Box B

Inflation and the Housing Cycle

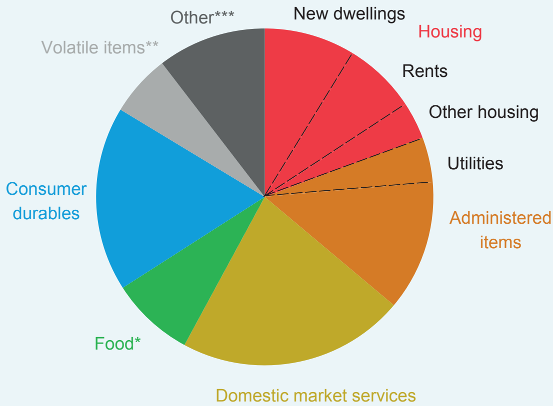
Strong conditions in the housing market over the past year or so have exerted upward pressure on inflation. This is in contrast to a general easing in domestic inflationary pressures, associated with spare capacity in product and labour markets. Stronger demand for new and established housing affects inflation directly and indirectly:

- *Direct effects:* housing components represent about one-fifth of the total CPI basket, and around one-third of non-tradable items (Graph B1). Housing components include the cost of owner-occupied housing and rents, as well as other housing-related costs. Importantly, the cost of owner-occupied housing is measured as the price of a newly built dwelling, excluding the value of the land, so it is related to price pressures in the new housing market. That is, the price of established dwellings has no direct influence on CPI inflation.[1]
- *Indirect effects:* demand for a wide range of goods and services included in the CPI might be affected indirectly by conditions in both the new and established housing markets.

In terms of the direct effects, housing inflation has picked up over the past two years, to be around its average over the inflation-targeting period (Graph B2). In contrast, the other components of non-tradables inflation have generally slowed over the past two years. Non-tradables inflation overall is below its inflation-targeting average.

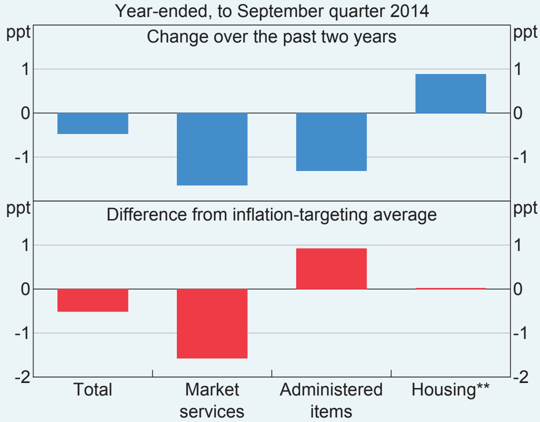
1 The cost of servicing a mortgage is also not included in the CPI, although is included in the ABS analytical living cost indices. For a discussion see Jacobs D, D Perera and T Williams (2014), 'Inflation and the Cost of Living', RBA *Bulletin*, March, pp 33–46.

Graph B1
CPI Basket
Per cent



* Excluding alcohol, fruit, vegetables, meals out and takeaway
** Fruit, vegetables and automotive fuel
*** Alcohol, tobacco, pet & related products, and international travel & accommodation
Sources: ABS; RBA

Graph B2
Non-tradables Inflation*
Year-ended, to September quarter 2014

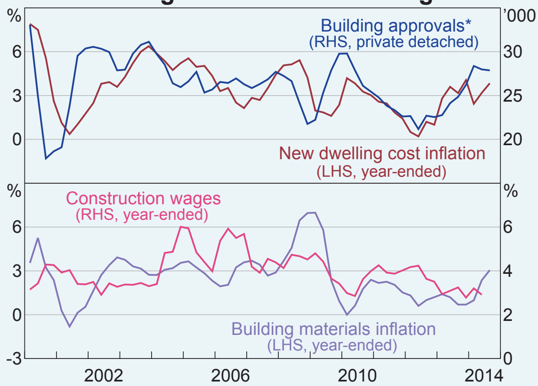


* Excluding utilities
** Excluding administered items; new dwelling costs not directly included in CPI basket prior to September quarter 1998
Sources: ABS; RBA

The pick-up in housing inflation has been driven by the cost of new housing. The price of a newly built dwelling has risen by nearly 4 per cent over the past year – faster than its historical average and around the quickest pace in nearly five years, a period over which conditions in this market had generally been subdued. New dwelling inflation has tended to move closely with the cycle in residential building activity, as gauged by building approvals (Graph B3).[2] An upswing in residential building activity typically places upward pressure on new dwelling prices both by providing scope for builders to increase their margins and by pushing up the costs of labour and materials in this market.[3] The Bank's liaison suggests that builders have been able to increase margins over the past year or so, which is consistent with inflation for new dwellings exceeding growth in construction wages and materials costs. Labour cost pressures have been subdued to date, with construction wage growth around its slowest pace in the past decade or so. Workers with skills in construction are reported to be readily available, in part because demand for such labour from the resources sector has declined. In contrast, building materials inflation has risen somewhat over the past year or so – particularly for items such as timber, cement and sheet metals – and now is a little above its historical average.

In contrast to new dwelling costs, the growth in rents has eased in recent years, to be around its slowest pace since the mid 2000s (Graph B4). This has been accompanied by a gradual increase in the rental vacancy rate, although this remains below its long-run average. The balance of supply and demand in the rental market will be affected by conditions in the established housing market; in principle, more households seeking to own rather than rent will weigh on rental demand. At the same time, increased housing construction activity and strong growth of investor purchases will add to the supply of rental properties.[4]

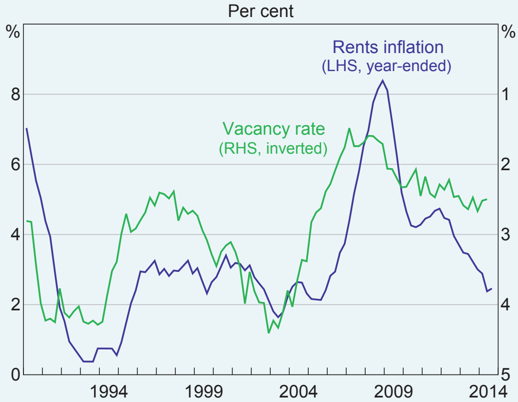
Graph B3
New Dwelling Inflation and Building Costs



* Three-month rolling sum

Sources: ABS; RBA

Graph B4
Rents Inflation and Vacancy Rate



Sources: ABS; REIA

The housing cycle may also exert an indirect influence on inflation through its effect on demand for a broad range of goods and services. The level of turnover in the market for established housing is likely to be positively correlated with demand for durable goods, such as furniture or white goods. However, despite

2 See Jacobs D and T Williams (2014), 'The Determinants of Non-tradables Inflation', RBA *Bulletin*, September, pp 27–38.

3 According to liaison, the cost of residential construction is roughly evenly split between materials and labour.

4 Outcomes for aggregate inflation may also affect the rate of rental inflation because some landlords may index rents to the CPI. Accordingly, the relationship in Graph B4 is stronger still if considering 'real' rents, deflated by the aggregate CPI.

the overall strength in housing market conditions, turnover has increased only moderately to date (see 'Box A: Housing Prices, Turnover and Borrowing'). More generally, higher labour earnings and profits in the construction sector would be expected to contribute to aggregate demand. In addition, a rise in housing prices resulting from more housing activity raises the wealth of households that already own property. This is typically associated with a rise in spending across a range of goods and services, providing retailers greater scope to raise prices. Working in the other direction, some households may reduce their spending in order to accumulate a deposit or service a new mortgage. Altogether, these indirect effects are likely to be small and therefore difficult to observe among the many other influences on prices in the CPI basket.