Interest Rates Hit Historic Low

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Pop the bubbly! Interest rates are down with overall good signs for retailers and first home buyers. But don't celebrate too hard - an incoming Abbott government will likely crash the party, writes Ian McAuley

Corks will be popping from bottles of Yarra Valley sparkling white (we no longer produce "champagne", remember) after the Reserve Bank's decision to cut official interest rates from 4.25 per cent to 3.75 per cent, bringing the real interest rate (after inflation) down to levels usually seen in a recession. The Reserve Bank's media release comes as close as the conventions of bureaucratic language will allow to saying they should not have held off so long.

Even if the banks were to pass on only two thirds of this cut, it would still provide a $1000 a year interest relief for someone with a $300,000 mortgage. Retailers, restaurants and house builders will be hoping for this extra disposable income to come their way. They have some reason for optimism, because, after rising steeply in 2008, household savings have tended to stabilise. We are no longer stashing away every bit of extra income.

The voices in favour of lower interest rates, however, are always louder than those that urge caution. Immediate losers will be those conservative investors who, in their personal savings or in their superannuation funds, have chosen to be heavily weighted in cash or fixed interest. A dismal pattern in financial markets is that after stock market crashes there is a rush of small investors to the "safety" of fixed interest, usually just before equities are about to resume their long-term upward trend.

Lower interest rates will not ease the costs faced by conservatively managed businesses, including farmers, who carry little debt. Nor will they provide immediate help to that majority of Australians who do not have a significant mortgage.

At first sight we might expect that lower interest rates will be welcomed by first-home buyers, coming on top of falling house prices. Prices of houses have been falling over the past year — by about 4.5 per cent for established homes according to the ABS and by about 4.7 per cent according to Rismark International. In real terms, after CPI inflation, that suggests a fall of about 6 per cent.

But there are qualifications for those who might be entering the housing market for the first time. First, it is possible that much of the fall is at the top end of the market. One hint from Rismark's survey is that house prices have fallen faster than apartment prices.

Second, easier personal finance will undoubtedly see increased investor activity, resulting in upward pressure on house prices. This may be welcomed by those who became over-committed during the boom and are fearful about their falling equity but it will be bad news for first home buyers.

Although house price inflation is not strictly in the Reserve Bank's remit, its board members would be well aware of the lesson from the US where Greenspan's easy money policy fed into excess borrowing for real estate, causing a boom and bust in house prices and triggering the 2008 financial crisis. Our real estate is still over-valued, and we need a well managed soft landing.

The other, more general, qualification is that even this quite sharp stimulus may not loosen up private financial markets, where nervousness prevails. Europe's woes are far from over: it is becoming apparent that European governments have pushed austerity too far — a chilling echo of the situation in the 1930s when those same countries engaged in trade protectionism in the hope that some other country would buy their produce. China's growth is slowing, and is becoming more domestically oriented. America's recovery is wobbly, with the Republican-dominated Congress doing all it can to make sure there is no sustained recovery before the November election.

Here we have our own version of the American situation, with an Opposition in prime position to win an election, promising to undo most of the current Government's economic reforms. In this endeavour it is helped by the Government itself which is inept at engaging with the electorate, and by a lazy and partisan media which fails to give considered coverage to economic issues.

So long as opinion polls show that voters see the Coalition as more able to handle the economy than Labor Abbott can use his unearned economic credentials to belittle the Government's economic performance.

Some of this may be bluff. Even within his own party some are uneasy about Abbott's economic recklessness and an incoming Coalition Government would find it hard to undo the Government's reforms (unless the Labor Party's suicidal urge is so strong that voters give Abbott a Senate majority).

Uncertainty dampens business confidence, because what most business investors seek from governments is a degree of policy certainty. Abbott, unchallenged by Gillard and her advisers, is effectively creating a climate of uncertainty, even as the country's economic fundamentals remain strong.