

Australian Economic Comment

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Rents, housing supply and inflation

Australia

- ◆ The housing rental market has been heavily disrupted by the effects of the pandemic and the related policy responses – much like many other parts of the economy. The closed, and then re-opened border; sharply lower, then rapidly rising interest rates; fiscal policy changes; and, behavioural changes of renters themselves, amongst other effects, have all played a role. The upshot has been a very tight rental market recently, and rapidly rising rents, which are contributing to inflation, creating a cost-of-living challenge for some households. Understanding the rental market dynamics is also important for the RBA's policy rate outlook.

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A key factor was closing the border, which policymakers did from March 2020 to early 2022, to manage the pandemic. This stalled inward migration and, on its own, would have been a big drag on demand for housing, particularly of rental properties.

However, at the same time, household behaviour changed markedly. Renters living in group housing chose to move out into individual houses. Lockdowns, state restrictions on contacts, and increased work from home seem to have meant renters needed more space and wanted fewer flatmates. This drove a sharp fall in Australia's average household size (from around 2.6 to 2.4). On the RBA's estimates, this sharp shift created an additional 120,000 households.

The net of these two effects meant that the rental market did not loosen up much through the pandemic. The rental vacancy rate rose only modestly, from around 2.5% pre-pandemic to a peak of around 3.25% in mid-2021.

At the same time, sharply lower interest rates supported the housing market more generally, lifting housing prices by around 25% from September 2020 to April 2022. Lower interest rates also tend to suppress rents, by lowering the cost of finance for landlords and rewarding them through rising capital gains rather than rental incomes.

On the construction side, sharply lower interest rates, combined with pandemic stimulus-related government subsidies for home building, saw a significant rise in new building approvals, adding to the stock of dwellings, albeit slowly.

The past 18 months has seen a sharp shift in the other direction for a number of these factors.

The border has re-opened and, while slow to start with, inward migration is now rocketing along. On the government's estimates from the budget, net overseas migration will be 400k in financial year 2022/23, well above the 180k expected back in the March 2022 budget. This is creating demand for housing, and particularly rental properties, as new migrants typically tend to rent. Rental vacancy rates have fallen to below 2% recently. The rental market is tight.

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Interest rates have risen sharply, with the RBA raising its cash rate by 375bp in 12 months. Sharply higher interest rates have driven a 10% fall in housing prices. They have also motivated landlords to seek greater rental return, as the cost of funding has risen. The tight rental market has allowed rents to be lifted substantially. Advertised rents (that is, a measure of new rental agreements) are up around 20% over the past 18 months, having been broadly flat in the previous couple of years.

Rents in the CPI, which measures the stock, are up by only 5% y-o-y but are set to accelerate, given the pace of advertised rents. Rents are 5.8% of the CPI basket and the RBA forecasts rental inflation to continue to lift over coming quarters.

The sharply higher interest rates have also seen a sharp fall in new building approvals, to their lowest levels since 2012. In addition, the shock to construction costs, other pandemic-related supply disruptions and sharply higher interest rates have seen a sharp rise in construction company insolvencies. Combined, this is limiting the supply of new housing and contributing to the tight rental market.

Some of the patterns observed are typical of previous cycles. When interest rates fall, and housing prices rise, rents tend to be more subdued. When rates rise and housing prices come down, rents tend to rise faster and catch up. However, in this cycle, the effects have been faster than normal, reflecting the sharper rates cycle, particularly the recent hikes.

However, the border closure and re-opening, as well as many other pandemic effects, are highly unusual, as might be expected.

Where to from here?

Persistent elevated rental inflation is adding to overall inflation, which is likely to mean a low chance of RBA rate cuts anytime soon. Further hikes are a risk.

Without rate cuts, a near-term upswing in housing construction seems unlikely. Construction cost inflation is falling, which should be expected to smooth the way for completing construction projects already in the pipeline. The re-opened border should provide more workers, such that skills shortages become a less prominent issue for the construction industry. However, the typical trigger for a strong pick-up in construction, and housing prices, is rate cuts. Rate cuts are also the typical trigger for an upswing in housing prices, which also usually encourages more construction. Although housing prices have stabilised recently, we are not expecting a strong upswing in the near term.

We expect that a large part of the economy's adjustment will be through behavioural changes. After all, the price mechanism works. Sharply higher rents will likely mean an increase in average household size. Some renters may choose to move back into group housing arrangements, or back into a family home, while new migrants may also choose to move into housing in larger groups. Office occupancy may rise, if work from home becomes less viable as dwelling rents rise.

Policy measures that improve the supply side, such as deregulation, faster approvals, more rapid green-field development, and more urban in-fill, could all help; however, even with a move in the right direction on these policies they would take time to have their effects. They have also been on the agenda for many years and are often difficult to achieve.

Finally, while the re-opened border boosts housing demand it also boosts labour supply. As a result, although rents are set to boost the CPI more than usual, stronger migration also means more workers, which should help to keep wages growth from picking up too much, and likely mean that other services inflation starts to ease soon.

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