TREASURER'S ADDRESS TO THE URBAN DEVELOPMENT INSTITUTE OF AUSTRALIA (UDIA)

SYDNEY, MONDAY 24 OCTOBER

Introduction (option 1)

One of the best things about Australia is the pride we take in our homes and our strong culture of home ownership. Our homes provide much more than shelter. They're places to raise a family, enjoy the company of our friends and they give us a sense of attachment to our communities. Home ownership improves health outcomes and gives us stability in retirement.

Nevertheless, strong property price growth in Sydney and Melbourne in recent years is creating challenges for housing affordability, particularly for first home buyers. With more young people renting for longer, housing affordability problems start to cascade down to what is sometimes termed the 'affordable housing' segment of the market, by which I mean low rental cost housing, social housing and ultimately homelessness.

Introduction (option 2 – a little more forthright)

One of the best things about Australia is the pride we take in our homes and our strong culture of home ownership. Our homes provide much more than shelter. They're places to raise a family, enjoy the company of our friends and they give us a sense of attachment to our communities. Home ownership improves health outcomes and gives us stability in retirement.

But let's be frank. House prices in Australia are high. Regional differences exist. But by the standards of our own history they are high. And relative to other countries they are high. They are cyclically high and they are structurally high. Should this be a concern if around two-thirds of us are home owners?

The answer to this question is almost certainly yes. We should care about high house prices because of what this means for those aspiring to home ownership. We should care about whether the price of what, for most of us, is our most valuable asset is sustainable; especially given that many of us have mortgages. And we should be cognisant of the lessons of history—in Australia in the 1890s and in the United States and various parts of Europe more recently—that too much exuberance in the housing market can end in disaster for the financial system and the economy.

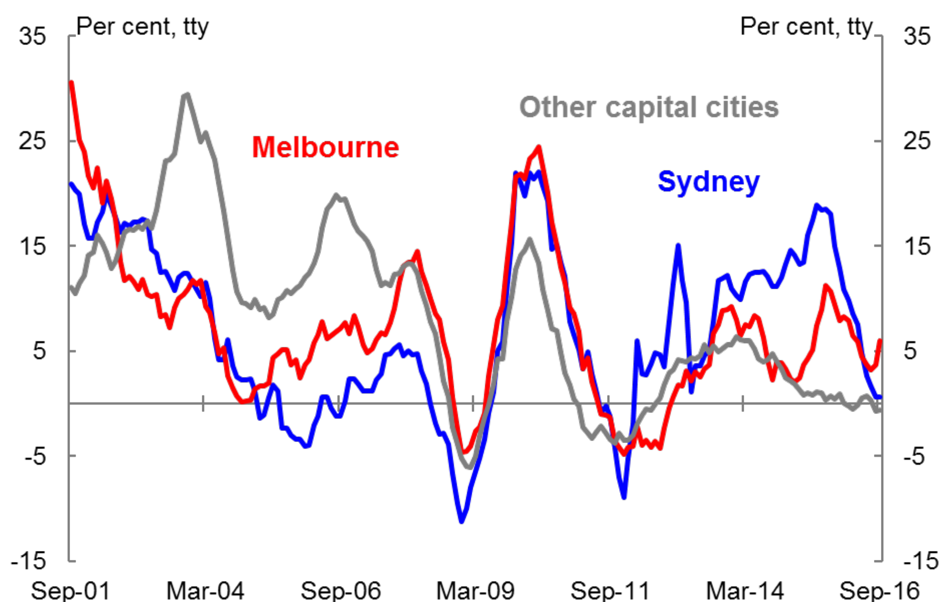
High house prices also have an indirect impact upon what is sometimes termed the 'affordable housing' segment of the market, by which I mean low rental cost housing and social housing. With first home buyers increasingly priced out of the market, leading more young people to rent for longer, housing affordability problems start to cascade down to those receiving Government rent assistance in the form of heightened competition for low cost rental property. In turn, this can push more people towards social housing and, amid few additions to the social housing stock in Australia in recent years, ultimately towards homelessness.

Current State of the Housing Market

Growth in capital city dwelling prices appears to be moderating after several strong years. Prices only grew 0.9 per cent through the year to September 2016 compared with growth approaching 10 per cent per annum over the past couple of years.

The strength of the recent cycle has largely been concentrated in Sydney and Melbourne, where prices have risen around 60 per cent and 30 per cent, respectively, since their late 2014 lows. Price growth has been moderate or flat elsewhere, while prices in Perth and Darwin have been falling for the last two years, impacted by the slowdown in mining investment, rising unemployment and weaker interstate and overseas migration.

Chart 1 – Dwelling Price Growth: Sydney, Melbourne and Rest of Australia



Affordability

People occupy dwellings under different arrangements, but broadly speaking people either own outright or with a mortgage, rent (possibly with Government assistance) or are housed in social housing.

We know that the Australian market is not homogeneous and comprises many different markets with unique characteristics that differ state-by-state and region-by-region, but it is worth considering some aspects of the aggregate picture as well.

I will touch on the state of affordable housing shortly, but in terms of housing affordability, the aggregate picture shows that compared with income and through time: renting is relatively more affordable; servicing a mortgage is around historical averages; but getting together a deposit to become a home owner in the first place is becoming a significant challenge.

In aggregate, rental affordability improved over the decade before the financial crisis and has remained fairly stable since. Rent payments relative to income remain below long-term averages.

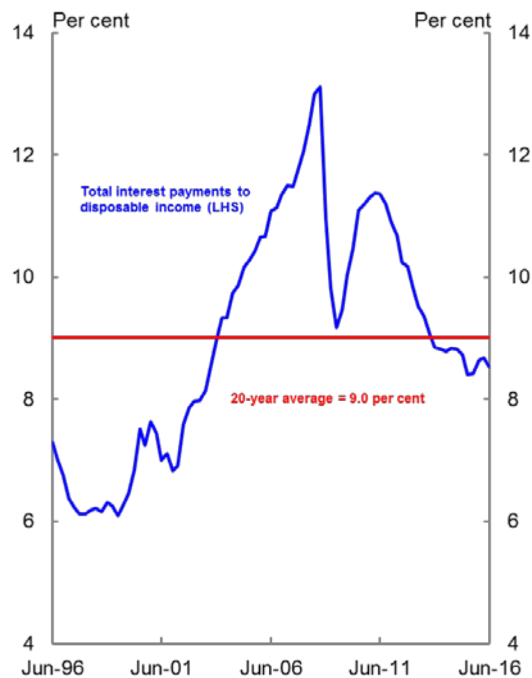
While in aggregate there appears to be less cause for alarm, for some low income households rent payments may be a source of financial stress. And pressures are likely to be particularly acute in Sydney where rents are much higher than in the rest of the country.

In terms of servicing a mortgage, the effect of rising prices has been offset by the decline in nominal interest rates. The standard variable mortgage rate is at its lowest level since the late 1960s.

According to the RBA, the average buffer in mortgage offset accounts and redraw facilities has risen to around two and a half years' worth of scheduled repayments at current interest rates. However, these buffers tend to be bigger among high income households and many households remain vulnerable to higher interest rates in the future or to changes in their employment status.

Chart 2 – Rent-to-Disposable Income Ratio

Chart 3 – Total Interest Payments-to-Disposable Income Ratio



The real pinch point is being able to get into the housing market in the first place, which is affecting many would-be first home buyers. House prices have risen relative to incomes making it difficult for some first home buyers to save

an adequate deposit. In some regions of Sydney, median prices are as much as 9 times higher than disposable incomes.

For households in the lowest income quintile, it would take around 6 years of saving their entire disposable income to reach the deposit required for the median capital city house.

Even acknowledging that new households may want to buy a cheaper house than the median, this is nonetheless much higher than in the past and, again, these aggregate figures likely mask regional differences and the acute pressures of those contemplating entry into the Sydney market.

Although we will have to wait for the recent census data to become available, I am concerned that affordability pressures may have begun to push down our home ownership rate.

The last census gave a hint of this trend, with the average number of people per dwelling rising for the first time since the census began in 1911, which may indicate that more young people could be staying in the family home into their twenties.

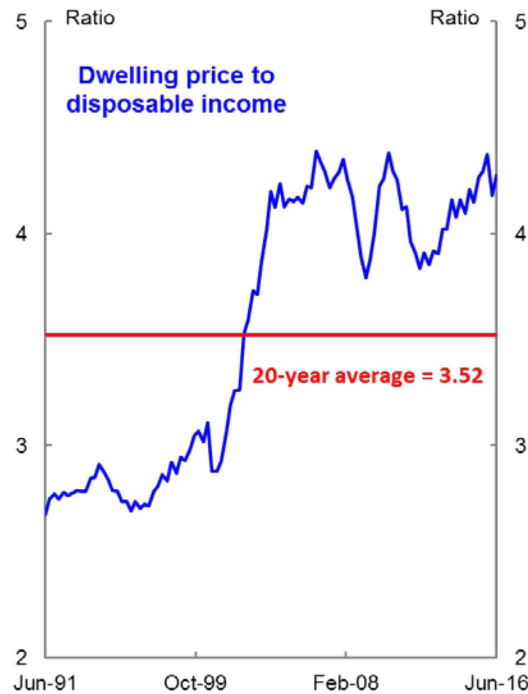
We've also seen the average age at which people first become a home owner rise by about a year.

It's hard to be sure that these pieces of evidence aren't being driven by other social trends, but this is nonetheless of great concern because of all the benefits of home ownership to the individual and to our society.

Possible section on the affordable housing segment of the market (SPD input?)

So what has been driving up house prices and kept them high relative to income for more than a decade?

Chart 4 – Dwelling Price-to-Disposable Income Ratio



Drivers of Price Growth

The cyclical drivers of recent price growth appear relatively clear.

Relatively rapid population growth, notwithstanding a slight deceleration lately, has underpinned demand. Australia's population grew at an average annual rate of 1.7 per cent between the start of 2005 and the end of 2014. Between 2005 and 2010, Australia had the highest average rate of population growth in the OECD, except for Israel.

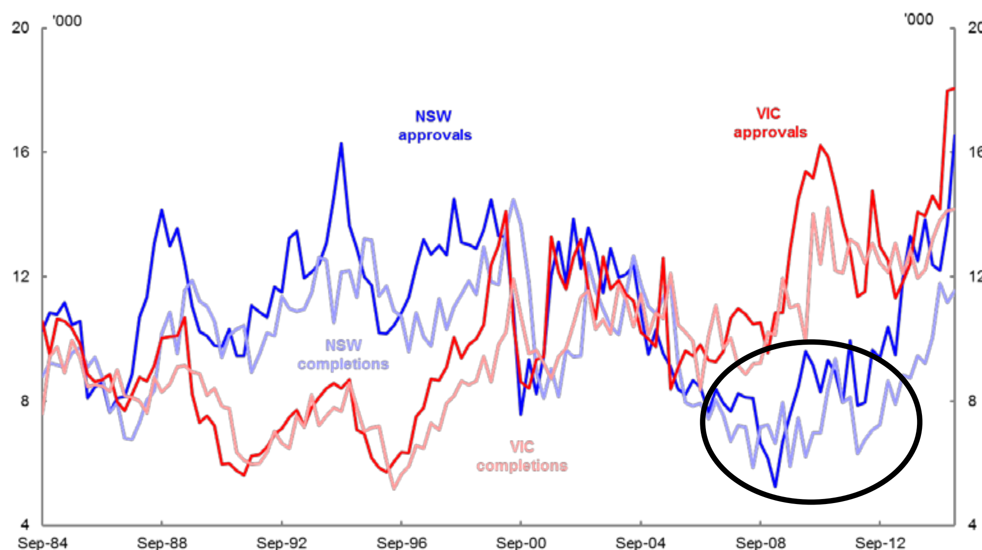
Accommodative domestic monetary policy has increased the amount of debt serviceable by households and, commensurately, the price they are able to pay. With the RBA's target for the cash rate at an historic low, the average standard variable mortgage interest rate is at its lowest point since the late 1960s and most banks offer substantial discounts to this standard rate for even moderately creditworthy borrowers.

Low yields on alternative investments have driven particularly strong investor activity during the current cycle and, although rental yields have also fallen, they remain attractive relative to what can be earned in the bond market or in term deposits.

Easier monetary policy globally and specific push factors out of China have led to increased foreign investment in Australian residential real estate. Recent work by the Treasury Department indicates that increases in foreign investment applications tend to have a positive impact on Australian property prices—if an increase in demand did not have an impact on price it would bring the functioning of the housing market itself into question—but the results are that this impact is very small.

A period of weak residential construction activity in the mid-to-late 2000s left many markets undersupplied, particularly in New South Wales. Supply is responding strongly but with a longer than usual lag due to the greater proportion of high-density dwelling construction in the current cycle, which takes longer to build. A large volume of construction is already coming on line and much more is anticipated in the next few years.

Chart 5 – Housing Supply in New South Wales and Victoria (to be updated)



A number of long-term, structural drivers, both on the demand and supply side of the market, also help to explain the high level of Australian house prices.

Both the availability of finance and its cost have improved in recent decades. Financial liberalization, starting in the 1980s, has given more Australian households access to credit, including for mortgages to finance the acquisition of real estate.

Successful inflation targeting by the Reserve Bank since the early 1990s has helped to structurally lower nominal interest rates, reducing the costs of servicing debt.

Longer-term demographic factors are also likely to have underpinned demand in recent decades, such as increased labour force participation, which has led to more two-income households being able to afford higher house prices, even if this trend has been accompanied by rising part-time work.

But of all the determinants of house prices in Australia, whether cyclical or structural, perhaps the most important have been the long running impediments to the supply side of the market.

While any increase in demand in the short-term would be expected to increase prices—due to the time it takes to construct new dwellings—in the long-run the cost of new dwellings should set the marginal price in the market. So why isn’t new supply pushing down prices?

Firstly, there may have been some increase in construction costs in recent decades, in part reflecting improvements in the quality of new dwellings. But it is probably no surprise to this audience that increased land values have been a bigger driver, mostly reflecting a burdensome policy environment.

Supply-side constraints include: complex land planning and development regulation; insufficient land release; the cost and availability of infrastructure provision; public attitudes towards urban infill; and, for Sydney in particular, physical geographic constraints.

Most of these factors either increase development costs directly or increase the time between a developer purchasing a site and being able to sell completed dwellings which, when financed by debt, is itself a cost that has to be capitalised into the prices of new dwellings.

While State Governments cannot do much about the physical geography occupied by our cities, they could do a great deal to improve planning processes and the provision of infrastructure.

My Department has heard from developers about increasing development times, with one noting that it took 12 years for a recent project on the outskirts of Melbourne to go from the acquisition of vacant land to a new

suburb. This was how long it took for the land to be rezoned and for the developer to meet the onerous hurdles required in construction.

Some of these hurdles sounded almost farcical. For example, the developer wasn't permitted to design the shopping precinct of the new suburb they had built because the Victorian Government required that their own architects did the work (and at their own pace).

We've heard other examples of local councils in Sydney requiring scale models of developments, costing tens of thousands of dollars, be created before approvals will be granted, despite developers having more informative digital models available.

Input from MG on Harper…

Sydney as an Example (Option for the Office to leave this section out)

But perhaps given its higher recent price growth and the high levels of its house prices, it's worth looking a little more closely at Sydney.

Sydney is a large city, but one of the least densely populated when compared with other global cities. Sydney's greenfield activity has been limited by physical geographic constraints: the Pacific Ocean to the east; the Blue Mountains to the west; and the national parks north and south. But even without these constraints, its large footprint and low density would likely make it difficult to ease affordability pressures through the construction of new greenfield sites alone.

Newer greenfield sites, for example Edmondson Park near Liverpool and Spring Farm near Camden, are a long way from the CBD and lack expedient public transportation. While it is completely the prerogative of Australian households to form their own preferences for housing, preferences for low density housing make public transport at the city periphery uneconomic.

So a lot of Sydneysiders end up driving to work. But this can mean commuting times of an hour or more each way. Anecdotally, there is significant commuting from as far afield as the Blue Mountains, Mittagong, Wollongong and even Newcastle. These impracticalities in part explain why it is land prices more than construction costs that are behind price rises. Proximity has become more valuable.

Chart 6 – Greenfield Supply and Proximity in Sydney

The rising value of proximity, measured as much in commuting time as actual distance, surely implies that better rezoning and approval processes for urban infill are required. Current policies tend to limit greater density in established suburbs and instead rely on the occasional rezoning of former industrial site.

Recent examples include the former industrial areas around Sydney Airport and the Olympic Park site as well as the activity in the CBD and around Sydney's central railway station a little to the south. More recently, in response to the Westward spread of price growth, changes to zoning in some of Sydney's western centres with good access to train lines such as Parramatta, Bankstown, Blacktown and Liverpool have seen a number of higher density development proposals approved. But there is perhaps too much sporadic construction of high-rise and not enough construction of medium density dwellings within a reasonable commuting distance to the CBD.

Bubble risks (This section can easily be shortened if it's the preference of the Office)

Wherever and whenever property prices rise quickly, there will inevitably be a chorus of commentators calling developments a bubble.

Perhaps there is, at times, some kind of euphoria—what Alan Greenspan described as irrational exuberance with reference to the late 1990s tech boom—under which the prices people are willing to pay become divorced from some conception of fundamental value.

The inherent difficulty here is that, while prices for most assets are readily observable, propositions about value are more subjective.

Ex-ante, rising prices are a necessary pre-condition for what might later be described as a bubble.

But it is only ex-post, if prices crash, that we can definitely characterise exuberance as folly.

Having observed many fundamental determinants that have pushed up Sydney and Melbourne property prices, should we nonetheless be worried about a reversal? After all, previous bubbles, housing or otherwise, have typically been justified by fundamentals (at least initially).

Compared with episodes in other countries that are popularly cited as bubbles that burst, you might think the answer is yes. But rapidly rising prices are not always followed by a crash.

In identifying what is likely to be a bubble ex-ante, you should probably be able to point to things that will cause prices to fall. And you may need to consider things beyond simply blaming too much speculation; all property (or asset) purchases necessarily involve speculation whether you're an investor or an owner-occupier.

Given not all rapid price appreciation ends in a crash, it is worth considering why some episodes did and, most importantly, where recent experience in Australia differs.

In the late 1990s and early 2000s in the United States, households with relatively low incomes or ability to demonstrate a capacity to repay were drawn into the housing market by innovative but flawed mortgage structures dependent on ever rising prices to create home equity.

These were mainly option-adjustable rate mortgage (option-ARM) structures that gave the lender the option to refinance the borrower into a regular prime

mortgage two-to-three years into the loan, if they had been making payments on time and if price growth had helped to create equity in the property.

Along with woeful lending standards propagated by skewed incentives all along the originate-to-distribute chain that had come to characterise mortgage finance in the US, these products sucked more and more buyers into the US housing market.

The flaw in this model was that it required rising prices to create home equity equivalent to a deposit. When further homebuyers could not be enticed into the market, even with the skewed incentives in the originate-to-distribute model, the market reversed.

Rather than being refinanced into prime mortgages at the option of the lender at the two-to-three year point, the option-ARM structures gave the lender the option to allow the mortgage interest rate to step up to a fairly high floating rate, pushing many borrowers into default.

While lenders individually pushing borrowers into default was rational, system-wide, this triggered a spiral of foreclosures and forced sales that pushed prices ever lower, eroding equity creation, with more borrowers pushed into default and yet more foreclosures. As we all now know, this was a disaster for the US and ultimately for the global economy.

Australia had a comparable run up in dwelling prices to the US in the early 2000s, but with better lending standards and full recourse loans, prices did not fall significantly during the financial crisis.

You could also look at Spain or Ireland. In the early-to-mid 2000s, monetary policy in the Eurozone was set for the economic circumstances of Europe's core. This was because in the early days of the single currency Germany was still labouring under the costs of re-unification.

Easy monetary policy led to a boom in Europe's periphery, with contributions also coming from a combination of poor lending standards and eventually a big supply overhang was created.

The reverberations of the financial crisis in the US and the sovereign debt crisis in Europe helped push prices lower, but the falls became steeper in the markets with big overhangs of supply.

In Australia, against a background of undersupply in recent years, which has only recently begun to be addressed, there currently appear to be few

potential triggers for a significant and widespread reversal in prices nationwide—notwithstanding concerns regarding oversupply in some areas, such as inner-city Melbourne and Brisbane or weak demand in some mining-dependent towns.

It is likely a sizeable correction would require: a supply overhang being created; lending standards deteriorating significantly (though initially this could inflate prices further); or, an external shock lowering aggregate demand, driving up unemployment and reducing bank willingness to lend.

Notwithstanding some regional risks, the current construction cycle would likely have to run-up faster and continue for longer before oversupply became a nationwide macroeconomic risk. This is not to say that price growth won't slow as completions increase in the months ahead, and that prices may fall, but a crash remains only an outlying possibility.

Of course, the size and length of the current construction boom will warrant attention in the coming months and years.

The intensity of prudential regulation of the mortgage sector has increased markedly in recent years, which should help guard against a systemic deterioration in lending standards.

In particular, APRA announced in December 2014 that it will further increase its supervisory intensity (increased reporting obligations and on-site visits) and may require banks to hold extra capital, if they fail to:

- Limit investor lending growth to 10 per cent (though some discretion will be applied where banks achieve a substantial reduction from high rates of growth);
- Impose a minimum serviceability buffer of 2 per cent above the standard variable interest rate on new loans or a floor rate of 7 per cent (whichever is higher) to ensure borrowers can maintain payments in circumstances where interest rates are higher; and
- Cease high risk lending practices, such as making excessive numbers of interest-only loans, loans over very long terms (greater than 30 years) as well as making too many loans at high loan-to-income and loan-to-value ratios.

Largely as a result of these measures, investor credit growth has slowed and indicators of the quality of credit being extended in the mortgage market have improved.

Although it is hard to guard against external shocks directly, highly capitalised banks provide some insurance that the impact of any shock will be lower. This is the direction APRA has and will continue to move in.

Conclusion

So…

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The answer to this question is almost certainly yes. We should care about high house prices because of what this means for those aspiring to home ownership. We should care about whether the price of what, for most of us, is our most valuable asset is sustainable; especially given that many of us have mortgages. And we should be cognisant of the lessons of history—in Australia in the 1890s and in the United States and various parts of Europe more recently—that too much exuberance in the housing market can end in disaster for the financial system and the economy.

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Current State of the Housing Market

Growth in capital city dwelling prices appears to be moderating after several strong years. Prices grew by 7.1 per cent through the year to September 2016 compared with growth above 11 per cent per annum at various times over the past couple of years.

The strength of the recent cycle has largely been concentrated in Sydney and Melbourne, where prices have risen around 65 per cent and 40 per cent, respectively, since their late 2011/early 2012 lows (Chart 1).

Price growth has been moderate or flat elsewhere, while prices in Perth and Darwin have been falling for a year or so, impacted by the slowdown in mining investment, a softer labour market and weaker interstate and overseas migration.

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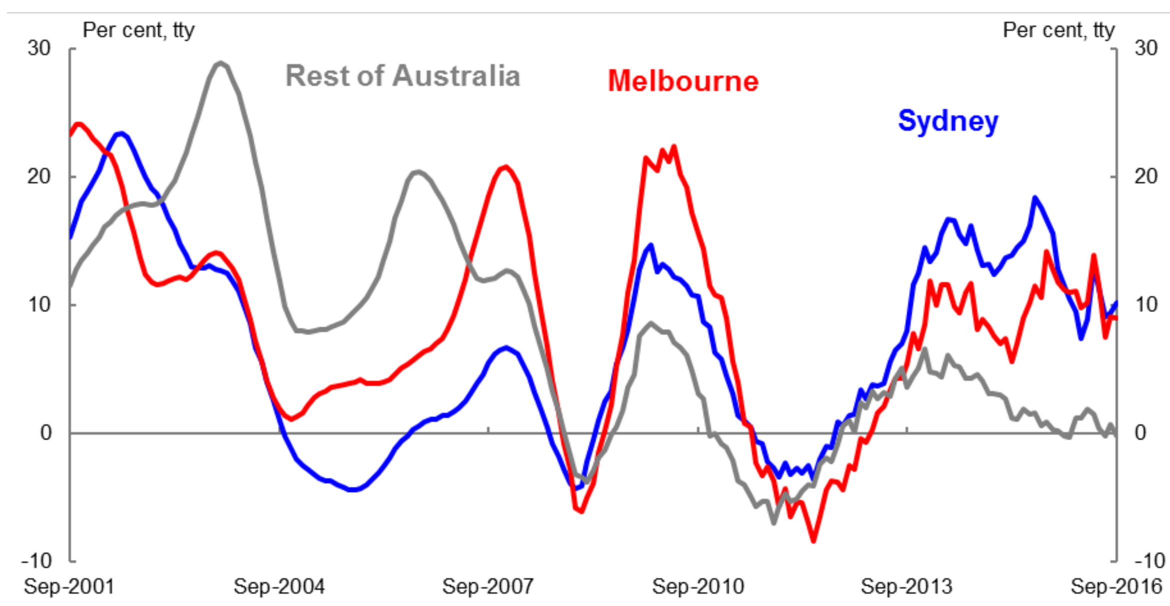

In-Depth Look at Sydney (Treasurer can opt to leave this section out entirely)

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More recently, in response to the westward spread of price growth, changes to zoning in some of Sydney's western centres with good access to train lines such as Parramatta, Bankstown, Blacktown and Liverpool have seen a number of higher density development proposals approved.

But there is perhaps too much sporadic construction of high-rise and not enough construction of medium density dwellings within a reasonable commuting distance to the CBD.

Drivers of Price Growth

The cyclical drivers of recent price growth appear relatively clear.

Relatively rapid population growth, notwithstanding a deceleration lately, has underpinned demand. Australia's population grew at an average annual rate of 1.7 per cent between the start of 2005 and the end of 2014. Between 2005 and 2010, Australia had the highest average rate of population growth in the OECD, except for Israel.

More recently, interstate migration patterns have reversed from flows towards the mining states to flows back to Sydney and Melbourne where the labour market is stronger. This, in turn, adds to housing demand in these capitals.

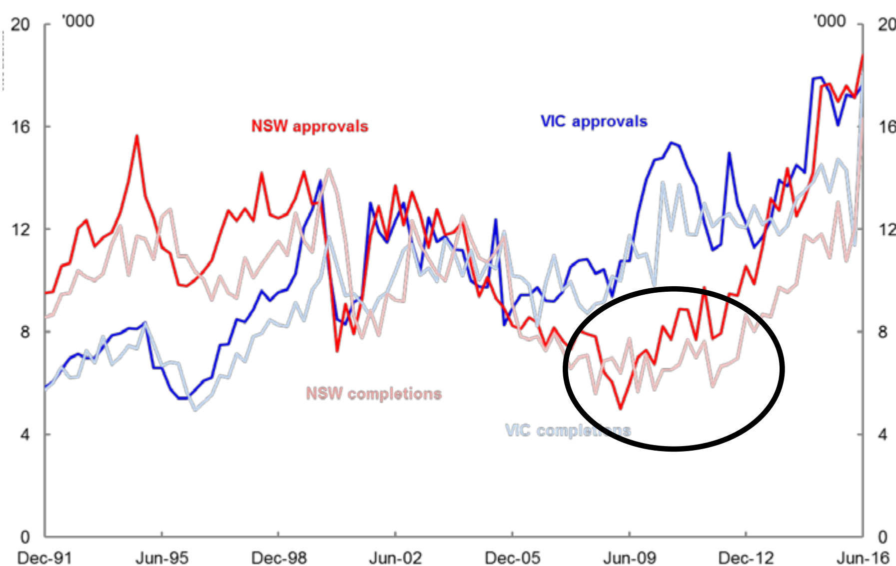
Accommodative domestic monetary policy has increased the amount of debt serviceable by households and, commensurately, the price they are able to pay. With the RBA's target for the cash rate at an historic low, the average standard variable mortgage interest rate is at its lowest point since the late 1960s and most banks offer substantial discounts to this standard rate for even moderately creditworthy borrowers.

Low yields on alternative investments have driven particularly strong investor activity during the current cycle and, although rental yields have also fallen, they remain attractive relative to what can be earned in the bond market or in term deposits.

Easier monetary policy globally and specific push factors out of China have also led to increased foreign investment in Australian residential real estate.

On the supply side, a period of weak residential construction activity in the mid-to-late 2000s left many markets undersupplied, particularly in New South Wales (Chart 3). Supply is responding strongly but with a longer than usual lag due to the greater proportion of high-density dwelling construction in the current cycle, which takes longer to build. A large volume of construction is already coming on line and much more is anticipated in the next few years.

Chart 3 – Housing Supply in New South Wales and Victoria



A number of long-term, structural drivers, both on the demand and supply side of the market, also help to explain the high level of Australian house prices.

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Successful inflation targeting by the Reserve Bank since the early 1990s has helped to structurally lower nominal interest rates, reducing the costs of servicing debt.

Longer-term demographic factors are also likely to have underpinned demand in recent decades, such as increased labour force participation, which has led to more two-income households who are then able to afford higher house prices, even if this trend has been accompanied by rising part-time work.

But of all the determinants of house prices in Australia, whether cyclical or structural, perhaps the most important has been the long running impediments to the supply side of the market.

While any increase in demand in the short-term would be expected to increase prices—due to the time it takes to construct new dwellings—in the long-run the cost of new dwellings should set the marginal price in the market. So why isn't new supply pushing down prices?

There may have been some increase in construction costs in recent decades, in part reflecting improvements in the quality of new dwellings. But it is probably no surprise to this audience that increased land values have been a bigger driver, mostly reflecting a burdensome policy environment.

Supply-side constraints include: complex land planning and development regulation; insufficient land release; the cost and availability of infrastructure provision; public attitudes towards urban infill; and, for Sydney in particular, physical geographic constraints.

Most of these factors either increase development costs directly or increase the time between a developer purchasing a site and being able to sell completed dwellings which, when financed by debt, is itself a cost that has to be capitalised into the prices of new dwellings.

While State Governments cannot do much about the physical geography occupied by our cities, they could do a great deal to improve planning processes and the provision of infrastructure.

My Department has heard from developers about increasing development times, with one noting that it took 12 years for a recent project on the outskirts of Melbourne to go from the acquisition of vacant land to a new suburb. This was how long it took for the land to be rezoned and for the developer to meet the onerous hurdles required in construction.

While some construction standards are important for maintaining the safety and quality of newly constructed dwellings, some of these hurdles sounded almost farcical. For example, the Melbourne developer wasn't permitted to design the shopping precinct of the new suburb they had built because the Victorian Government required that their own architects did the work (and at their own pace).

We've heard other examples of local councils in Sydney requiring scale models of developments, costing tens of thousands of dollars, be created before approvals will be granted, despite developers having more informative digital models available.

Harper

In 2014, the Government commissioned a Competition Policy Review to identify regulatory impediments across the economy that unnecessarily restrict competition and reduce productivity. This review recommended the removal of a range of regulatory restrictions where they are not in the broader public interest.

In response, the Commonwealth is working with the States and Territories on developing a new intergovernmental agreement on competition and productivity reform. This will include the potential for Commonwealth payments to states that remove unnecessary regulations.

The Competition Policy Review did not directly address land-use planning regimes that impact housing supply. Nonetheless, many land-use planning regulations involve similar challenges.

I am therefore also considering providing payments to states that remove land-use planning regulations that unnecessarily impede housing supply and that are not in the broader public interest.

Most of you know better than I that land-use planning is a complex and difficult task. Those involved need to balance many competing interests such as protecting local amenity and the need for more housing. I therefore invite you all to work with my department in advancing this reform path, including by identifying regulatory reform priorities.

Bubble risks (Note: this section can easily be shortened)

Wherever and whenever property prices rise quickly, there will inevitably be a chorus of commentators calling these developments a bubble.

Perhaps there is, at times, some kind of euphoria—what Alan Greenspan described as irrational exuberance with reference to the late 1990s tech boom—under which the prices people are willing to pay become divorced from some conception of fundamental value.

The inherent difficulty here is that, while prices for most assets are readily observable, propositions about value are more subjective.

Ex-ante, rising prices are a necessary pre-condition for what might later be described as a bubble.

But it is only ex-post, if prices crash, that we can definitely characterise exuberance as folly.

Having observed many fundamental determinants that have pushed up Sydney and Melbourne property prices, should we nonetheless be worried about a reversal? After all, previous bubbles, housing or otherwise, have typically been justified by fundamentals (at least initially).

In identifying what is likely to be a bubble ex-ante, you should probably be able to point to things that will cause prices to fall. And you may need to consider things beyond simply blaming too much speculation; all property (or asset) purchases necessarily involve speculation whether you’re an investor or an owner-occupier.

So why did some episodes, such as in the United States, Spain or Ireland, end so badly? And, more importantly, where is recent experience in Australia similar or different?

In the late 1990s and early 2000s in the United States, households with relatively low incomes or ability to demonstrate a capacity to repay were drawn into the housing market by innovative but flawed mortgage structures dependent on ever rising prices to create home equity.

These were mainly option-adjustable rate mortgage structures (option-ARMs). If the borrower had been making repayments on time and if price growth had helped to create equity in the property, these structures gave the lender the option to refinance the borrower into a regular prime mortgage two-to-three years into the loan.

Along with woeful lending standards propagated by skewed incentives all along the originate-to-distribute chain that had come to characterise mortgage finance in the US, these products sucked more and more buyers into the US housing market.

The flaw in this model was that it required rising prices to create home equity equivalent to a deposit. When further homebuyers could not be enticed into the market, even with the skewed incentives in the originate-to-distribute model, the market reversed.

Rather than being refinanced into prime mortgages at the option of the lender at the two-to-three year point, the option-ARM structures gave the lender the option to allow the mortgage interest rate to step up to a fairly high floating rate, pushing many borrowers into default.

While lenders individually pushing borrowers into default was rational, system-wide, this triggered a spiral of foreclosures and forced sales that pushed prices ever lower, eroding equity creation, with more borrowers pushed into default and yet more foreclosures. As we all now know, this was a disaster for the US and ultimately for the global economy.

Australia had a comparable run up in dwelling prices to the US in the early 2000s, but with better lending standards and full recourse loans, prices did not fall significantly during the financial crisis.

Moreover, our regulators have experience of these kinds of risks and have shown in the past that they can successfully manage them. In fact, the Reserve Bank tightened monetary policy in Australia in 2003 and 2004 with specific reference to developments in the housing market, while APRA increased the intensity of its supervision.

You could also look at Spain or Ireland. In the early-to-mid 2000s, monetary policy in the Eurozone was set for the economic circumstances of Europe's

core. This was because in the early days of the single currency Germany was still labouring under the costs of re-unification.

Easy monetary policy led to a boom in Europe’s periphery, with contributions also coming from a combination of poor lending standards, and eventually a big supply overhang was created.

The reverberations of the financial crisis in the US and the sovereign debt crisis in Europe helped push prices lower, but the falls became steeper in the markets with big overhangs of supply.

In Australia, against a background of undersupply in recent years, which has only recently begun to be addressed, there currently appear to be few potential triggers for a significant and widespread reversal in prices nationwide—notwithstanding concerns regarding oversupply in some areas, such as inner-city Melbourne and Brisbane or weak demand in some mining-dependent areas.

It is likely a sizeable correction would require:

- A supply overhang being created;
- Lending standards deteriorating significantly (though initially this could inflate prices further); or,
- An external shock lowering aggregate demand, driving up unemployment and reducing bank willingness to lend.

Notwithstanding some regional risks, the current construction cycle would likely have to run-up faster and continue for longer before oversupply became a nationwide macroeconomic risk. This is not to say that price growth won’t slow as completions increase in the months ahead, and prices may fall, but a crash remains only an outlying possibility.

Of course, the size and length of the current construction boom will warrant attention in the coming months and years.

Policy makers are very cognisant of the risks and have been doing something about it.

In fact, the RBA has been calling attention to the risks in its bi-annual Financial Stability Review for some time and the Council of Financial Regulators has been active in tightening prudential supervision.

The intensity of prudential regulation of the mortgage sector has increased markedly in recent years, which should help guard against a systemic deterioration in lending standards.

In particular, APRA announced in December 2014 that it will further increase its supervisory intensity—increased reporting obligations and on-site visits—and may require banks to hold extra capital, if they fail to do any of the following three things:

1. Limit investor lending growth to 10 per cent (though some discretion will be applied where banks achieve a substantial reduction from high rates of growth);

2. Impose a minimum serviceability buffer of 2 per cent above the standard variable interest rate on new loans or a floor rate of 7 per cent (whichever is higher) to ensure borrowers can maintain payments in circumstances where interest rates are higher; and

3. Cease high risk lending practices, such as making excessive numbers of interest-only loans, loans over very long terms (greater than 30 years) as well as making too many loans at high loan-to-income and loan-to-value ratios.

Largely as a result of these measures, investor credit growth has slowed and indicators of the quality of credit being extended in the mortgage market have improved.

The proportion of loans made at the highest loan-to-value ratios has declined, low-documentation loans have dwindled to an insignificant proportion of bank lending and new interest-only lending to owner-occupiers has declined sharply.

In addition, the Australian banks themselves have, to a certain extent, also tightened lending standards independent of some of these regulatory measures. For example, applying greater scrutiny to foreign source income on loan applications and varying maximum loan-to-value ratios for loans in higher risk areas.

But our small, relatively open economy will always be exposed to external shocks of one kind or another. In this regard, developments in Western Australia in the last couple of years are perhaps a microcosm of the risks that the broader economy faces from external shocks.

As the terms of trade and mining investment began to decline, interstate migration reversed, net overseas migration largely stalled and unemployment began to rise. With a large amount of supply reaching completion, prices have fallen over the past year and the banks are reporting a pick-up in non-performing housing and personal loans.

The fact that we have a strong attachment to our homes—but also because Australia has full recourse lending arrangements—means that people tend to maintain mortgage interest repayments unless they lose their jobs. The increase in non-performing loans in Western Australia is thus a significant concern, particularly seeing as these loan metrics tend to be very lagging indicators.

Although it is hard to guard against external shocks directly, highly capitalised banks provide some insurance that the impact of any shock will be lower. This is the direction APRA has and will continue to move in.

So if we're not convinced that prices will likely suffer a sharp correction, what does this imply for housing affordability?

Affordability

People occupy dwellings under different arrangements, but broadly speaking people either own outright or with a mortgage, rent (possibly with Government assistance) or are housed in social housing.

We know that the Australian market is not homogeneous and comprises many different markets with unique characteristics that differ state-by-state and region-by-region, but it is worth considering some aspects of the aggregate picture as well.

I will touch on the state of affordable housing in the coming months, but in terms of housing affordability, the aggregate picture shows that compared with income and through time:

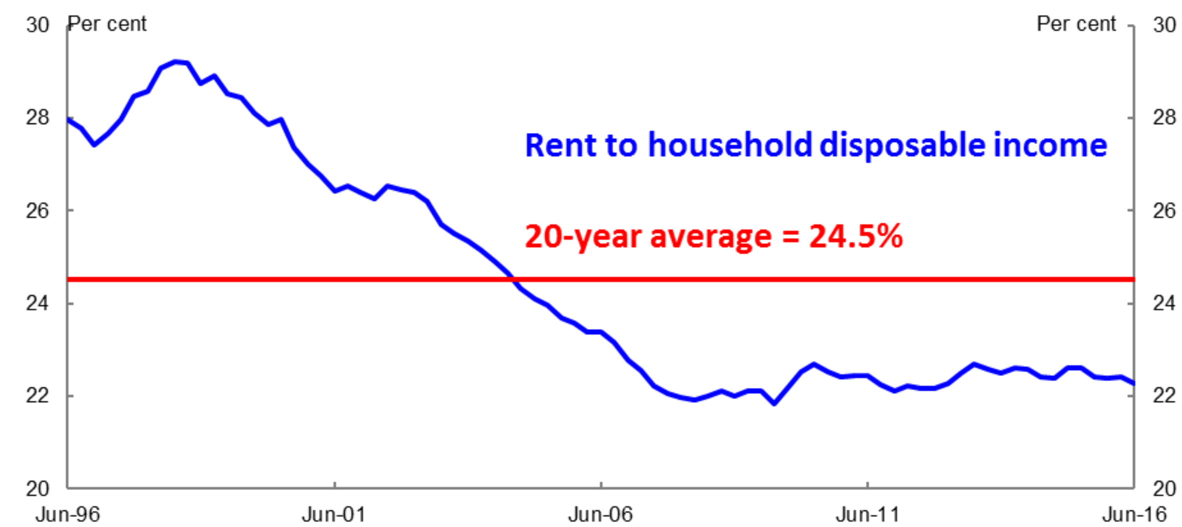
- Renting is relatively more affordable;

- Servicing a mortgage is around historical averages;
- But getting together a deposit to become a home owner in the first place is becoming a significant challenge.

In aggregate, rental affordability improved over the decade before the financial crisis and has remained fairly stable since (Chart 4). Rent payments relative to income remain below long-term averages.

However, the situation is different for lower income households, particularly those in capital cities. In 2014, half of low income households in the private rental market were in housing stress. For Sydney, it was 54 per cent.

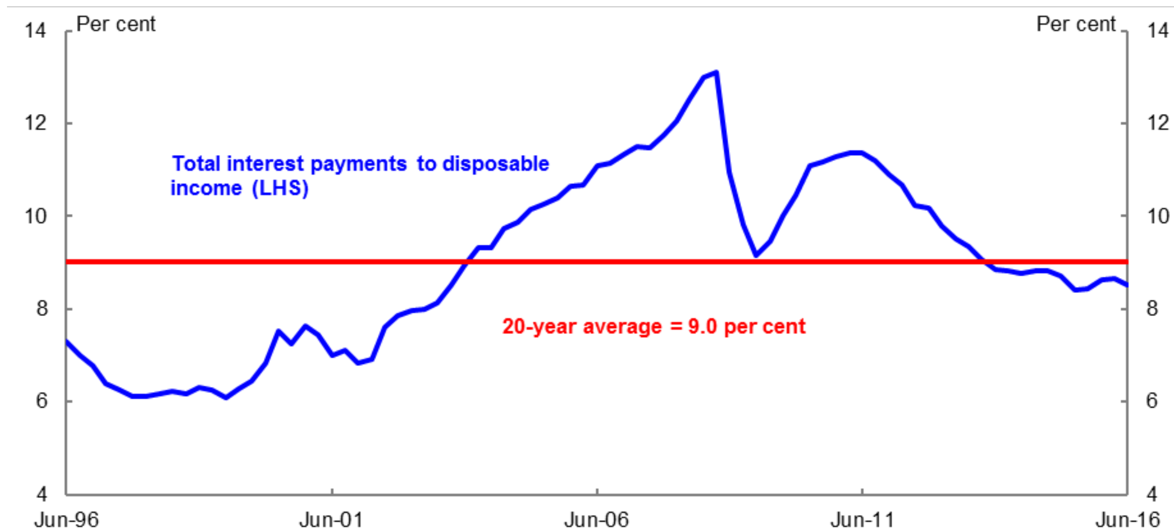
Chart 4 – Rent-to-Disposable Income Ratio



In terms of servicing a mortgage, the effect of rising prices has been offset by the decline in nominal interest rates, with the proportion of income going to service a mortgage around historical averages (Chart 5).

According to the RBA, the average buffer in mortgage offset accounts and redraw facilities has risen to around two and a half years' worth of scheduled repayments at current interest rates. However, these buffers tend to be bigger among high income households and many households remain vulnerable to higher interest rates in the future or to changes in their employment status.

Chart 5 – Total Interest Payments-to-Disposable Income Ratio



The real pinch point is being able to get into the housing market in the first place, which is affecting many would-be first home buyers. While low interest rates may make it easier to pay down a mortgage, they also make it harder to save to get one in the first place.

House prices have risen relative to incomes making it difficult for some first home buyers to save an adequate deposit (Chart 6). In some regions of Sydney, median prices are as much as 9 times higher than disposable incomes.

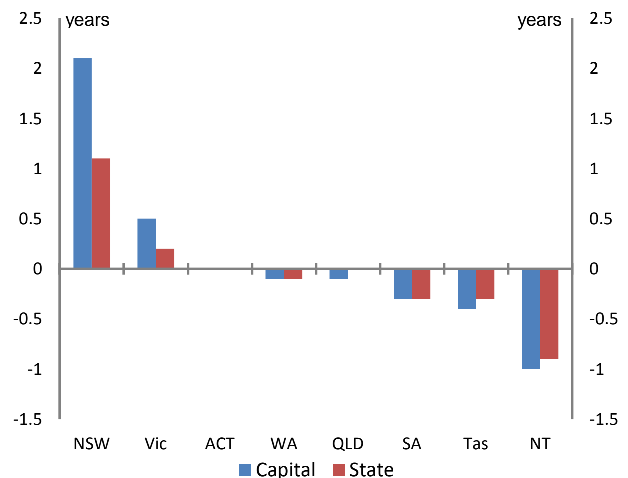
Chart 6 – Dwelling Price-to-Disposable Income Ratio

Even if first home buyers are more likely to buy a cheaper house than the median, this is nonetheless much higher than in the past and, again, these

aggregate figures likely mask regional differences and the acute pressures of those contemplating entry into the Sydney market.

For example, between June 2010 and June 2015, the time taken for a dual income couple to save for a 20 per cent deposit in Sydney has increased from 5.8 years to 7.9 years (Chart 7). In Melbourne it increased from 5.3 years to 5.8 years. The time taken to save for a house has decreased in the other capital cities.

Chart 7 – Saving for a Deposit



Source: BankWest First Time Buyer Deposit Report[1]

Although we will have to wait for the recent census data to become available, I am concerned that affordability pressures may have begun to push down our home ownership rate.

In 2011, home ownership amongst Australians aged 25-34 fell below 50 per cent for the first time since 1961.

The proportion of home loans that are being provided to first home buyers fell to 13.3 per cent in August 2016, its lowest point since February 2004.

We've also seen the average age at which people first become a home owner rise by about a year.

[1] The report's calculations assume that a household is made up of two people saving 20 per cent of their median income towards a median priced house.

The last census gave a hint of this trend, with the average number of people per dwelling rising for the first time since the census began in 1911. This may indicate that more young people could be staying in the family home into their twenties.

It's hard to be sure that these pieces of evidence aren't being driven by other social trends. Nonetheless this is of great concern because of all the benefits of home ownership to the individual and to our society.

The thing is, when life is harder for first home buyers, life is also harder for lower income households in the rental market.

There are indications that delayed home ownership is crowding out lower income households and increasing pressure on social housing services. Young working couples that would normally be purchasing their first home are instead renting for longer, crowding out lower income households.

Housing is a spectrum, and problems at the top of that spectrum have flow on effects for all incomes and tenure types. Moves to address constraints on the supply side of the market will go some way to alleviating pressures long this spectrum. But governments also need to address the undersupply of social and affordable rental housing which will be the subject of a forthcoming speech.