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Can't afford to buy a house? Don't blame population growth

Greg Jericho

A new Reserve Bank paper has found house price rises have been driven much more by interest rate cuts

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New research from the Reserve Bank of Australia has revealed the extent of the impact interest rate cuts have had on house prices, rents and dwelling investment. The research suggests that without the rate cuts housing affordability would have remain largely unchanged after 2011. It found that rate cuts have far outweighed the impact of higher population growth, although the situation is reversed when it comes to rental prices.

At the end of 2011, the economy was struggling: annual employment growth had slowed from 2.6% in 2010 to just 1%. The unemployment rate was rising, and the volume of private sector residential dwelling construction had fallen 8% from the previous year.

In response the RBA cut the cash rate from 4.75% to 4.5% in November 2011 and by a further 0.25% points in December. Over the next five years it cut 10 more times, until it reached the current level of 1.5%.

And in that period house prices - especially in Sydney and Melbourne - took off:

While it is clear that the cut in interest rates were a major contributor, other factors such as population growth were also believed by many to be significant - fuelling comments that our housing market (and broader economy) was essentially driven by population growth.

A new paper by Trent Saunders and Peter Tulip, of the Reserve Bank's economic research department, has developed modelling to identify the impact of interest rate cuts and population growth on the housing market.

They have found that, over the long term, dwelling investment rises along with household income. But since the end of 2011, while real household income has been flat, dwelling investment has surged 33%:

They found that "much of the strength in housing prices and construction over the past few years can be explained by the fall in interest rates."

Indeed, they found that the impact of a cut in rates is quite immediate - a one percentage point cut leads to a surge in building approvals for houses within nine months, and for residential apartments within a year and half:

This also flowed through to a surge in dwelling prices - especially for apartments:

Their research found that within two years, a one percentage point rate cut causes house prices to rise 8%, before falling back to previous levels should rates be increased to the old level after three years:

And yet, while over the past seven years we have seen rate cuts, there has also been an increase in our population growth. They estimate that if our population growth had remained at the 2005 level of 1.5% per annum, rather than rising to at times 2.3% in 2009, we would now have around 650,000 fewer adults living in this country.

Such a population increase has fuelled claims housing affordability will only improve if we cut population growth.

However, the research suggests the impact of 12 years of higher population growth on housing affordability has been greatly outweighed by the impact of the rate cuts.

The researchers estimate that the ratio of dwelling prices to income has risen 21.1% since 2005. Had we kept population growth at the 2005 rate, they estimate the ratio would have risen by just 12.2%. Now certainly that is a significant increase, but it is somewhat exaggerated by the length of the time period.

Up to the end of 2011, the ratio was just 2.5% higher, due to population growth. And since the end of 2011, the price to income ratio has risen 35% while with a lower level of population growth it would have still risen a sizeable 29%.

That is because during that period the RBA was slashing interest rates. But had the RBA kept the cash rate at 4.75% in November 2011, the researchers estimate the dwelling price to income ratio would now be 7% below 2005 levels:

It is clear that interest rates have a much bigger impact on house prices than does population growth.

But the situation is reversed when it comes to rental prices.

The paper estimates that a stable population growth average would have seen real rents across Australia just 3% above 2005 levels compared with the 12% rise that has actually occurred, while cutting rates had barely any impact:

This research suggests that in the current environment of slumping house prices it is very unlikely that the RBA would contemplate any interest rate rise - especially given the paper also offers a warning about what can happen should people's expectations of house price growth dramatically fall.

It estimates that, should people shift from an expectation of house prices rising 2.5% a year in real terms to just keeping pace with inflation, then within four years house prices could fall by more than 30%:

Such a situation would be extremely dramatic - the researchers argue "nothing like it has happened in Australia before", but that it resembles the housing collapses in Ireland, Spain and the US following the GFC.

It is a sobering thought and one which will no doubt occupy the Reserve Bank board members' minds the next time they come to set interest rates in April.

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