economics

Residential Construction – Looking Towards 2015

December 2014

Key Points:

- **Amidst sub-par economic growth and weak confidence, Australia's national new home building sector has been a star performer.**
- **National new dwelling commencements are set to reach a record high in 2014 and remain at a very elevated level in 2015.**
- **Geographical divergences in new housing conditions across states and territories are wider than usual.**
- **Renovations activity remains close to a decade low, but there is a strong prospect of growth in 2015.**
- **Dwelling price growth is modest at best outside Sydney, Melbourne, and from a weak starting point – Brisbane.**
- **Reform of a plethora of inefficient and inequitable taxes on housing is one of the heartbeats of successful economic reform in Australia.**

Looking back to look forward

The end of 2014 has not shaped up quite the way that was widely anticipated back in December 2013/January 2014.

The prospect of further official interest rate cuts is again on the table. Almost everybody who had that prospect in mind at the start of this year subsequently moved to rule out further cuts; now further rate cuts have been ruled back in again, at least by some forecasters. At one stage early in the year there was a forecast for a first rate hike by mid-2014. Financial markets are now pricing in for the next move to be down.

Outside of monetary policy, the fiscal landscape has deteriorated by more than expected, largely due to additional revenue write-downs but also due to greater than usual political intransigence. The deficit for 2013/14 was earlier this week announced as $40.4 billion, more than $10 billion higher than that forecast in the May Federal budget. The cumulative deficit over the four years to 2017/18 has increased by $43.7 billion since the May budget to $103.9 billion.

The new Senate dimension has proved even more fractious than anticipated and followed a poorly-received federal budget, about which negative rhetoric still flows. It has been a challenging political year for the Federal government, and a frustrating one given the incessant fights with elements of the Senate over and above the usual argy bargy.

This dynamic has weighed down on business and consumer sentiment. It is, however, weaker economic conditions than initially anticipated that has scarpered a sustained recovery in confidence.

These areas of weakness include: the terms of trade shock in 2014 (i.e. the substantial decline in the ratio of export prices to import prices), which has further to

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run; the rise in unemployment, with youth unemployment at very concerning levels (from both an economic and social perspective) and; weak real household income growth, which has dominated 2014 and generated a 'feedback loop' to further repress business and consumer confidence. These circumstances have translated into softer household (and housing) expenditure and business investment than would otherwise have occurred.

New home building – another healthy year?

Through all of this, national new home building activity has been the shining domestic light. In 2013/14 the number of new dwelling commencements in Australia increased by 11.6 per cent, following almost exactly the same growth rate (11.4 per cent) the previous fiscal year.

There are two particularly impressive aspects to this result. Firstly, the level of commencements in 2013/14 of 180,648 was the second highest on record, surpassed only by 187,000 dwellings started in calendar year 1994. Secondly, these two years of growth represented the first time since the early 2000s that new dwelling commencements increased in consecutive years. The last time was the three consecutive years of growth over 2001/02 – 2003/04.

HIA is forecasting a third consecutive year of growth in 2014/15 – an increase of 2.9 per cent which would take commencements to a level of 185,805. We are forecasting that in calendar year 2014 Australia will commence a record number of new homes, 188,024. Commencements are forecast to ease by only 2.2 per cent in 2015 to a level of 183,856.

We have long maintained that the balance of risks rests with a higher peak for the cycle. The prospect of this occurrence would naturally be enhanced if it turned out that there were further interest rate cuts in early/mid 2015. Regardless of the interest rate outlook, the new home building recovery could be much stronger than it is. Supply side blockages, of which a lack of titled residential land and excessive infrastructure charges are but two examples, are locking out an otherwise willing cohort of additional new home buyers this cycle. Addressing such blockages would generate growth in economic activity and productivity. The new home building recovery is very good for the Australian economy, but could deliver even more. It is unfortunate that policy makers have afforded little attention to policy reform which could unlock some of that additional potential.

The national profile of a strong new home building recovery is a little misleading. The expectation of a record-breaking year masks significant differences across geographical boundaries and dwelling types. There is considerably larger divergence than in previous cycles. A healthy new home building recovery is consequently still not being experienced by many in the industry. It is unclear whether all policy makers fully grasp this fact.

Renovations activity – finally off the mat?

We will look back on 2014 as being another disappointing year for renovations activity.

It would be a beneficial outcome for not only the industry but the wider domestic economy if there was greater balance to residential construction in 2015. That is, growth in renovations activity at the same time as the level of new home building remains very elevated by historical standards.

During 2013, the volume of home renovations hit its lowest level in over a decade. In 2013/14 renovations investment crawled only 0.3 per cent higher. Renovations activity then eased back by 0.7 per cent in the September 2014 quarter to a level only 4.1 per cent higher than the cyclical low reached during the March 2013 quarter.

Activity in the renovations market reflects the interaction of a number of factors, including: home price developments; dwelling stock age; the composition of new builds; interest rates; and the household savings rate.

The fact that interest rates are at such low levels and that home price growth has been strong over the last two years in several key markets augers well for renovations activity. We project that a modest recovery in renovations will occur over the next couple of years, driven by the combination of higher home prices and low interest rates. Over the medium term, economic growth will revert to trend and unemployment will start to move downwards. As a result, wages growth will strengthen with the renovations market receiving further support as a result. Notwithstanding these medium term prospects, the current weaknesses in the labour market (and therefore in real incomes) as well as poor consumer confidence are likely to weigh on the rate of growth in the near term.

We are forecasting that renovations activity will increase by 0.9 per cent during 2014/15 to $28.65 billion. In calendar year 2015, renovations activity is forecast to grow by 1.3 per cent to $28.98 billion.

Dwelling values – post peak growth throughout 2015?

There has been a great deal of focus on dwelling price growth in Australia in 2014. This focus has included stoking fears of a housing price bubble and inaccurately labelling negative gearing as the policy of evil, the removal of which will magically solve Australia's housing affordability challenge.

Over the 12 months to November this year, capital city dwelling values increased by 8.5 per cent. The geographical differences were enormous and widely disparate growth outcomes are likely to persist in 2015.

Sydney and Melbourne were the fastest growing price markets in 2014 (13.2 per cent and 8.3 per cent, respectively), followed increasingly by Brisbane with 6.0 annual growth. The situation was far more subdued, if not weak, in the remaining capitals, with annual growth in dwelling values ranging from 5.2 per cent in Hobart to less than 2 per cent in Perth, Darwin and Canberra. This translates into a real (inflation adjusted) outcome that is flat to negative for dwelling values in those cities. Dwelling price growth for Regional Australia as a whole is also weak.

Annual growth in Australia's home values looks to have peaked back in April. Against a backdrop of falling real household income, the rate of growth in home values is projected to trend down throughout 2015, although the trajectory would be influenced by any further reductions to borrowing costs. The Australian Prudential Regulation Authority (APRA) last week announced a further tightening of lending standards - this process actually began some time ago - which may reduce upward pressure on existing dwelling prices in Sydney and Melbourne. Any broader dampening, including of investment activity in new housing, would be undesirable.

Policy reform – two dirty words, still?

Reform of a plethora of inefficient and inequitable taxes and regulations on housing is one of the heartbeats of successful economic reform in Australia. With housing currently the second most heavily taxed sector of the Australian economy, such reform is obvious and would allow for the provision of affordable housing for Australia’s growing and ageing population. Less obvious, but nonetheless important is that meaningful housing taxation reform would generate productivity gains for the broader economy and raise Australian living standards.

The dual White Papers regarding taxation and federalism will need to recognise and act on this reality, which at once presents both a challenge and opportunity for policy makers. If this critical white paper process focuses its treatment of housing simply on esoteric bases, such as negative gearing, then by definition the bigger and important picture will have been missed. All Australians would be poorer for that outcome.