Economic factors affecting the housing market

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Australian residential property prices have shown remarkable resilience despite the end of the boom in most major cities around three years ago. Under the influence of the mineral boom, property prices in Perth, Darwin and some other centres such as Mackay have continued to rise rapidly, at least up to the end of 2006. But in most parts of south-eastern Australia, with the exception of western Sydney, the stellar price increases chalked up between the mid-1990s and the early years of this decade have not been reversed; and indeed in some cities property prices have continued to rise, albeit at a more modest rate.

To a very large extent, the rise in Australian property prices over the past dozen or so years is the result of a number of favourable developments (from the standpoint of would-be home buyers) being 'capitalized' into prices. Foremost among these is of course the dramatic decline in interest rates as Australia transitioned from the high and volatile inflation of the 1970s and 1980s to the low and stable inflation we have enjoyed since the mid-1990s. This has been supplemented by enhanced competition in mortgage markets which has seen mortgage rates fall by more than the official cash rate. The borrowing capacity of home-buyers has also been assisted by 15 years of rising real incomes (in contrast to the decline in real incomes over much of the 1980s).

The combined effect of these trends has been to lift the amount which a two-earner household on average earnings can afford to borrow without debt-servicing absorbing more than one quarter of their income from around $100,000 in the early 1990s to over $300,000 today. And financial innovation has meant that this 'rule of thumb' for determining maximum loan sizes is a less binding constraint than it used to be.

Over the same period, however, net additions to the housing stock of about 1.25 million were sufficient only to absorb the increase in the number of households requiring accommodation (thanks to rising net immigration and a decline in the average number of people per household).

So although the borrowing capacity of buyers has more than trebled over the past 15 years, there has been no net increase in the supply of housing. In these circumstances, it is hardly surprising that the price of housing has roughly doubled.

And now that the structural decline in interest rates (between 1990 and 2002) has clearly come to an end, and been more or less fully capitalized into the value of the existing housing stock, house prices are (in general) rising at a much more subdued pace.

Suggestions that because houses are now 'over-valued' relative to incomes or rents, and that therefore a 'law of gravity' will inevitably result in a fall in house prices in much the same way as 'over-valued' share prices inevitably decline, ignore a fundamental difference between shares and residential real estate.

Although equities have, over long periods of time, typically been at least as rewarding an investment as real estate, no-one *has* to own shares. If shares are widely perceived to be 'over-valued', enough investors will reduce their exposure to shares (that is, sell them) to push their prices down to levels which will eventually be perceived as 'fairly' or 'under-valued'.

On the other hand, we all *have* to live somewhere. And in Australia, we generally prefer to live in our own dwelling rather than someone else's, if we can.

Very few Australians are ever going to respond to being told that their property is 'over-valued' by 'shorting' to property market – that is, by selling their residence, renting for a while and hoping to re-enter the housing market at a lower price. The transactions costs as well as the personal inconvenience represent major barriers to anyone contemplating doing with their house what Kerry Packer did with Channel Nine at Alan Bond's expense.

So when house prices do reach a level at which the marginal would-be buyer can no longer afford to buy, it's turnover which drops (by 28% over the past three years), rather than prices. Prices do not fall across the board unless interest rates and/or unemployment start rising by amounts sufficient to force some existing owners to become sellers.

This *has* happened in some pockets, such as Western Sydney – where, it would appear, some people who borrowed a very substantial proportion of their purchase price at the trough of the interest rate cycle and who made very little if any allowance for the possibility that rates could rise even by a percentage point or so have found themselves unable to maintain their mortgage commitments. But these are the exception rather than the rule. And in the more affluent suburbs of Australia's larger cities, rising incomes and share values have boosted the capacity of buyers to purchase residences whose value is enhanced by their scarcity.

Buoyed by rising immigration, 'underlying demand' for housing is now running at around 165,000 units per annum. But current levels of housing starts (dampened by the rises in interest rates over the past few years) imply net expansion in the housing stock of less than 140,000 units per annum. Not surprisingly, rental vacancy rates are declining sharply and will likely be down to around 1% in most cities by the end of this year – a prospect which is certain to prompt an acceleration in rents.

A key lesson for those concerned about improving 'housing affordability', whether for buyers or renters, is that policies which work only on the 'demand side' of the housing market are doomed to fail. Anything which puts additional cash in the hands of buyers (such as grants or stamp duty concessions) or renters (such as cash assistance) with a view to enabling them to buy or rent more expensive houses results merely in more expensive houses. Instead, policy needs to focus on increasing the supply of housing – particularly low-cost housing – and reducing the time taken to bring land and housing to market.

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