A liquidity crisis we had to have

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In his April 15 Melville lecture, Reserve Bank governor Glenn Stevens noted that, beyond modifying the bank rate, central banks had traditionally sought to control liquidity by buying or selling only "gold-plated" securities. He said the crisis had led some central banks to widen the range of securities they bought and sold. But, he added, as yet no central bank had proposed buying the collateralised debt obligations (CDOs) of packaged mortgages of varying and unknown quality. It is these securities that have been the root cause of the present financial crisis.

But the US Federal Reserve had already announced $US200 billion ($214 billion) to buy mortgage-backed assets. The crisis has revealed the value of these to be, at best, suspect. Extending the open-market window to such assets is clearly in Stevens's view not quite buying CDOs, but the difference must be very subtle.

Just days after the governor's speech, the RBA has been on a mortgage buying spree, at a premium of only 0.25 per cent above the cash rate, which has injected $1 billion into the market.

Similarly, the Bank of England announced a new Â£50 billion ($107 billion) to Â£100 billion bail-out to buy securities, including "own name" mortgages that have no market. These will be subject to a 5 per cent premium to the cash rate.

All these central banks are treading a dangerous path. Their open-market operations (plus interest rate lowerings in the US) mean injections of liquidity into the economy. The corollary is faster inflation.

Previous monetary injections with resulting inflationary outcomes are the root causes of the crisis that central bankers are desperately trying to quell. The inflation from rapid monetary expansion in recent years was hidden in Australia, Britain and the US by the excess liquidity being channelled into housing. This was combined with a restraint on housing land availability, which meant the excessive funds resulted in higher prices for existing dwellings rather than increased volume or quality.
House prices in the past six years rose 60 per cent in Britain and Australia and almost 50 per cent in the US. In countries without housing land restraints, prices have been more moderate - even falling in Germany.

Based on the underlying worth of land - which is particularly abundant in Australia - the excessive valuation of the average Australian dwelling is at least $100,000. That amounts to $800 billion for Australia's 8 million dwellings. In other words, two-thirds of Australia's household wealth is tied up in housing, which is overvalued on average by 25 per cent as a result of artificially created regulatory scarcity.

Central banks have caused the problem. A heady cocktail of excess liquidity and land and planning restraints has artificially inflated housing prices. This was a gigantic Ponzi game which has now crashed down to earth. With luck, unwinding this may result in a mild recession; but the activities of the central banks here and overseas bring a risk of a far more serious financial collapse down the track.

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