

Rate cuts, not supply, the key to house prices

By Matthew Cranston Economics correspondent

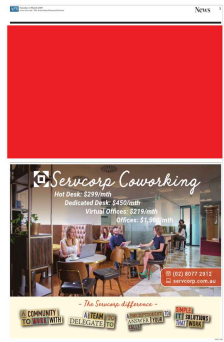
Australian Financial Review (AFR)

Tuesday 12th March 2019

652 words

Page 5 | Section: News

405cm on the page



Rate cuts, not supply, the key to house prices

Matthew Cranston
Economics correspondent

Changes in interest rates are the primary driver behind the movement in house prices and not supply and demand, according to a Reserve Bank paper that appears to contradict the bank's governor.

The most significant driver behind house prices and the level of construction was interest rates, says an analysis, *A Model of the Australian Housing Market*, by RBA analysts Trent Saunders and Peter Tulip.

They say that other factors such as economic growth, population growth, construction costs, depreciation, the price of vacant land, rents, and the user cost of capital have a smaller effect.

"The strong and clear response of residential construction to interest rates is evidence of the potency of monetary policy," the report says.

"Interest rates have a large and highly significant direct effect on construction activity.

"We find that low interest rates (partly reflecting lower world long-term rates)

Key points

The RBA's latest research ran a model looking at primary influences for house prices.

The analysis says low interest rates explain much of the rapid growth in prices.

explain much of the rapid growth in housing prices and construction over the past few years."

They estimate that at a 6 per cent interest rate, a sustained percentage point drop from then on would, in the long run, boost housing prices by 17 per cent, holding rents and other components of the user cost equal.

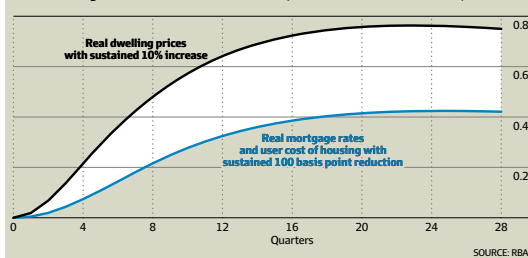
However, these unequivocal statements are, to a degree, at odds with what governor Philip Lowe told The Australian Financial Review Business Summit last week.

"The origins of the current correction in prices do not lie in interest rates and unemployment. Rather, they largely lie



Rate debate

RBA housing interest rate effect scenario (% deviation from baseline)



in the inflexibility of the supply side of the housing market in response to large shifts in population growth," Mr Lowe said. "The decline we're seeing in house prices has very little to do with APRA's

measures. They were both targeted and temporary, and that was appropriate. The decline in prices we're seeing now is the supply response that took place almost a decade too late."

An RBA study has found interest rates are the major driver of housing prices and construction activity. PHOTO: RYAN STUART

While Mr Lowe said low interest rates had "added" to the attraction of investing in an appreciating asset, it was actually the "rigidities on the supply side", coupled with investors' desire to benefit from a rising market in a low interest rate environment, amplified the price increases."

"An obvious question to ask is what are the underlying, or structural, drivers of the large run-up in housing prices and the subsequent decline? There isn't a single answer to this question. Rather, it is a combination of factors."

The bank's latest research into housing ran a model looking at the primary influences for house prices, which have fallen 14 per cent peak-to-trough in Sydney this cycle.

Their conclusion is that: "The model suggests that much of the strength in housing prices and construction over the past few years can be explained by the fall in interest rates."

The qualification is that while interest rates may be the driving factor it is only change in rates that drive prices and not the level at which rates are at, such as the historically low 1.5 per cent official rate that has not been changed for 28 decisions in a row.

"It is changes in interest rates and in existing housing prices that drive construction, not their level," the study says.

The analysts note that the ratio of approvals to income has been below average over the past decade but that the level of real interest rates had been unusually low and the relative price of established housing has been unusually high.