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Renting may be better than buying, says Reserve Bank

Jonathan Shapiro

The Reserve Bank of Australia has told property buyers they will be better off renting rather than buying their home unless house prices keep growing as fast as they have over the past two generations.

House prices are not overvalued, the central bank said, but it warned prospective buyers that house prices would need to grow in line with historical averages to recoup the costs of home ownership such as mortgage rates, stamp duty and council rates.

"If house price growth were to be slower than the historical average, as some forecasters predict, then the average home buyer would be financially better off renting," say RBA researchers Ryan Fox, and Peter Tulip in a provocatively titled research paper *Is Housing Overvalued.*

The RBA analysed costs involved in owning a house compared with renting, such as council rates, interest rates and the purchase price.

It estimated average rent yields of 4.2 per cent since 1955 were equal to the annual cost of owning a house.

The researchers calculated the annual rate at which the inflation-adjusted price of a house should rise for an owner to be no better off than a renter at just below 2.5 per cent. This was in line with the annual expectation of house price rises of 2.4 per cent after adjusting for inflation, since 1955.

"If this rate of appreciation is expected to continue then our estimates suggest that houses are fairly valued," the paper said.

The RBA's conclusion is that house prices would have to continue to rise at the same expected rate as they had since 1955 – 2.4 per cent after adjusting for inflation – for owners to be as well off financially as renters.

"To put this another way, the expectations of future capital gains implied by current house prices are in line with historical norms," they write.

The research, the central bank explained, allayed concerns about a housing bubble because investors were assuming house price growth would maintain the pace of the last 60 years.

The paper, however, contained a veiled warning to home owners to temper their expectations of capital gains.

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Renting better then buying: Reserve Bank

University of New South Wales Professor Nigel Stapledon said the paper was a caution to investors to "think in terms of what is plausible in terms of house price growth in the future".

Professor Stapledon, who was widely cited in the research, said the paper was "tentatively forward looking" which was unusual for Australia's central bank.

"The bottom line is an expression of caution going forward. To really justify jumping into the housing market you really want to be assuming you are getting similar house price gains," he said.

"The underlying message is there has been a lot of capital gains but be careful because they are far less certain in the future."

The paper follows warnings from the central bank governor Glenn Stevens this month that "people should not assume that prices always rise" when deciding to buy property. "They don't; sometimes they fall," he said.

The RBA has largely dismissed suggestions of a housing bubble even as house prices in Sydney rose 15.4 per cent last financial year.

The International Monetary Fund said in June Australia had the third most expensive housing market in the world and called on local regulators to avoid "benign neglect".

In the paper, the RBA referenced the The Economist and The Organisation of Economic Co-operation and Development arguments that Australian property is "overvalued" by 24 per cent and 21 per cent.

Remarkably, the research said it could take as long as 30 years for owners to be better off if the rate of house price growth did not better the 10-year average "real" expected rate of 1.7 per cent. Owners would be no better off after eight years if the "real" expected growth rate was 2.4 per cent.

"But be cautious about buying for short-term gain and if you aren't confident about that rate of appreciation being achieved and if you're not, then renting maybe a better option," said Professor Stapledon regarding the findings of the paper.

HSBC chief economist Paul Bloxham, a former Reserve Bank economist, said the paper was part of the central bank's "ongoing research agenda to look at whether Australia has a housing bubble" and suggested house prices were fairly valued.

"What the RBA is trying to do is assess whether prices can be supported by the fundamentals - such as rents and interest rates – whether the level of house prices is in line with what you would expect given where rates and rents are," he said.

"Expectations of capital gains is one of the variables they include n their frameworks. There have been periods in the past where expectations are the main drivers of house price growth ... but not at the moment."

"On their model, the growth we are seeing in house prices is very much supported by the fundamental factors rather than irrational exuberance."

Professor Stapledon, who has done extensive studies on Australian property prices said that house price gains over the last two decades was largely explained by falling mortgage rates.

"From the mid-90s the big story has been falling rates but that's not going to be a factor in the next 20 years," he said.

"So you need something happening on the rental side for prices to keep moving up," he said.

Predicting future house price growth is difficult, the RBA said but it pointed out that forecasters were expecting the rate to slow.

"That said, many observers have suggested that future house price growth is likely to be somewhat less than this historic average," the paper said. "In that case, at current prices, rents, interest rates and so on, the average household is probably financially better off renting than buying."

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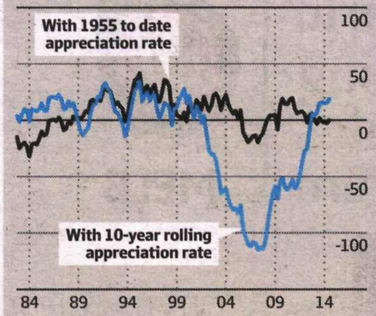
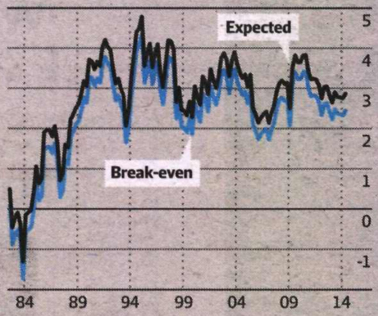
To rent or not to rent

Property overvaluation as a per cent of fundamental value



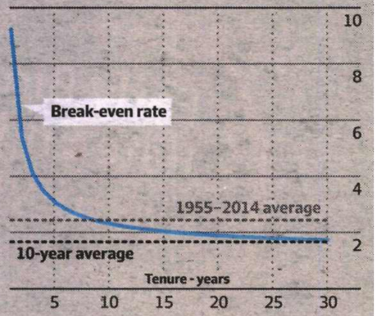
Property is fairly valued if owners expect prices to grow at 2.4% but over valued if that rate is 1.79%

Future real capital appreciation rates (%)



Owners expectations of house price growth tracks the break-even rate between owning and renting

Break-even appreciation rate by tenure – April 2014 (%)



Renters may be better off even over longer periods

SOURCE: RBA