

MACROECONOMICS AT WORK EXERCISE

INTEREST RATES AND RESIDENTIAL INVESTMENT

REFERENCE: ‘RBA’s secret interest rate formula brings the house down’ (by Alan Wood), *The Weekend Australian*, February 21-22, 2004, p. 40.

CHAPTER RELEVANT TO THIS EXERCISE: Chapter 16.

OVERVIEW

The Reserve Bank of Australia adjusts interest rates primarily in order to maintain inflation within its target range of 2-3 per cent. One of the major determinants of inflation (and anticipated inflation) is the level of aggregate demand. Aggregate demand is made up of different elements, each of which is affected by interest rates in different ways. Thus the adjustment of interest rates has to take account of effects on these differing elements as well as a number of other factors. One of the important factors is the effect of the level of interest rates on the value of the currency (one implication of which is the way that it affects different components of aggregate demand such as exports). This article – stimulated by a formal *Monetary Policy Statement* made periodically by the Reserve Bank – is about one element of aggregate demand – *residential investment*. Of particular concern is the likely effect of a change in interest rates on this component. The article focuses on a piece of quantitative analysis undertaken by the Reserve Bank to explore the consequences of interest rate changes for expenditure on housing.

QUESTIONS

1. To set the scene for this analysis, explain the meaning of the term ‘the housing boom’ and how this might be an indicator of ‘a high level of residential investment’.
2. Under what circumstances might the level of residential investment be considered to be higher than desirable?
3. Explain the meaning of the aggregate measures of ‘housing credit growth’ and ‘loan approvals’ that have been highlighted in the Reserve Bank report and why these aggregate measures have been selected.
4. How is the aggregate of loan approvals affected by changes in interest rates?
5. Is the recent fall in housing loan approvals sufficient reason for the Reserve Bank to stop contemplating further interest rate increases (i.e. on top of the two increases made in late 2003)?

6. How would you interpret someone saying: 'all this has got to be seen in the context of the larger scheme of things'?