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Journal of Policy Modeling 34 (2012) 849–863

Journal of Policy Modeling

www.elsevier.com/locate/jpm

Monetary policy and the housing market in Australia

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Received 12 January 2012; received in revised form 25 May 2012; accepted 25 June 2012
Available online 4 July 2012

Abstract

This paper models the role of monetary policy in the Australian housing market using structural vector autoregression model. Our results show that a contractionary monetary policy significantly reduces housing activity but does not exert any significant negative effect on the real house prices. The housing output and real house prices also respond significantly to shocks stemming from housing supply, housing demand and a number of other variables. The findings further suggest that monetary policy rule in Australia takes into account the changes in house price along with the usual targets of inflation and output gap. On the backdrop of the observed high house prices and increased affordability problem, the findings of this paper are expected to shed some lights on the current policy environment pertaining to the Australian housing sector.
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JEL classification: R31; E52; E62; C51

Keywords: Monetary transmission; Housing market; Structural VAR

1. Introduction

The role of housing industry in economic activity has attracted widespread concerns among academics and policy makers in recent years. There has been a plethora of studies examining issues pertaining to growth in house prices, increased indebtedness of the households and the need to evaluate the efficacies of monetary policy to stabilise the housing market (for example, see Calza, Monacelli, & Stracca, 2009; Catte, Cova, Pagano, & Visco, 2011; Mishkin, 2007;

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http://dx.doi.org/10.1016/j.jpolmod.2012.06.002

Vargas-Silva, 2008; Von Arnim, 2000). On the one hand, the growth of residential investment significantly affects an economy's output level and on the other, housing market developments have an important bearing on the credit market. Recent global financial crisis showed us how the housing market bubbled in the US, followed by large falls in house prices causing substantial losses to the security holders and severe damages to the economy. This invigorated the debate on whether monetary policies should respond to the housing market developments (Mishkin, 2007).

Monetary policies have far-reaching implications for the housing market as housing sector is generally more interest-sensitive than the economy as a whole and the degree of such sensitivities can vary through time and across countries (Berger-Thomson & Ellis, 2004). One important aspect of housing market sensitivities to the monetary policy mechanism is that there are both direct and indirect monetary transmission channels affecting the housing market (Maclennan, Muellbauer, & Stephens, 2000; Mishkin, 2007). These channels provide a basis for understanding the monetary transmission mechanism, which are central to adopting efficient set of policy instruments for the monetary authorities.

Australian monetary policies have seen strategic changes over last several decades. The Reserve Bank of Australia (RBA) pursued monetary targeting from 1976 to 1985; and adopted inflation targeting strategy from 1993. However, there has been ongoing debate on the use of monetary policy to control the asset prices in an Australian context (Otto, 2007). The Reserve Bank of Australia (RBA) pursued regimes of monetary contraction in the 1970s and in the 1980s, followed by phases of expansions beginning from the early 1990s.[1] While there have been fluctuations in interest rates over the past decades, house prices typically continued to increase until 2008.[2] In particular, growth in house prices were accelerated during 2002–2008 period, making the housing affordability problem even worse. On the backdrop of the observed high house prices and increased affordability problem, it is interesting to see if the changes in monetary policy had any role to play in the movements of house prices and housing output in Australia.

While a number of studies are available examining the housing market responses to a variety of fiscal measures (Dvornak & Kohler, 2003; Wood, Watson, & Flatau, 2006; Wood, 1999; Yates, 2008), there seems to be an absolute dearth of studies addressing issues of monetary transmission in Australian housing. However, researchers attempted to analyse the monetary transmission effects on the housing markets in the US and in a few other developed countries. Jarocinski and Smets (2008) showed that monetary policy shocks have significant negative effects on real GDP, residential investment and house prices in the US. In a related study, Vargas-Silva (2008) maintained that contractionary monetary policy shocks exert adverse impact on the US housing starts and residential investment. A number of other recent studies also confirmed the price and demand sensitivities of the US housing market to monetary policy shocks (Choudhry, 2010; Erceg & Levin, 2002; Gupta & Kabundi, 2010; Iacoviello & Neri, 2010).

Iacoviello (2002) and Aoki, Proudman, and Vlieghe (2004) found that tight monetary policies lead to a fall in real house prices in six European economies and in the UK, respectively. In another study, Elbourne (2008) showed that tight money causes UK house prices to fall by

[1] The interest rate increased from around 8 to 10% in the 1970s to about 18% by the end of the 1980s. This was followed by monetary expansions as the RBA lowered interest rates from about 11% in the early 1990s to about 5% by the end of the decade. During 2000s, the cash rate approximately ranged between 3 and 7%.

[2] From 1960 to 2006, real house prices increased at an average rate of 2.7% per annum, outweighing the 1.9% per annum growth in per household real income (Yates, 2007, 2008). Otto (2007) suggested that the growth in real house prices could be attributed to the combined effect of the growth in per household real incomes and the growth in number of households.

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