Inflation weaker than expected

Expectations that the Reserve Bank will lower interest rates in the months ahead have firmed following the release of inflation data for the March quarter. The Consumer Price Index (CPI) showed that there was zero price growth over the 3-months to March, resulting in the annual rate of inflation falling sharply from 1.8% to 1.3%. As shown on the chart below, this is the lowest annual rate of increase recorded since September 2016.

Lower global oil prices contributed to the lack of inflation in the March quarter, with the price of petrol falling 8.7%. As has been the trend over recent years, prices for items predominantly manufactured overseas, such as clothing and footwear (down 1.4%) and furniture (down 2.5%), recorded price falls. A 3.8% decline in domestic holiday, travel and accommodation costs was also recorded last quarter.

Offsetting the price falls described above was a 7.7% jump in the cost of vegetables and a 1.8% rise in fruit prices. Drought and adverse weather conditions have played a role in constraining supply and increasing the price of vegetables and fruit. Service items, such as education (up 2.7%) and health (1.9%), also recorded price increase; although these categories were also impacted by standard seasonal factors.

After adjusting for the effect of one-off “outlier” price movements, the underlying rate of inflation is now calculated to be 1.4% per annum. As this is well below the Reserve Bank’s (RBA) medium-term target 2% to 3% range, market expectations of a monetary policy loosening have increased. By loosening policy and lowering interest rates, increased incentive to borrow and spend could result in firmer demand “pull” pressure on prices and thereby shift inflation higher.

Q1: Describe the factors that contributed to such low inflation being recorded over the March quarter.

Q2: Evaluate the merits of the central bank lowering interest rates in response to the decline in inflation recorded recently.

Housing cycle may impact on policy setting

In addition to the recent decline in inflation, the Reserve Bank may also consider the state of the housing industry in its deliberations on monetary policy. Over recent years, the housing industry has demonstrated characteristics of strong or “boom like” conditions, with escalating purchase prices and record levels of new construction. Strong population growth, low interest rates and below average levels of construction in the years immediately following the Global Financial Crisis, all appear to have contributed to the booming conditions of recent years.

In the environment of a thriving housing industry, the RBA may have been somewhat reluctant to reduce interest rates, given the potential for this to stimulate “excessive” housing price levels and production activity. However, with the housing cycle demonstrating signs of slowing, this may create more scope for the central bank to consider lowering interest rates to address weak inflation.
Activity in the housing industry is typically cyclical, with periods of high building activity often coinciding with strong housing price growth. One reason housing sector activity tends to be cyclical is because it is highly sensitive to changes in interest rates (which also tend to move in cycles). The sensitivity to interest rates arises because a large proportion of housing purchase is financed by borrowings. Lower interest rates make it cheaper to purchase housing and can therefore stimulate demand. Rising demand tends to lead to higher prices, thereby creating the incentive for property developers to increase the supply of new dwellings via new construction.

In the month of February 2019, the number of approvals provided for the construction of new residential dwellings totaled 17,000. This is well below the peak level of 22,800 recorded in November 2017 - but is still materially above the average monthly volume from the past 20 years of 14,500.

The construction of housing has an important influence on economic activity and employment. In addition to contributing to the activity directly associated with dwelling construction, housing purchase (whether for newly constructed or existing dwellings) acts as a catalyst for the purchase of other items associated with houses, such as furniture and white goods.

In addition to assessing the implications of housing construction on economic activity, policy makers have also become increasingly focused on housing prices. This focus results from the sharp escalation in housing prices recorded in the recent cycle. The chart below traces an index representing the weighted average of housing prices in the eight Australian capital cities. In the 5-years leading up to the cyclical peak in December 2017, the housing price index appreciated some 48%; with Sydney (up 68%) and Melbourne (up 54%) having the most significant contribution to the increase. However, the chart indicates that since this peak, prices have declined, with the average price across the capital cities falling by 5.1% over the year to December 2018.

Given the magnitude of the increase in housing prices, policy makers may be concerned about the potential destabilising impact that a “correction” or decline in prices may have on the economy. A sharp fall in housing prices could cause a reverse of the “wealth effect” i.e. where consumption expenditure declines due to a fall in the net wealth of households. Additionally, declining house prices could impact on bank stability and profitability, as a large percentage of bank assets are in the form of loans secured by mortgages over residential property.

Acknowledgement of the risks of escalating housing prices (and the impact of any subsequent correction in prices) has also been consistently expressed by the Reserve Bank. Mention of an easing in the housing market was made in the Reserve Bank’s April Board minutes as per the extract below:

“Dwelling investment appeared to have passed its peak, although there continued to be uncertainty about how quickly dwelling investment might decline over the forecast period. Construction of new dwellings had contracted in the second half of 2018. Slower housing activity had also weighed on the incomes of some building contractors and property professionals in the December quarter. Conditions in the established housing market had remained weak in recent months. Housing prices had continued to fall in Sydney, Melbourne and Perth, and had declined a little in most other capital cities and regional areas.”
In addition to any macro-economic impacts, movements in housing prices are also of relevance to policy makers due to the effect on the equality of wealth distribution. An abnormal rise in the price of housing re-distributes relative wealth away from those who don’t own a residential dwelling to those that own a dwelling(s). As such, housing price movements have implications for both the economic and social objectives of policy makers. The fact that the movement in housing prices has been of a very different magnitude across different cities and regions, makes any policy response more challenging.

Q3: Explain why housing prices escalated strongly in Australia over the 5 years to December 2017.

Q4: Evaluate the impact that the recent fall in housing prices, and reduced construction activity, may have on the Reserve Bank’s considerations around monetary policy settings.

**Government new bond issuance to slow**

Whenever the Commonwealth Government is in deficit, it needs to borrow in order to fund the deficit. This borrowing adds to the Government’s debt position. The main mechanism the Government has available to generate the finance required to fund its budget deficit is to issue (sell) Commonwealth Government Securities (CGS), which are also referred to as Government bonds. By issuing bonds, the Government receives money (effectively a loan) from the buyers of the bonds. The Government then promises to pay regular interest and a repayment of the bond principal (the loan amount) on the bond maturity date.

The chart below shows the steady increase in the value of Government bonds on issue that has occurred over recent years. This is indicative of the string of budget deficits recorded, and subsequent accumulation in government debt, over the past decade. At the end of the 2019/20 financial year, it is expected that the face value of Government securities on issue will be some $560 billion. It can be seen from the chart that the rate of increase in bonds on issue has slowed in recent years, as the size of the Government’s deficit has fallen. Despite the fact that the Government forecasts it will move to a surplus position in 2019/20, it still plans to issue new bonds.

An ongoing bond issuing program in times of financial surplus is typically conducted to maintain liquidity in bond markets, thereby ensuring the ongoing viability of the market. If the Government is in surplus and issues new bonds, then it will use the proceeds of the bond issuance to invest in financial assets. As such, there will be no change in the net debt position (as the increased gross debt of the new bonds is neutralised by the new financial assets).

**Commonwealth Government Bonds on Issue ($bn)**

Source: 2019/20 Budget Papers

When a government issues more bonds to fund a deficit, the supply of bonds is increased. Generally, a rise in the supply of bonds issued by the Government will increase the interest rate that is required to be paid by the Government. This is because more investors need to be enticed to purchase bonds to take up the larger supply. In this way, the movement in the price or yield on the bonds brings about equilibrium between the supply and demand for bonds.

Each series of issue of Government bonds has a different maturity date so that at any one time there is a range of different bond yields available - given this difference in maturity dates. Whilst the Reserve Bank is able to use open market operations to “manage” the overnight cash interest rate to a desired level, longer term interest rates across the economy tend to be heavily influenced by the market determined yields available on Government bonds (which reflect the “risk free yield curve”).

This impact that Government borrowing can have on interest rates is sometimes referred to as “crowding out”. The additional supply of bonds soaks up available funds in money markets due to the higher interest rates on offer, making it more difficult and expensive for the private sector to access and pay for borrowings.
However, over recent years, there has been minimal evidence of this “crowding out” effect, with bond yields being kept near historical lows despite their rising supply. One factor that may have contributed to this lack of “crowding out” could be the large proportion of Australian Government bonds that are currently held by foreigners, thereby reducing the call on domestic savings to fund the deficit.

It could also be argued that any impact from “crowding out” is less significant in periods of low interest rates, as the cost of borrowing is generally less of a barrier to the private sector when making decisions to invest. None-the-less, to the extent that any crowding out effect exists, the slowing in the rate of bond issuance over recent years has reduced the significance of any crowding out impact.

**Q5: Contrast the terms “Government budget deficit” and “Government net debt”.

Q6: Discuss the impact that the slowdown in growth of government debt could have on the general level of interest rates.

### GST receipts allocated to States

A major component of Commonwealth Government expenditure is the provision of funding to State Governments via grants. A significant proportion of the grants to State Governments are derived from the collection of the Goods and Services Tax (GST). Under current arrangements, the Commonwealth Government collects the GST and this revenue is then passed directly through to the States.

Each year around March, the Government Grants Commission makes its recommendations on the distribution of GST amongst the States. Currently, the Grants Commission aims to distribute sums so that each State has “the fiscal capacity to deliver services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.”

Population size heavily influences allocations, as do other factors, such as the State’s ability to earn revenue from other sources. That is, those States with a greater revenue raising capacity will tend to receive lower allocations per person. Costs to provide services are also considered.

Those States with higher costs will be compensated by higher GST allocations. The table below shows the planned distribution of GST in 2019/20 and the funding variance per person.

<table>
<thead>
<tr>
<th>State</th>
<th>Funding from GST Pool (bn)</th>
<th>Population (m)</th>
<th>Funding per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>$19.3</td>
<td>8.2</td>
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<tr>
<td>VIC</td>
<td>$17.7</td>
<td>6.7</td>
<td>$2,648</td>
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<td>QLD</td>
<td>$14.6</td>
<td>5.1</td>
<td>$2,839</td>
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<tr>
<td>WA</td>
<td>$3.7</td>
<td>2.6</td>
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<tr>
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<td>$6.9</td>
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<tr>
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<td>0.2</td>
<td>$11,498</td>
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<tr>
<td>TOTAL</td>
<td>$69.0</td>
<td>25.7</td>
<td>$2,690</td>
</tr>
</tbody>
</table>

**Q7: Describe the process by which GST revenue is currently distributed to the States.

As has typically been the case, WA has the lowest proposed allocation of GST revenue per person due to its strong ability to raise revenue from other sources, especially via mining royalties. As such, this method of distribution of GST revenue is one mechanism by which the benefit of the mining industry is shared across the wider economy.

Last year the Commonwealth Government announced the planned introduction of changes to the State funding approach via what has been termed “Horizontal Fiscal Equalisation”. This process will involve moving to a “new benchmark that will ensure the fiscal capacity of all States and Territories is at least the equal of NSW or Victoria (whichever is higher).” In addition, a new floor will be introduced that will ensure each State receives no less than 70% of the actual GST revenue raised in that State from 2022/23. This floor will increase to 75% from 2024/25. The new approach is planned to be introduced gradually over the course of 8 years.