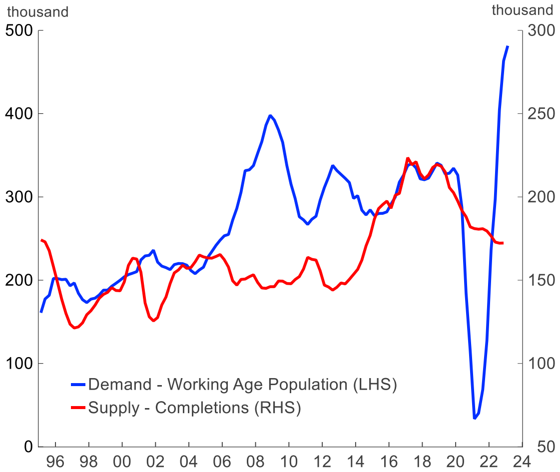
Monday, 8 May 2023

Fiscal Insights

Circuit Breaker for the Housing Challenge

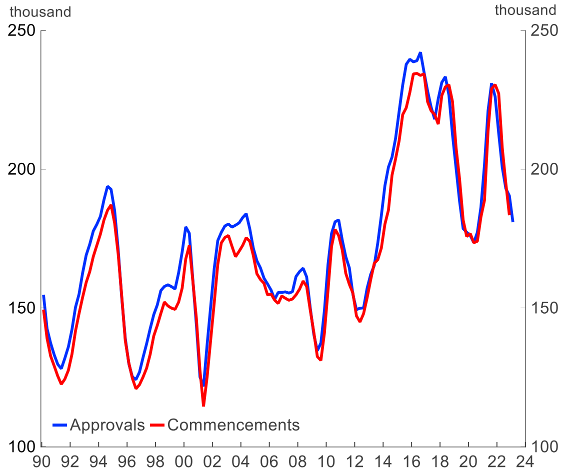
- **Housing supply has not kept up with demand. Estimates from the National Housing Finance and Investment Corporation suggest that Australia's housing shortfall will rise to at least 80,000 by 2025. In fact, the lift in new dwellings for each addition to the working-age population is near an all-time low and continues to trend down.**
- **New supply has recently fallen due to several factors including ongoing pressures in the construction sector. Approvals and commencement data suggests that this will continue.**
- **Demand for dwellings has risen; a record rise in net overseas arrivals has contributed to the recovery in demand. Federal Treasury expects net overseas migration to be 715,000 over the next two years, which could boost underlying housing demand by ~250,000 over that period.**
- **As a result, rents have accelerated at a record pace and house prices appear to be stabilising even while the Reserve Bank (RBA) has continued to raise rates. Reports suggests housing affordability has deteriorated sharply and financial stress has lifted, particularly for renters.**
- **As we near the peak of the RBA's hiking cycle and dwelling prices firm, we could see a supply response. But it can take several years to get a meaningful response. Further, given the issues that have plagued the construction sector, any supply response could be more subdued this cycle.**
- **Against this backdrop, the Federal Treasurer has flagged a housing package in tomorrow's Budget. Announcements to date, including tax incentives to help the build-to-rent sector, have merit and could see more capital flow to the sector, creating opportunities for the sector.**
- **Increasing the supply of housing should help address the imbalance. The Housing Accord sets up the framework that can help drive more housing projects. However, we await to see further detail on how this framework will be used to help address this challenge.**

Housing Market Indicators
Rolling Annual Change



Sources: ABS, Macrobond

Forward Housing Indicators
Rolling Annual Change



Sources: ABS, Macrobond

Disequilibrium in the housing market and macroeconomic impacts

The National Housing Finance and Investment Corporation (NHFIC) estimates that there is a housing shortfall in Australia and that the shortfall will increase to around 80,000 dwellings by 2025. The shortfall in apartments and medium-density dwellings is expected to be more severe – around 62,000 by 2027.

This disequilibrium in the housing market is a key reason why house prices have recently stabilised, and even increased in pockets, notwithstanding increases in the Reserve Bank's cash rate (and the flow on of those cash-rate increases to variable mortgage rates).

The macroeconomic impacts are hard to predict – on the one hand, the stabilisation in house prices could encourage more spending among households that own a dwelling as they are more confidence in their level of wealth. However, an increase in the price of "housing services" to renters reduces the amount of disposable income available for consumption, which could reduce spending for this cohort. For those that have a mortgage, the lift in prices or rents is unlikely to be enough to outweigh the lift in mortgage repayments.

It's hard to precisely tell which impact dominates; however, retail trade data suggests that the underlying slowdown in spending continued and even accelerated in March. Spending per working-age person declined by 0.6% over the March quarter – outside of COVID, this fall is in line with the fall observed during the GFC. Adjusting for population and consumer prices suggests that real spending per capita fell by around 2%.

What's driving the disequilibrium?

Supply has taken a hit. Forward indicators point to continued weakness.

Ongoing skills shortages in the construction sector along with elevated prices for inputs, such as timber and aluminium windows and doors, continue to put pressure on margins in the construction sector. Input prices for the construction sector grew by more than 17% over the year to the June quarter 2022. While there has been a recent deceleration in input prices growth, input prices remain elevated and are up by 11.7% over the year to the March quarter 2023.

We have seen the combination of fixed-price contracts and increasing costs lead to several high-profile insolvencies. This has put projects in jeopardy and delayed the completion of projects that were approved and financed during the pandemic when interest rates were low and governments provided subsidies to stimulate demand. Indeed, housing completions data declined by 1.8% over the December quarter 2022 and remains 15% lower than pre pandemic levels (December quarter 2019). This occurred notwithstanding the elevated pipeline of approved projects, which remains on the books, making it clear that disruptions in the sector are reducing supply.

Forward indicators suggest that the weakness will continue. Building approvals have been trending lower since March 2021. Approvals are around 46% off from the peak. This has flowed through into lower commencements, which have trended down, falling by around 22% over the year to the December quarter 2022. In previous cycles, a stabilisation in prices would support construction activity. However, we are not living through a usual cycle.

While we expect the stabilisation in dwelling prices to provide an important signal across the economy, the response may be more subdued than usual. As builders and developers have been hurt by the combination of higher costs and fixed-price contracts, market intelligence suggests that the sector is moving to increase margins to compensate for heightened risks or changing the structure of contracts. This, coupled with a reduction in the number of builders and developers, may delay the supply response we would normally see.

Demand has expanded at a record pace.

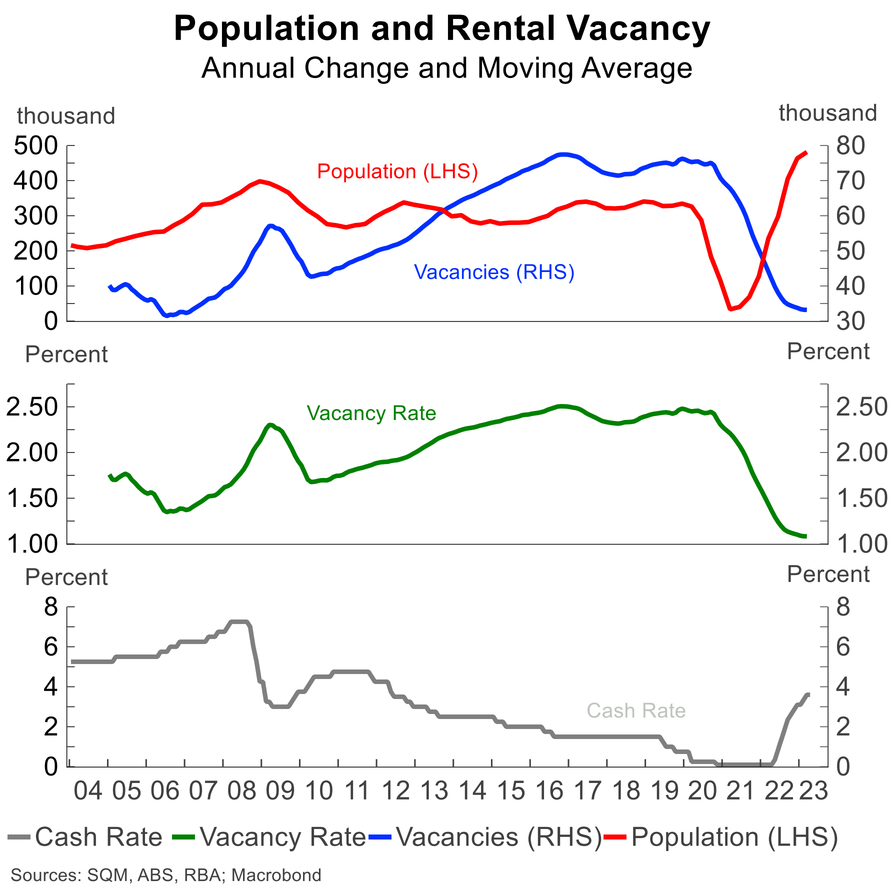
Underlying demand for housing increased during the pandemic, even with the international borders being effectively closed. The demand boost came from the sharp fall in the household formation rate or the average number of people living in a dwelling.

Since the international border reopening, we have seen a record surge in overseas arrivals. Net overseas arrivals in the temporary visa categories that add to labour supply were around 390,000 over the first nine months of 2022-23 – a record high. Consistent with these numbers, the Federal Treasurer has publicly flagged that net overseas migration will be upgraded to around 715,000 over 2022-23 and 2023-24 in tomorrow's Federal Budget – much higher than the 470,000 expected in the last Budget, the October 2022 Budget. The increase in net overseas migration could increase underlying demand for dwellings by around 250,000 over the next two financial years (2022-23 and 2023-24).

It is important to understand the scale of this bounce back in net overseas arrivals. For example, the Australian Capital Territory's (ACT) population is estimated to be around 450,000 – close to the net migration increase expected in 2022-23 alone. And there are an estimated 175,000 dwellings in the ACT. This is in addition to the infrastructure services and public services offered to ACT residents.

What's the outcome of this disequilibrium?

The disequilibrium in the housing market has seen rental vacancy rates fall to historic lows and rents accelerate at record pace. It has also contributed to house prices stabilising. This has contributed to a deterioration in housing affordability and an increase in financial stress for some households, particularly for renters. The RBA Governor recently said at a Press Club appearance that rent has quickly become one of the most reported concerns reported to the National Debt Helpline.



Will the May Budget be a circuit breaker for the Housing Challenge?

Only time will tell! The Treasurer has flagged a housing package that will include several measures aimed at boosting the supply of dwellings. Measures targeted at supply include:

1. **Tax concessions for the build to rent sector -** reducing the withholding tax rate to 15% from 30% for income from new build-to-rent properties funded through managed investment trusts (MITs). This will support cash flow and encourage more foreign institutional investments, such as pension funds, to invest in new build-to-rent properties. Tax concessions has helped the build to rent sector expand in other countries, including the UK. In addition, the Government will Increase the depreciation rate to 4% per annum (from 2.5%) for new build-to-rent projects. This will bring forward the tax benefit from depreciation, encouraging investment.
2. **Increase capital for National Housing Finance and Investment Corporation (NHFIC)** – This will boost the supply of concessional capital NHFIC can lend for the construction of social and affordable rental housing by $2 billion.
3. **Housing Future Fund** – Establishment of a $10 billion fund with the earnings income to fund the construction of social and affordable housing. Legislation remains in the Senate. It was announced in the 2022 October Budget.
4. **Housing Accord** – Agreement between all levels of government, the construction sector, and institutional investors (including superannuation funds) to boost the supply of housing. Through the Accord the Government hopes to get alignment between all levels of governments when it comes to planning, land release, investment in infrastructure, and funding. This could include state government expediting zoning, planning and land release. Working with local governments to deliver planning reforms. In addition, the Government is trying to make it more attractive for institutional investors to invest in the sector. Announced in the 2022 October Budget.

There will also be measures that will assist with affordability on the demand side. These appear to be targeted at vulnerable cohorts. Measures include:

5. **Expanding the First Home Guarantee –** expands eligibility to include people who have not owned a property in the past 10 years and allow a broader cohort to make joint applications, including friends and siblings. Joint applications were previously restricted to married or de facto couples. Under the scheme the government acts as guarantor on up to 15 per cent of a loan.
6. **Boost to rental assistance –** rental assistance is also expected to be increased to help vulnerable Australians through this period of accelerating rent. Further details will be released in the Budget.

Is this enough?

The Treasurer has noted that there will be other measures announced on Budget night.

Thus far, what has been announced, such as the Housing Accord, provides the framework to boost supply. Changes to the tax treatment of build to rent projects should also help attract more forging capital at the margins. However, given the ongoing housing challenges, this framework needs to be backed up with practical actions and deliverables. We await to see what else the Treasurer will deliver on Budget night to help meet this challenge.

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