

# **The \$4 trillion part of the economy that few people really understand...**



**Melbourne Institute**  
**2009 Economic and Social Outlook Conference**  
November 2009



## 1. Introduction

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- Policy confusion surrounding “**housing affordability**”:
  - Cost of buying a home?
  - Cost of renting a home?
  - Cost of producing new housing?
- Nebulous “affordability” concept typically confuses **five things**:
  1. Cost of owner-occupation (house prices)
  2. Cost of rental accommodation
  3. Cost of mortgage debt
    - Home loan rates (determined by RBA)
  4. Disposable household incomes
    - Determined by tax rates, employment conditions, economic activity etc
  5. Cost of producing new housing
    - Cost of land
    - Cost of building materials
    - Heavily influenced by regulation



## 1. Introduction

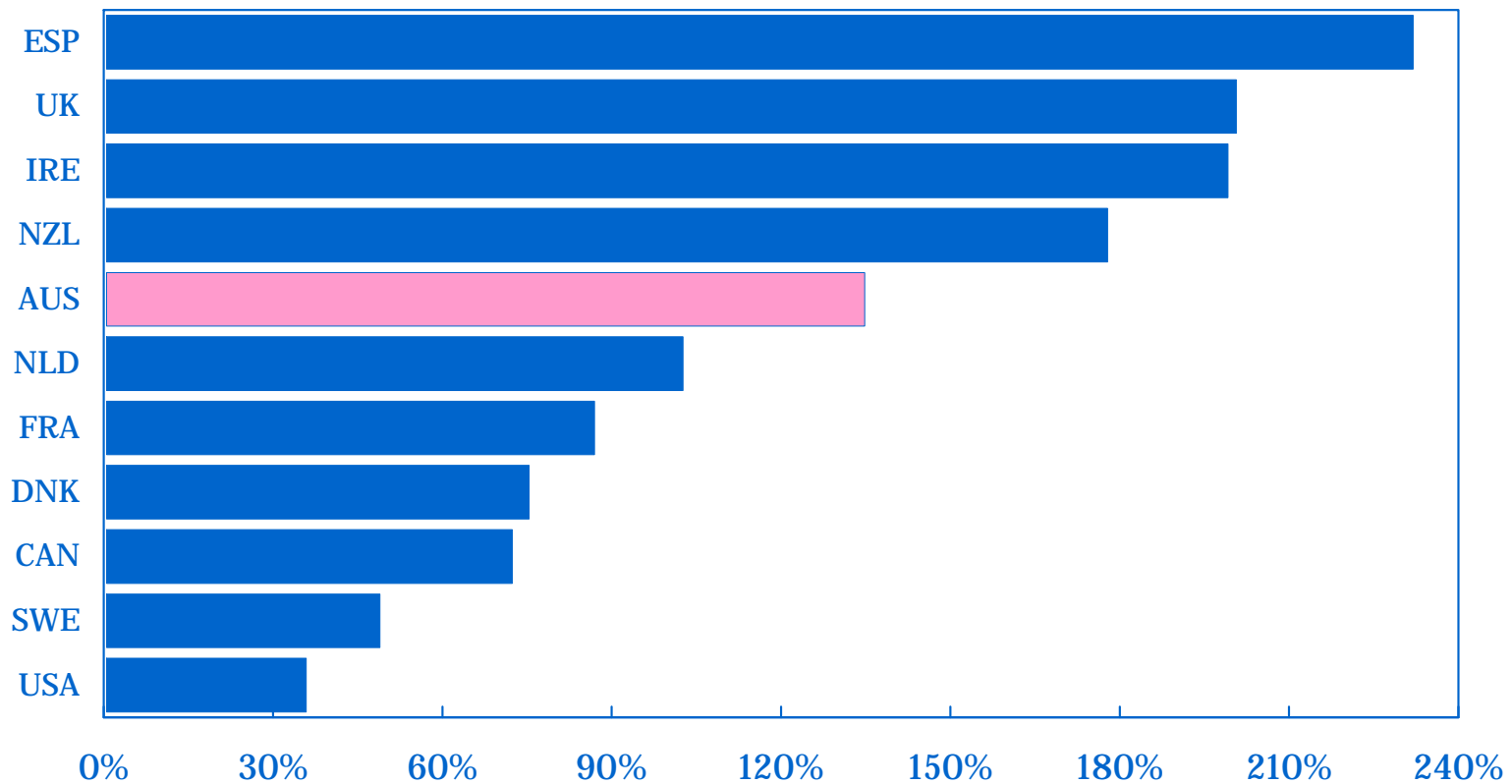
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- Today I will examine seven issues:
  1. *Have our house prices risen too quickly?*
  2. *Have our house price-to-income ratios risen too quickly?*
  3. *What is the state of home buyer affordability?*
  4. *What is the state of rental affordability?*
  5. *Has the cost of producing new housing increased?*
  6. *Innovative supply-side policy solutions*
  7. *Innovative demand-side policy solutions*



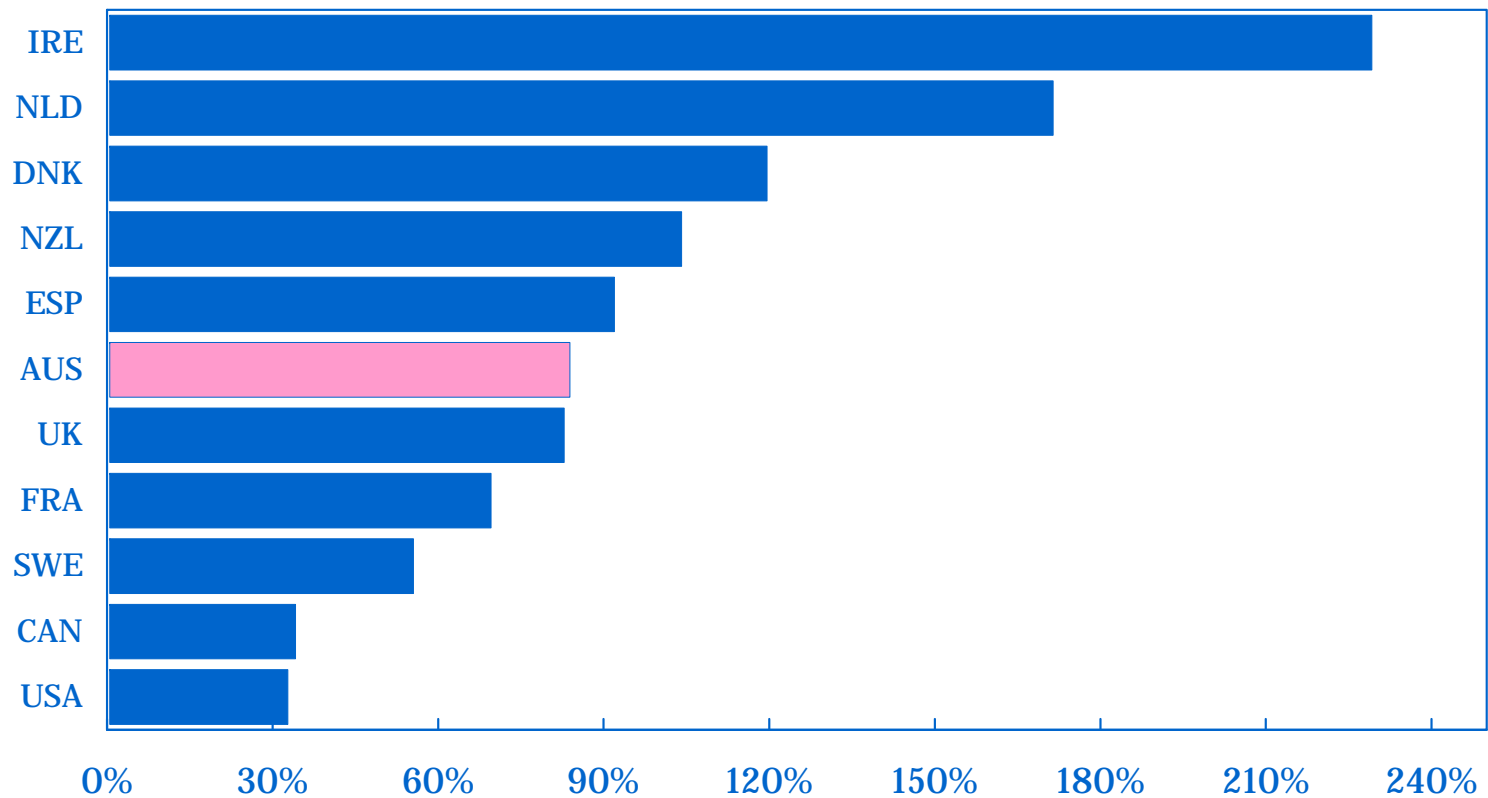
## 2. Have Our House Prices Risen Too Quickly—1980 to 2008?

**IMF Analysis of Real House Prices:  
1980 to 2008; Cumulative Growth Rate**



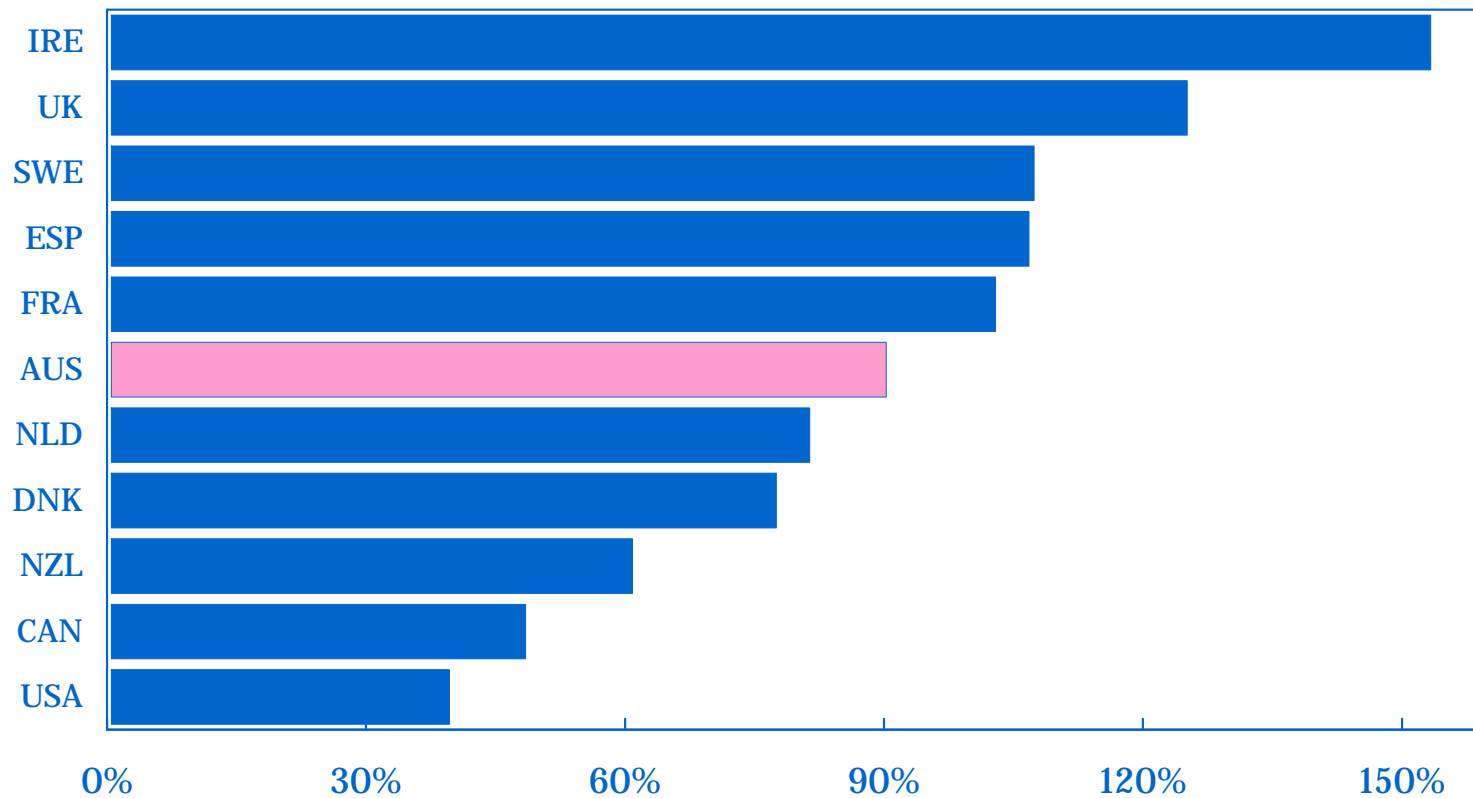
## 2. Have Our House Prices Risen Too Quickly—1990 to 2008?

**IMF Analysis of Real House Prices:  
1990 to 2008; Cumulative Growth Rate**



## 2. Have Our House Prices Risen Too Quickly—1997 to 2008?

**IMF Analysis of Real House Prices:  
1997 to 2008; Cumulative Growth Rate**



## 2. Have Our House Prices Risen Too Quickly—Summary?

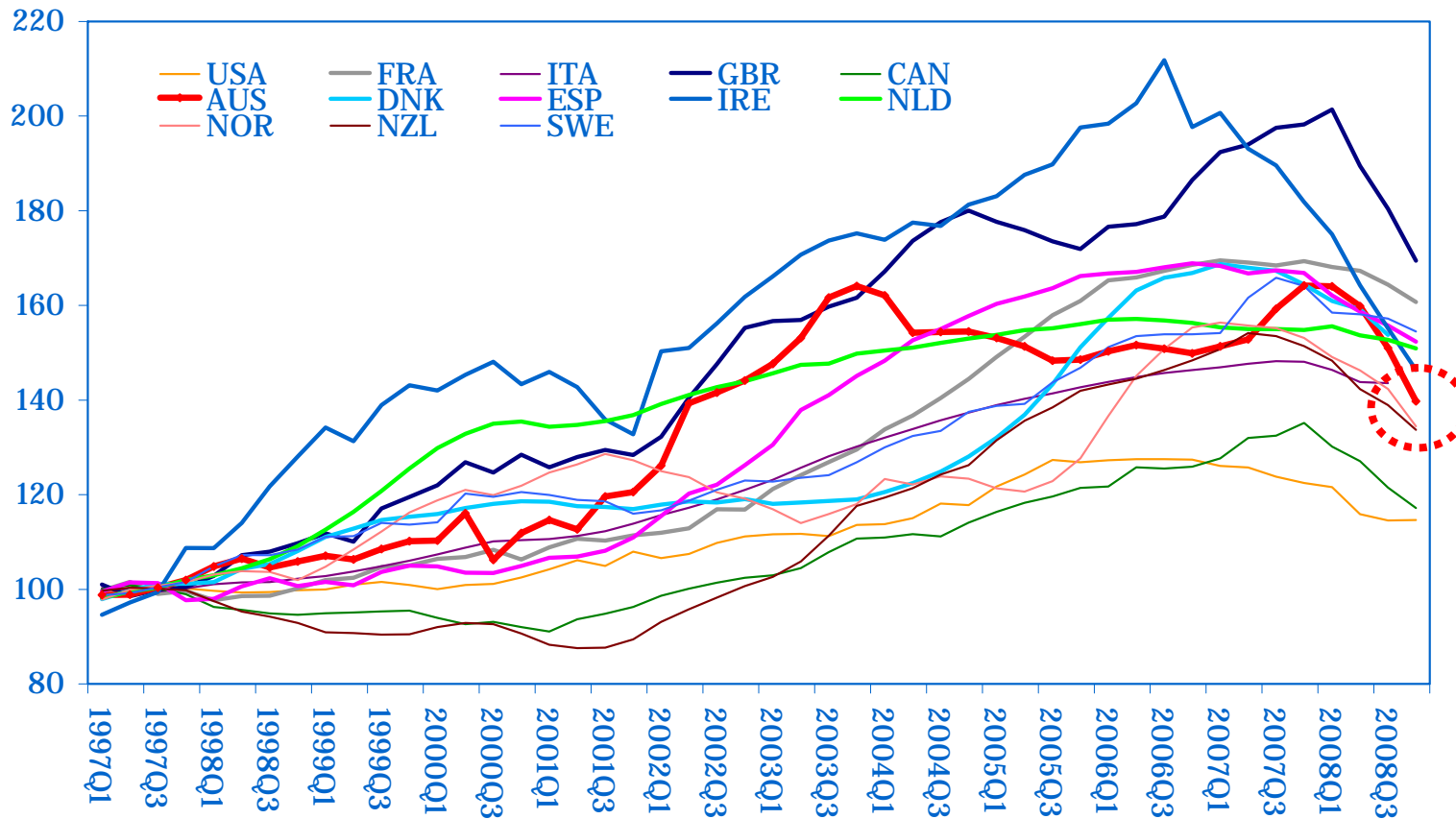
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- Key conclusions based on IMF data:
  - **Between 1980-2008** house price growth was **slightly above average peer**
    - Spain, Ireland, UK and New Zealand outperformed
  - **Between 1990-2008** house price growth was **slightly below average peer**
    - Spain, Ireland, New Zealand, Netherlands and Denmark outperformed
  - **Between 1997-2008** house price growth was **in line with average peer**
    - Spain, Ireland, UK, France and Sweden outperformed



### 3. Have Our House Price-to-Income Ratios Risen Too Quickly?

**IMF Analysis of International House Price-to-Income Ratios: 1997: 100; 1997 to 2008**



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### **3. Have Our House Price-to-Income Ratios Risen Too Quickly?**

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- Based on IMF data, between 1997 and 2008 Australia's house price-to-income growth was **lower than** the following peers:
  - UK
  - France
  - Sweden
  - Spain
  - Netherlands
  - Ireland
- Australia's house price-to-income growth was **higher than** the following peers:
  - US
  - Canada
  - Italy (just)
  - New Zealand (just)
  - Norway (just)
- Key conclusion: no evidence of unusually high growth in housing costs
- Sample period may disadvantage Australia given only small correction in 2008



### **3. Cannot compare “levels” across countries**

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- **Erroneous inferences drawn from house-price-to-income ratio levels**
  - Demographia: Bundaberg less affordable than New York/London!
- **Absolute comparisons do not work because of differences in international**
  - house price collection and measurement methodologies
  - legal and tax treatment of housing
  - home ownership rates
  - urban densities
  - population growth rates
  - the distribution of income
  - economic characteristics of representative home owner
- **IMF correctly compares *growth rates* over time rather than levels**



## 4. Where Does the (Previously Hawkish) IMF Stand?

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- October 2009 IMF World Economic Outlook Report findings:

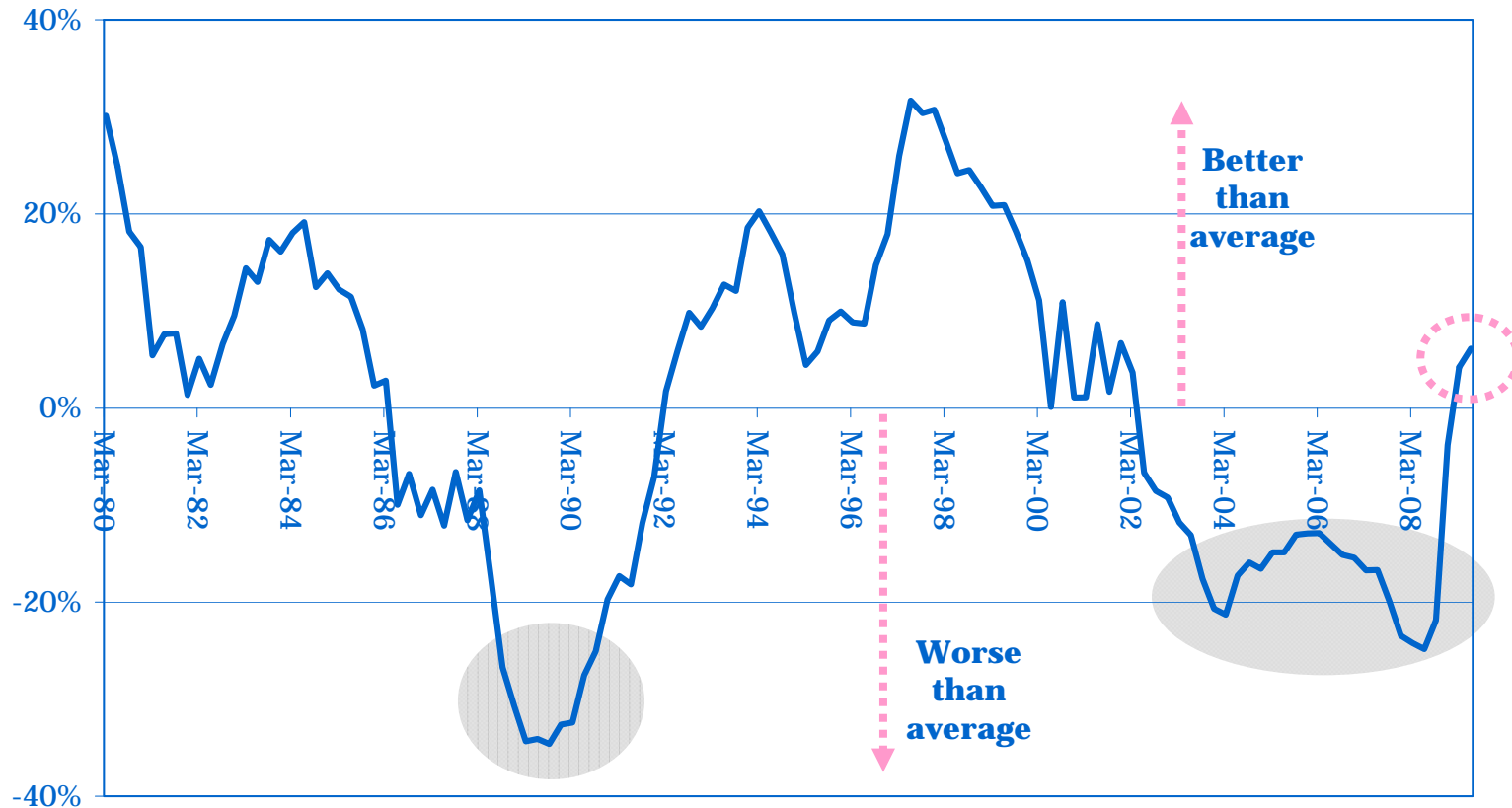
***“In the case of Australia, if the impact of long-term migration on housing demand is taken into account, the results do not produce evidence of a significant overvaluation of house prices.”***

***“If past is prologue, these estimates suggest that the Netherlands and Finland are likely to see further house price declines, whereas the corrections in Australia and the United States are close to complete...”***



## 5. Historical Home Buyer Affordability (RBA)

**RBA Housing Affordability Index:  
Deviation from Long-Run Average; 1980 to 2009**



Note: Index represents ratio of average household disposable income to the required monthly repayment for the median priced home (houses and apartments) financed with a 25-year loan assuming an 80 per cent LVR at the full-doc prime mortgage rate.



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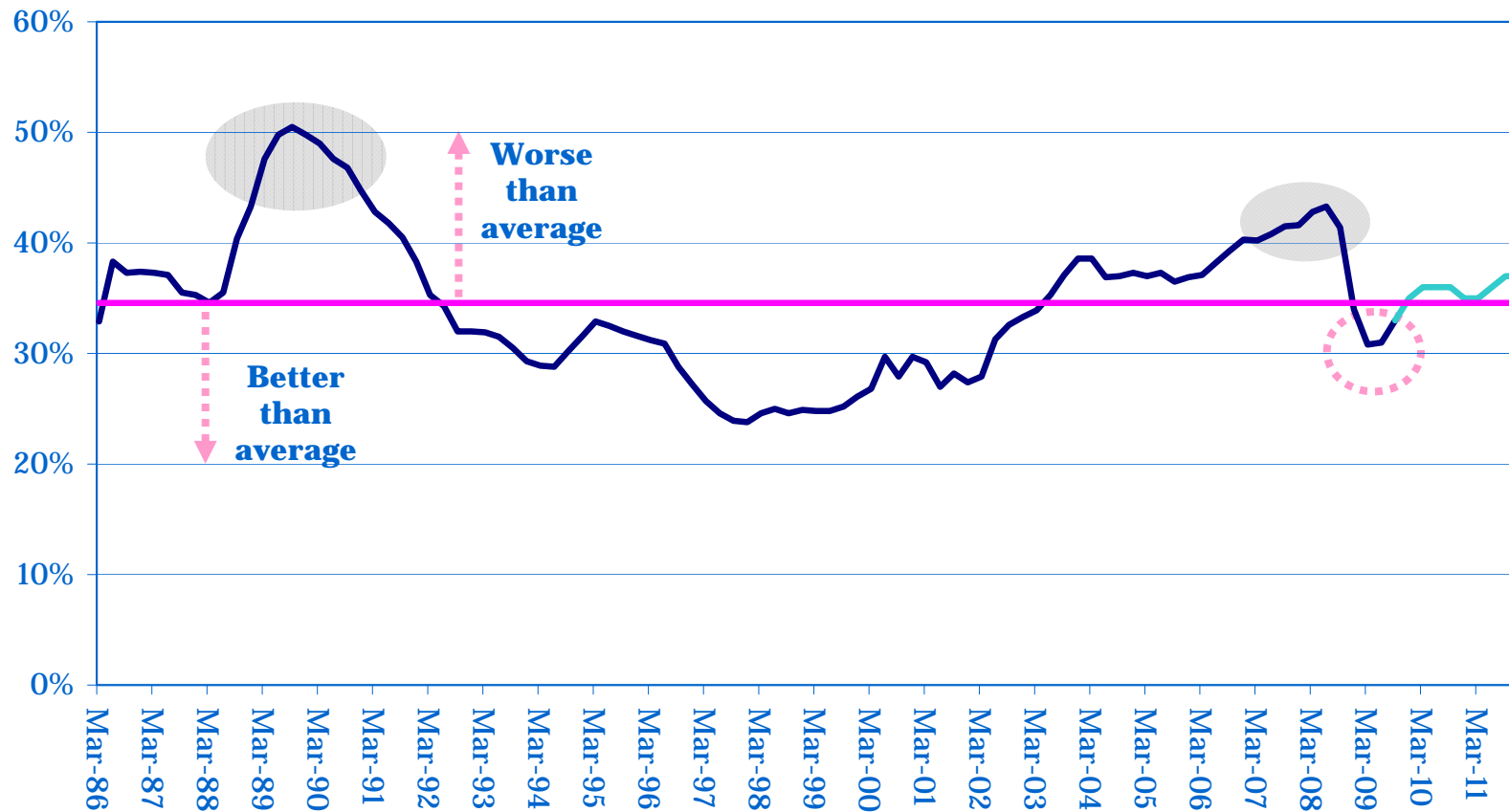
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## 5. Historical Home Buyer Affordability (ANZ Forecasts)

**ANZ House Purchase Affordability:  
Mortgage Repayments as a % of Disposable Income; 1986 to 2011**



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## 5. Home Buyer Affordability Summary

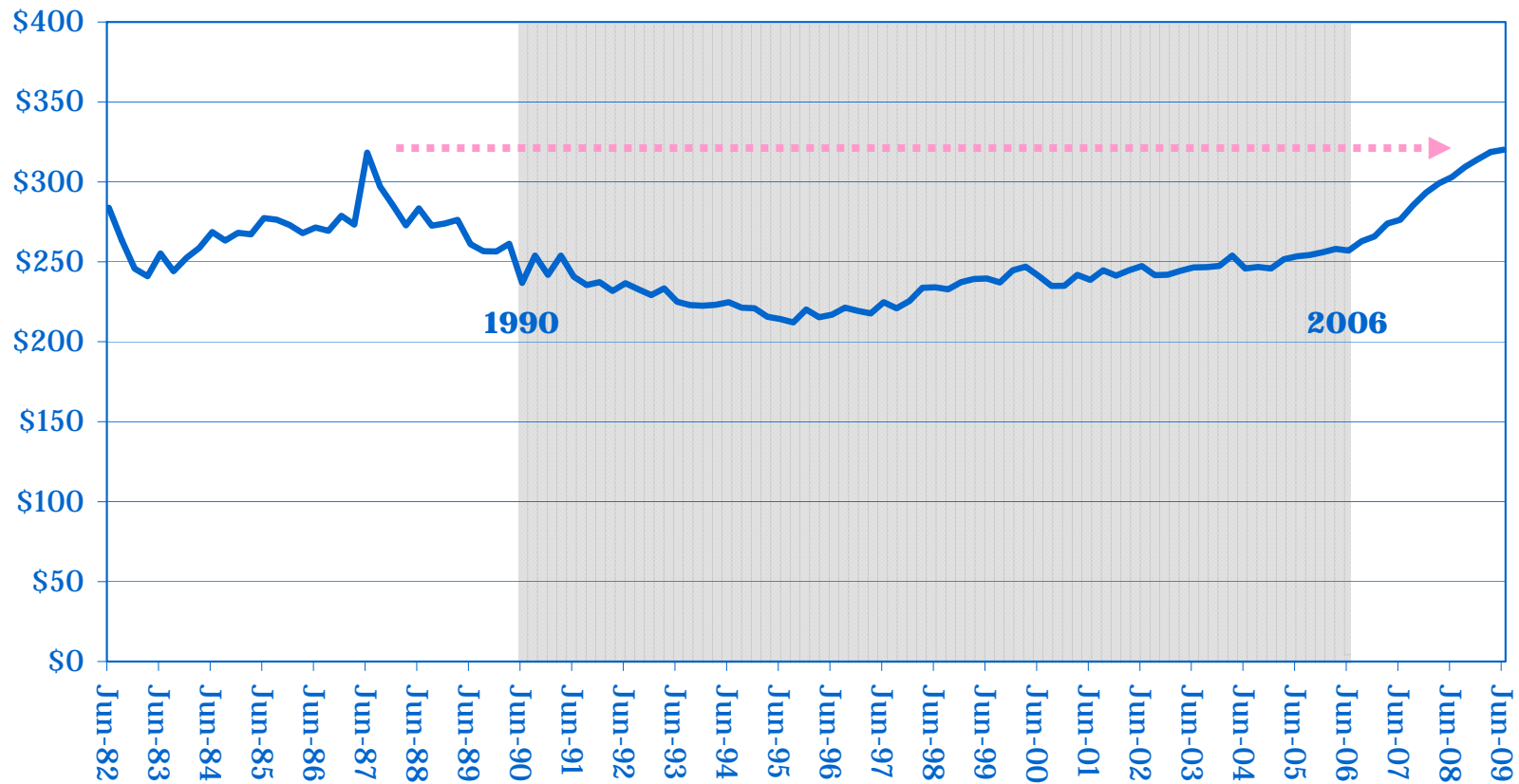
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- Poorest affordability conditions in 2000s significantly **better than late 1980s lows**
- Current housing affordability **better than long-term average** (since 1980)
- Current mortgage repayments as share of deposable income **better than average**
- ANZ forecasts housing affordability to be slightly worse than **average** through to 2011



## 6. Historical Rental Affordability (REIA 3 Bedroom Houses)

**Real Australian Median Rents:  
REIA; 1982 to 2009**



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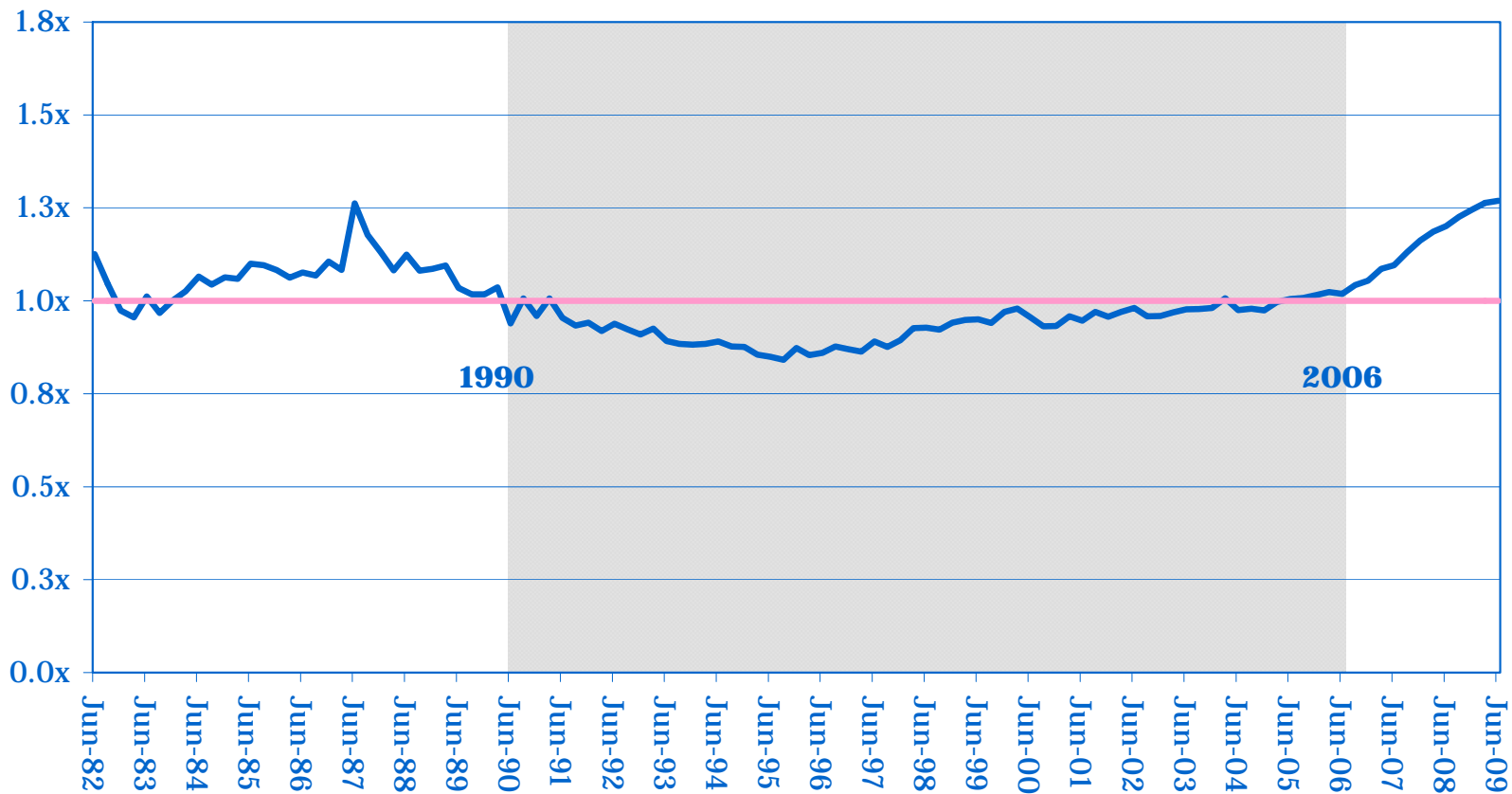
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## 6. Historical Rental Affordability (REIA 3 Bedroom Houses)

**Ratio of Real Median Rents to Long-Term Average:  
REIA; 1982 to 2009**





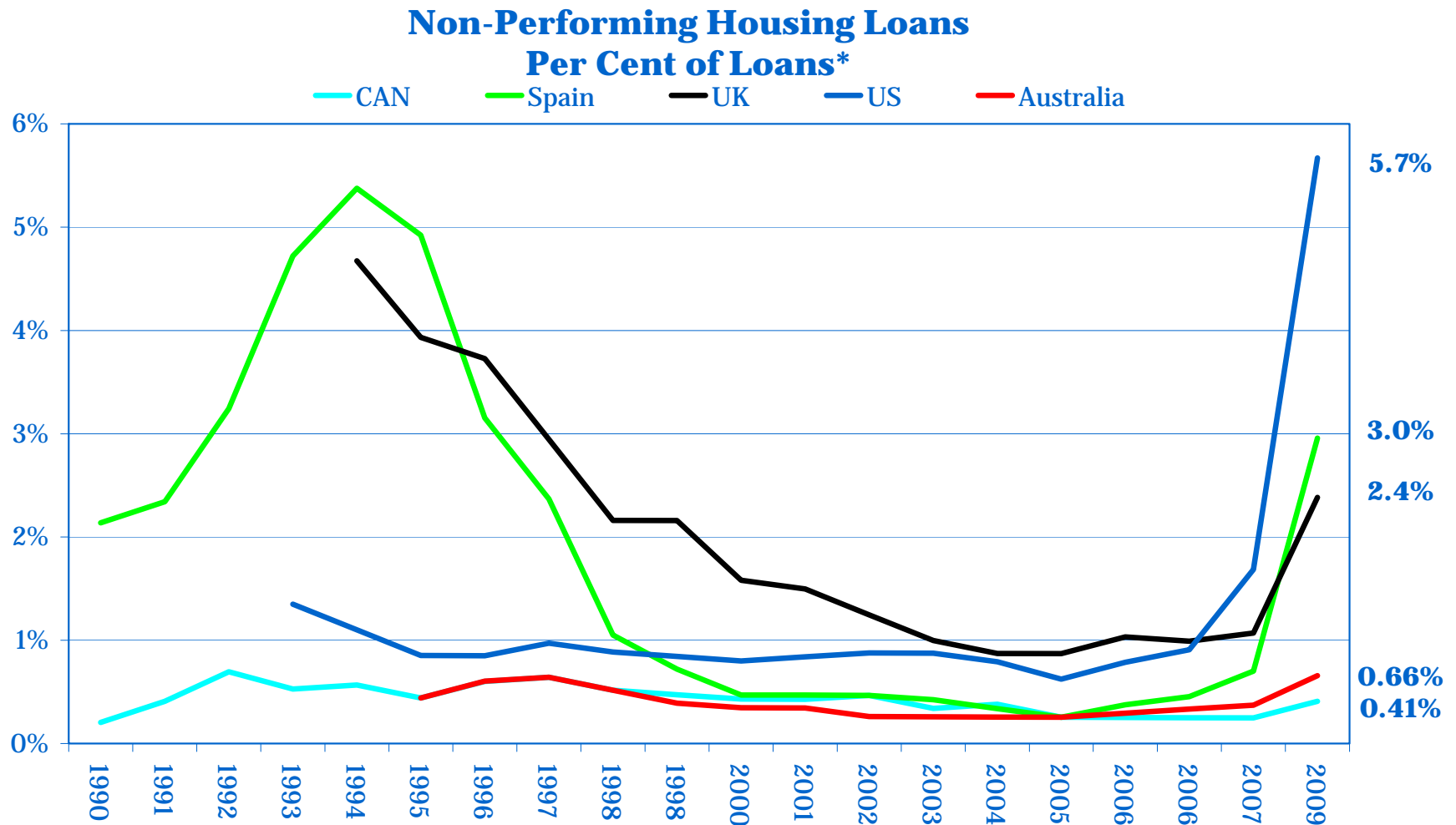
## 6. Rental Affordability Summary

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- Little inflation-adjusted change in cost of rental accommodation since 1982
- Rental affordability was **better than average between 1990 and 2006**
- Rental affordability **currently worse than average** due to record low vacancy rates
- Important market signal to private investors to produce new housing supply



## 7. Australian Mortgage Stress? Amongst Lowest in the World...



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## 8. House Price and Affordability Summary

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- Australian house price growth has not been unusually high
  - Many countries realised higher growth
- Inflation-adjusted rents historically well-contained but currently higher than average
  - Surprisingly little change in real rents over time
- Housing purchase affordability currently better than average
  - Recent lows much better than late 1980s
- Mortgage stress much lower than many other countries
  - Australia has one of the lowest long-term default rates in the world
- **If house prices rise too strongly and affordability deteriorates**
  - Demand-side response: lower demand
  - Supply-side response: higher housing investment
- National house prices have very low volatility of 3-4% per annum
  - Market prices will naturally respond to changing demand and supply conditions



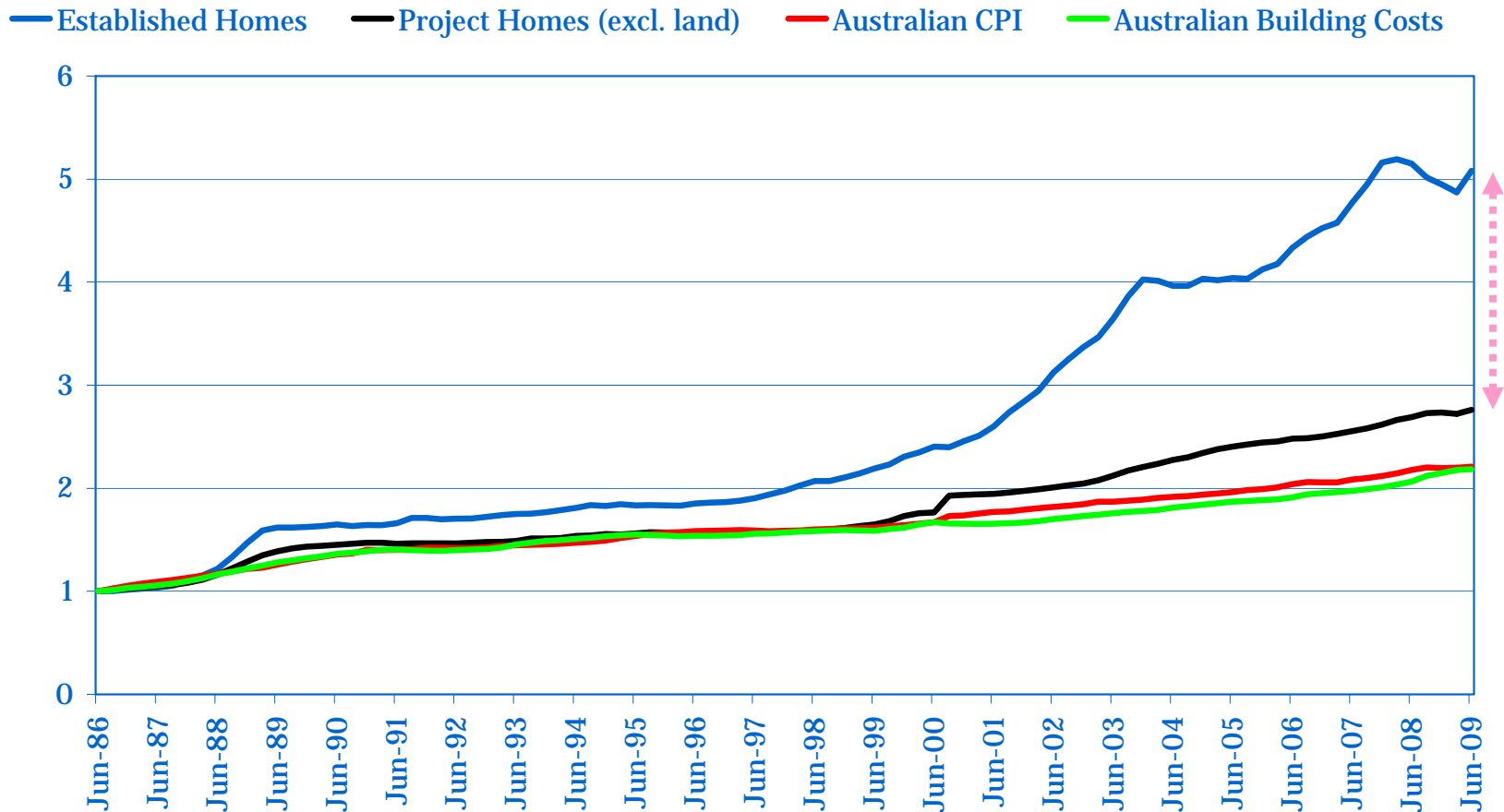
## 9. Supply-side: The Cost of Producing New Housing

- Prior to 2003 Prime Minister’s Home Ownership Task Force, real house price growth in Australia explained by “demand-side” factors:
  - Secular decline in inflation and interest rates
  - Secular decline in unemployment
  - Rise of non-bank lenders and securitisation
  - Benign economic conditions—the Great Moderation
- Supply-side was absent from housing debate
- 2003 Task Force was first study to demonstrate growing gap between the price of housing in Australia and the underlying costs of production
  - Compare price of ABS established homes that **include land** with
    - Project homes that **exclude land**
    - Building materials prices
    - Inflation (CPI)



## 9. Supply-side: The Cost of Producing New Housing

**The Extrinsic Value of Land: Australia; 1986 to 2009**



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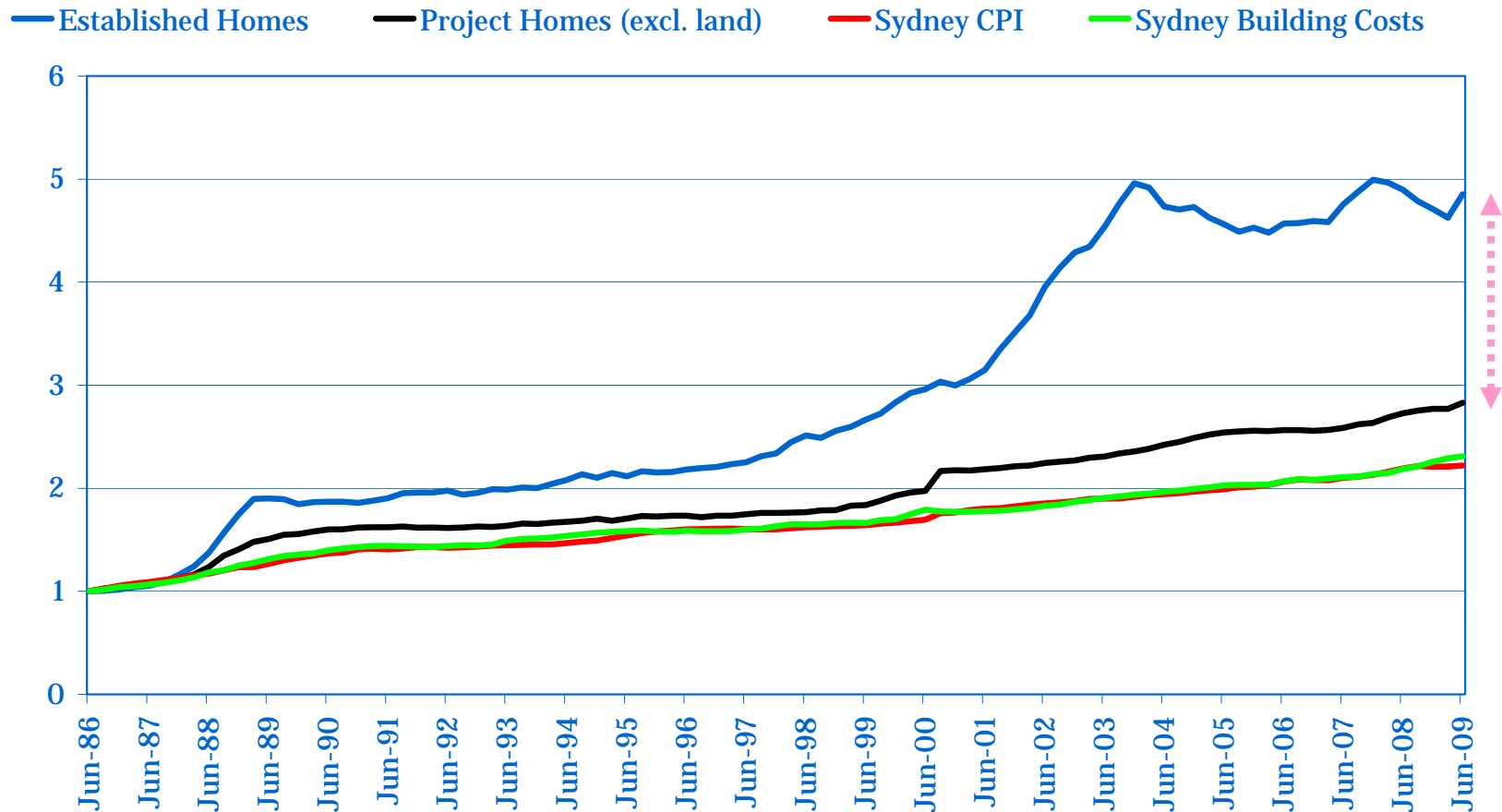
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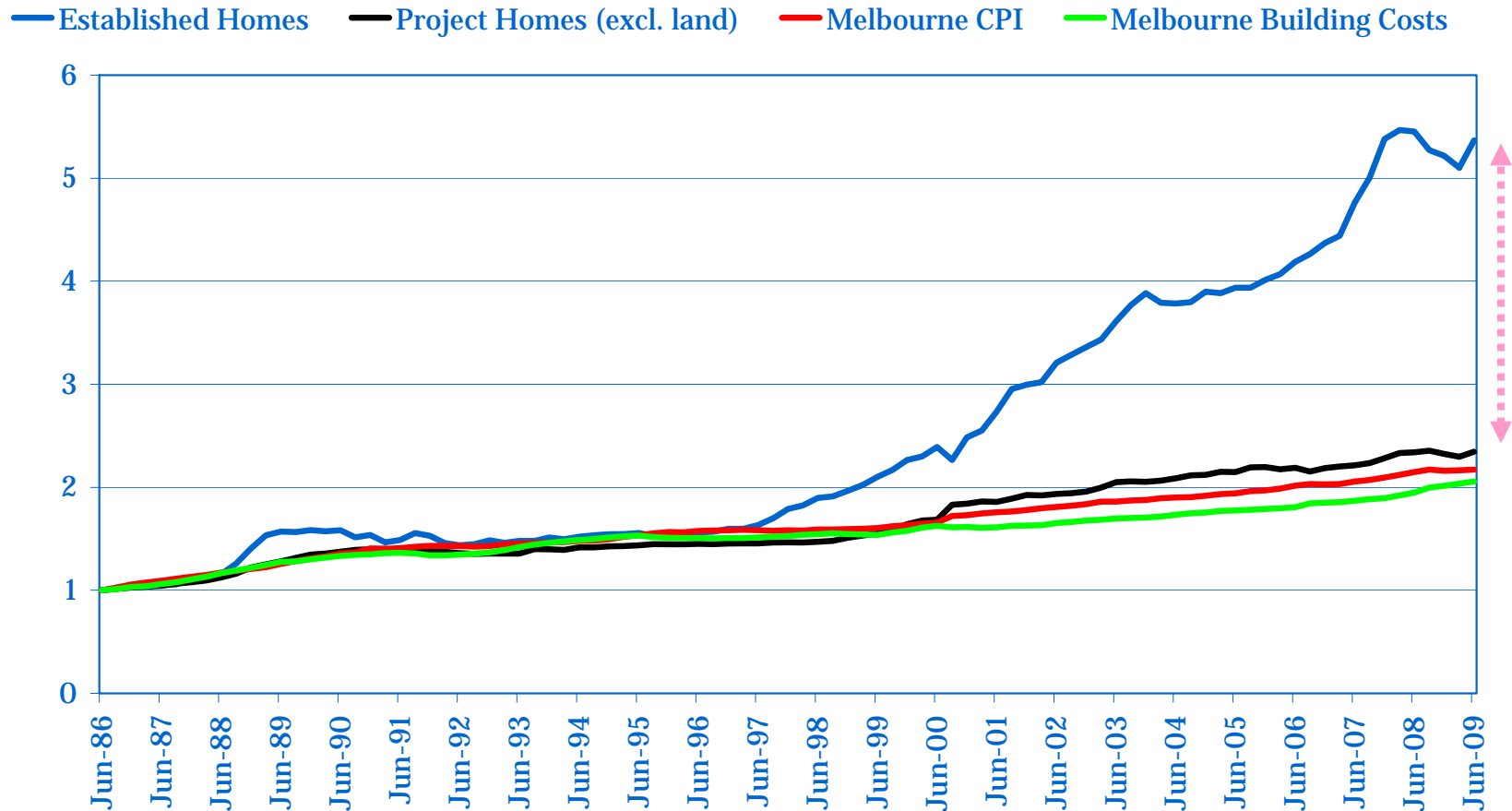
## 9. Supply-side: The Cost of Producing New Housing

**The Extrinsic Value of Land: Sydney; 1986 to 2009**



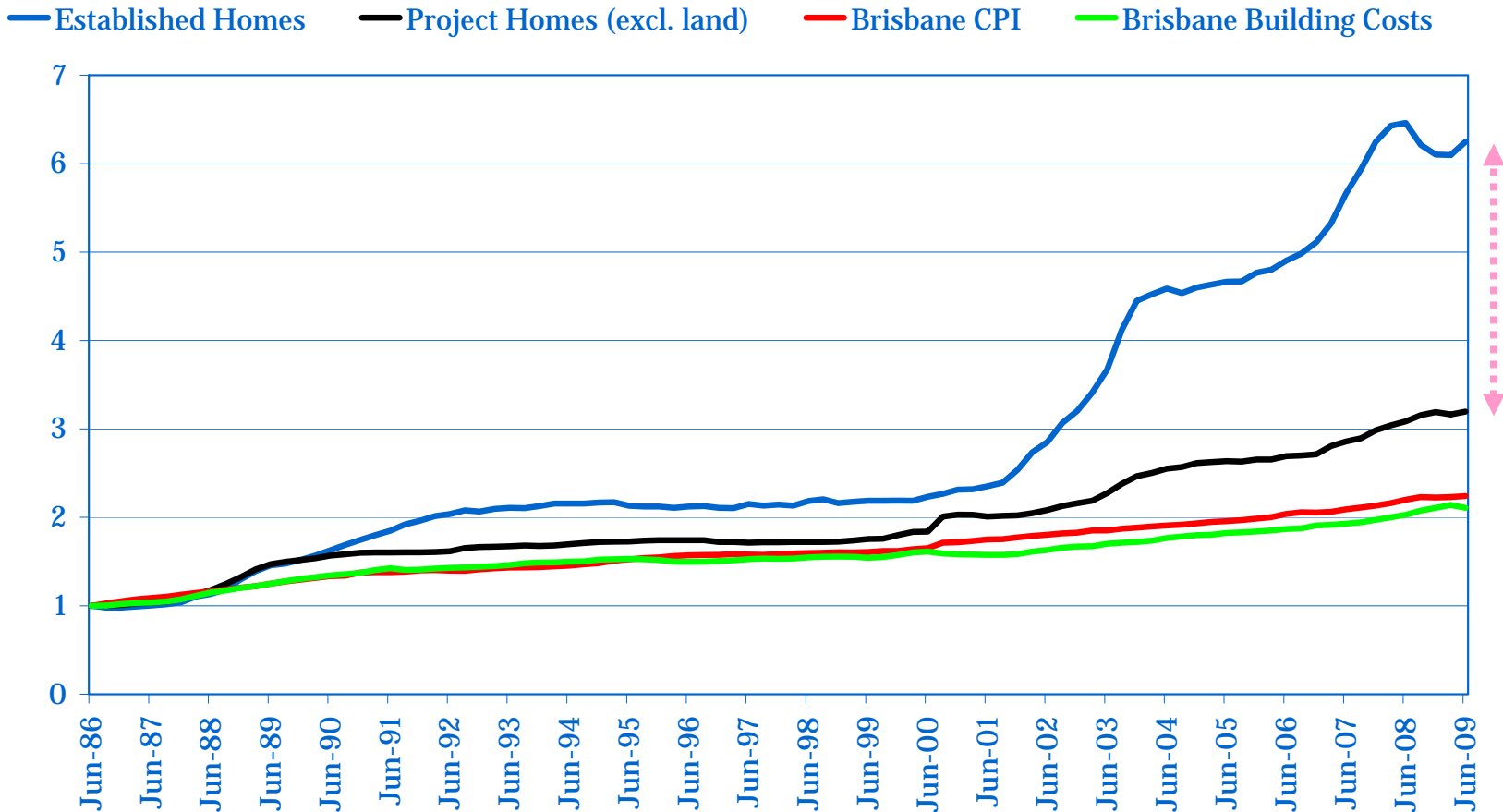
## 9. Supply-side: The Cost of Producing New Housing

**The Extrinsic Value of Land: Melbourne; 1986 to 2009**



## 9. Supply-side: The Cost of Producing New Housing

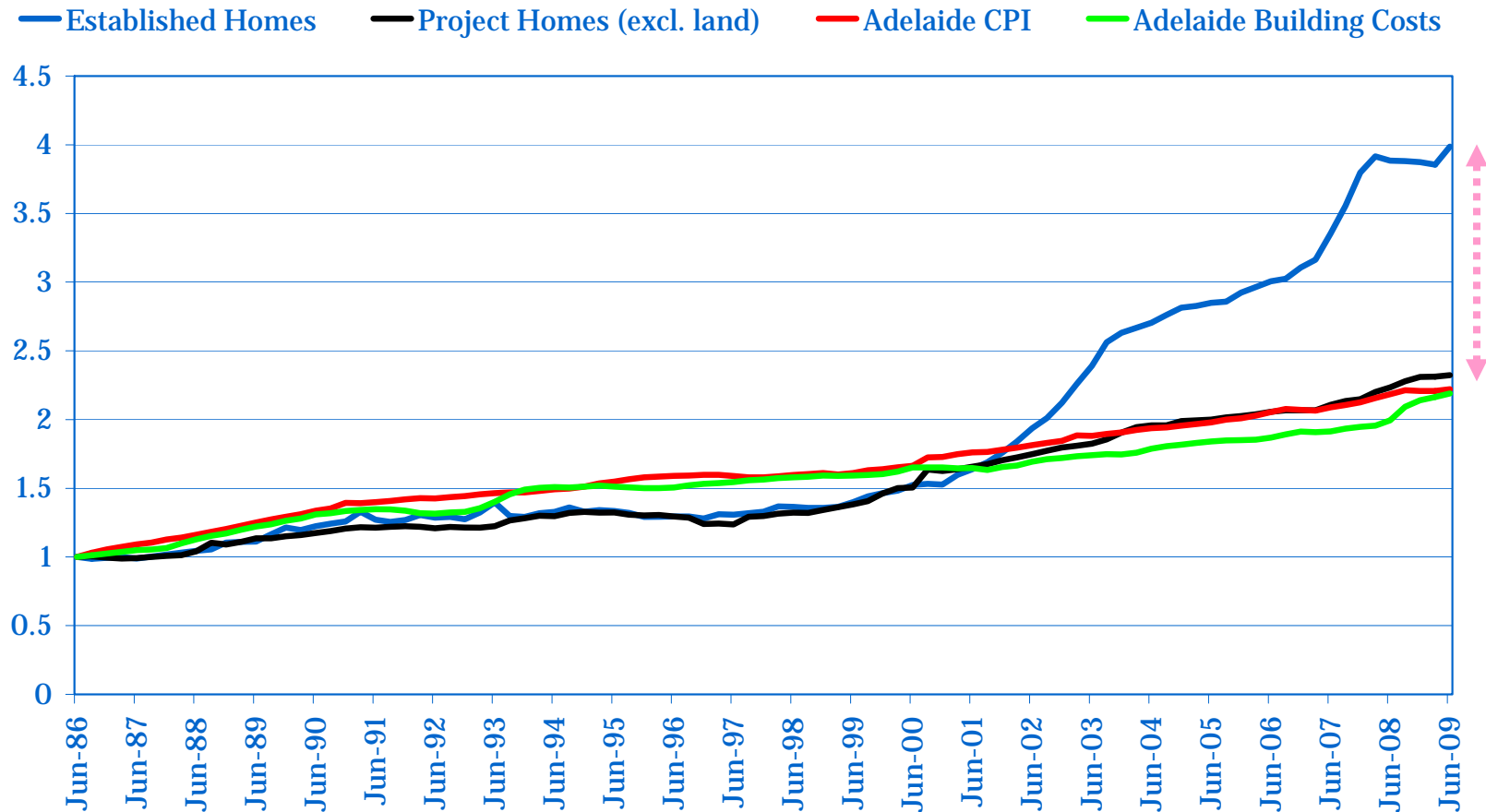
**The Extrinsic Value of Land: Brisbane; 1986 to 2009**





## 9. Supply-side: The Cost of Producing New Housing

**The Extrinsic Value of Land: Adelaide; 1986 to 2009**



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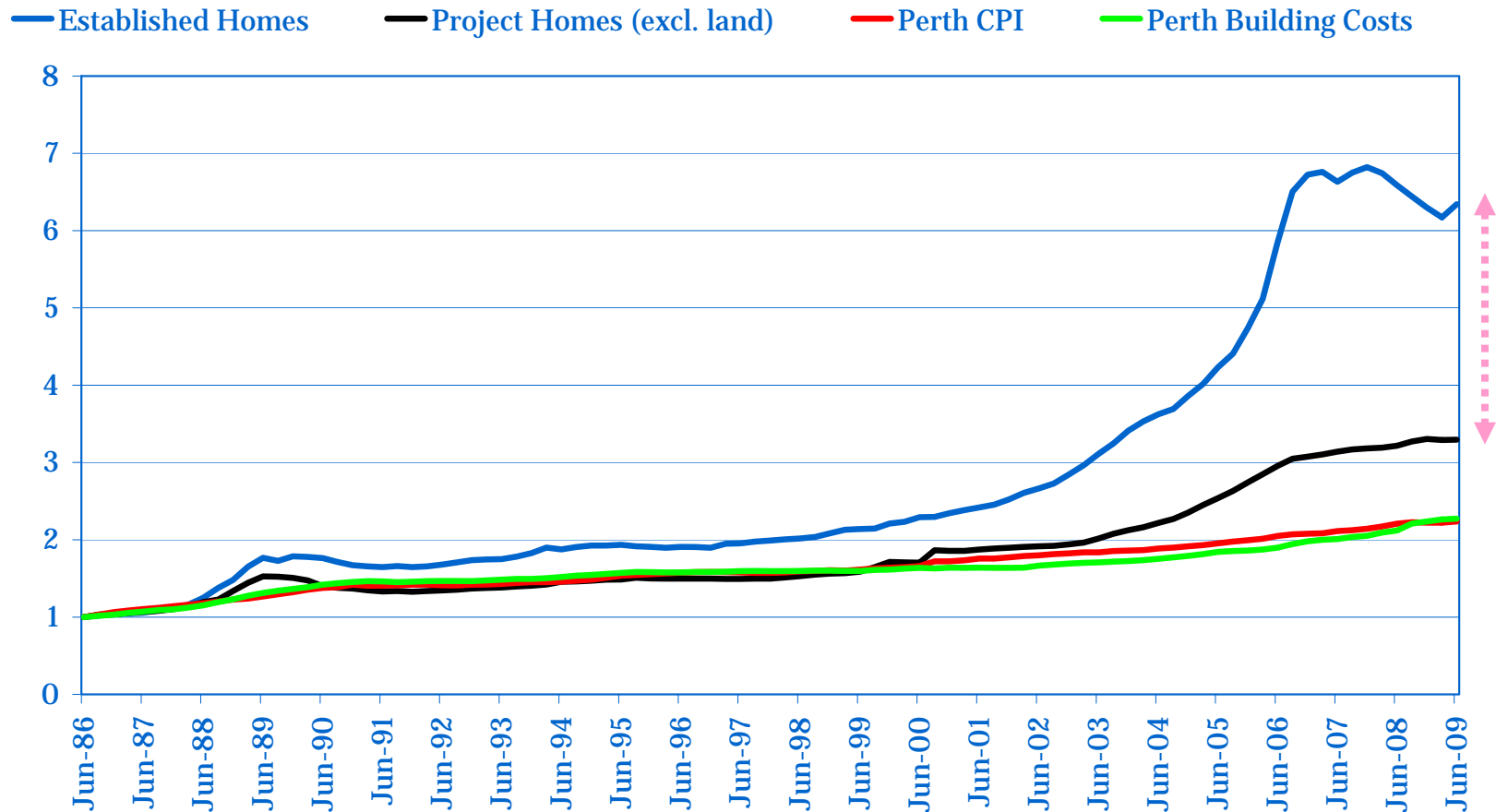
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## 9. Supply-side: The Cost of Producing New Housing

**The Extrinsic Value of Land: Perth; 1986 to 2009**



## 9. Supply-side: Key Findings

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- Key findings from 2003 Task Force Report...
  - Real building materials prices have **not changed** over time
    - Building materials industry very efficient
  - Price of homes **excluding land** generally tracked inflation
  - The price of land has grown at **much greater rate than inflation**
  - Zoning restrictions, long approval processes, environmental constraints, inadequate infrastructure investment, and government levies and charges are all driving up the extrinsic price of land in urban areas
    - **Supply-side is becoming “inelastic”**
- 2003 Task Force Report :

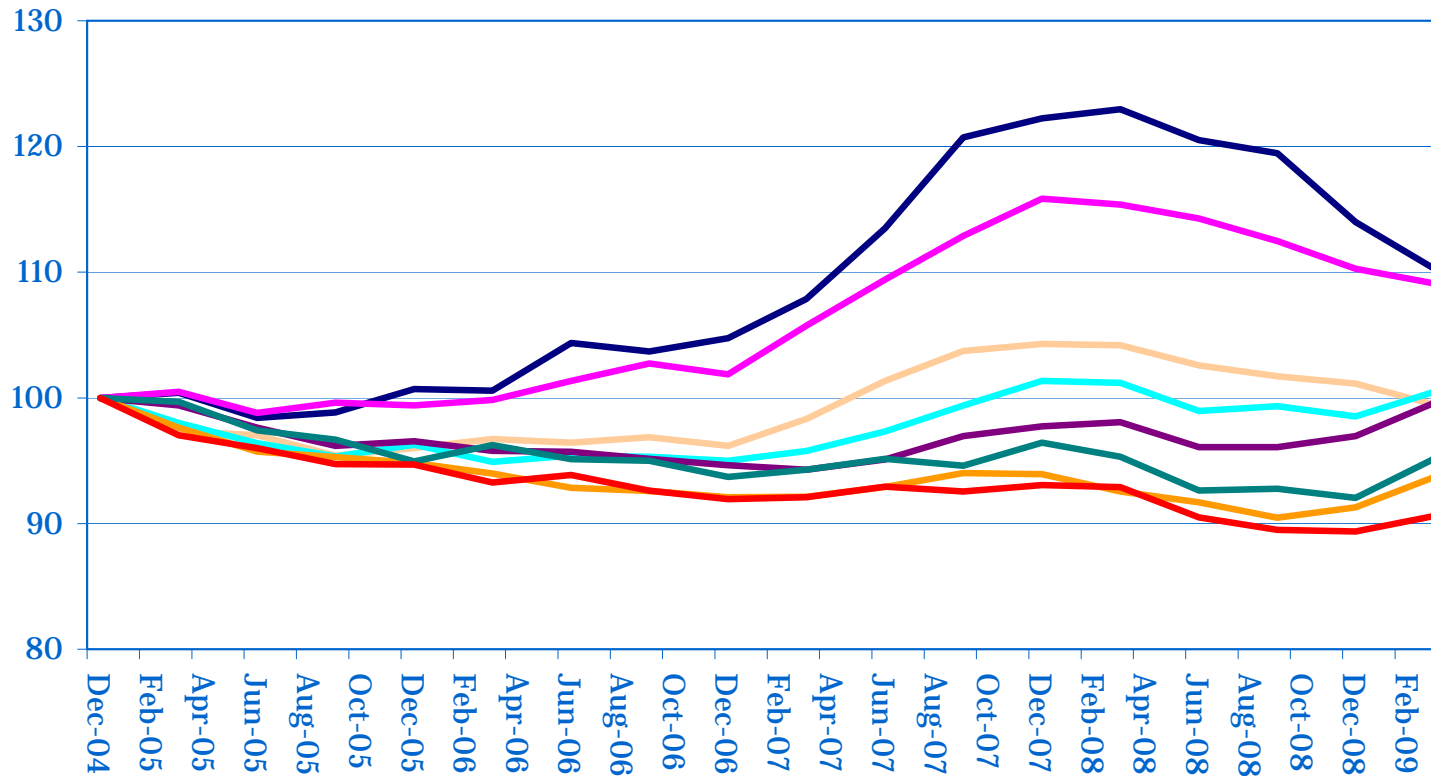
*“There is an ever-growing divergence between the price of...properties and their underlying costs of construction. Importantly, this does not appear to be a manifestation of natural constraints on the supply of land, but rather a product of regulatory restrictions that artificially inflate the price of housing. Viewed differently, these limits on dwelling dispersion and the release of greenfield sites act as a burdensome tax on new building, which...leads to a mismatch between the accommodation needs of Australian households and the stock of available properties.”*



## 9. Hedonic Analysis of House Price Growth based on Distance from GPO

**Individual Property Performance based on Distance from GPO:  
Sydney Houses; Hedonic RP Data-Rismark Indices; 7 km increments**

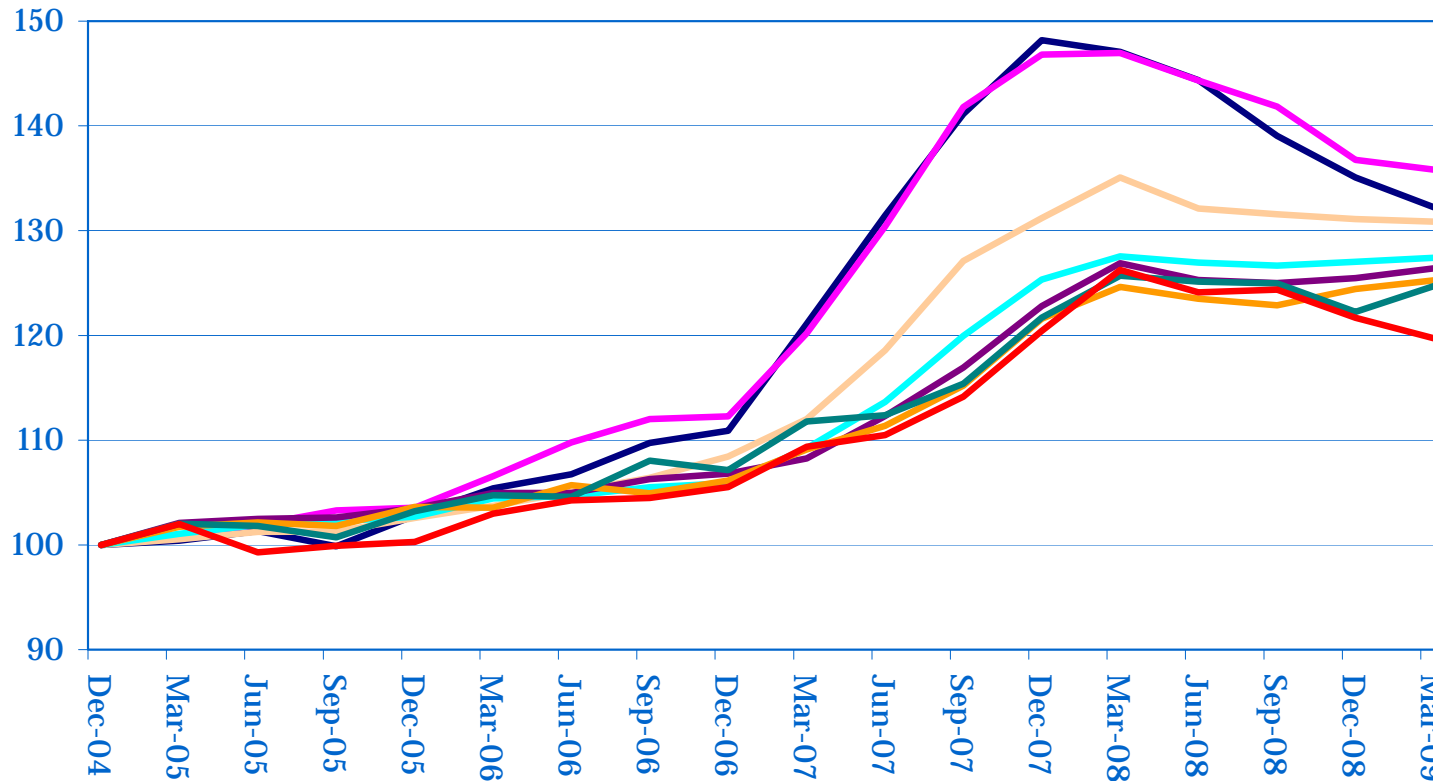
- ≤7km
- >7km but ≤14km
- >14km but ≤21km
- >21km but ≤28km
- >28km but ≤35km
- >35km but ≤42km
- >42km but ≤49km
- >49km but ≤SD



## 9. Hedonic Analysis of House Price Growth based on Distance from GPO

**Individual Property Performance based on Distance from GPO:  
Melbourne Houses; Hedonic RP Data-Rismark Indices; 7km increments**

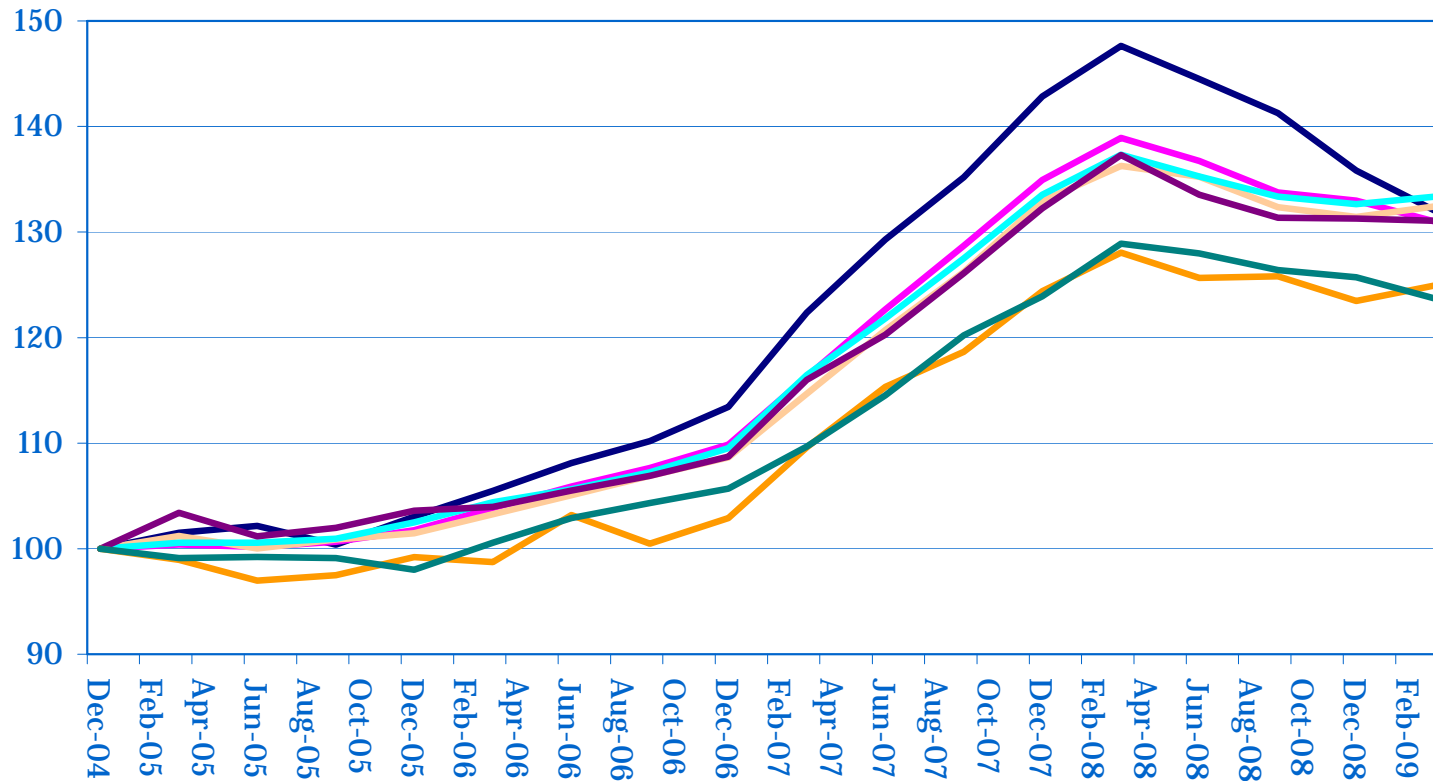
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## 10. Housing Policy Solutions

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- **Supply-side affordability solutions**
  - Relax zoning restrictions and increase densities in **urban areas**
    - Fringe areas have arguably greater environmental, economic and social costs
  - Migrate conception of great Australian dream away from quarter acre block
  - Needs to be accompanied by government investments in “public goods”
    - Public goods will enable/liberate new supply
      - Roads
      - Trains
      - Hospitals
      - Schools
  - Problem is that new supply is coming online in low demand (fringe) areas
  - New supply is not “substitutable” for existing supply
  - New supply does not have the “amenity value” of existing supply
  - 2003 Task Force proposed setting supply targets for local councils
    - Allow councils to trade supply permits
  - Generally developing supra-national urban planning strategies



## 10. Housing Policy Solutions

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- Demand-side problems are just as clear
  - We need to reduce household debt
  - **Deleverage household balance-sheets** and reduce default risk
  - Only way to deleverage is through **increased use of equity**
  - But households cannot draw on external “equity finance”
  - Households **limited to purely debt finance**
  - Companies raise debt and equity finance every day...
  - An ASX-listed company with 90% gearing would get crucified
  - But we allow households to draw on this much debt all the time
  - Growing support from leading academic economists following GFC for governments to facilitate development of equity finance markets
    - Edward Glaeser (Harvard), Luis Zingales (Chicago), Ian Ayers and Barry Nalebuff (Yale) Nassim Taleb (Black Swan)
    - Australia is the global leader in private-sector shared equity markets
    - I was invited to present to Obama Administration on this subject in February





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