loans for the most part, would no longer be contributing to inflationary expenditure. The extension of higher interest to old loans is therefore unfair. A tax instead would be as fair or fairer.

The extension of higher interest to the mortgage-stress area is also unnecessary and indeed harmful, because the additional credit-creation facilitated by the banks' extra receipts, actually exacerbates inflation, thereby negating the very intent of the RBA's initial increase in interest.

Inflationary expenditure has to be financed. This funding may come from new debt. Indeed over the past decade, Australia's Indebtedness from financial institutions has tended to expand relative to its Net Worth in housing and other productive infrastructure.

The basic way to curtail inflation is to target debt availability towards non-inflationary levels. This ought to be the primary objective and function of MP and the RBA (rather than to provoke unfair mortgage-stress).

Prices of imported Clothing & Footwear in the CPI have exceptionally fallen over past years. It is this which has moderated CPI growth, not the odd interest rate increase.

When interest is increased, the transfers to the banks of these extra funds increase their profits and cash resources available for further lending.

To the extent that these additional funds from interest on new 'loans' could be tailored by the banks to 'precisely' pay higher interest on new and renewed 'deposits' with the banks, this could serve the dual purpose of discouraging new borrowing and encouraging new saving, instead of the present net increase in bank profits and cash for re-lending.

But to the extent that net higher funds flow from the public to the banks from extending higher interest into the "mortgage-stress" area of old/existing loan balances , the RBA initiative becomes counter-productive. The funds involved will form the basis for subsequent rounds of credit –creation. The additional bank lending will exacerbate inflationary expenditure, precisely the opposite of what the RBA intended by raising official rates.

The mortgage –stress areas most adversely and unfairly affected will be small and medium housing borrowers and small businesses of marginal viability. These loans may have been approved up 10 to 20+ years earlier. Their balances, ignoring any re-draws, would have been static or progressively repaid. Incomes may have failed to keep up with rising interest and other costs. Thus the monetary system itself provides incentives for legitimate higher wage claims .

The debacle caused by MP and any accompanying unemployment, breach the RBA's "prosperity and welfare" objective of section 10 as mentioned.

Rather than to require banks to quarantine extra receipts from their profits and future credit-creation, it would be better for the RBA to arrange exemption for old loan balances from RBA-initiated interest rate increases.

As a means of securing a more effective MP, the RBA ought to influence the volume and direction of new bank lending by communicating to banks monthly, on-going Target levels to achieve what the RBA considers, are acceptable volumes and productive levels of non-inflationary lending .

Under this system of MP, poorly performing, excessively lending banks would be charged penal interest. The total of this interest would be shared proportionately amongst the other banks. Separate targets could also be considered to encourage small, medium and rental housing, skills education and productive infrastructure.