Housing: it’s all about affordability

- Housing is central to many parts of Australia’s economic story, with affordability the linking factor.
- Interest rates, dwelling prices and incomes drive affordability.
- The RBA is reluctant to lift rates, but the ground has shifted, and rate rises are imminent.
- Higher rates will cut affordability and cool housing markets at a time of elevated housing supply.
- Uncertain economic times bring the risk of a policy “mistake” and could lift lending caution.

“Housing” is an endless source of discussion and debate. “Shelter” is a basic need, but “housing” cuts across many other parts of the Australian economic story.

We are fascinated by house price trends. We worry about where our children will live. Housing dominates our balance sheets and investment decisions. Bold predictions of price gains or price falls drive a mix of fear and greed. Politicians learn early on that housing policy and votes are closely connected. Policy makers view housing as a transmission channel for economic policy and a source of risk to financial stability. We are concerned about changing streetscapes as the builders roll through. We love TV programs on renovating and relocating. The list goes on.

Not surprisingly, housing is high on the list of issues that worry Australians. Long-running surveys, such as those conducted by IPSOS, regularly put “housing” in the top-four issues facing Australia (Chart 1).

The fate of the Australian property market is closely intertwined with that of the economy more broadly. So, the COVID-19 pandemic and its economic fallout was widely expected to create an existential crisis for the property sector as well.

Our Google search activity is revealing. There are any number of occasions over the past fifteen years where concerns about a property collapse were reflected in online search activity (Chart 2). These events are typically correlated with major "shocks" or "expert commentary".

COVID-19 and 2020 were no different. The consensus in the first half of 2020 rapidly shifted to predicting falls in residential property prices. Predictions of 10% declines were common. The major banks were conducting stress tests involving dwelling price collapses of 30%. That consensus was, of course, wrong. The housing market boomed. Most recently, the RBA has warned about the combination of high household debt and higher interest rates. And so, the cycle rolls on!

If there is one factor that unifies all these disparate strands, it is *affordability*.

Affordability and housing

Housing affordability reflects trends in interest rates, dwelling prices, and incomes.

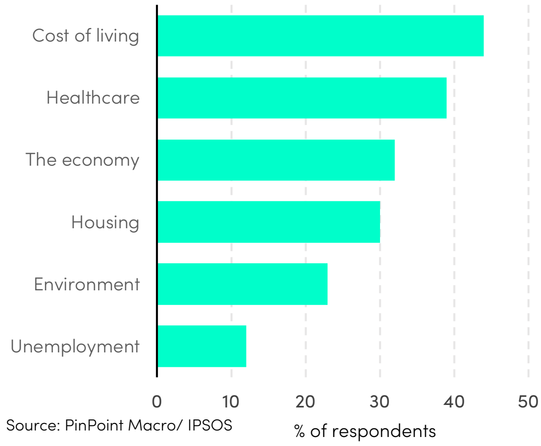
These three factors impact on spending, disposable income, wealth, construction, employment, government revenue and sentiment. It is why affordability is such an all-pervasive concept.

The Housing Industry Association (HIA) constructs an affordability measure for Australia. This measure shows a deterioration in affordability during 2021, albeit from near record highs in 2020 (Chart 3). Lower mortgage rates improved affordability in 2020. Rising dwelling prices dented affordability in 2021.

The formula that determines affordability allows some sensitivity analysis (Chart 4). The main points are:

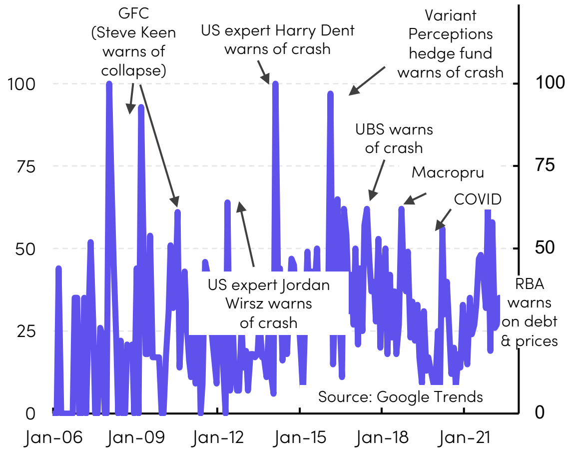
- a 1% rise in mortgage rates reduces affordability by 10%;

01. The Top Issues Facing Australia
(% of respondents in 2022)



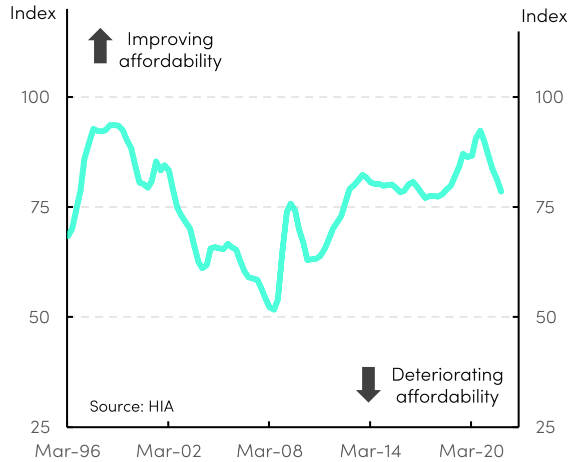
Source: PinPoint Macro/ IPSOS

02. Australia: Property Crash
(trending google searches)



Source: Google Trends

03. Housing Affordability



Source: HIA

- a 10% rise in dwelling prices reduces affordability by 9%; and
- a 1% drop in income or wages reduces affordability by 1%.

Affordability and interest rates

Changes in mortgage rates have the largest proportionate impact on housing affordability. Therefore, interest rate trends are key.

The interest rate structure in recent years is one that was at or near record lows. That structure provided a huge impetus to housing activity – sales, construction, and prices. And until recently, expectations were that low rates were here to stay.

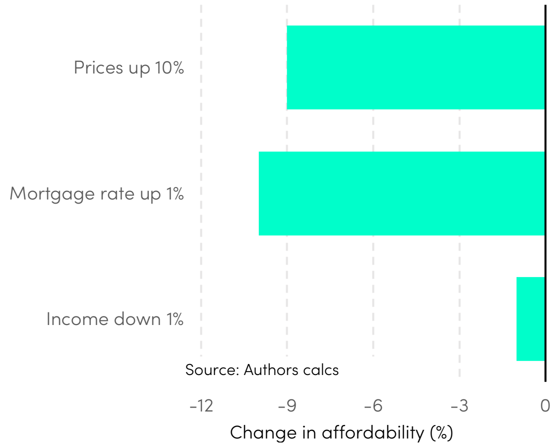
The monetary authorities, who control short-term interest rates, are particularly vocal on the interest rate outlook. The mantra from the RBA for most of 2021 was that rates were on hold until inflation was "sustainably" within the 2-3% target band and that "this condition will not be met before 2024". The message was clear.

What has muddied the water is the lift in global inflation rates in the second half of 2021 and in to 2022. Some central banks have lifted interest rates and signalled more to come.

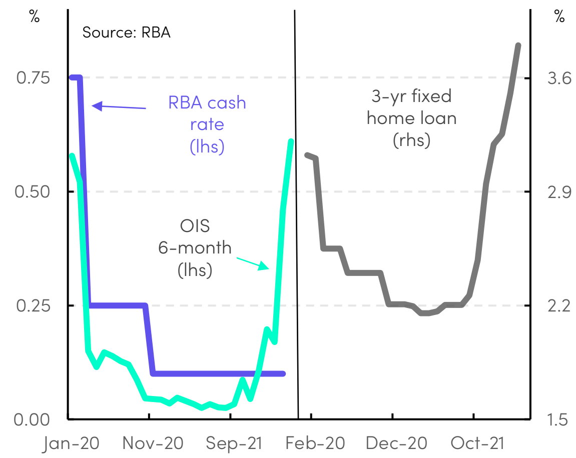
The RBA fought a valiant rear-guard action. RBA Governor Lowe insisted for many months that the Bank will be "patient" but he has been forced to acknowledge that interest rate rises are "plausible". The outsize increase in the Q1 CPI has put a rate rise on the table. The Q1 wage readings will probably cement that rate rise in place. Financial markets have taken the interest rates decision out of the RBA's hands (Chart 5):

- The Overnight Index Swap market (OIS), which provides an indication of where financial markets expect the RBA's cash rate to go, is pricing in significant rate rises.
- The RBA was essentially forced to abandon its target for keeping the yield on 3-year bonds at 0.1%. This target reflected the RBA's approach to quantitative easing (QE).

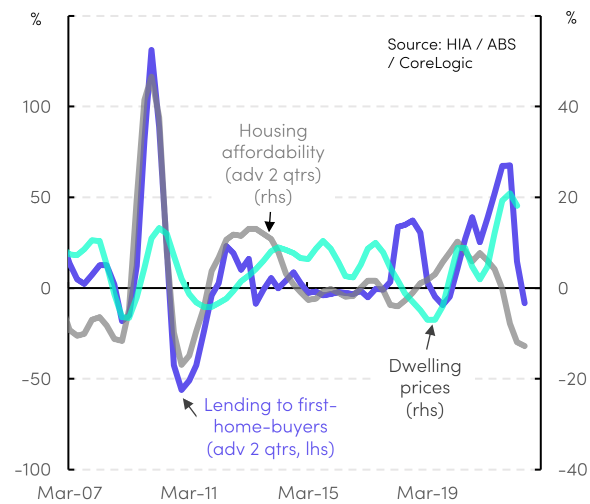
04. Housing Affordability
(impact from changes to key inputs)



05. Selected Interest Rates



06. Affordability, Lending & Prices
(annual % change)



- The commercial banks have already increased rates on fixed-rate home loans (which are now above pre- COVID-19 levels).

Rate rise risks

The risk is that the RBA begins lifting interest rates soon. The consensus is for the first move to follow the May or June RBA Board meetings. Experience shows that once the RBA overcomes its initial reluctance, rate rises proceed relatively quickly. Previous tightening cycles are generally complete within a twelve-month period.

It's been a long time between drinks. The last rate rise cycle commenced in October 2009 and was completed in November 2010. That twelve-year gap between then and now means many of today's borrowers have never experienced a tightening cycle. APRA data shows that 75% of current home loans were only funded in the past five years!

The *direction* of rates is one thing. But it is the *level* of rates that matters for affordability.

Central banks will always stress that initial moves on the rates front are not policy tightening. Rather it is about removing some of the policy stimulus. Once underway, however, the objective is usually about getting back to some neutral level of rates.

Fortunately, RBA Governor Lowe gave us some idea about where the neutral rate lies back in November 2021. He put neutral as "at least 2.5%". In best central bank fashion, he then immediately qualified that estimate by adding "if not 3.5%".

His guidance is more than a little vague. But given the usual sorts of spreads between the cash rate and mortgage rates, housing market participants could be looking at mortgage rates around 5-5½% by the second half of 2023. Based on the earlier sensitivity metrics, higher mortgage rates could reduce affordability by more than 20%.

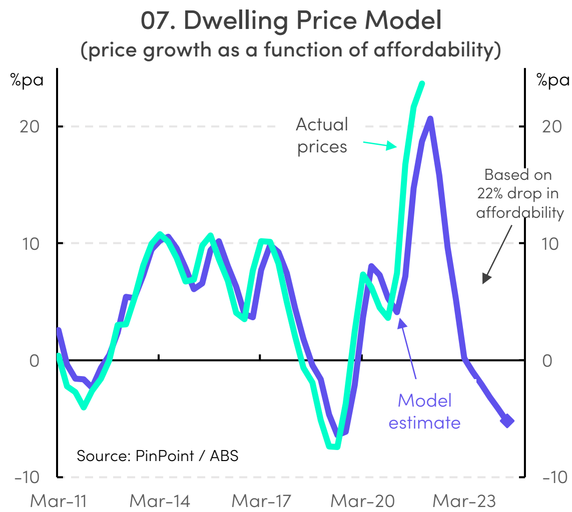
Affordability and dwelling prices

Interest rate changes don't occur in isolation. Other changes are also likely to follow a mortgage-rate-

Table 1: Dwelling Price Forecasts (%pa)

	2021 (a)	2022 (f)	2023 (f)
Sydney	27	2	-9
Melbourne	18	1	-8
Brisbane	24	9	-5
Adelaide	21	7	-6
Perth	16	2	-7
Hobart	28	5	-6
Darwin	17	3	-8
Canberra	26	7	-9
Australia	**22**	**3**	**-8**

Source: CBA / NAB / WBC / ANZ / CoreLogic



driven decline in affordability. Specifically, falling affordability can contribute to *lower* dwelling prices.

The transmission channel is well established. Lower affordability reduces housing demand, especially from first-home buyers. Furthermore, less housing demand can mean lower dwelling prices (Chart 6).

These sorts of considerations are why the research teams at the major banks are uniformly projecting lower dwelling prices for 2023 (Table 1). Any fall does, of course, need to be benchmarked against the large price rises of the past couple of years.

Some simulation analysis prepared for this report emphasises the point (Chart 7). The analysis uses a simple model that explains house price trends based on affordability and lagged dwelling prices (to capture the price momentum associated with the boom-bust cycle in prices).

Given the rise in mortgage rates to 5-5½% noted earlier, housing affordability drops by more than 20% (all else equal). Dwelling price growth would grind to a halt in 2022 before turning negative in 2023 (Chart 7).

The RBA has recently provided some support for this analysis. The RBA's April *Financial Stability Review* warns that "future increases in interest rates could also weigh on housing and other asset prices". Their more sophisticated house price model suggests that a 200bpt increase in interest rates would cut real house prices by 15% over two years.

Lower dwelling prices would, of course, offset some of the decline in affordability from higher mortgage rates. But the interest rate effect will dominate.

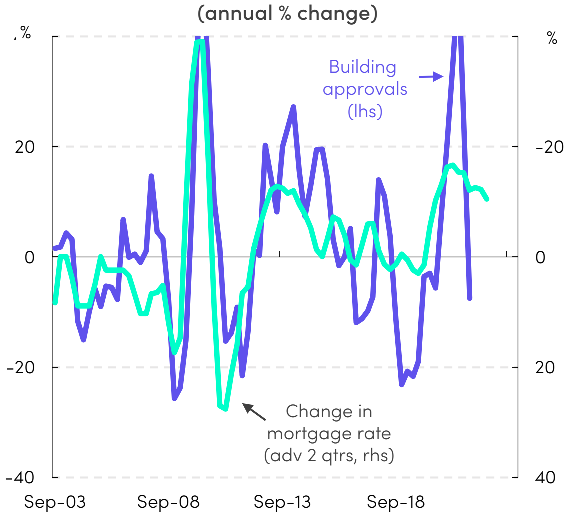
The construction pipeline is full

Lower affordability is typically a precursor to reduced construction activity as well (Chart 8). A lesser supply of new dwellings would normally moderate any downward pressure on dwelling prices.

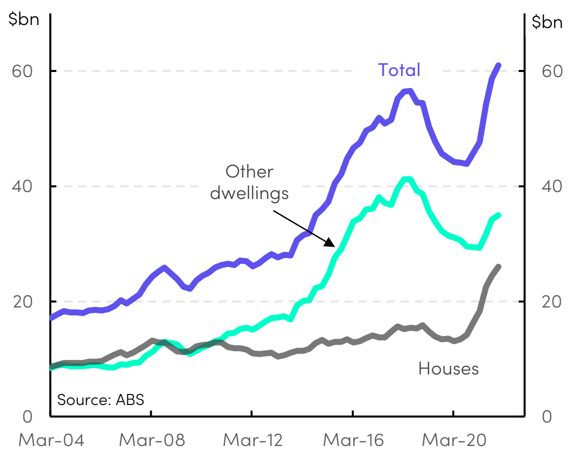
But the current construction cycle is different.

Low interest rates pushed up dwelling *commencements* to record highs. COVID-19-

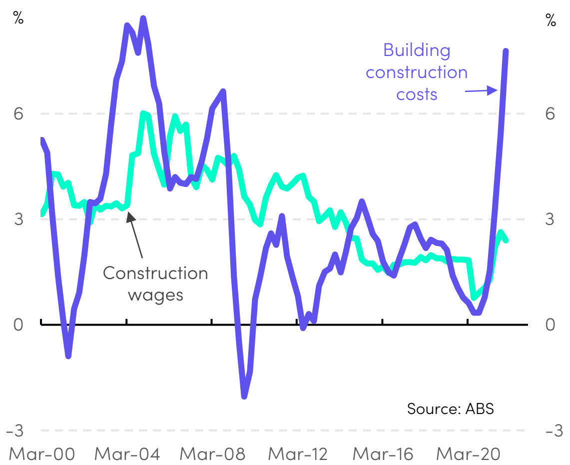
08. Building Approvals & Rates
(annual % change)



09. Construction Pipeline



10. Construction Cost Indicators



related disruptions cut dwelling *completions* to the lowest level since 2014. The pipeline of construction activity is full as a result.

The pipeline sits, in fact, at record highs (Chart 9). The ABS data shows some $50 billion of residential construction underway, with a further $11 billion of activity approved but not yet commenced.

About 60% of this pipeline is in the medium-high density segment favoured by downsizers. Allowing for the usual 6-7 quarter construction time frame, the risk is that a significant amount of new supply will hit the market at a time of low affordability. This additional supply could place further downside pressure on dwelling prices.

The sheer volume of construction activity (non-residential as well as residential) partly explains the lift in inflationary pressures across the Australian economy. ABS data shows building construction costs rose by 7.8% during 2021, the fastest rate of increase since 2004. Construction sector wages rose by 2.4% in 2021. Growth at that sort of pace was last seen back in 2013 (Chart 10).

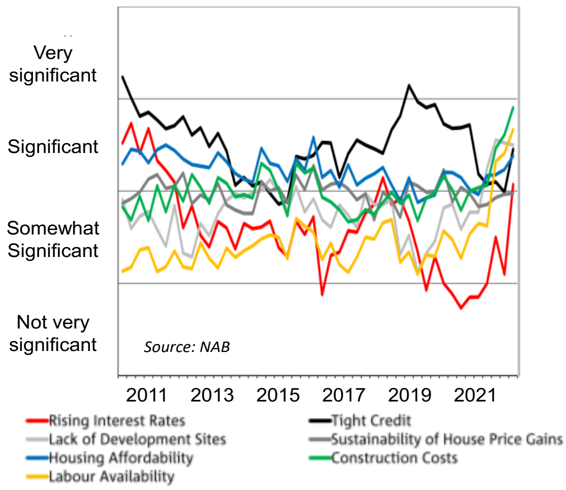
Business surveys on the perceived constraints on new housing developments also make the point. Survey respondents include real estate agents/managers, property developers, asset/fund managers and owners/investors.

The big issues at present are construction costs, labour availability and lack of suitable development sites (Chart 11).

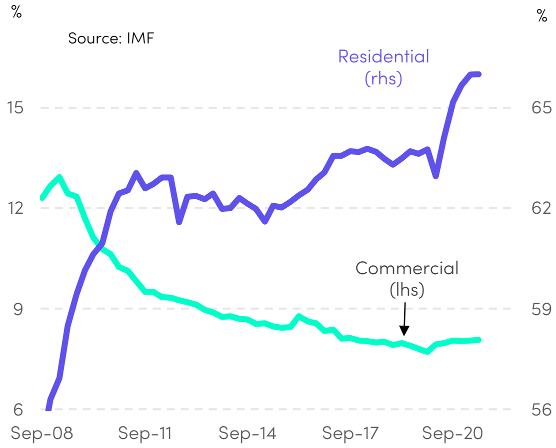
Financial considerations such as interest rates, housing affordability and credit availability were seen as relatively minor constraints. But speculation about higher interest rates saw concern about these factors rise quickly in the latest survey at the end of 2021.

For developers, the "perfect storm" could involve falling dwelling prices at a time of rising construction costs, higher borrowing costs and an excess supply of dwellings.

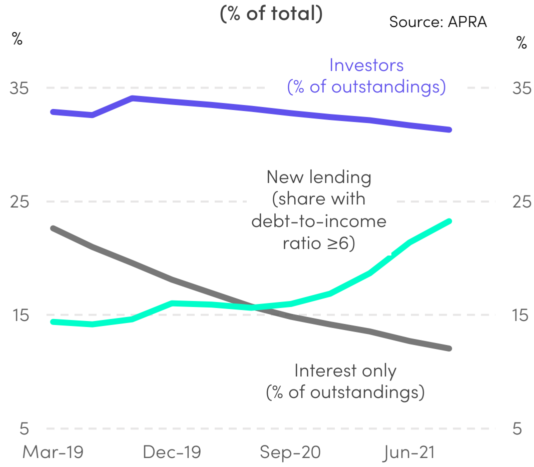
11. New Housing Developments
(perceived constraints)



12. Bank Real Estate Exposures
(% of total loans)



13. Bank Residential Exposures
(% of total)



Affordability and incomes

The general expectation is that the Australian economy will turn in a respectable economic performance in 2022. Lower unemployment should be one outcome. And normally that would flow through to wages and income growth as well.

But a forecaster's life is full of disappointment. One persistent disappointment is the failure of national wages growth to lift. Any support to housing affordability in the year ahead from rising incomes seems unlikely.

Housing and financial stability

Policy makers also worry about the housing market from a financial stability perspective. It is the banks' biggest exposure (Chart 12). Residential property accounts for 66% of bank books, so problems with housing can have a big impact on the banks.

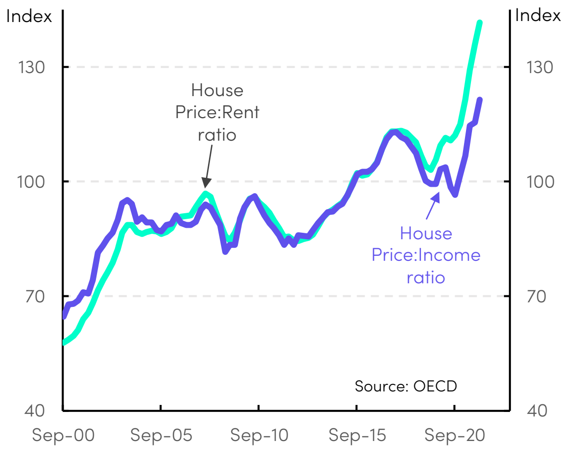
Interest rates are not the only policy tool available to influence the housing market. Macroprudential measures imposed by the Australian Prudential Regulation Authority (APRA) are a risk factor to consider. These measures are typically designed to impact on the supply of credit.

The regulators, for example, have previously worried about the amount of borrowing by investors and the dominance of interest-only lending. The actions they took in 2015-16 successfully reduced lending. And dwelling prices, sales and construction activity all weakened.

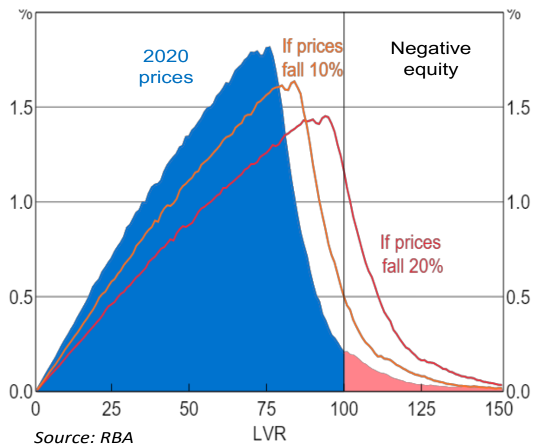
The regulators did take another step down the macroprudential path in 2021 by lifting the interest rate margin on loan serviceability. They have hinted at further action given concerns about the share of high debt-to-income lending in Australia (Chart 13).

So even if the RBA remains on the sidelines in the year ahead, APRA may take further steps.

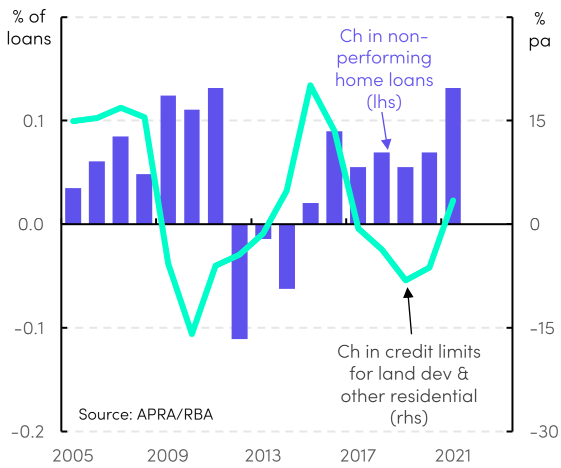
14. Dwelling Price Ratios



15. LVR Distribution
(% of balances | 2020)



16. Lending & Loan Performance



The risks of a policy mistake

When the monetary authorities and banking regulators set off on their policy adventures they always do so with the best of intentions. They want to head off inflation pressures or contain financial stability risks.

i. The one rate rise, too many

The problem lies with calibration. There is always a risk of going too far and making a policy mistake. The very high interest rates in the late 1980's, for example, helped Australia join the low inflation club. But those rates arguably also deepened and prolonged the early 1990's recession.

ii. From boom to bust

A perennial fear in the residential market is that housing is overvalued and in imminent danger of a price collapse. Rising mortgage rates and other policy changes would almost certainly freshen up those fears.

Most debate centres around valuation metrics such as price:income ratios or price:rent ratios (Chart 14). These ratios have ratcheted up over time. And they are above long-run averages.

Falling dwelling prices would correct some of the perceived imbalances in the housing market. But falling prices would create new problems elsewhere.

iii. Negative equity

Some scenario analysis conducted by the RBA in 2020, for example, looked at the risk of negative equity (where a home loan *exceeds* the property value). The RBA concluded that a 10% drop in housing prices would raise the share of loans in negative equity by 3½ percentage points (Chart 15). The share of loans in negative equity would increase by proportionately more for larger price declines.

Note that the rise in dwelling prices since the analysis was undertaken in 2020 has reduced the share of loans in negative equity. The share currently sits at less than ¼% (vs 2¼ per cent in early 2020).

Nevertheless, the conclusions about the sensitivity of negative equity to house prices remain sound.

iv. Lending caution

The risk of losses for lenders would be expected to make them more cautious in their lending activities. There is a tendency, for example, for rises in the share of non-performing housing loans to be associated with a reduction in credit limits for land development and other residential lending (Chart 16).

It should be stressed that the discussion here is about the importance of affordability in many parts of the housing story, and the *risks* to affordability over the next couple of years.

It should also be stressed that the Australian financial system is well-run, well-regulated, and profitable. Concerns about falling dwelling prices are a long-running feature of the Australian housing market. But the housing market has passed the many stress tests imposed on it over the past couple of decades and emerged in pretty good shape.

Scan to learn more.

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