Response to some questions in the Issues Paper, September 2003

What factors have caused recent housing price increases?

The major factor causing **recent** housing price increases is *low interest rates* (refer to next question for more details relating to this major factor). Other factors that have contributed to the recent increase in housing prices include:

- Low investment returns offered by other assets (including cash and equities) in recent years. Superannuation funds have reported low or negative investment returns in recent years. This environment has contributed to an increase in investment in geared housing property. Many people have come to believe that geared housing investment is the best way to "build wealth".

  Australian households appear to have a relatively low proportion of their balance sheets directly invested in shares (e.g. compared to US households). Australia's stock market weathered the global equity downturn relatively well. So, it is likely that Australian households' wealth suffered less from the stock market downturn post June 2001 compared to households in some other countries. This may have, at the margin, preserved Australian households' equity for subsequent investment in housing. But, another implication is that Australia may have had more speculative activity in its housing markets prior to June 2001, relative to other countries.

- Capital tax gains tax changes. To the extent that investors have forecast high growth in housing prices, the tax change may have provided additional investor demand (which has had a positive effect on housing prices).

- Easy credit terms. For example, loans are available for 100% of purchase price and, in some cases, 100% of purchase price plus transaction costs (based on a radio report). Deposit bonds are available. Low-doc loans require little, if any, proof of income.

- Frenzied purchasing activity by both owner occupiers and investors. Some purchasers aim to "get in before it is too late". Some purchasers have extrapolated past housing price growth forward and have developed unrealistic expectations of future price increases. "Success" has being associated with the type and value of home one has (refer below). There has been the emergence of individuals or partners purchasing a large number of investment housing properties (refer further on). Housing investment has been promoted as a "highway to wealth and financial security" and some investors have taken on high levels of debt to achieve this goal. The RBA has estimated that the ratio of debt to the value of housing assets for investment housing rising from 15.6% in 1992 to 36.1% in 2002.

- Population growth and more particularly immigration. Immigrants are more likely to have immediate housing needs. The last housing boom in the 1980s occurred during a period of high immigration.

There are other factors that may have increased housing prices over the longer term. These factors include:

- Rising household disposable incomes (HDI), growing at an average annualised rate of 5.8% in the five years to 2002-03. However, growth in HDI was lower in the last two years (4.8% in 2001-02 and 3.5% in 2002-03). Moreover, HDI grew at a much slower rate in real terms (1% in 2002-03). It should be noted that growth in HDI per capita or per household was obviously slower (due to population growth). In addition, not all of the increase in HDI may be available for debt servicing. New products, services and government cost shifting may have eaten into household budgets and this is not fully accounted for by inflation data (these new expenditures are on things such as mobile phone, pay-TV, road tolls, school fees, HECS, medical services co-payments etc).

- An increase in economy-wide employment, which grew at an average annualised rate of 2% in the five years to 2002-03. However, there has been very slow growth in full-time employment since 1999-2000 (growing at an average rate of less than 0.3% in the three years to 2002-03). Financiers have tended to be averse to lending to people without a full-time job, although some financiers have recently introduced low-documentation loans (where proof of income may not be required) and reverse mortgages.

- An increase in the female workforce participation rate. This has contributed to an increase in the number of double-income families. However, a rise in the number of single person households and single income families has had an offsetting effect. Also, marriage numbers may have declined in recent years (marriage numbers fell by 9.1% in 2001 – latest data held by this writer).

- A reduction in the average number of persons per household (due to growth in the number of single person households, a trend toward families with fewer children and an aging of the population), which has had a positive effect on demand for existing housing stock. ABS Census data suggests that the average number of occupants per dwelling fell from 3.6 in 1961 to 2.8 in 1991 to 2.7 in 1996. However, this is a very gradual long-term trend, which probably has not had a significant effect on prices in recent years.

- An increase in the average size of new separate dwellings. These houses are often highly capitalised on a relatively small block of land. As buildings usually depreciate in the long term, the high investment in buildings may have adverse long term effects for some owners (i.e. relative to owners of less capitalised properties).

- Commonwealth government subsidy incentives for first home buyers, although this appears not to have had a significant effect on prices in the last couple of years. Indeed, the subsidy has recently fallen.

- Easier access to debt finance, deposit bonds and other financing. Lending practices are dealt with in a previous submission.

- Low growth in public housing and greater reliance on the private rental markets to accommodate low income households (with rent assistance subsidies). According to the Australian Council of Social Service, public housing stock has fallen in the last ten years from 6.2% to 4.7% of all housing (The Australian, 14 May 2003).

- Investment and property advisers who promote debt driven wealth accumulation, and who capitalise on fears of financial insecurity in retirement.

- The media promotes life-styles which people aspire to. This may motivate the accumulation of excessive debts by some people who wish to attain such life-styles.

What evidence is there that there is a bubble in housing prices?

A number of historical relationships between housing prices and other variables have moved way out of alignment, as the following illustrates:

- Housing prices are currently very high relative to average earnings and household disposable incomes. This situation remains true when comparing this relationship at other points in time, including when interest rates were comparable with current interest rates. ANZ Economics states that "the ratio of housing prices to average earnings is now at an all time high" ("Assessing the fundamental value of Australian house prices", 19/11/02). ABS data suggests that housing prices in the major capital cities increased on average by 61.2% between 1998-99 and 2002-03. Household incomes increased by 25.8% over the same period. The average interest rate on a bank standard variable rate mortgage was 6.58% in 1998-99, compared to 6.55% in 2002-03 (mortgage manager variable rates were higher in 1998-99 compared to 2002-03). Moreover, real interest rates were much higher in 1998-99 than in 2002-03.

- Rental yields on investment housing are currently very low, even when compared to yields during periods when interest rates were comparable with current interest rates. It should be noted that rental yields are calculated before revenue losses from tenant vacancies, property expenses, and before tax.

  Housing investment returns before unrealized capital gains are relatively low compared with some other assets.

> While rental yields are low on an historical basis, dividend yields on equities are currently relatively high compared to the average experienced over the 1990s. This may be partly due to the introduction of dividend imputation during this period. There are, of course low expenses associated with receiving dividends and they offer a tax credit for tax paid by the dividend payer (e.g. the company or trust).

A number of reputable organisations have published research on the fundamental value of Australian housing assets. The findings of this research are often contradictory – and to a very large degree in some cases. Some research suggests a large bubble has formed in housing prices, but some other research has suggested otherwise (at least until earlier this year).

ANZ Economics has published interesting papers on "Assessing the fundamental value of Australian house prices" (19/11/02) and "Revisiting the fundamental value of house prices" (26/6/03). The latest of these papers appeared to suggest that the market was fairly valued (with the possible exception of a small overvaluation in Melbourne and Sydney). It must be said that new housing price data was released after publication of the latest of these papers (June 2003). This new data may cause ANZ Economics to revise the conclusions it reached in its June 2003 paper. Nevertheless, ANZ Economics' assessment of fundamental values was based on a number of assumptions which can be credibly challenged – including those on (1) <u>real</u> interest rates, (2) investors required rates of returns, and (3) rental growth. If real interest rates increase from current levels, it would appear that ANZ Economics would need to adjust 'fundamental values' downward. Similarly, if investors require a rate of return that is higher than that assumed by ANZ Economics it could a have a significant downward effect on such values (for example, recent housing price growth may have resulted in unrealistic expectations of future returns). ANZ Economics has also assumed that rental price growth should continue to follow consumer prices for the foreseeable future, and this assumption may not be realized (particularly in view of rising vacancy rates).

<u>Real</u> interest rates have been abnormally low for a long period and are unsustainable over the longer term (refer to my previous submission, which shows that the RBA's cash rate has declined in recent years). Low real interest rates can be a disincentive to save and can encourage higher debts, which can also drive up asset prices (and associated debts). This can bring forward economic activity. The Governor of the Reserve Bank, Ian Macfarlane, seems to have indicated in the past that interest rates will eventually go up to "normal" levels. If the RBA acts on this previous indication, it will affect housing prices in the future. The following points show the implications of abnormally low real interest rates.

- Monetary policy has set interest rates at low real levels, which means policy is in an expansionary setting. There is an inverse relationship between interest rates and asset prices. Indeed, the Deputy Governor, Glenn Stevens, has stated "Monetary policy works, after all, in changing financial prices".

The decline in real mortgage interest rates			
	Ave Bank Standard Variable Mtge Interest Rate	*Change in CPI (All Groups) – last quarter*	*"Real Interest Rate"*
1982-83	15.4	11.1	4.3
1983-84	14.2	4.0	10.2
1984-85	13.8	6.6	7.2
1985-86	15.9	8.5	7.4
1986-87	18.1	9.3	8.8
1987-88	16.9	7.1	9.8
1988-89	17.8	7.6	10.2
1989-90	19.7	7.7	12.0
1990-91	18.4	3.4	15.0
1991-92	13.0	1.2	11.8
1992-93	11.9	1.9	10.0
1993-94	9.9	1.7	8.2
1994-95	10.0	4.5	5.5
1995-96	10.4	3.1	7.3
1996-97	8.3	0.3	8.0
1997-98	6.7	0.7	6.0
1998-99	6.6	1.1	5.5
1999-00	7.0	3.2	3.8
2000-01	7.6	6.0	1.6
2001-02	6.3	2.8	3.5
2002-03	6.6	2.7	3.9
Source: RBA Statistics			

- But low real interest rates have a more pervasive effect on asset prices. Low real interest rates encourage demand from both owner-occupiers and investors, and provide the motivation to bid-up prices. Some people perceive that saving for a deposit is a losing proposition in an environment where real interest rates are low and housing prices are rising. And this has weighed on decisions to purchase housing earlier rather than later and with a lower deposit (aided by willing financiers). This has brought forward demand from first home buyers. Lower real interest rates have also motivated existing owners to trade-up and investors to purchase houses.

The Futility of Saving The real value of initial deposit of $50,000 invested on July 1, 1999 in a cash management account by a person on the top marginal tax rate.				
	1999-2000	**2000-01**	**2001-02**	**2002-03**
Deposit cf	50000	51183	52587	53620
Interest Income	2297	2726	2006	2185
Tax (@ 48.5%)	-1114	-1322	-973	-1059
Balance in current prices	51183	52587	53620	54746
Real Value of Initial Deposit at year-end prices	**48455**	**45703**	**44440**	**43277**
Ave Interest Rate on CMA	4.5%	5.2%	3.75%	4.0%
Note: *Values expressed in quarter end prices, discounted by CPI (All Groups) at quarter end.*				

- The above analysis is conservative because it does not discount interest received (net of tax) by the CPI All Groups. Nevertheless, the implications of low real interest rates are much more serious for prospective house buyers, as house asset inflation has significantly exceeded consumer price inflation (as measured by the CPI). There are also other economic implications associated with low real interest rates.

- Australian households spent more than they earned in each of the last three quarters of 2002-03 (and their spending exceeded their income for the full 2002-03 year). The household savings rate has not been negative in any year in the records studied by this writer (i.e. dating back to 1960). Negative household saving has an adverse effect on Australia current's account and external debt. Household savings rates over various periods are provided as follows:

Savings as a percentage of Household Disposable Income

	Average Rate
10 years to June 1990	9.0%
7 years to June 1997	5.6%
6 years to June 2003	1.9%
2001-02	2.3%
2002-03	-0.7%
Last quarter of 2002-03	-1.2%

- The recent rise in housing prices will, if sustained, lock in unacceptable growth in housing credit. Part of the future growth in housing credit is already locked-in due to extended settlement periods. A large number of high-rise units are scheduled for completion in the next few years, which will add to household debt levels. In addition, new financing products, such as low-doc loans and reverse mortgages for seniors, will accentuate growth in housing credit.

  Growth in housing credit is increasing the risks to the economy and, in particular, to indebted households (with potentially significant implications for housing prices). The Deputy Governor of the RBA, Glenn Stevens, noted in August 2003, “leverage may yet increase a good deal further, since the as-yet-untapped equity in the housing stock is still very large, and the capacity to access it is growing”. Yet, back in February 2002 , the RBA’s statement on monetary policy stated that "it is not clear what would be a sustainable household debt-to-income ratio in the longer term, but some deceleration in the growth in household indebtedness would be desirable in coming years" (in February 2002 this ratio stood at about 113% and in June 2003 it stood at 134%). In August 2003, Macfarlane told the House of Representatives Standing Committee on Economics, Finance and Public Administration “… if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing – the credit driven house spiral – also continues over the 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession”. Yet Australia seems to be doing its part to help this doom scenario come to fruition.

- Household debt as a percentage of household disposable income increased from 56 per cent in June 1993 to 134 per cent in June 2003. Australia had a low debt-to-income ratio in the early 1990s when compared to other countries, but Australia now has a relatively high ratio of debt-to-income. So the rapid increase in household debts (mainly housing debt) in a relatively short period must mean that household debt in Australia is more highly concentrated relative to other countries. That means that there appears to be more households in Australia with very high debt-to-income ratios, compared with many other countries. More data needs to be collected by the RBA on the distribution of household debt.

- One economy-wide debt-service measure is *interest paid by households on housing debt as a percentage of household disposable incomes*. RBA data suggests that gross interest paid by households represented 7.9% of household disposable income in the June quarter of 2003, compared to 6.4% February 2002. Interest commitments relative to income have not been as high as 7.9% since the September quarter of 1990 (a time when the standard variable home loan interest rate was 16.25%).

Quarter ended June	Household Interest Paid* as a % of Household Disposable Income	Average bank variable mtge interest rate (%)
1980	5.9	9.81
1989	8.2	16.25
1990	8.5	16.63
1991	7.6	14.00
1992	6.1	10.88
1993	6.0	9.75
1994	5.7	8.75
1995	7.0	10.50
1996	7.6	10.31
1997	5.8	7.38
1998	6.4	6.70
1999	6.4	6.50
2000	7.5	7.61
2001	6.5	6.93
2002	6.8	6.24
2003	7.9	6.55
Source: RBA Note: Mortgage interest rates are a simple average		

- If household debts continue to grow at the present rates, within 12 months gross interest paid may take more of households' disposable income than in any June quarter in living memory (and that is without the RBA raising interest rates). And then add households' principal repayments, which are already at record levels.

Back of the envelope calculation of interest paid as a percentage of household disposable income (HDI) in June quarter of 2004 assuming: • *Household disposable income grows by 4.5% in 2003-04 (growth previous year 3.7%)* • *Household debt growth by 18% in 2003-04* • *No increase in interest rates in 2003-04*		
	June quarter 2003	**June quarter 2004**
Estimated HDI ($mil)	125874	131538
Estimated Interest ($mil)	9944	11734
Interest/HDI (%)	7.9	8.9%

- But growth in total mortgage repayments (i.e. interest and principal) as a percentage of household disposable income appears to be a more appropriate indicator of bubble-like behavior (i.e. compared to the interest-to-income ratio). The RBA estimated in April 2003 that, for households with housing debt, the total service payment (interest and principal) averaged 20% of disposable income (when variable home loan rates were 6.5%) compared to 14% in ten years earlier (when variable home loan rates were 10%).

- Credit as a percentage of GDP has risen rapidly for a number of years, due mainly to growth in housing credit. Macfarlane acknowledges that this cannot continue indefinitely. But if credit growth slows appreciably or contracts (as it did in the early 1990s), the liquidity driving the property market will dry up.

- To assist fund the growth in household debt, Australian financiers have borrowed from overseas. Net external debt increased by 9 per cent in 2002-03. Net external debt increased at an average annualised rate of 9.5% in the five years to 2002-03. As a percentage of GDP, net external debt had grown from 40.6% to 47.8% over this 5-year period. The rise in external debt also raises the risk to the economy from an external economic shock.

- Low real interest rates may have contributed to a decline in wealth among young Australians over the longer term. This may adversely affect housing prices going forward. A report prepared by the National Centre for Social and Economic Modelling for the Financial Planning Association of Australia suggested that there was a real decline in wealth among households whose head was aged 15 to 24 (with wealth declining by 33.3% on average over this period), 25-34 (declining by 38.9%) and 35 to 44 (declining by 10.3%) – refer to Letters to the Editor, Australian Financial Review, October 25, 2002.

- Some owner-occupiers are taking on high housing debt commitments (either by purchasing their own home or by trading up) at a later age. This means that some households are entering into high debt commitments closer to the time when other new financial commitments may come along (such as children). On the other hand, the fall in birth rates may indicate that some couples are putting off starting a family or are reducing the number of children they have due to high debts – this must have significant implications for society and governments.

- Investors now account for a larger proportion of housing stock. This will make the market much more volatile.

The above analysis illustrates some of the implications of low real interest rates. These implications may not be acceptable to policy makers, which could result in an increase in real interest rates in the future.

Other factors suggesting, or potentially triggering, a bubble

- A rise in vacancy rates for rental housing.

- High levels of construction (and approvals for construction) of new housing units. There are a large number of high rise units scheduled for completion in the next few years, which will add to supply.

- The incidence of some investors buying very large numbers of properties. Reported cases include the purchase by individual or small partnerships of over 300 housing properties. Some investors are buying sight unseen – refer below for more details.

- There are concerns about the sustainability of housing prices in other countries. A downturn in another major market may create nervousness among local investors and trigger a sell-off in Australia.

- Capital tax gains tax changes (i.e. the 50% discount). To the extent that investors have forecast high growth in prices, the tax change may have resulted in forecast after-tax returns being increased. This may have promoted additional investor demand (increasing prices). However, if forecast growth in housing prices is not sustained, investor's previous assumptions about after-tax returns may prove illusory. This may cause some housing investors to sell.

What effects have recent housing price rises had on the affordability of home ownership?

- It has significantly reduced affordability. But 'affordability' should be viewed as the ability to own a home (i.e. to meet the initial deposit, transaction costs and all mortgage payments, without making undue sacrifices, such as foregoing the necessities of life, having children, and providing for retirement). It may be prudent to calculate affordability by taking into account expenditure commitments and by using a "normal" interest rate.

Are current trends in housing prices and affordability likely to continue in the foreseeable future?

A key factor affecting prices in the short to medium term is real interest rates. But the recent price gains must provide some existing home owners with the capacity and motivation to "trade up" or to invest in additional houses. The Deputy Governor of the RBA, Glenn Stevens, noted in August 2003, "leverage may yet increase a good deal further, since the as-yet-untapped equity in the housing stock is still very large, and the capacity to access it is growing". Nevertheless, a continuing expansionary monetary policy setting (i.e. low real interest rates) may, ultimately, cause the market to fall under its own weight, for the following potential reasons:

- Some prospective first home buyers may have already pulled out of the market for affordability reasons. If so, other potential buyers may do likewise in the future.

- Households will eventually adjust their balance sheets and pay down debt, as they must. This will adversely affect consumer spending and economic activity (including growth in employment). Ironically, this will also affect debt serviceability, the demand for (and price of) property and may cause some forced sales. Financiers have relied to a significant extent on foreign borrowings to fund home loans, and when home loan growth slows or turns negative – this will cause funds to flow out of Australia, which may accentuate a downturn. But the longer household debt continues to climb, the more severe a downturn may turn out to be.

- Continuing strong growth in household debt will adversely affect access to capital by the productive sectors, which will adversely affect future economic and employment growth and, hence, affordability. Management consultant, AT Kearney, conducts surveys on foreign direct investment (FDI). According to an article in the Australian Financial Review (19/9/03), AT Kearney has noted that Australia had dropped from 10^{th} to 19^{th} in its latest FDI survey. The AFR quoted AT Kearney's south Asian managing director as saying "investors were also concerned about rising household debt and the country's real-estate bubble".

Are median price trends representative of trends within housing sub-markets?

- There appear to be large variances around the median. It may be worth collecting and analysing data at 25^{th} percentile, 50^{th}, 75^{th} etc. There does seem to have been higher growth in some areas (e.g. coastal areas, some CBD areas).

Is any 'bubble' in housing prices confined to particular market segments?

- Not to a significant extent. The high-rise apartment market segment, for example, is a very small part of the overall housing market. Nevertheless, rapid growth in this sub-market will take tenants away from other sub-markets. Also, some investors in high-rise markets have investments in other sub-markets, so a correction in the high-rise market could cause forced sales in other market segments. A correction in the high-rise market could affect investor sentiment generally.

- There has been significant investment in smaller units as well as houses. Some individuals and partners have accumulated very large housing investment portfolios. This appears to be a relatively unique phenomenon. If any such individuals were to suffer financial difficulties or bankruptcy, this could result in the forced sale of a large number of properties at a similar time, which could have significant ramifications in some markets. It is also possible that some of these investors have a large number of lenders (i.e. many separate loans for specific properties), which presents other ramifications.

- The fall away in first home buyer demand may to some extent reflect a wider imbalance.

- Some owner-occupiers have accumulated large debts and may not be able to cope financially with periods of unemployment or underemployment or higher interest rates. A mobile home lender candidly told the writer in March 2003 that there were a lot of borrowers who would not be able to fully meet scheduled loan repayments if interest rates were to rise by just 2%.

Why have different parts of Australia (capital cities and regions) experienced different trends in housing prices?

- It seems that one area (such as Sydney or Melbourne) can have a leading influence. Investors may have some influence in bringing relativities back. For example, there appears to have been significant investment by Victorians in lower priced Tasmanian property – in the face of low or negative growth in State GDP and population. There is also investment by Melbourne investors in Victorian provincial towns (yield chasers). Also, some families have moved from one city to another (e.g. from Sydney to Melbourne) to avail themselves of lower housing prices. Some people have moved from a capital city to a provincial city for the same reason.

How do Australia's housing price levels and trends compare with those in similar countries?

- The RBA's paper, "City Sizes, House Prices and Wealth" (2001) found that the Australia household sector holds a large proportion of its wealth in housing assets compared to other countries. The RBA also found that the ratio of Australia's housing wealth to income in 1998 was much higher than the ratio recorded in other advanced countries, with the exception of Japan. So, growth in housing prices in Australia seems to have come off an already high base in 1998.

- The Economist magazine has data on the returns from rental housing (including rents and capital gains) in various countries between 1992 and 2002. The Economist magazine ("Betting the House", 6/3/03) suggests that Australian housing prices grew by 13.4% in calendar 2001 (beaten only by Spain in its list of 13 countries) and grew by a further 18.4% in 2002 (beaten only by the UK).

- Housing price growth in Australia appears to have been strong in the 6 months to June 2003.

- In 2002-03, housing prices in Australian capital cities increased by an average 18.1% and housing credit was up 21.4%. In August 2003, the RBA released data showing that household credit in Australia had grown by 19.6% in the latest year - the highest rate of growth among the 12 countries it measured (Spain ranked second place with 12.7% growth). The latest data suggests that housing credit grew by 1.8% in July 2003. If sustained, this would represent an annualised growth rate of 23.9% for 2003-04.

What are the reasons for observed similarities or differences?

- This is difficult because price growth varies according to the time period selected. For example, the prices fell significantly in the United Kingdom in the early 1990s, so that it may be necessary to go back further in a comparing Australia with the UK.

- But, the RBA's paper, "City Sizes, House Prices and Wealth" (2001) suggests that Australia's housing prices in 1998 may have already been high compared with other countries. ABS data suggests that prices in Australia's capital cities grew by about 71% on average between July 1, 1998 and June 30, 2003.

- It appears that <u>real</u> interest rates in Australia were low compared to some other countries until about June 2001 (such as compared to the US). Global equity markets then suffered a severe downturn although the Australian market faired better than some other overseas markets. This helped the Australian economy. So, Australia's interest rates did not fall to the same extent as they did in some other countries (such as the US).

- The capital gains tax changes.

How should affordability for first home buyers be defined and measured, both in principal and in practice (taking into account data availability)?

- Existing indicators of home loan affordability tend to base results on medians and averages of family incomes, loan amounts, and interest rates at a distinct point in time. This is really "top of the envelope" analysis. The reality is that there are enormous differences around the median and average. Loan commitments can be contracted for up to 30 years and interest rates could vary significantly over this period. Many other factors will affect affordability going forward, such as the age of purchaser/borrower, economic growth rates (affecting employment outcomes) and future household spending commitments.

- If policy makers want to have more informative data on housing affordability they will need to construct a range of indexes based on varying types of households (i.e. incomes, family size). They will need to take into account household expenses. It may involve actuarial calculations.

- In view of current real interest rates not being "normal" (i.e. being low in real terms), affordability should also be calculated by using some higher rate, which would more likely prevail in the longer term. This rate could be determined by consultation with the RBA.

Is it possible to assess affordability using a single measure?

- Household incomes and expenditure commitments vary by household size, age, location and occupation.

Is it lower now that at times in the past?

- In the absence of better measures, affordability is very low on an historical basis, particularly if interest payments are adjusted to incorporate a sustainable real interest rate.
- There is new spending, which affordability measures may not take into account.

Does it reflect different influences to previous episodes of declining affordability?

- Yes. Based on the current measures (which are inadequate – refer above) affordability in the late 1980s was low. During the 1980s, there was high inflation and significant speculative asset price inflation, so interest rates were very high. But high inflation was good for borrowers because the real value of their debts declined quickly (and household incomes rose with inflation to ease repayment stress very quickly).

Do affordability trends differ for first home buyers with different income and household characteristics?

- Yes. The rise in prices relative to income mean that it is harder for households with incomes which are low or not growing to save and borrow to buy a home.

- Some first home buyers may receive tenants to lighten the debt burden.

Is the fall in the number of first home buyers due to a decline in affordability or is it due to other factors?

- Not all due to affordability. It may to some extent represent a long-term trend. For example, the fall in marriage rates may have contributed to an increase in lone-person households (which may find it more difficult to afford a home). Nevertheless, ABS data suggests an increase in first home buyers who form lone person households.

- Some house purchases were probably brought forward by the Federal Government's first home buyer grant. There may also be some demographic reasons flowing through. Other possible reasons include longer periods spent in higher and other education, a fall in wealth (refer above), debts (e.g. HECS), higher spending commitments on new products and services (e.g. mobile phones, pay-TV, road tolls, education fees, bulk billing for medical services etc).

- Some people perceive that saving for a deposit is a losing proposition in an environment of both low real interest rates and rising housing prices. And this has weighed on decisions to purchase early with a lower deposit (aided by willing financiers), bringing forward demand.

- A long term rise in the number of single income families.

- An increase in lone person households. The ABS has pointed out that the cost of living alone can be high.

- A fall in marriage rates.

- Low growth in full-time employment. Employment growth has been in part-time and casual workers, who may find it difficult to obtain finance or who may not have the confidence in themselves to service loan commitments.

What are the characteristics of first home buyers?

- They are younger than changeover buyers (refer to ABS data, which also provides other characteristics on a number of bases).
- They tend to have low savings and other wealth. It appears that more lone person households are buying a home.

Have these characteristics changed over time?

- It appears that savings and wealth has declined for young people (refer above). Younger people are in education for longer periods. There is a relatively high unemployment rate among young people.

Will these changes continue in the future?

- Yes. At least while the incentive to save is low.

Is the culture of home ownership as strong among younger people as it has been in the past?

- It may not be because of a long term trend decline in marriage and birth rates. There also appears to be a culture of "lifestyle" spending and a diminishing culture of saving.
- There is spending on new goods and services, such as mobile telephones, pay-TV, computers, Internet access, road tolls, HECS fees, etc. These relatively new payments are not initially picked up by consumer price inflation measures (i.e. an increase in products rather than prices), even though they may replace other services (such as free road use or fee education).

Have first home buyers' preferences or aspirations changed concerning housing size, quality or amenity?

- Appears that there is a preference for large homes. But these homes are usually highly capitalised.

How should housing markets be defined?

- By price range, by area, by housing type, by block size.

What are the characteristics of investors in housing?

- Refer to ABS data. The Australian Tax Office also has information. The Reserve Bank may have instituted reporting requirements for financiers, which may provide more relevant and timely information on borrowers.

How much of the recent activity in housing is coming from small, first-time investors?

- Anecdotal evidence suggests that a lot of activity is coming from first-time investors. But some of these investors have become quite large. There is a new development where relatively new investors have purchased large numbers of properties. ABC Local Radio's "Nightlife" program interviewed two such investors recently (both of whom planned to publish books about property investment). The Productivity Commission may consider it appropriate to obtain a transcript of this interview. But if my memory serves me correctly, one of these investors had accumulated over 300 housing properties and the other over 100 housing properties. Steven McKnight, the other investor, had acquired over 100 properties (perhaps with a partner). Mr. McKnight had a strategy of investing in properties offering high rental yields which cover debt servicing costs. Apparently a large number of these properties are located in provincial towns). Mr. McKnight, aged in his late-20s, stated that he did not inspect properties prior to purchase (in order to remove any emotional attachment).

Should the costs of providing services such as schools, parks and libraries be recovered via infrastructure charges.

- Inequitable.

Taxation

In relation to taxation of housing investment, the following should also be considered:

- depreciation rules.
- Withholding taxes in respect of housing owned by foreigners.

Housing Lending

The Productivity Commission could consider the following:

- Honeymoon interest rates. This may confuse some borrowers about future commitments.

- Low documentation loans and reverse mortgages.

- Information provided to borrowers on the risks of borrowing.

- Should lenders take some financial responsibility for irresponsible lending?