Ric Battellino: Housing affordability in Australia

Background notes for opening remarks by Mr Ric Battelino, Deputy Governor of the Reserve Bank of Australia, to the Senate Select Committee on Housing Affordability in Australia, Melbourne, 24 April 2008.

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The Reserve Bank is very pleased to have been invited to participate in this inquiry into housing affordability.

The terms of reference of the Committee are wide-ranging and extend well beyond the areas in which the Reserve Bank has expertise. We will therefore limit our remarks to four areas – namely house prices, housing affordability, housing loan arrears and the rental market.

The key points we would like to make are as follows:

1. The increase in house prices in Australia since the mid 1990s, while very large, has been part of a broad trend evident in most other developed economies. This suggests that the main forces that have underpinned this rise have been global in nature, rather than country-specific.
2. Traditional measures of housing affordability have declined since the mid 1990s. Specifically, housing loan repayments have risen strongly relative to incomes. The overwhelming factor that has led to this is the rise in house prices; mortgage interest rates in Australia are no higher today than in the mid 1990s, when housing was at its most affordable.
3. Despite the sharp fall in traditional measures of housing affordability, arrears rates on housing loans remain low by historical standards. To some extent, this is a sign of the extraordinary commitment of Australian households to meeting their housing loan repayments, even in the face of financial pressure. It is also the case, however, that for the household sector as a whole, rising levels of income have allowed households to devote a larger share of their income to housing repayments, while maintaining or even increasing their overall living standards. This has meant that, for many households, traditional benchmarks of affordability – such as the often-quoted 30 per cent rule – may now be somewhat dated. While the picture on arrears for the household sector as a whole is quite benign, there are nonetheless significant pockets in the community where the high price of housing is causing financial distress.
4. The rental market is currently very tight, with vacancy rates at low levels and rents rising quickly. This comes after a decade when rents increased by much less than the price of houses, causing rental yields to fall to levels that discouraged increases in the supply of rental properties. It is hard to avoid the conclusion that the rental market might have substantial further adjustment to undergo before rents stabilise.

1. House prices

Since the mid 1990s, the median house price in Australia has risen by 180 per cent, compared with an increase of a little over 30 per cent in the CPI. This real increase in house prices can be seen in the orange line in Chart 1. You can see that the rise in house prices has been much faster than that in construction costs, so the implication is that most of the increase in house prices has been due to increases in the price of land.

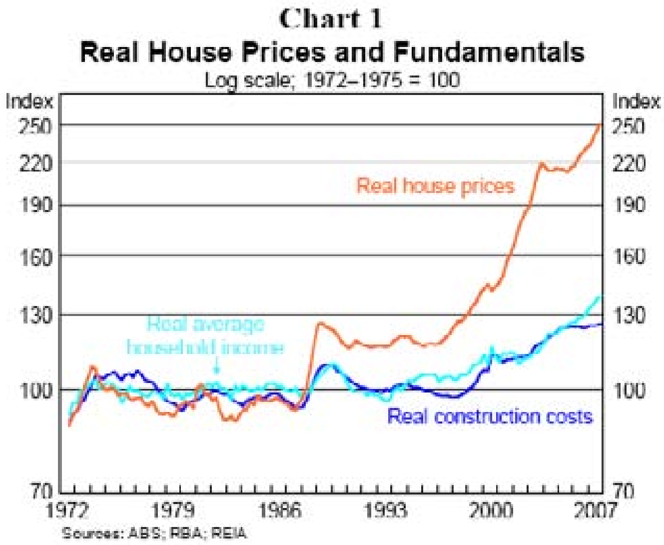
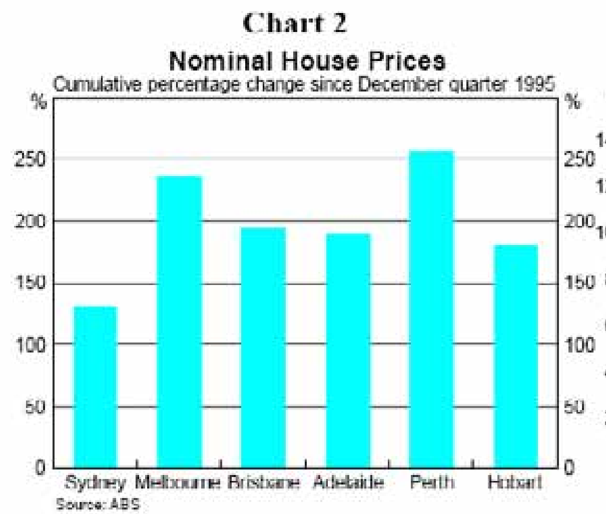


Chart 2 shows that all the major cities in Australia have experienced large increases in house prices, while Chart 3 shows that the increases have been reflected in both cities and country towns. In other words, the increases have been broadly spread across the country.



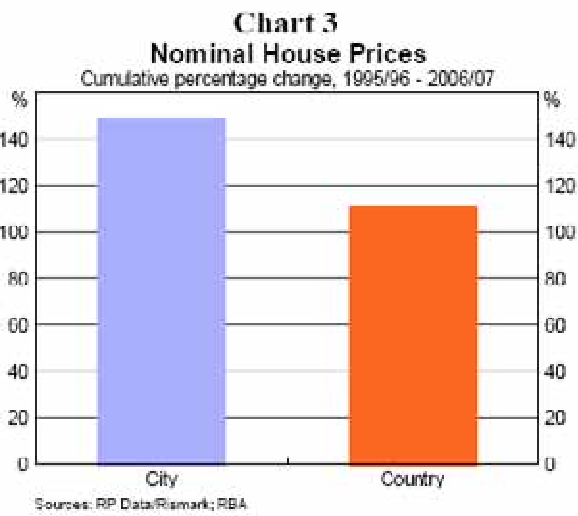
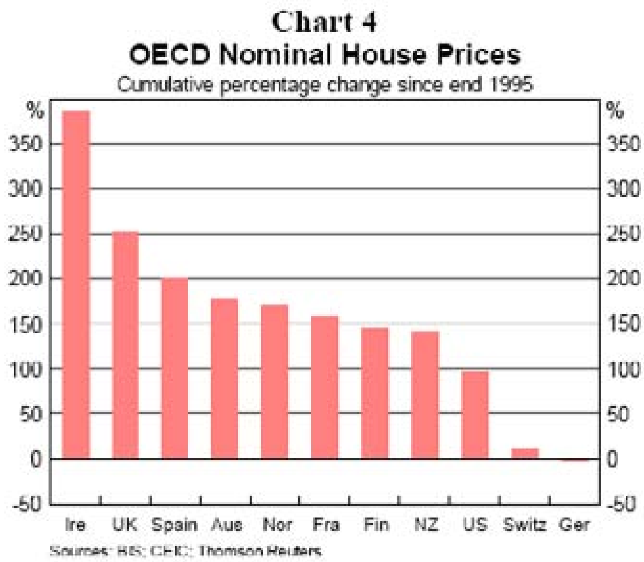


Chart 4 shows that Australia has not been alone in experiencing this rapid rise in house prices. With very few exceptions, most developed countries have experienced a doubling or trebling of house prices since the mid 1990s.



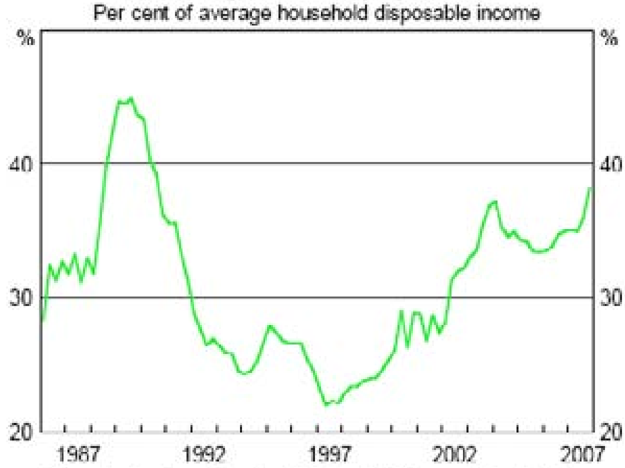
Two common elements in the countries that experienced rapid house price increases were financial innovation (which greatly increased the access of households to finance) and relatively low interest rates (which reduced the cost of finance). The latter is true not only for the official interest rates set by central banks, but for longer-term rates set in capital markets. While there has been much discussion about the causes of the low long-term interest rates, I think it is fair to say that the majority view is that it has reflected a global excess of desired saving over desired investment – i.e. the so-called savings glut. Put another way: With the amount of money that people wanted to save running ahead of the amount that people wanted to invest in physical assets, there was a strong incentive for the financial sector to find ways to issue more financial claims against the stock of existing investment. That, of course, is a recipe for rising asset prices.

In our view, the widespread nature of the increases in house prices, which, as I have noted, have encompassed most major countries and virtually all parts of Australia, makes it hard to attribute them only to factors which have localised effect – e.g. land usage policies, taxes and transport arrangements. Rather, a big part of the increases over time is due to factors affecting demand and capacity to pay, such as increased household access to finance. Supply considerations are more likely to have affected prices on the edges of urban development. These areas, of course, are important for households at the entry level of the housing market.

2. Affordability

The standard measures of housing affordability essentially try to measure housing loan repayments relative to household income. There are various measures in existence. The one shown in Chart 5 is calculated by the Reserve Bank. It measures the proportion of average household disposable income needed to cover repayments on a median-priced house (assuming a 20 per cent deposit and a 25-year loan). The broad picture is that this ratio is now much higher than it was in the mid 1990s, and only a little below what it was in the late 1980s.

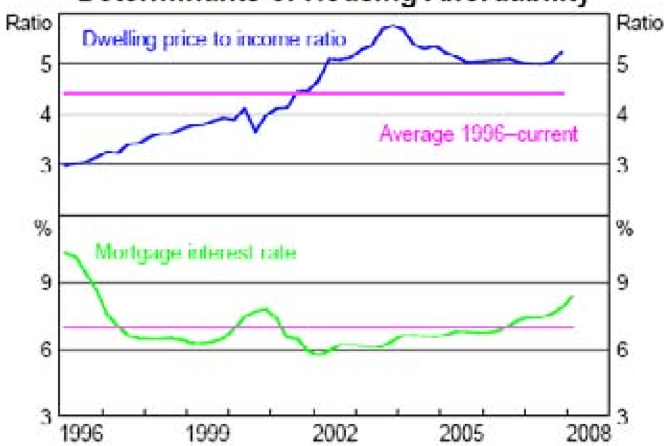
Chart 5
Housing Loan Repayments*
Per cent of average household disposable income



* Based on loan for median-priced dwelling, with 20 per cent deposit and 25 years to maturity
Sources: ABS, RBA

There are three factors that drive changes in this measure: house prices; household incomes; and interest rates. Chart 6 shows how these factors have changed in recent years.

Chart 6
Determinants of Housing Affordability



Sources: ABS; RBA; Perpetual; REIA

The top panel of the graph shows the ratio of median house prices to average annual household income. In the mid 1990s, house prices were around 3 times average annual income; by the end of the housing boom in late 2003, this ratio had risen to about 6. It then declined for a couple of years, as house prices stabilised while incomes grew, but more recently house prices have been rising at least as fast as incomes.

Mortgage interest rates are plotted in the bottom panel. They have shown a couple of cycles over the period shown in the chart, rising in the late 1990s and again in recent years, but these cycles have taken place around a flat trend. Mortgage interest rates today are much the same as they were around 1996-1997.

We are therefore left with the conclusion that the decline in measures of housing affordability since the mid 1990s is almost entirely due to the rise in house prices relative to incomes.

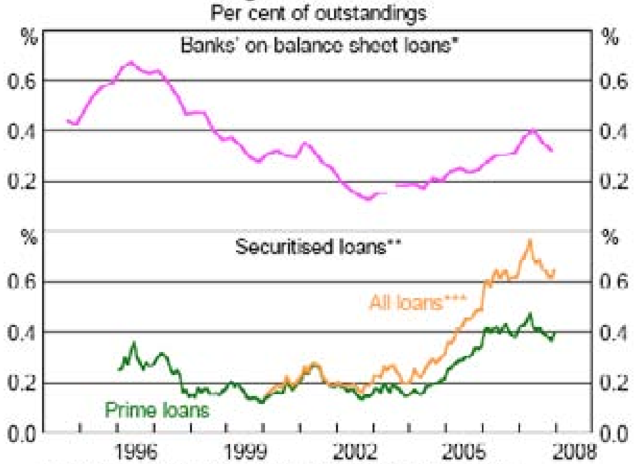
3. Arrears

Housing loan arrears are the most tangible indicator of the extent to which households are getting into difficulty with their housing loans.

The series for the proportion of loans for which repayments are in arrears by more than 90 days is shown in Chart 7. The key points worth noting about this chart are that:

- While arrears rates rose somewhat between 2002 and 2006, they remain relatively low by historical standards, and in fact fell through much of 2007.
- The arrears rate for loans on banks' balance sheets is about 0.3 per cent, while that for securitised loans is about 0.6 per cent in total, or 0.4 per cent for prime mortgages. We estimate that there are around 15 000 households in Australia which are 90 days or more in arrears on their housing loan repayments. An additional 30 000 or so are between 30 days and 90 days in arrears. These are quite low numbers for a country the size of Australia.

Chart 7
Housing Loans in Arrears
Per cent of outstandings



* Loans that are 90+ days past due, includes impaired loans from September 2003
** Loans securitised by all lenders, 90+ days past due
*** Includes non-conforming loans
Sources: APRA, Standard & Poor's

From a macroeconomic perspective, there do not appear to be any major problems here. Indeed, given the historically low level of unemployment, it would be surprising if there was a widespread problem with housing loan arrears at present.

How do we square the relatively benign picture on arrears with the apparent sharp decline in housing affordability such as shown in Chart 5? The explanation largely lies in the fact that real incomes of Australian households have been rising quite strongly. This has allowed households to devote a larger proportion of their income to housing, while still maintaining their living standards more generally. For example, a typical household that in 1996 was devoting 30 per cent of its disposable income to debt servicing would today be able to devote 47 per cent of its disposable income to debt servicing while still having the same standard of living in terms of being able to buy other goods and services. This, broadly speaking, is the outcome that has occurred.

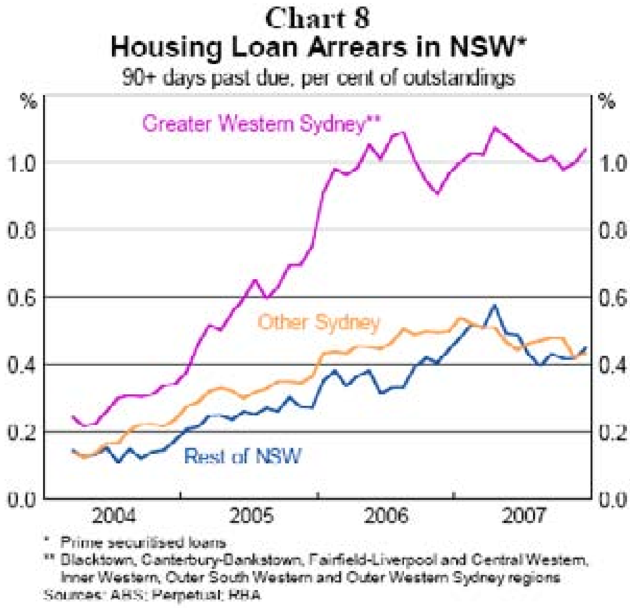
It is not surprising, therefore, that some commentators who use a fixed benchmark for housing stress – such as housing repayments exceeding 30 per cent of income – are finding that more and more households are exceeding the benchmark.

I should also point out that the 30 per cent benchmark is sometimes applied more loosely than was intended by those who initially proposed it. The benchmark dates back to work done for the Australian Government's 1991/92 National Housing Strategy. That work recommended that 30 per cent of income be adopted for the maximum level of housing costs for households in the bottom 40 per cent of the income distribution.[1] Some commentators have since begun to apply it to all households, including those with very high levels of residual income. More generally, the rise in real incomes since the early 1990s has substantially changed the basis on which the 30 per cent benchmark was calculated.

While housing loan arrears for the country as a whole are quite low, there are some regions where the financial position of households is relatively tight.

The pressures seem to be particularly concentrated in suburbs of western Sydney. Various measures point to financial pressures being more intense in this area:

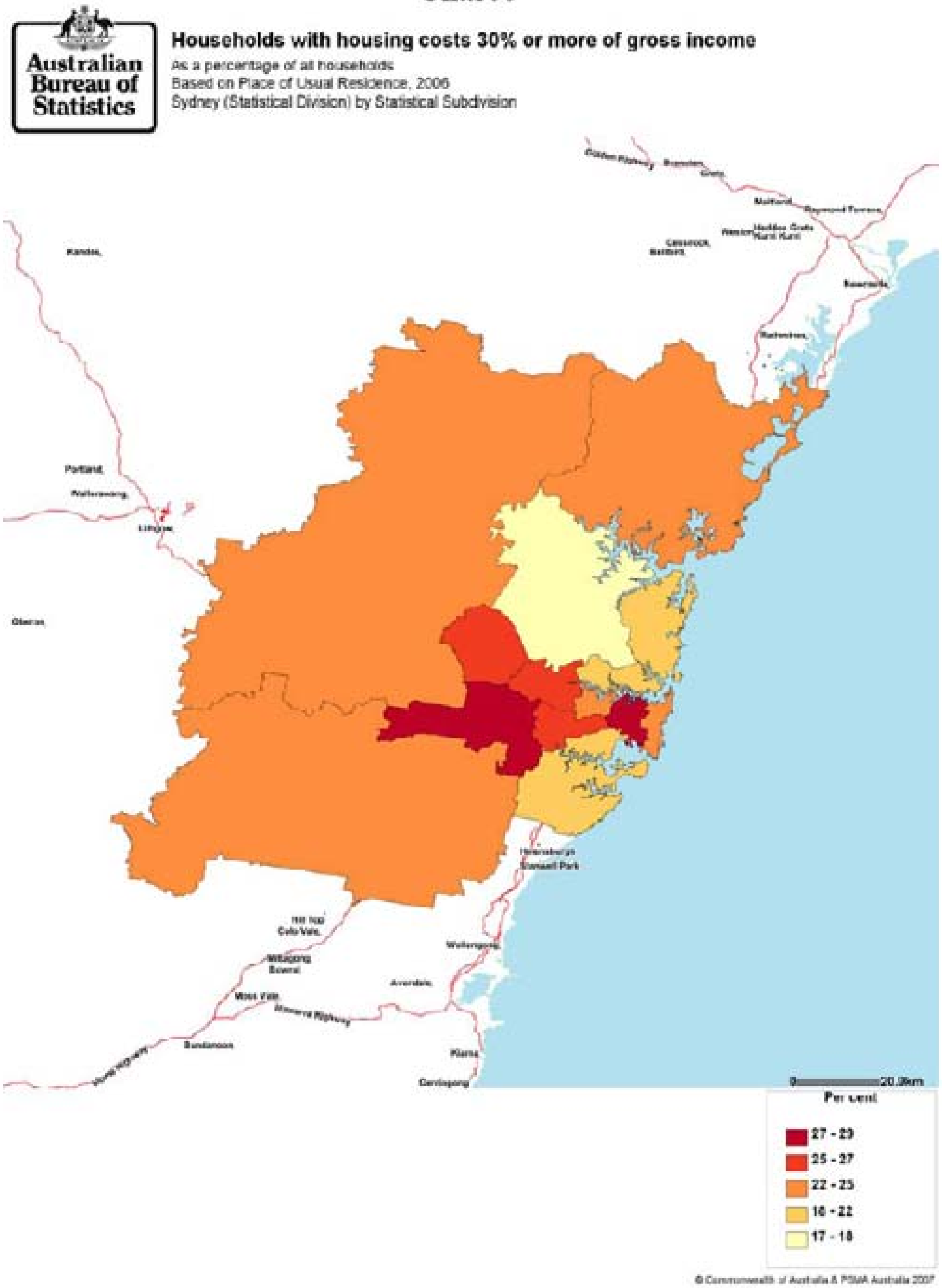
- First, arrears rates on housing loans in western Sydney are significantly higher than those in other parts of Sydney, or Australia more generally (Chart 8).



- Second, suburbs in western Sydney feature prominently in lists of Australian regions with the highest proportions of households with relatively high debt-servicing ratios. Chart 9 is published by the ABS using data from the 2006 Census. It shows the proportion of households in each of the major regions of Sydney that is paying more than 30 per cent of gross income in housing costs (including rent). While, as I noted, there are some qualifications surrounding the significance of the 30 per cent benchmark, it is nonetheless the case that the proportion of households paying more than 30 per cent in housing costs is higher in areas of western Sydney than in other parts of the city.

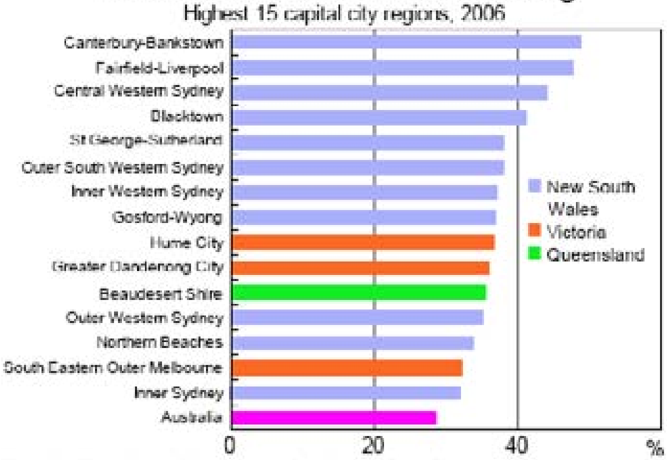
[1] National Housing Strategy (1991), "The Affordability of Australian Housing", National Housing Strategy Issues Paper No.2, p.7

Chart 9



- Chart 10 provides more detail on this. It shows the 15 regions across Australia that in 2006 had the highest proportion of owner-occupier households paying more than 30 per cent in debt servicing. Parts of western Sydney are again over-represented in this group. In the Canterbury-Bankstown region, for example, 49 per cent of households with housing debt were paying more than 30 per cent of their income in debt servicing. This compared with about 29 per cent for the Australia-wide average.

Chart 10
Proportion of Households Paying More Than 30 Per Cent in Debt Servicing*
Highest 15 capital city regions, 2006

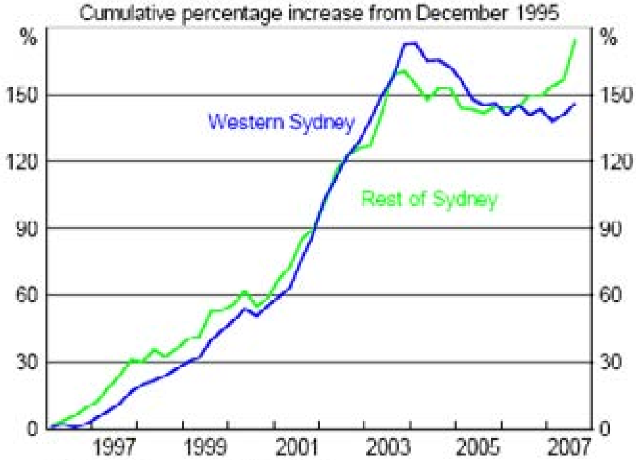


* Indebted households with owner-occupier debt-servicing ratios over 30 per cent
Sources: ABS; RBA

In examining why the problems of housing affordability are more severe in western Sydney than in other parts of Australia, a few key features stand out:

- First, the rise in house prices and the associated increase in turnover in this region came later than in the rest of Sydney, and the increase ended up being larger (Chart 11). An implication of this is that a higher proportion of households in this region bought towards the peak of the market.

Chart 11
Sydney House Prices*
Cumulative percentage increase from December 1995



* Weighted average of suburb medians
Sources: ABS, APM, RBA, RESIDEX

- Second, incomes in this region have on average grown more slowly than elsewhere. Over the decade to 2006, for example, median household income grew by an average rate of 3.7 per cent per annum in western Sydney, compared with 4.2 per cent in Sydney overall, and 5.0 per cent in Australia. In other words, the rise in house prices in western Sydney was less well supported by income growth than elsewhere. As an illustration of this, even in 2001, at the low point in the interest rate cycle, a relatively high proportion of households in this part of Sydney had high debt-service ratios.

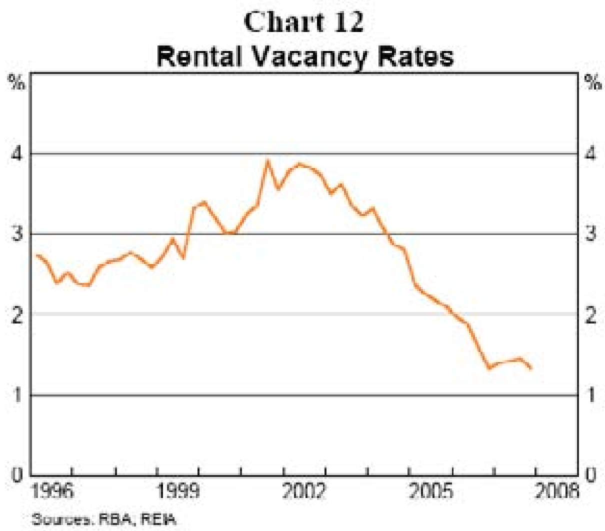
- Third, a disproportionately large share of the housing loans in this region was sourced from non-bank lenders. This may imply that a smaller proportion of the borrowers in the region met banks' lending guidelines and/or that some of those marketing the non-bank loans arranged loans that were inappropriate for some people. The arrears rate on loans from non-bank lenders in this part of Sydney is running at three times that for loans on the major banks' balance sheets. That said, it is still only about 1.5 per cent.

This combination of outcomes created substantial financial pressures in this region after the housing boom ended in early 2004, as evidenced by the sharp rise in the arrears rate in the region over 2005 and 2006. Having said that, the situation appears to have stabilised in the past year, most likely due to rising income levels.

4. The rental market

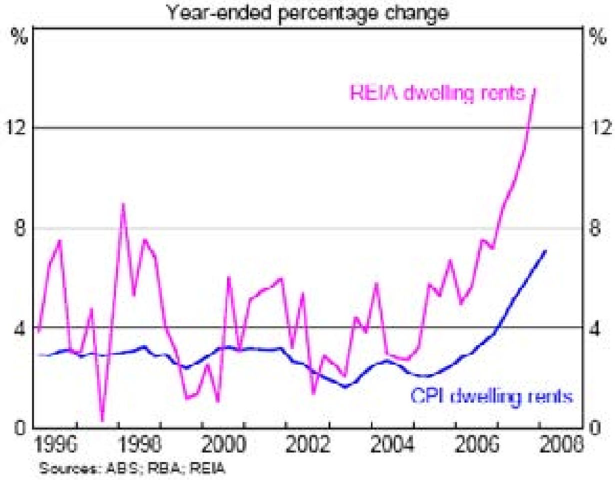
The rental market is currently very tight right around Australia:

- Vacancy rates are very low, at less than 1½ per cent on average across Australia (Chart 12); and



- Rents are rising quickly. In the past year, newly negotiated rents rose by about 13 per cent, while all rents outstanding (as measured in the CPI) rose by about 7 per cent (Chart 13).

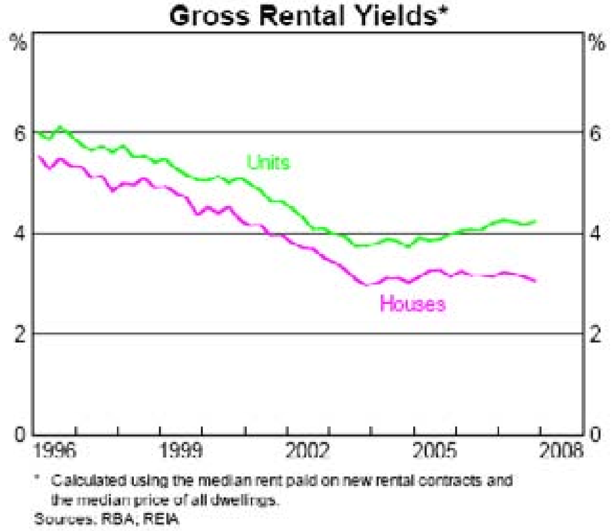
Chart 13
Rents
Year-ended percentage change



Why has this happened, and why isn't more investment in rental housing taking place?

To answer these questions, we need to look back to the start of the housing boom in the mid 1990s. At that point, commonly used measures of gross yields on rental properties were in the order of 5-6 per cent. Over the subsequent decade, rents rose much less than dwelling prices, so that rental yields fell to relatively low levels – about 3 to 4 per cent (Chart 14). During this period, investment continued to flow into rental properties, as investors anticipated that capital gains would more than compensate for the low yield.

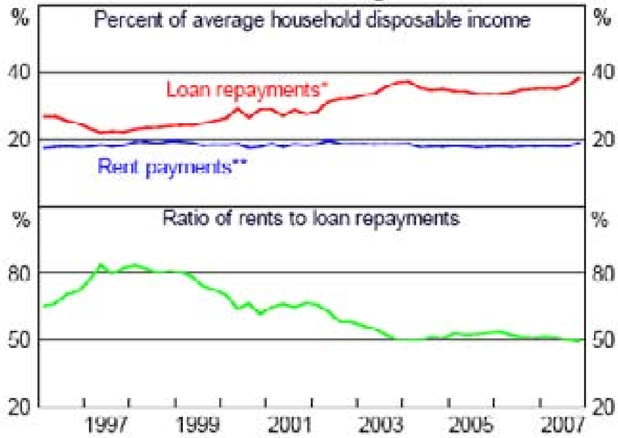
Chart 14
Gross Rental Yields*



However, once it became clear that dwelling prices may no longer keep rising, the rental yield by itself was not sufficiently attractive to sustain the rate of investment, and the vacancy rate started to fall.

Even though rents have been rising quickly recently, over the longer term the cost of renting has risen less than the cost of buying a home (Chart 15). The price signals are therefore pushing households towards renting. On the other hand, the price signals facing investors are not conducive to increasing the supply of rental properties, as yields remain low and the prospects of capital gains uncertain.

Chart 15
Relative Dwelling Costs



* Based on a loan for the median priced dwelling, with 20 per cent deposit and 25 years to maturity
** Weighted average of the median rent for 3-bedroom houses and 2-bedroom units
Sources: ABS; RBA; REIA

It is hard to see how equilibrium can be restored to the market until rental yields return to more normal levels. One way for this to be achieved would be for house prices to rise more slowly than incomes and rents for a period. Measures that lower the cost of adding to supply of housing, particularly low-cost housing, would be helpful in aiding the transition process. This includes initiatives, such as that announced by the Australian Government in March, to help increase the supply of rental properties by giving tax subsidies to institutions investing in rental property.