FOI 3251
Document 1

TREASURY EXECUTIVE MINUTE

Minute No. 20082455

22 August 2008

Treasurer

STATE OF THE HOUSING MARKET

Timing: At your convenience

Recommendation/Issue:

- That you note this briefing.

Noted Signature: .... …../…../2008

KEY POINTS

- The housing market is being affected by a combination of longer-term influences and the more recent effects of tighter monetary policy and global financial market turbulence.
  - In the near term, the effects will play out differently in the market for purchase of housing — which will be driven by weakness in demand — and in the market for rental of housing — which will continue to be driven by supply shortfalls.
- Strong growth in demand — driven by growth in incomes and employment, lower interest rates and increased access to credit (as a result of financial deregulation) — caused house prices to grow much faster than incomes from the mid-1990s. Large increases in net migration have also increased 'underlying' demand for housing since 2003-04.
- More recently, however, demand from home buyers has been suppressed by the effects of rises in mortgage interest rates (up about 155 basis points since mid-2007).
  - New housing construction has been weak for some time, housing finance commitments have fallen sharply this year and established house prices have recently fallen slightly.
- The immediate outlook is for housing construction and prices to remain weak, with the duration and severity of this weakness dependent on the future course of interest rates and the extent to which the economy slows.
- Nonetheless, we are unlikely to experience a housing downturn of the severity currently being experienced in the US and the UK. The Australian market is entering this period in a position of excess underlying demand rather than excess supply.
  - While the current downturns in the US and UK were preceded by surges in home building, activity in Australia has been subdued since 2004.
  - Australia did not experience anywhere near the same decline in lending standards, with sub-prime loans comprising a much smaller share of mortgages.
- Rising interest rates have increased rates of mortgage arrears and repossessions, which are likely to rise further due to the lagged effects of past interest rate rises and the expected

slowing in the economy. However, arrears rates should remain moderate, particularly relative to overseas experience.

- In contrast to house prices, rents have recently been growing strongly — driven by low vacancy rates — and this is likely to continue for some time.
  - This is partly due to higher interest rates but also to rental yields having been unsustainably low in recent years. Much higher rental yields will be needed to induce the necessary increase in rental housing investment.
  - This prospect raises distributional concerns, as renters have much lower average incomes than home buyers and 'housing stress' is already disproportionately concentrated on low income renters.
- The medium-term outlook for home buyers appears more favourable, as some of the longer-term factors driving up house prices as a share of income may have run their course and supply response should improve somewhat over the medium term.
  - If house prices stabilise as a share of income, then eventual normalisation of interest rates would improve affordability.

s22

- Financial Systems Division has been consulted in the preparation of this minute.

David Gruen
Executive Director
Macroeconomic Group

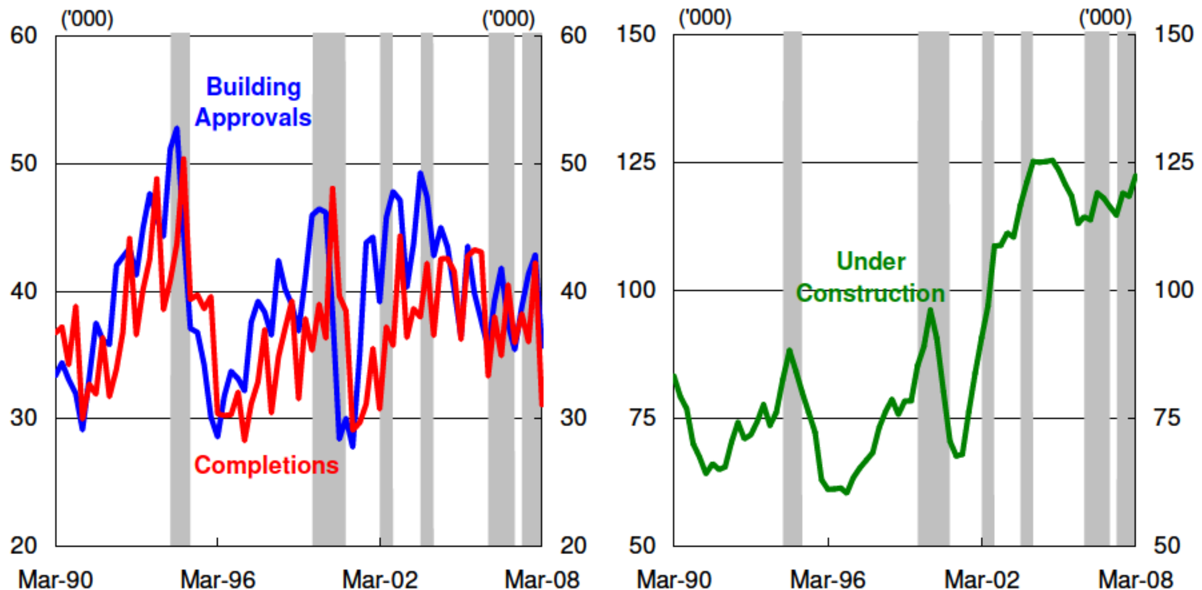
Contact Officer: s22

ADDITIONAL INFORMATION

New housing construction

Housing investment accounts for about 6 per cent of GDP, but often has a larger impact on GDP growth because of large cyclical fluctuations in new housing construction, which are linked to cycles in monetary policy (Chart 1). The housing investment cycle has been much more muted in recent years, with new construction remaining subdued, but comparatively stable, since 2004.

Chart 1: Dwellings Approved, Completed and Under Construction



Note: Shaded areas represent periods of monetary policy tightening.
Source: RBA, ABS Catalogue Number 8731.0, 87520.0 and Treasury.

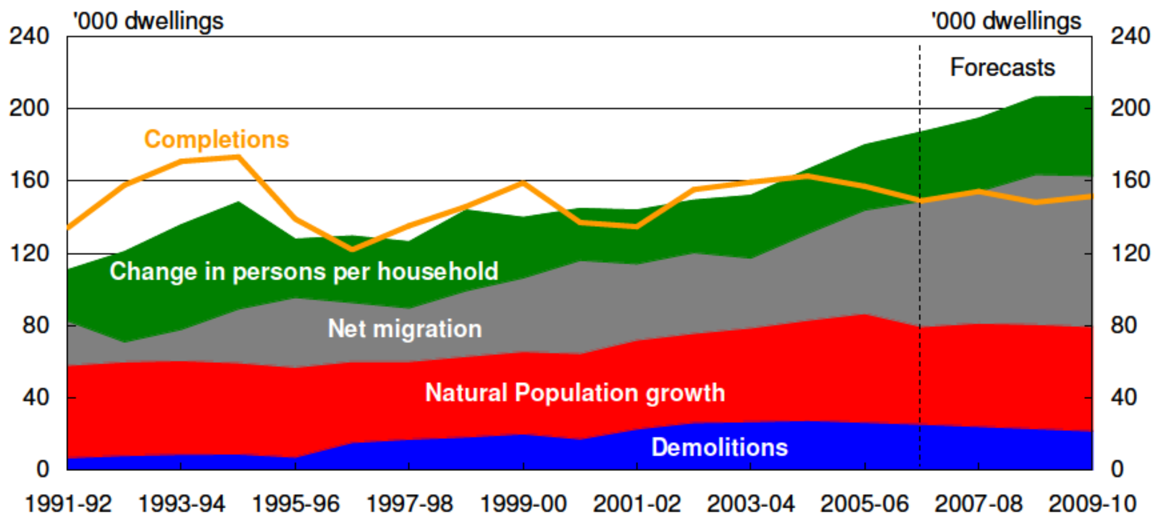
While recent data point to weak housing activity, this weakness is already reflected in our forecasts, which are for a slight contraction in activity over the next three quarters. The moderate downturn being forecast in this cycle reflects both the absence of a preceding upturn in activity and strong underlying demand for new housing. This means that the housing sector is entering this slowdown in a position of excess underlying demand, rather than excess supply. An indicator of constrained supply is the unusually large backlog of dwellings under construction, which built up during the housing boom in 2002-03 and has yet to be reduced (Chart 1). While recent data point to a downturn in new housing starts, work in the pipeline will help support activity.

Underlying demand for housing

Underlying demand is the demand for new housing arising from population growth, changes in average household size and demolitions. Treasury estimates of underlying demand use internal estimates of net migration and natural population growth and assume that average household size continues its long-run trend decline and demolitions continue at the rate of recent years.

Recent growth in underlying demand has been caused by a large increase in net migration since 2003-04, which has not been matched by an increase in dwelling completions (Chart 2). With completions forecast to remain subdued, an underlying demand shortfall of around 60,000 dwellings is expected in both 2008-09 and 2009-10.

Chart 2: Underlying Demand and Dwelling Completions



Source: ABS Catalogue Numbers 3101.0, 8752.0 Census (1991, 1996, 2001 and 2006) and Treasury calculations.

Any actual gap between underlying demand and completions must be met by either a reduction in the number of vacant dwellings or a slower rate decline (or a rise) in average household size. As vacancy rates are currently very low, any future gap would be met primarily by changes in average household size. If average household size was to remain constant rather than continuing to fall, this would largely eliminate the underlying demand shortfall. Such a change would occur primarily through high prices and rents inducing behavioural changes: for instance, younger people living with their parents for longer, more people living in group houses and more home owners renting out spare bedrooms.

Underlying demand is only one factor affecting demand for housing. Demand is a function of the number of dollars seeking housing, rather than the number of households. Over the past decade, the number of households has increased by 18 per cent, while real disposable income per household (before interest payments) has increased by 37 per cent and real home lending by more than 150 per cent. This suggests that demand growth has been driven more by increases in households' desired spending on housing than by growth in the number of households. As will be seen in the next section, most of the growth in house prices preceded the recent increase in underlying demand.

House prices

Established house prices have grown strongly since the mid-1990s, increasing from around 3 times to 6 times average household disposable income (Chart 3). This rise occurred largely between 1997 and 2003. Prices have risen strongly in all capitals and in non-metropolitan regions, suggesting that the primary causes have been nationwide influences rather than localised supply factors.

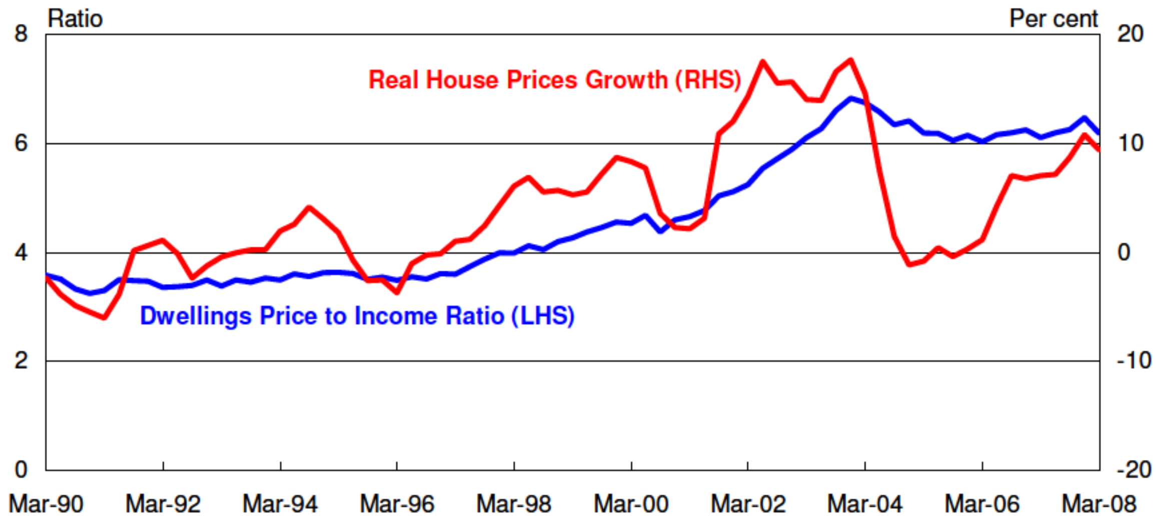
Rises in house prices have been mainly driven by increased demand arising from factors that have increased households' capacity and willingness to pay for housing:

- a long period of growth in incomes and employment and declining unemployment;
- a sizeable fall in interest rates, relative to the previous two decades, as low inflation credibility was established; and

- increased access to credit as a result of financial deregulation and innovation.

In addition, the reduction in capital gains tax in 1999 led to a surge in investor demand for housing in the early part of the current decade.

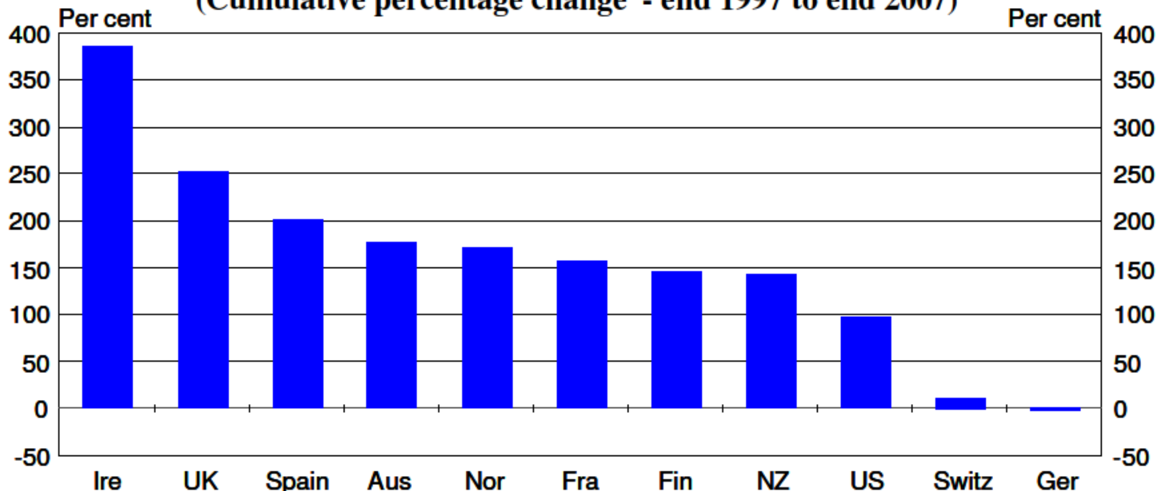
Chart 3: Real House Price Growth (Through the Year) and House Price to Income Ratio



Source: ABS Catalogue Number 5206.0, 6416.0, REIA and Treasury.

This experience is not unique to Australia, as house prices have grown significantly over time in most advanced economies (Chart 4). This suggests that common factors have been at work: in particular, the decline in global interest rates and greater availability of credit.

Chart 4: OECD Nominal House Prices
(Cumulative percentage change - end 1997 to end 2007)

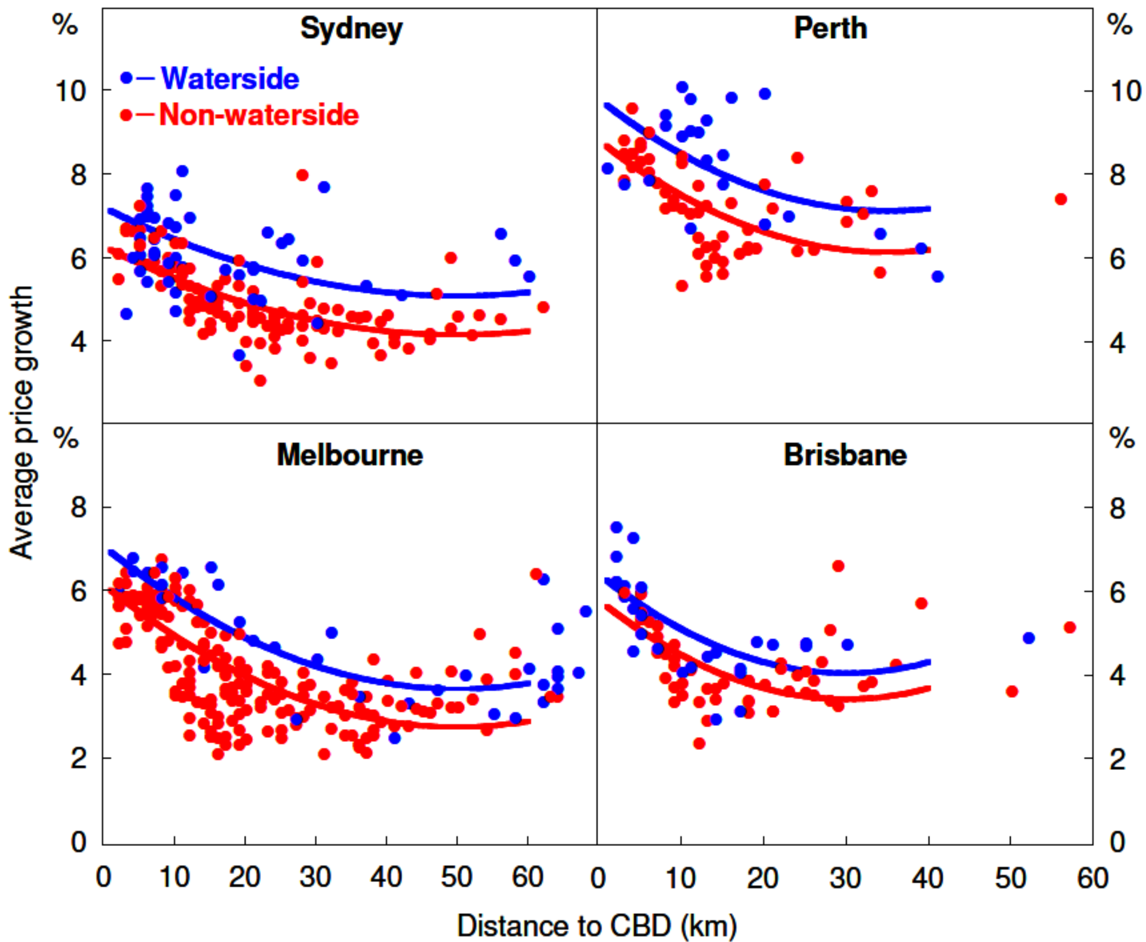


Source: BIS, CEIC and Thomson Reuters.

Nonetheless, Australian house prices relative to income are high by international standards. This probably reflects the relative concentration of Australia's population in a small number of large cities. Nearly 40 per cent of Australia's population resides in Sydney and Melbourne, and around 60 per cent in the five largest cities. As the premium on location closer to the city centre tends to be greater in large cities, a high concentration of the housing stock in such cities implies higher median house prices.

An important contributor to median house price growth over time has been rises in the premia for location. Capital city house prices have grown significantly faster in suburbs closer to the CBD than those further out, and also in waterfront suburbs than in other suburbs (Chart 5). This indicates relatively strong growth in demand for housing in better-located suburbs, where supply is generally less able to expand than on the urban fringe. The main driver has been increases in households capacity to pay, which have fuelled aspirations to move up to better-located housing.

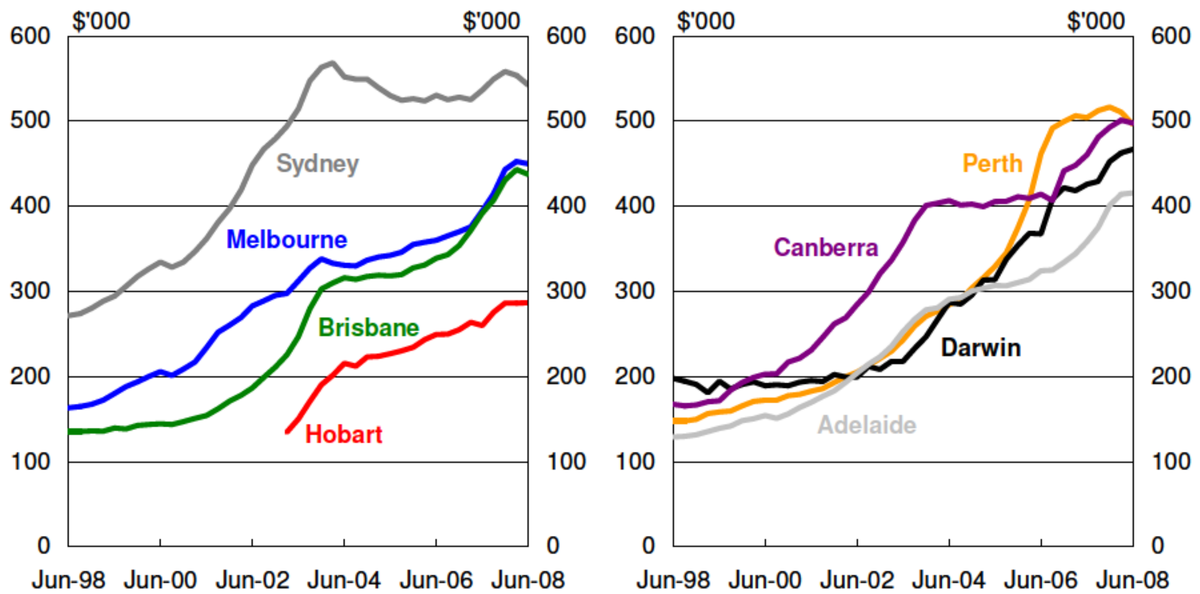
Chart 5: Postcode-Level House Price Growth*
(Average annual real growth)



* Data for the following periods: Sydney, 1984-85 – 2006-07; Melbourne, 1979-06; Brisbane, 1982-83 – 2006-07; Perth, 1989-90 – 2006-07.
Source: RBA and RP Data.

Since 2004, price growth has generally been more moderate, although growth picked up again in 2007 (Chart 6). This was mainly due to an extended fall in Sydney prices, but price growth also slowed in most other capitals. Perth prices continued to grow strongly, driven by the resources boom, but have eased more recently.

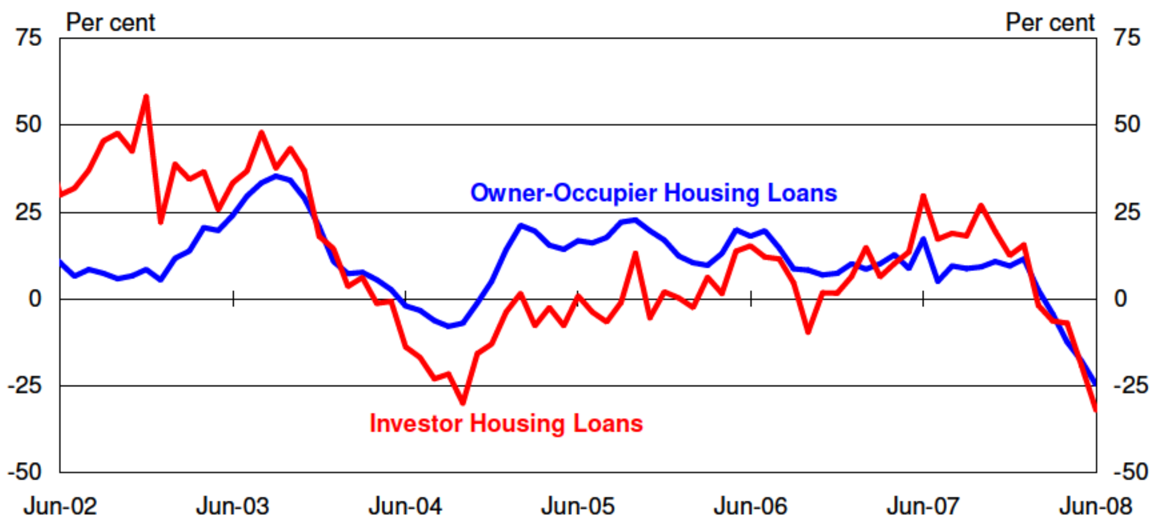
Chart 6: Established House Prices



Source: Australian Property Monitors.

Interest rates have recently begun to bite more deeply into housing demand, signified by a sharp fall in housing finance commitments in recent months (Chart 7). As a result, house price growth has softened markedly, with prices in all capitals either falling or rising only modestly in the June quarter. The immediate outlook is for house prices to remain soft while interest rates remain high and credit conditions remain tight. House prices are likely to fall at least moderately.

Chart 7: Housing Finance Commitments (Through the Year Growth)

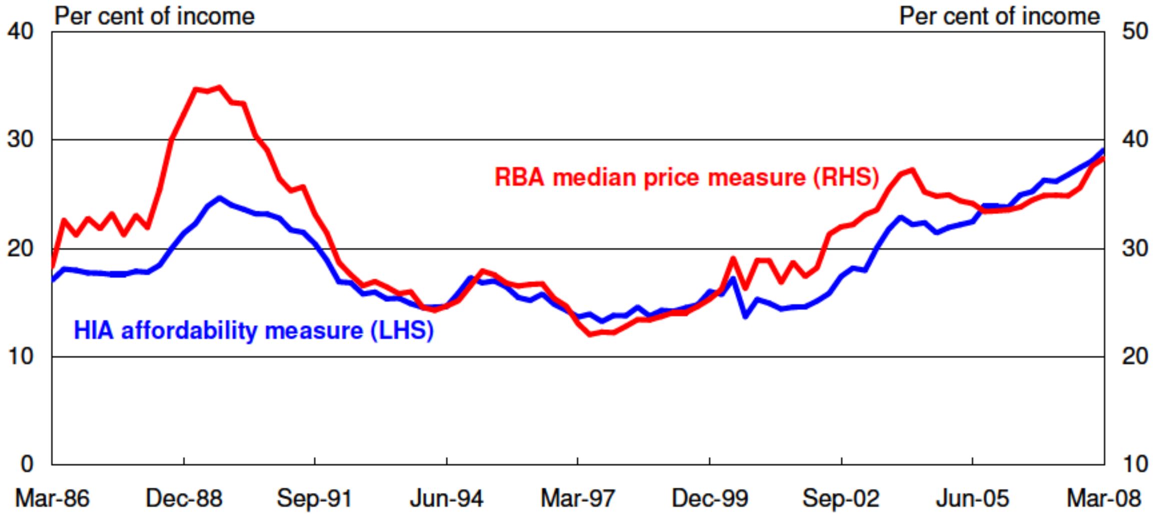


Source: ABS Catalogue Number 5609.0.

Since 2002, rises in both interest rates and house prices relative to income have contributed to declining affordability for home buyers (Chart 8). It is notable that the RBA median price measure shows less deterioration in affordability since 2004 than the widely-cited HIA measure, which is

based on CBA loan data. The RBA measure is preferred; the HIA measure may have been distorted recently by compositional shifts in the CBA loan portfolio.[1]

Chart 8: Alternative Measures of Housing Affordability



Source: Reserve Bank of Australia, HIA and Treasury.

A normalisation of interest rates would improve affordability, barring an offsetting rise in house prices as a share of income. The medium-term outlook for prices will depend mainly on the extent to which the factors that have boosted housing demand since the mid-1990s continue to operate.

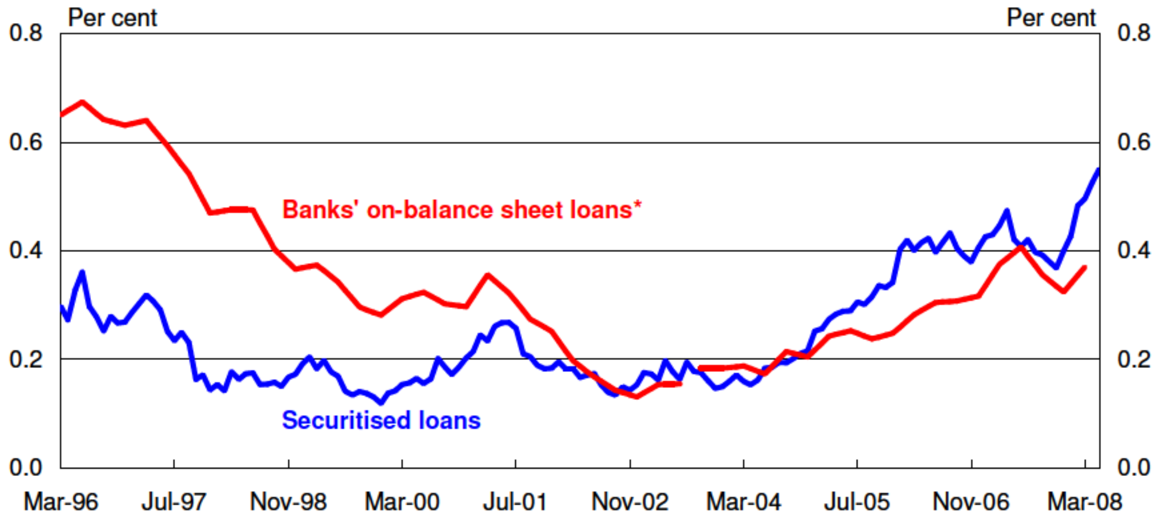
Of the contributory factors noted above, the reduction in inflation and unemployment rates are once-off shifts that will not be repeated, as is the expansion of access to credit following financial deregulation. Housing supply should be able to respond more over the medium-term as capacity constraints in the economy ease and policy efforts to boost supply bear fruit. On the other hand, sustained high commodity prices could prolong high immigration levels and, hence, strong growth in underlying demand. On balance, there is a reasonable prospect that house prices may at least stabilise relative to incomes, as they have largely done since 2004.

Mortgage arrears and repossessions

Rising interest rates have seen housing loan arrears rise over the past four years, although loans in arrears remain a very small proportion of all mortgages (Chart 9). Arrears of 90 days or more on bank loans, which account for almost three-quarters of mortgages, have risen to around 0.4 per cent of outstanding loan value. Arrears rates on securitised prime loans have risen more, to 0.55 per cent, reflecting the lower average quality of these loans. Arrears on non-conforming (sub-prime) loans are much higher at around 8 per cent, but these account for less than 1 per cent of all mortgages.

[1] Both measures calculate the share of average household disposable income needed to service a mortgage, assuming an 80 per cent loan-to-valuation ratio and a 25-year loan. The RBA measure is based on REIA median house price data. The HIA measure was originally based on the median price for first home buyers borrowing from the CBA. In recent years, however, this has been extrapolated using growth in the median price over all CBA loans.

Chart 9: Housing Loans 90+ Days in Arrears
(Per cent of total loan value)



* Prior to September 2003 includes only loans well secured by collateral.
Source: APRA and Standard & Poors

Further rises in arrears rates are in prospect, due to the lagged effects of past interest rate rises and an expected slowing in economic growth, resulting in higher unemployment. Rises in interest rates appear to affect arrears with a lag of around three quarters, implying that 130 basis points of mortgage interest rate rises may be still to show up in the arrears data. Our analysis suggests that each 100 basis points rise in interest rates leads to around a 0.1 percentage point rise in the arrears rate on bank loans. This implies that the bank loan arrears rate could rise to over 0.5 per cent, which would still be below arrears rates in the mid-1990s.

The effect of rises in unemployment is difficult to quantify, as arrears data are only available from the mid-1990s: a period of largely falling unemployment rates. However, two episodes of moderate rises in the unemployment rate — by around ½ a percentage point in 1996-97 and 1 percentage point in 2000-01 — did not appear to cause significant rises in arrears.

High rates of arrears are heavily concentrated in western Sydney, which was particularly affected by the property investment boom of 2003-04 and subsequent falls in house prices and has also experienced relatively weak economic conditions. Arrears rates in the rest of Sydney and non-metropolitan New South Wales are in line with the national average, as are arrears rates in Victoria, while other states are significantly lower.

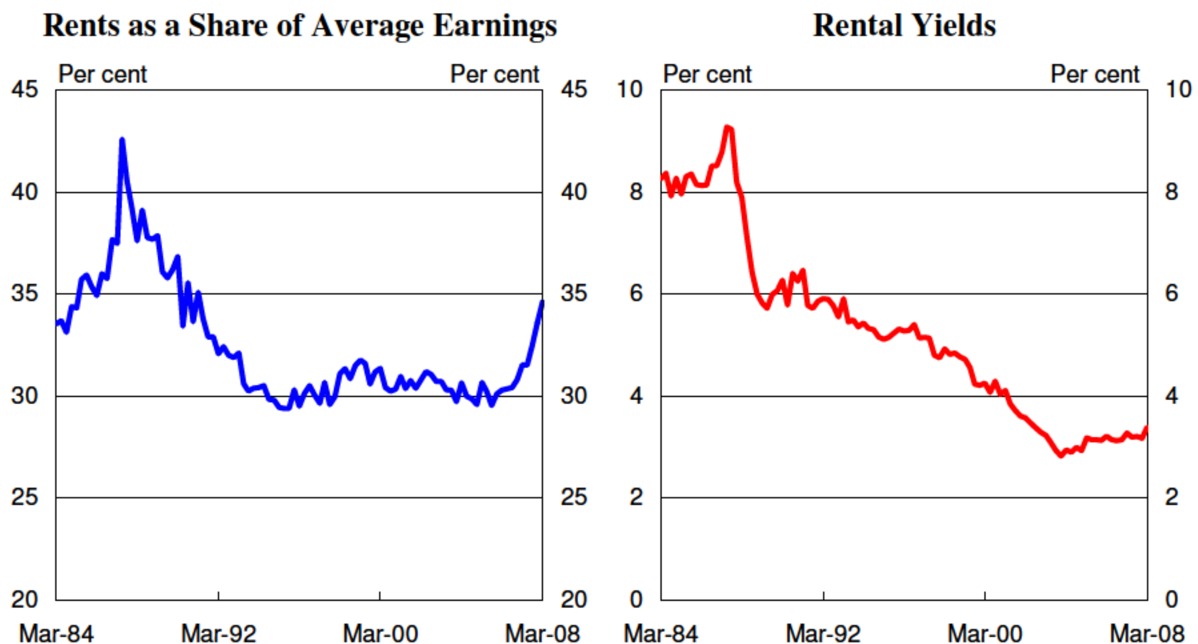
Home repossessions show similar trends to arrears. In 2007, there were around 10,000 applications for repossession nationwide, which is less than 0.4 per cent of all households with mortgages, although not all applications result in writs being issued. Applications stabilised in 2007, after doubling over the previous three years. Lags in the response to interest rates will be longer for repossessions than for arrears, so renewed rises can be expected.

Rents

In contrast to house prices, rent growth has been moderate until recently, so that rents have been relatively affordable over most of the 1990s and 2000s (Chart 10). As a result, rental yields (rental income as a proportion of house prices) have fallen significantly since the late 1990s and have been below 4 per cent since 2001. The decline in rental yields can be attributed to three factors:

- lower interest rates reducing the cost of funds invested;
- an extended period of strong house price growth, allowing investors to achieve healthy rates of return despite low rental yields;
- the 1999 reduction in capital gains tax, which reduces the pre-tax rate of return required by investors.

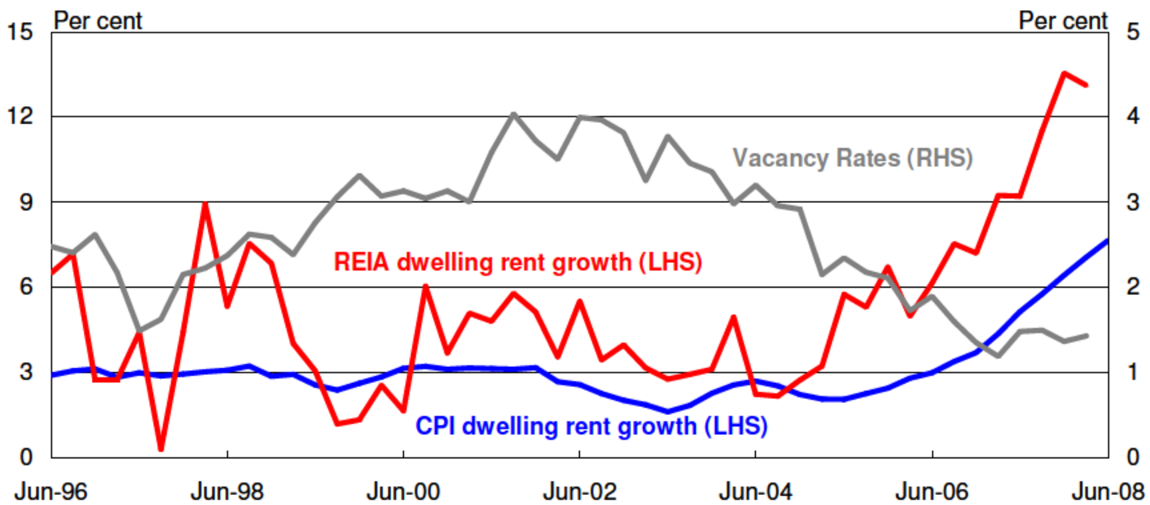
Chart 10: Rental Affordability and Rental Yields



Source: ABS Catalogue Number 6302.0, REIA and Treasury.

Over the past two years, however, rent growth has increased significantly, driven by low vacancy rates (Chart 11). The dwelling rent component of the CPI — which measures average growth across all rental housing — has risen by 8 per cent over the past year, while the REIA measure of rents on new leases has risen by 13 per cent. The REIA measure generally tracks above CPI rents and may be affected by compositional differences. Nonetheless, faster growth in newly-negotiated rents suggests that CPI rent growth is likely to increase further.

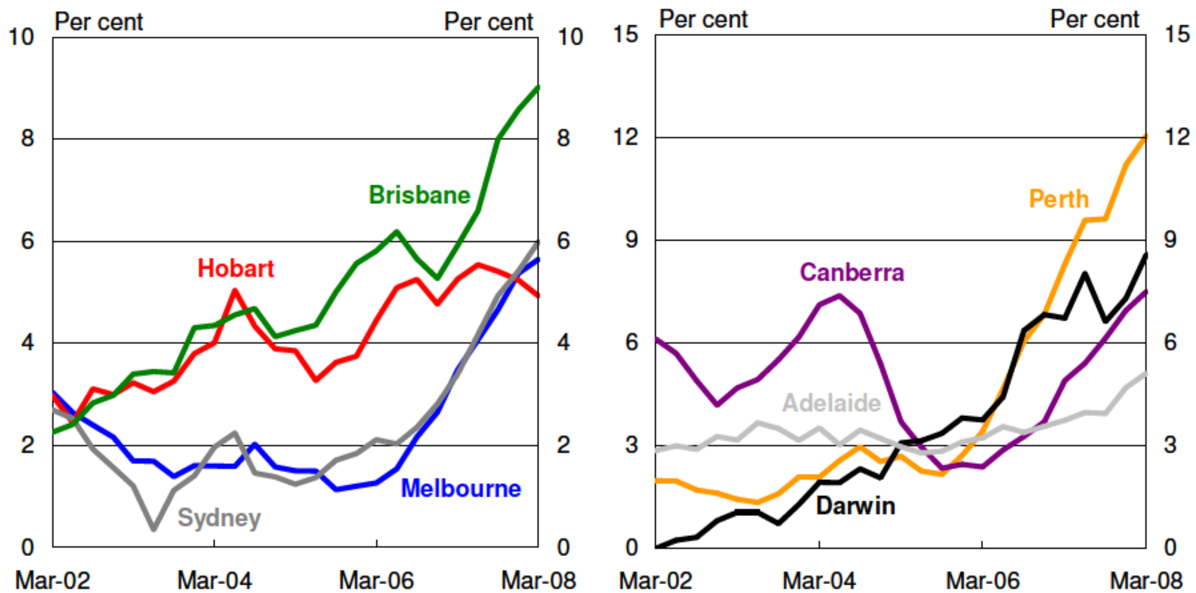
Chart 11: Rent Growth (Through the Year) and Vacancy Rates



Source: ABS, RBA and REIA.

Rents have been accelerating in all capital cities, but are growing most strongly in Perth, Brisbane and Darwin, reflecting the impacts of the resources boom (Chart 12). Vacancy rates are low in all cities, ranging from 1 per cent in Sydney to around 2½ per cent in Canberra.

Chart 12: Rent Growth (Through the Year) by Capital City



Source: ABS Catalogue Number 6401.0.

Subdued rental housing investment since 2004, despite strong demand and low vacancy rates, suggests yields will need to rise to induce the necessary increase in investment. Two factors are likely to have increased the rental yield required by investors since 2004:

- higher interest rates, which raise the required rate of return; and
- slower house price growth, which is likely to have reduced the expected rate of capital gain, so that more of the required rate of return must come from rental yields.

A reduction in interest rates would relieve some of the pressure on rents. However, upward pressures would likely remain as recent rental yields appear unsustainably low, even at more normal interest rates.

Future growth in rents will depend on the both the rental yield required by investors and the future course of house prices. There are considerable uncertainties around both factors, but it is conceivable that rental yields might need to rise 2 percentage points or more. For unchanged house prices, this would imply rents rising by 60 per cent or more over some period. Part of the adjustment could come from a fall in house prices in the near term; however, even a 10 per cent price fall would increase current yields by only 0.3 of a percentage point.

Who is affected by rising rents?

In 2005-06, around 2.3 million households were renting, which is 29 per cent of all households. Renters typically have much more limited means than home owners with mortgages, with median household incomes 45 per cent lower and median wealth 80 per cent lower. Half of renters are in the bottom 40 per cent of the income distribution. Renters are also typically younger: 55 per cent of households whose reference person is aged under 35 are renting, compared to 13 per cent of households 65 and over.

Almost half of all renter households are lone persons (33 per cent) or sole parents (14 per cent), and these household types have significantly higher housing costs as a share of income than other renters. In addition, 32 per cent of renter households have government pensions and allowances as their principal source of income, representing 35 per cent of all households in this category.

Low income renters are disproportionately affected by ‘housing stress’. In 2006, 23 per cent of all renter households were spending more than 30 per cent of their incomes on rent. Some 57 per cent of renters in the bottom 20 per cent of the income distribution were in this category, accounting for nearly 40 per cent of all households spending more than 30 per cent of their incomes on housing. Using the standard definition of housing stress (restricted to the lower 40 per cent of the income distribution), three-quarters of all households in housing stress were renters.

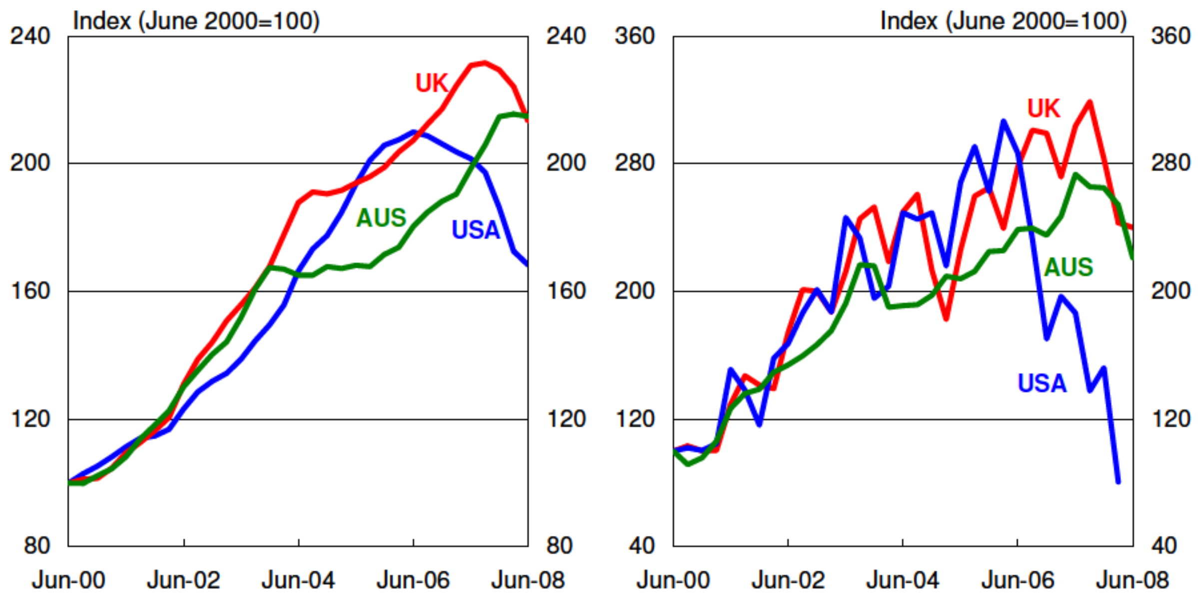
Overseas housing markets: how does Australia compare?

The United States has experienced a very sharp housing downturn over the past two years, and a recovery in the housing sector is not expected until at least 2009. House prices in major urban areas have fallen almost 20 per cent since their peak in mid-2006, and further falls are likely (Chart 13). US banks have been progressively tightening lending standards, and new lending for housing has plummeted to just over one-quarter of its peak level in early 2006 (Chart 13). New housing starts have fallen by around half over the same period (Chart 14).

The United Kingdom is also going through a significant housing downturn. UK house prices fell by 8 per cent over the past year, while new home lending for housing has fallen around 20 per cent and housing starts around 25 per cent over the same period. With the UK economy deteriorating, housing demand and prices are likely to remain weak in the near term.

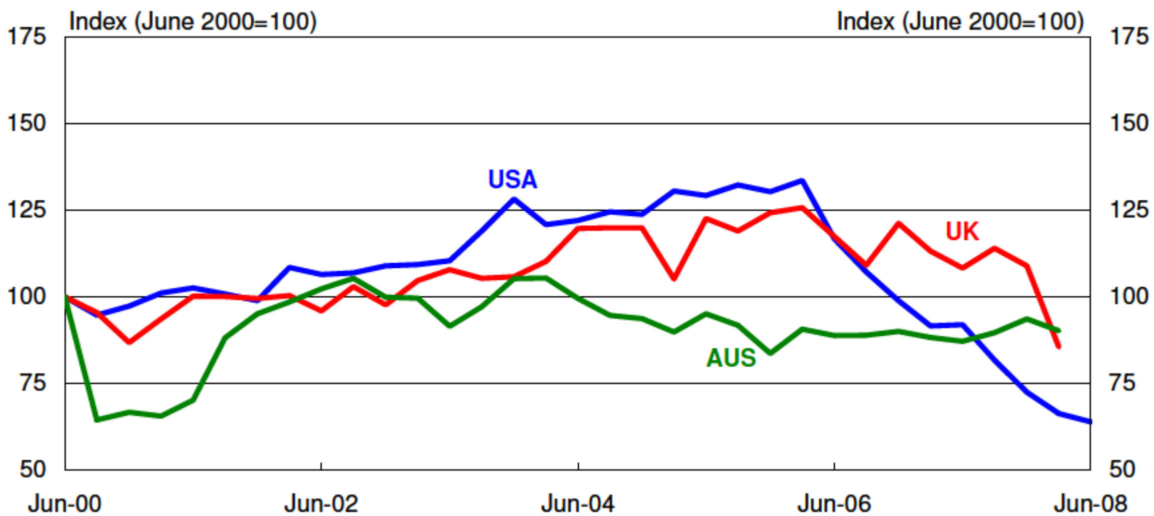
Australia has so far seen relatively modest declines in house prices and activity, although a significant decline in new home lending points to further weakness. Some observers have suggested that Australia is also at risk of a substantial downturn, given it has had similarly large rises in house prices over time to the US and UK (Chart 13). Despite this similarity, there are substantial differences between Australia’s housing market experience in recent years and those of the US and UK.

Chart 13: House Prices and Value of New Housing Loans



Source: ABS Catalogue Number 5609.0 and 6416.0, Standard & Poor's, HBOS plc, Nationwide Building Society UK, Bank of England and US Federal Reserve.

Chart 14: Housing Starts



Source: ABS Catalogue Number 8752.0, UK Communities and Local Government, US Department of Commerce.

Australia did not experience the expansion in new housing construction seen in the US and the UK in the lead up to their downturns. Housing starts in Australia grew strongly in the early part of the current decade following the post-GST downturn, but slowed in 2004 and have remained subdued ever since. At the same time, increased immigration has significantly added to underlying demand for new housing.

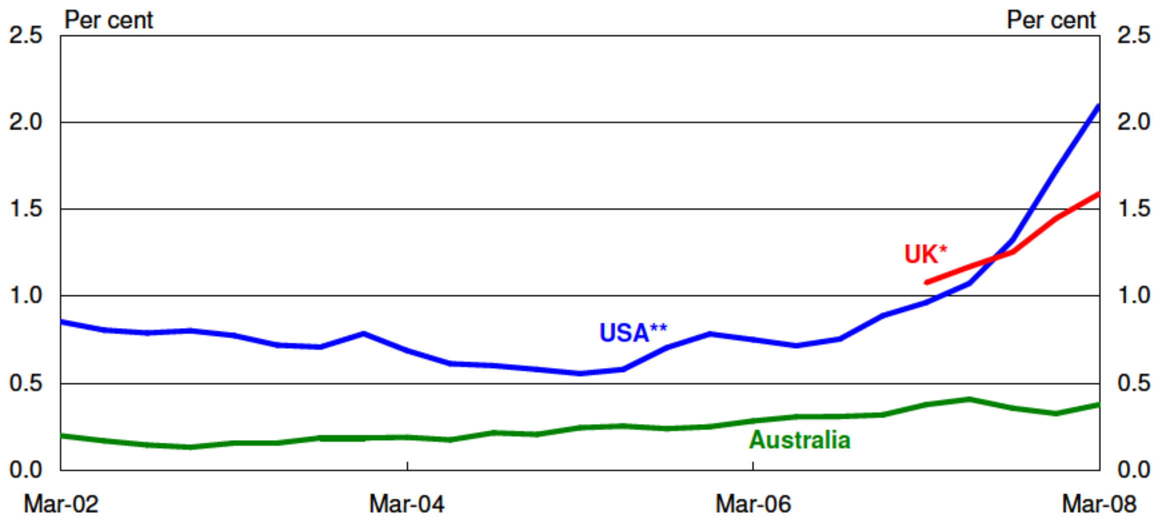
In contrast to Australia, housing starts in the US and the UK continued to grow strongly up to mid-2006. The UK has also experienced a significant immigration-driven increase in population growth over recent years. Hence, an increase in new construction may have been justified by fundamentals. This has not been the case in the US, where annual population increases have held steady, suggesting there has been an over-supply of new housing.

Another key difference is that Australia did not experience the same relaxation in lending standards, and associated expansion of sub-prime lending.

The central factor in the US housing downturn has been the expansion and subsequent collapse of the sub-prime lending industry. Sub-prime loans represent around 15 per cent of the overall US mortgage market. The IMF has estimated that sub-prime loans constitute about 6 per cent of the total mortgage market in the UK. In contrast, sub-prime loans account for only 1 per cent of the Australian mortgage market. Further, arrears rates on Australian sub-prime loans are about half those on US sub-prime loans.

It is also notable that arrears rates more generally have been remained much lower in Australia than in the US and the UK, as has been the case for some time (Chart 15). The contrast between the moderate rise in arrears on Australian banks' housing loans and the sharp rise in arrears on US banks' loans is particularly stark. Overall arrears in the UK have also started to climb more recently.

Chart 15: Banks' Non-performing Housing Loans
(Loans more than 90 days past due, per cent of total loan value)



* Share of unsecuritised loan value for FSA-regulated institutions.
** Share of loan value for FDIC-insured institutions.
Source: APRA, FSA and FDIC.

s22

The remaining three pages of this document have been removed as outside the scope of the request