Australian central bank lifts interest rate

Nick Beams
6 November 2003

The Reserve Bank of Australia has lifted its official interest rate by 0.25 percentage points in a move that could be the start of a series of interest rate escalations. The rise in the cash rate from 4.75 percent to 5 percent is expected to be followed by a further 0.25 percentage point increase next month and a similar rise early next year.

When it is passed on by the banks and other lending institutions, the rate rise will add about $35 a month to repayments on a home loan of $200,000, with a similar increase if rates rise again by the same margin.

According to some analysts, interest rates could increase by another 0.75 percentage points before the end of next year. Such a rise would push total household debt repayments as a proportion of income to record levels, rendering many families vulnerable to even a slight downturn in the economy.

In explaining the reasons for the increase, Reserve Bank governor Ian Macfarlane pointed to the growth in household debt. “Credit outstanding,” the Reserve Bank (RBA) statement said, “is rising at around 14 percent per year, and at over 20 percent to households. That is a much faster rate of growth than can be expected to be consistent with economic stability over the longer run. Short periods of rapid credit growth have not typically been a major concern for monetary policy, but this growth has been sustained for some time and at present shows no sign of abating.” It was therefore “no longer prudent” to continue with an expansionary policy stance.

While the interest rate rise came as something of a surprise to market analysts, most of whom thought it would take place next month, the Reserve Bank has for some time been signalling its concerns about the growth of debt, particularly to finance home buying and the purchase of investment properties.

Since the mid-1990s, the ratio of household debt to gross domestic product (GDP) has doubled. House prices in the capital cities increased by 40 percent in the two years to last June and the near-23 percent rise in housing credit in the year to September was the fastest rate of increase in almost nine years.

In its quarterly survey of monetary policy published last August, the RBA warned that the belief that interest rates would stay low had led to a “significant increase” in the ratio of household debt to GDP. While there was no firm benchmark as to what constituted a “normal” relationship, it pointed out that at 14 percentage points above the GDP growth rate, the increase in household credit was “faster than is sustainable in the medium term”. There was a risk that the longer such processes continued, the more severe would be their impact on the economy when they inevitably turned.

However, there are fears that in seeking to deflate the credit bubble, the RBA may be setting the stage for the emergence of the very problems it has been trying to avoid. In particular, there could be a collapse of the property investment market, where money has been flowing in at the rate of about $5.5 billion a month.

This market operates through the process known as negative gearing. Investors incur a large debt to undertake a housing investment, rent out the property, write off the interest bill against income tax and then sell the property to recoup a large capital gain. The process can continue so long as the money flow continues. But the RBA decision could see the flow of funds slow down, leading to a sharp reversal.

As *Australian Financial Review* writer Alan Mitchell noted: “[T]he investment property market is now like a pyramid selling operation. It can continue to attract and retain negatively geared investors only by generating more capital gains. And it can generate more capital gains only by attracting a steady flow of new investors who are ready to ignore the increasingly obvious signs of oversupply.”

© World Socialist Web Site

At some stage the market has to turn, and when that happens there could be a property bust, as the processes fuelling the rapid rise over the recent period go into reverse.

Politically, the RBA move is bad news for the Howard government, which has sought to capitalise on the property boom since it came to office in 1996. Reflecting its sensitivity to interest rate increases, Finance Minister Nick Minchin commented less than two months ago that “it would be crazy” for the Reserve Bank to try to bring down house prices with an interest rate rise. Prime Minister Howard also declared at the time that there was nothing to be gained by an increase.

In the aftermath of the rise, Howard was quick to try to play down its significance, claiming that home buyers were still $600 a month better off, as far as mortgage repayments were concerned, than they were in 1996. But the inflation in house prices since then has meant that mortgages are much bigger than they were seven years ago, and even a small increase in the interest rate can have a major impact on family disposable income. If the official cash rate were to rise to 6.5 percent, implying a home loan rate of around 8 percent, the impact could be as great as the mortgage rates of 18 percent in the late 1980s.

As a comment in the *Australian Financial Review* noted, both Howard and his Treasurer Peter Costello “were clearly not happy about the vista opening up before them” as their “extraordinary run of economic luck has finally come to an end”.

Internationally, the RBA decision has attracted more than the usual level of attention because it could herald the start of a series of interest rate increases by the major central banks. The Bank of England is poised to make a decision on rates, with the *Financial Times* insisting that, in the light of the rising housing market, the case for an increase is “overwhelming.”

The BSBC bank chief economist John Edwards noted that the RBA was the first of the independent central banks to tighten rates, but would not be alone for long. The Bank of England was likely to take back the cut it made last July, the Reserve Bank of New Zealand has indicated it will tighten rates early next year and money markets “now expect a global monetary tightening”.

Global moves to higher rates will focus attention on the position of the US Federal Reserve Board. It has reduced its official cash rate to a 45-year low of 1 percent and has pledged to keep it there for a “substantial” period. But if interest rates start to climb elsewhere, the Fed may be forced to lift them in the US in order to sustain the inflow of funds, which is financing the country’s $500 billion balance of payments deficit. And if that takes place, the present “recovery” in US growth could turn out to be short-lived.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site