Speech

Housing Market Cycles and Fundamentals

RESERVE BANK OF AUSTRALIA

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I would first like to pay respect to the traditional and original owners of this land, the Muwinina people, to pay respect to those who have passed before us and to acknowledge today's Tasmanian Aboriginal people who are the custodians of this land. I also extend that respect to any First Nations people joining us here today.

It's exciting to be here to commemorate 100 years of REIA. Thank you for the invitation. The housing sector sits at the heart of the economy. Everyone needs a place to live and finding suitable housing is fundamental to people's quality of life. For many people, the family home is also a significant store of their wealth. And beyond that, the housing sector is responsible for a significant share of jobs, with supply chain linkages through most sectors.

Given the importance of the sector, I'm going to focus my remarks on how the RBA analyses and interprets the demand and supply dynamics, what these mean for construction activity and the broader economy, and the implications of these dynamics for our setting of monetary policy. I'll begin with some observations of the sector's demand fundamentals before discussing how the housing market responds in the short run when supply is constrained. I'll finish with our view of the outlook for supply over the next two years.

The drivers of underlying demand

Underlying demand for housing, whether people rent or own their own home, is fundamentally determined by the size of our population and the number of people that live (on average) in each dwelling.[1]

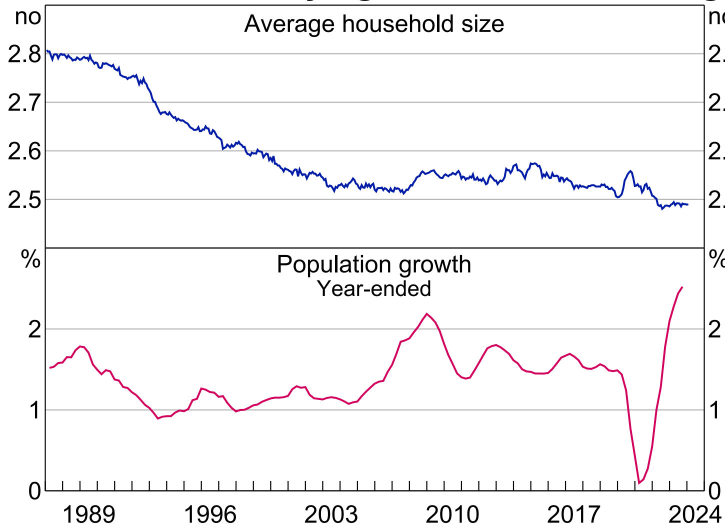
Although it has ebbed and flowed over time, the pace of population growth in Australia is typically faster than other advanced economies. Cycles in population growth tend to be driven by net overseas migration – a trend shown clearly during the pandemic. Border closures saw population growth fall to zero in mid-2021, and the reopening drove a rebound to 2.5 per cent per annum in mid-2023 (Graph 1).

A growing population clearly implies that underlying demand for housing is rising over time – all of these extra people need a place to live.

Right now, just under 27 million people live in Australia, in about 11 million households. The average number of people living in each household has trended lower, from around 2.8 in the mid-1980s to around 2.5 of late (Graph 1). This may sound like a small change. But, if for some reason average household size rose back to 2.8, we would need 1.2 million fewer dwellings to house our current population – no small difference.

Graph 1

Drivers of Underlying Demand for Housing



Sources: ABS; RBA.

Understanding the changes in average household size is therefore important for understanding demand for housing. At the RBA, we assess that part of the long-run decline in average household size can be explained by demographic factors. The ageing of the population means we now have more older couples and singles living alone, and lower birth rates means that the average size of a family is falling over time.[2]

Working in the other direction has been an increase in the share of young adults living with their parents. This might be because more young people are going to university and living at home for longer, but it could also be due to affordability considerations. And this hints that demographics are not the only factor affecting household size – affordability affects people's choices of where and who to live with.

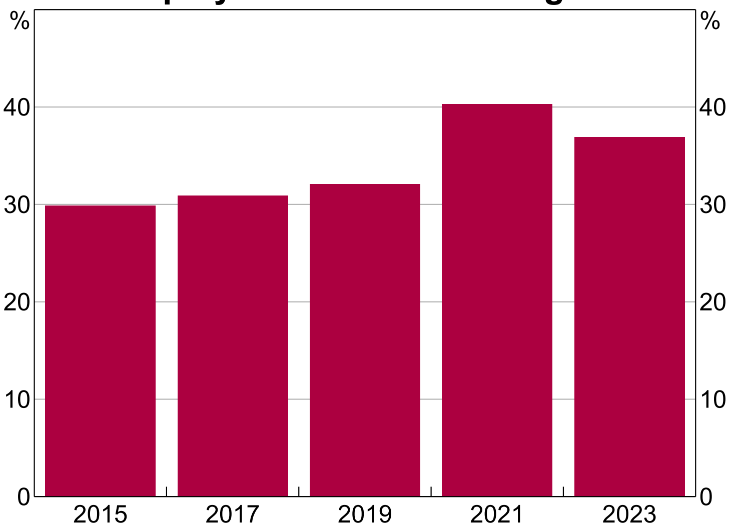
The demographic drivers of housing demand tend to be slow moving, but the pandemic period saw some dramatic shifts and acted as a catalyst for change.

During the pandemic, there was a shift in preferences towards more physical living space per person, which is understandable when lockdowns forced us to spend more time at home. This was particularly the case for people who shared a home with non-family members, such as young people living in a flat share.[3] This group shrank as a proportion of households, while the share living with their partner increased –as a result, the average household size declined.

The shift to working from home has also reinforced this change. While some people have returned to their workplace full time, there has been an increase in the proportion of people working from home – for many, a home office space is now highly desirable (Graph 2). This suggests that the recent falls in the average number of people per home will be at least partially permanent.

Graph 2

Share of Employed Persons Working from Home*



* Worked from home in the last four weeks.

Source: ABS.

Short-run response to rising demand

As many here today will know, housing supply does eventually respond to this growing demand. The speed and magnitude of that response can vary, however, and is determined by rental and housing prices, underlying construction costs and the time to design, approve and build.

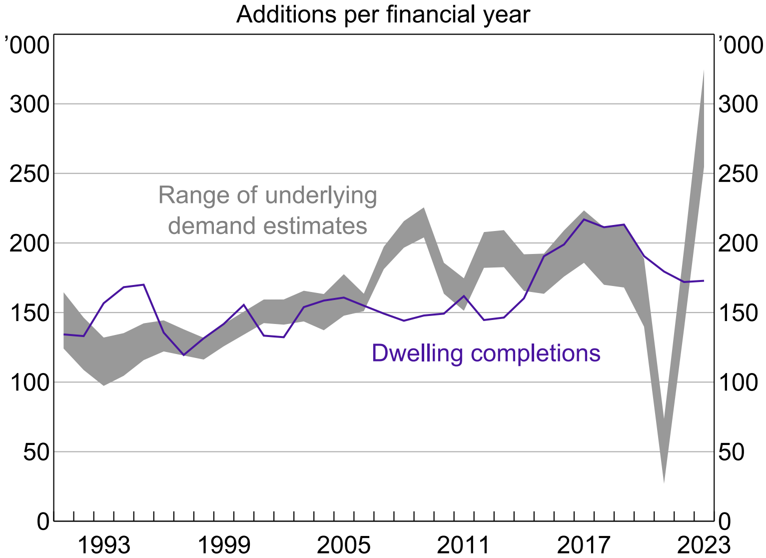
In the meantime, prices and rents do the adjusting. The extent of this adjustment differs through each cycle and depends on the relative movements in demand and supply.

The pandemic period – and its aftermath – stands out as a particularly sharp cycle. Growth in demand for new dwellings slowed rapidly in 2020 before rebounding strongly (Graph 3). Supply, as measured by dwelling completions, has been much less volatile and has trended down in recent years. Overall then, growth in demand is currently running well ahead of supply.

Graph 3

Underlying Demand and Supply

Additions per financial year

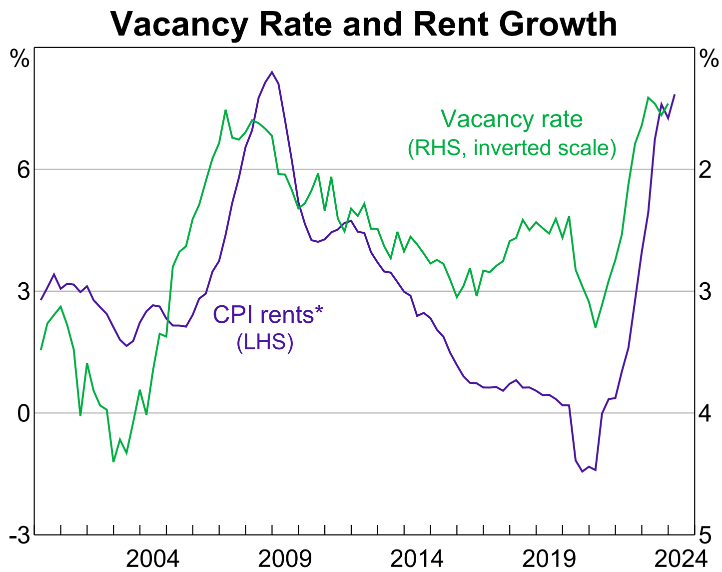


Sources: ABS; RBA.

The impact of the imbalance between new supply and new demand for dwellings can be seen in both the rental market and the established housing market. In most capital cities, rents are growing at a relatively rapid pace. And in the established housing market prices have risen significantly in recent years – demand versus supply fundamentals appear to be alive and kicking.

In the rental market, our assessment is that the level of demand relative to the stock of properties available is the key driver for market rents (Graph 4). There are a number of other potential drivers, one of which is the level of interest rates. Given the RBA's role in setting these, we are very aware of how interest rate settings transmit through the economy, and I will return later to the role interest rates play in determining the response of new housing supply.

Graph 4



* Year-ended growth.
Sources: ABS; RBA; REIA.

At first glance, it does appear that there could be a positive relationship between interest rates and market rents – the two often move together. However, our preliminary analysis suggests that market conditions (captured via the vacancy rate) explain most of the movement in market rents, and there is little to no evidence of direct pass through to rents from higher interest costs in the short term.

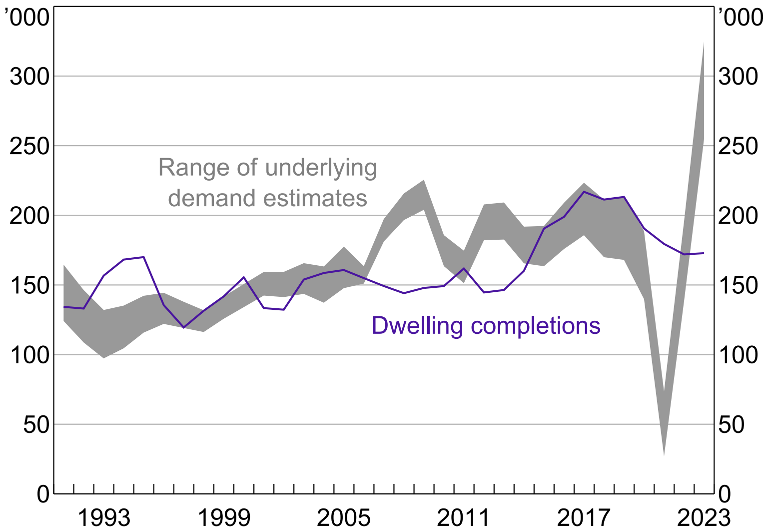
As such, the observation that market rents and interest rates move together appears to be a case of correlation, rather than interest rate rises causing rents to increase. For example, a strong economy with a pick-up in income growth will see increased demand for rental properties, which will put upward pressure on rents. At the same time, interest rates may need to be raised to combat broader inflationary pressures.

Indeed, there are a number of historical examples where rents and interest rates have diverged. For instance, rents continued to increase in Western Australia in the wake of the early-2010s mining boom even as the cash rate declined. And more recently, rents in many of the capital cities began to rise in 2021, before the first rise in the cash rate.

Current constraints on new dwelling supply

In the graph I showed earlier, the recent rapid growth in demand relative to supply was very clear. But it also showed that new supply has yet to pick up – dwelling completions have trended down over the last five years or so (Graph 5).

Graph 5
Underlying Demand and Supply
Additions per financial year



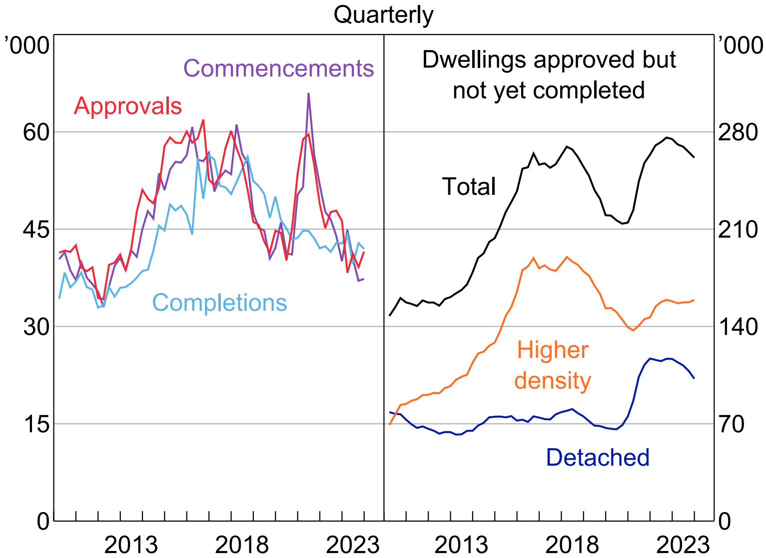
Sources: ABS; RBA.

Given the recent increases in demand and accompanying rise in rents and prices, this is a curious outcome – why hasn’t supply responded more strongly? I know many in the room are well aware of the challenges holding back new dwelling construction. Our assessment is that, at a high level, the last couple of years has seen a perfect storm of constraints on activity.

In the early days of the pandemic, COVID-related supply chain disruptions significantly limited the sector’s ability to respond to increasing demand, which was partly linked to the HomeBuilder program. Materials, fixtures and fittings, and skilled labour were in short supply, and shipping delays significantly extended build timelines.

While much of the supply chain disruption has been resolved, the pipeline of projects remains elevated and some capacity constraints are still binding. Businesses in our liaison program are reporting that finishing trades are currently in short supply, as the bulge of projects (particularly detached houses, as can be seen in the right-hand panel of Graph 6) started during the pandemic proceed towards completion.

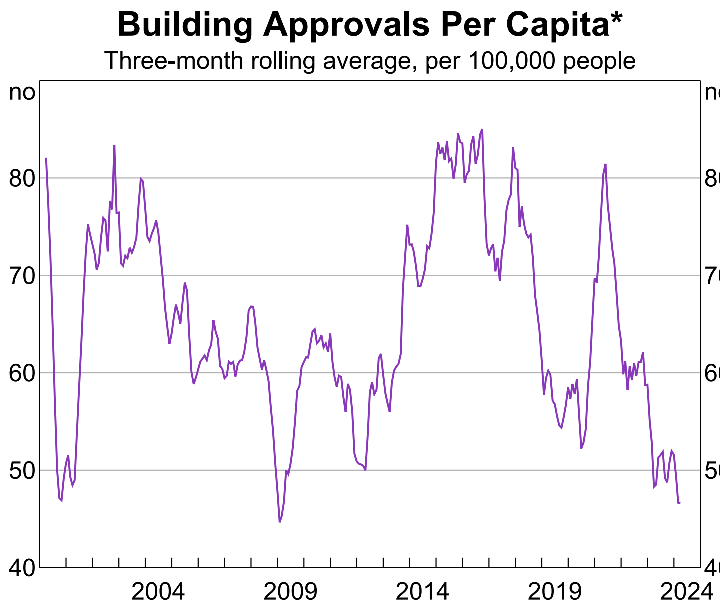
Graph 6
Residential Pipeline
Quarterly



Sources: ABS; RBA.

Having navigated through the temporary disruption created by the pandemic, the sector is now facing weaker demand – dwelling approvals per capita are sitting at decade-lows (Graph 7). In other words, some market participants have delayed projects or decided not to begin because of the relatively high cost of building when compared with the project's returns.

Graph 7



* Seasonally adjusted; for the population denominator, forecast is used from December quarter 2023.

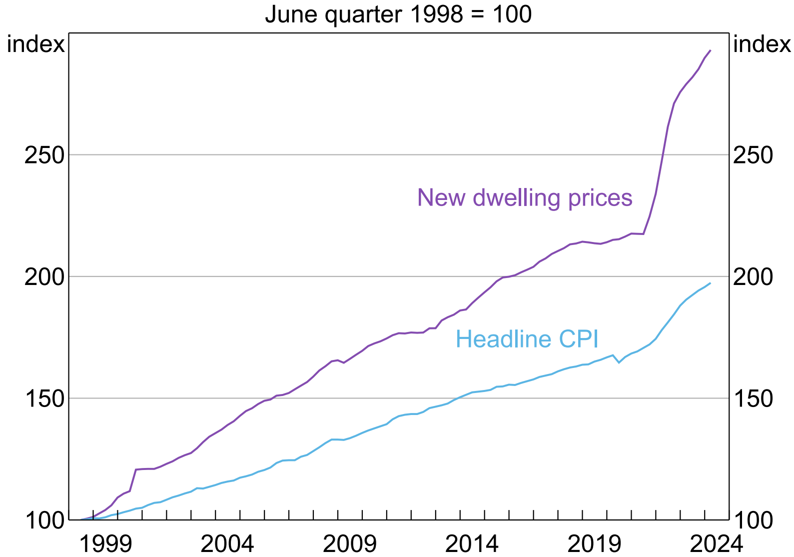
Sources: ABS; RBA.

So what has happened to the cost of building a home? A significant portion of dwelling construction costs are the direct costs of building materials and labour. In recent years these have risen sharply, and we do not expect them to fall back significantly. Pandemic-related supply chain disruptions and competition for resources from other types of construction have pushed up prices significantly, by nearly 40 per cent since late 2019 (Graph 8).

The cost of the underlying land, the approvals process, infrastructure availability and the time it takes to complete a project are also a key part of the sector's cost base, particularly for high-density dwellings (i.e. apartments). As has been highlighted by a number of industry participants and academics, an easing in zoning and planning restrictions and a streamlining of the approval process can reduce these costs, and all other things equal these changes would improve project viability and increase supply over time.

Graph 8

New Dwelling Prices

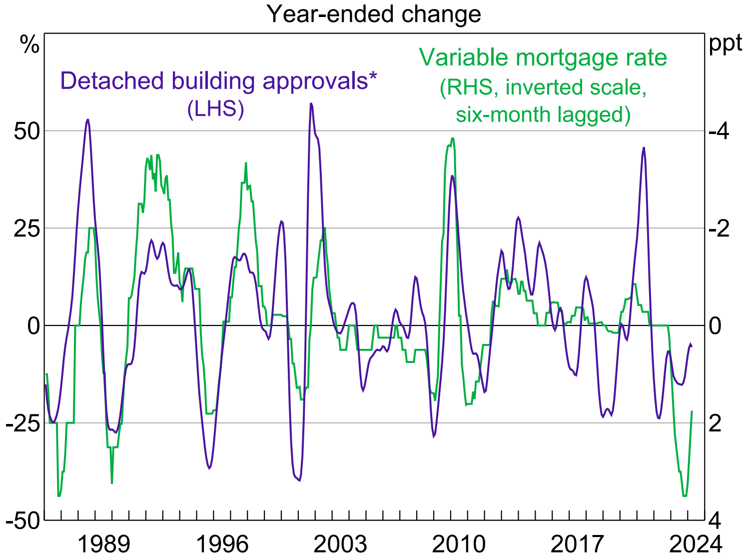


The level of interest rates is also a component of costs, and the impact of interest rate changes on new housing construction is one of the policy transmission channels we monitor. Many dwelling construction projects are funded by debt, and so higher interest costs will dampen the flow of new housing supply.

Graph 9 illustrates this relationship – there is some correlation between dwelling approvals and the mortgage interest rate, but it's not perfect. So, while we are very aware of the impact cash rate changes have on the decision to proceed with a building project, there are a number of factors that determine whether or not a developer or individual goes ahead.

Graph 9

Building Approvals and Interest Rates



Our assessment is that most of the impact of changing interest rates is cyclical rather than structural. When interest rates are rising dwelling approvals tend to fall, and this then flows into commencements and completions. But this typically reverses when the cash rate is cut.[4] Over the long run, it is the fundamentals of demand and the structural build cost that ultimately dictate supply – monetary policy does not have an impact on either of these underlying drivers.

Rebalancing supply and demand

Overall then, there is currently an imbalance between new supply of housing and growth in demand. Given the implications of this for rents, construction costs and activity, we are closely watching how these imbalances unwind.

Our assessment is that there are several potential avenues through which these imbalances may be resolved. We have already seen rents and prices rise, average household size could increase (which would reduce demand, for a given population size) and the pace of growth in construction costs could moderate. These responses will work towards rebalancing the market and resolve the current squeeze.

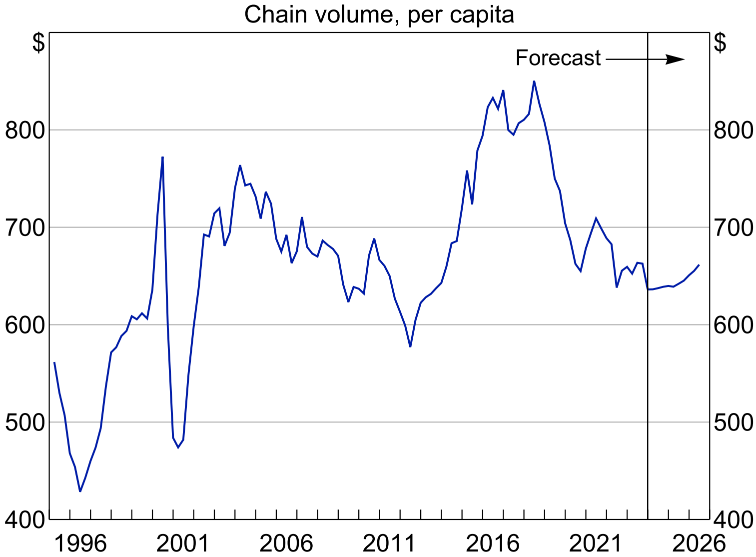
For example, we are hearing reports from our liaison program that some developers can see the strength in underlying demand and expect to respond with new supply (although it is early days). Federal and state government initiatives that streamline the approvals and build process will also reduce costs, which will ultimately lift supply.

But it will not be a quick fix. Demand pressure, and so upward pressure on rents and prices, will remain until new supply comes online. We expect this response to take some time to materialise, given the current level of new dwelling approvals and the information from liaison that many projects are still not viable. In the meantime, we expect residential construction activity to remain relatively subdued (Graph 10).

Graph 10

New Dwelling Investment*

Chain volume, per capita



* For the population denominator, forecast is used from December quarter 2023.

Sources: ABS; RBA.

Endnotes

[*] I would like to thank Andrew Hauser, Brad Jones, Chris Kent, Marion Kohler, Tom Williams, Michelle Bergmann, Claire Johnson and Declan Twohig for their input and comments.

[1] See also Kohler M and M van der Merwe (2015), 'Long-run Trends in Housing Price Growth', RBA *Bulletin*, September.

[2] See Agarwal N, J Bishop and I Day (2023), 'A New Measure of Average Household Size', RBA *Bulletin*, March.

[3] See Ellis L (2022), 'Housing in the Endemic Phase', Address to the UDIA 2022 National Congress, Sydney, 25 May.

[4] See also Saunders T and P Tulip (2019), 'A Model of the Australian Housing Market', RBA Research Discussion Paper No 2019-01.