Non-technical summary for 'The Distributional Effects of Monetary Policy: Evidence from Local Housing Markets'

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We know that housing prices vary substantially across different parts of the country. The average price of housing is higher in Sydney, for example, than it is in Hobart. We also know that changes in interest rates have an effect on housing prices. When the RBA lowers the cash rate housing prices typically end up higher than they otherwise would have been. These two facts have been well documented, but what we don't know is how these two facts fit together. For example, when the RBA lowers interest rates, is the change in housing prices larger in Sydney than in Hobart? And what are the factors that explain any differences in the response of housing prices to interest rates across the country?

In this paper we examine how monetary policy affects housing prices across local areas. We explore three related questions:

1) How differently do housing prices respond to monetary policy across areas?

2) What can explain these differences across areas?

3) Does monetary policy cause changes in the housing wealth distribution?

We document considerable differences in the response of housing prices to changes in monetary policy across local areas. While housing prices in the median region fall by 2.3 per cent two years following a 100 basis point increase in the cash rate, at the 25th and 75th percentiles, housing prices fall by 0.9 per cent and 3.5 per cent respectively in response to the same cash rate increase.

What can explain these differences across areas? We find that a diverse set of forces are associated with the sensitivity of local housing prices to cash rate changes. We find some evidence that housing supply conditions matter. This is because a fall in interest rates leads to higher demand for housing. For areas in which it is difficult to build new housing – when housing supply is `tight' – most of this increase in demand will be met by an increase in the price of housing, rather than in the quantity of housing. So changes in interest rates tend to affect prices more in areas in which housing supply is constrained, whether by geography or government regulation. But, on top of this, we find that areas with more mortgage debt, higher incomes and more housing investors also have larger housing price responses to changes in monetary policy.

Relatedly, we also find that changes in the cash rate alter housing wealth inequality. This occurs because expensive areas, which typically have tighter housing supply, are more sensitive to changes in interest rates. These differences, however, dissipate over time, suggesting any change in housing wealth inequality due to monetary policy is temporary.

Overall, this paper documents two findings on the effect of monetary policy on housing prices. First, the distribution of responses is substantial. And second, more expensive areas are more responsive to monetary policy. Housing supply conditions, and the availability of land, go some way to explaining these differences. But there is clear evidence that other factors, such as incomes, mortgage debt and investor concentration, matter too. This supports the view that housing price dynamics are complex and that a wide range of factors need to be considered when trying to understand how changes in interest rates affect the Australian housing market.