

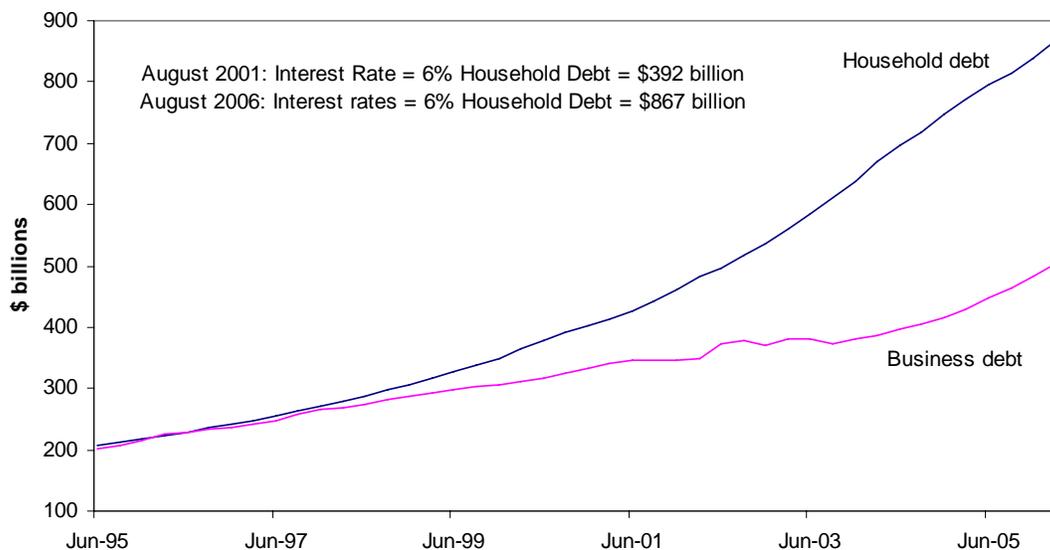
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Tighten your belts ... living standards are falling

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The figure below is scary! Yesterday's decision by the Reserve Bank of Australia (RBA) to increase interest rates by $\frac{1}{4}$ of a percent to 6 per cent is very dangerous. Since May the RBA has increased rates by $\frac{1}{2}$ a per cent. They are now at their highest level since 2000. Another rise will come later this year.

Private Debt in Australia June 1995 to June 2006



Why are rates rising? How will this impact on the Hunter? Why is the chart so scary? Why does demonstrate a failure of macroeconomic policy?

Let me explain the RBA's logic as they would see it before answering the questions.

The RBA follows an 'inflation targeting' approach and keeps interest rates steady if underlying inflation is between 2 and 3 per cent on average given economic ups and downs.

The RBA will not react if the upper limit is breached by once-off factors (like rising banana prices). It increases rates if it believes the breach reflects more underlying price pressures.

Yesterday's RBA statement said it believes that strong output and credit demand have increased inflation pressures. They think the economy is reaching full capacity with skill shortages increasing. They consider rising imported material costs (including oil) are pushing up production costs.

Last week's ABS data reported an annual inflation rate of around 4 per cent. After taking out once-off factors, the RBA believes underlying inflation is now breaching its upper limit.

The RBA raises rates to squeeze spending which keeps inflation checked. This works in several ways – all bad.

First, households have to cut back spending. Average home buyers are now \$100 per month worse off since January 2006 due to rising petrol prices and increased mortgage payments. Add \$40 per month for every \$250,000 of your mortgage as result of yesterday's rise.

Spending cutbacks damage businesses and worker layoffs accompany slowing production. Business investment contracts as financing costs increase, given all other interest rates are benchmarked off the RBA's target rate.

When the economy slows, unemployment rises quickly and takes years to decline. The costs of this sort of inflation control are enormous and long-lived.

Already 1.8 million Australians do not have enough work, with more than 1 million without any work because our economy fails to produce enough jobs. This reflects the Federal Government obsession with budget surpluses which continuously squeeze spending. Rising interest rates compound this problem.

You may well ask why skill shortages are present when there is so much unemployment. Answer: the Federal Government has no skills development plan and wastes resources on failed compliance programs like Work-for-the-Dole and the Job Network.

Why is the graph scary? Many households will cut spending and remain solvent. But many others will go broke because of the record indebtedness now evident.

When rates were last at 6 per cent (August 2000), household debt was \$392 billion. As rates return to 6 per cent, household debt is now \$867 billion. More starkly, it has grown by \$90 billion in the last year.

Household wealth has also grown but the debt to household income ratio (measuring capacity to pay) has gone from 50 per cent in 1992 to over 160 per cent now. It is now in dangerous territory.

Households have also increasingly used debt to purchase speculative assets (like shares) rather than housing, which lose value quickly in a downturn.

Many households, now on the margin of solvency, will be bankrupted by the rising rates. There will be many forced repossessions by banks. The most disadvantaged workers,

squeezed onto lower pay and more precarious work conditions by Work Choices, will suffer first. Then the damage will spread.

Only about 30 per cent of households have mortgages. But many others will also suffer.

Business contraction threatens our jobs.

Rents will also rise in an already stretched Hunter rental market as investors abandon housing and first-home buyers realise that a mortgage is now beyond them.

Differential regional impacts will occur. Australia now has a 'two speed' economy. The mining states of Queensland and WA are booming due to strong Chinese growth but manufacturing strongholds like Victoria and NSW are lagging. The commodities demand has pushed our exchange rate up, squeezing manufacturing which is not enjoying strong world demand.

The mining boom is good for the Hunter – just note the increasing line of ships outside the harbour. But we are also exposed to declining manufacturing both locally and across NSW.

On the positive side, retirees benefit from rising interest rates. Given the ageing Hunter population this will offset some of the grief that other households will feel in the coming months.

The economy is now heading into uncharted waters and the risks are huge.