

Interest Rates and

While home ownership is sometimes a financial and social 'headache' for families, the

The signs that Australia is again heading into a period of rising interest rates raises old questions about the impact on families wanting to buy their own home. If interest rates and house prices increase in the way they did in the 1980s, and incomes remain steady or fall in real terms, would we expect to see a sharp fall in rates of home ownership?

Despite such conditions in the past, the proportion of families who are owner-occupiers remains remarkably high. The 1991 Census indicates, for example, that of Sydney families not in government-rented accommodation, 80 per cent of the couples with children and 58 per cent of the single-parent families were owners or buyers.

Part of the explanation for continuing high rates of home ownership is that families, and the housing market, are not static and passive; they adjust and interact to meet changing economic and social opportunities and problems.

This article describes three of the adjustment processes by which families pursue their ownership ambitions and confound forecasters of falling rates of

home ownership. Here, the three factors are called substitution, postponement and market adjustment.

Substitution

As those who have gone looking for a place to rent or buy will remember, housing is a diverse mix of shelter and location services – the accommodation varying in age, appearance, size, quality, and condition. Each dwelling (apart from mobile homes) is spatially fixed in places with equally diverse advantages and disadvantages – views, levels of traffic and other pollution drawbacks, the quality of neighbouring dwellings, social status, access to services and employment: even summer and winter temperatures differ between parts of many cities!

All these variations mean that house prices also vary widely, from the mansion overlooking the water to the small house with poor access to services which is in need of renovation (or demolition).

The first of the ways in which families adjust to changed financial or housing circumstances is to change



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the price range of the accommodation they are looking to buy or rent. Thus, when interest rates rise, one of the ways in which prospective home buyers respond is to seek a cheaper dwelling, one which involves a smaller loan but which, other things being equal, may be smaller, in worse condition or in a less desirable neighbourhood. Conversely, if the family has gained the income of a second earner, a larger house may be sought, or one in a 'better suburb'.

Even the prospect of rising interest rates, as distinct from actual increases, may result in families reducing the amount they choose to spend on a dwelling so as to leave some reserve capacity to increase repayments if need be.

At least in theory, a rise in interest rates might result in no reduction in the rate of home

ownership, with all prospective purchaser families substituting cheaper houses for the ones they would otherwise have bought: the impact might then be observable through a slow-down in the rate of increase in the average size and quality of the housing stock.

Postponement

Some families and individuals respond to rising interest rates by making various sorts of postponements. House purchase or 'trading up' may be delayed, for example, to save a larger deposit and make repayments easier.

Similarly, young people may postpone setting up separate households – delaying the move away from their parents or the group household. Rates of marital separation may also be affected as some spouses delay the establishment of separate households after

Home Ownership

desire to buy a house remains high, particularly for households containing children.

marriage breakdown because of the cost of accommodation. Other responses with complex family and social impacts occur when families purchase as planned but postpone a period of absence from the workforce to have a child or enlarge the family.

Market adjustment

A third aspect of the family/housing-market dynamic in response to rising interest rates are changes in prices and rent levels.

Most of the dwelling sales in Australia are to and from owner-occupier families and only take place if the price is agreed to by both parties. When there are substantial increases in interest rates, large numbers of prospective buyers, particularly first home buyers, reduce the size of the amounts they borrow because they are unable or unwilling to meet loan repayments and therefore must seek cheaper dwellings.

As prospective buyer families look for cheaper substitutes (or delay purchase) housing prices are likely to fall as some sellers settle for a sale at a reduced price

rather than no sale at all. (Increased interest from investors in rental property may dampen falls in house prices but is unlikely to be a major influence unless returns from rental housing rise significantly relative to other investments, as occurred when the stockmarket crashed in 1987.)

Thus, while there may be some delay while prospective sellers adjust their expectations of the price they can get for their dwelling to the new conditions of what buyers are able and willing to pay, one of the impacts of rising interest rates is a tendency for dwellings of a given size and quality to fall in price.

Reductions in the price of properties help to maintain rates of home ownership in periods of rising interest rates – moderating impacts on buyers, but sometimes having serious consequences for sellers (for example, families relying on the sale price to buy into a nursing home).

Do interest rates matter?

If families adopt these measures to try to overcome the barriers to house purchase, does this mean

that we should be unconcerned by rising interest rates? Two points may be relevant here.

First, each of the methods of adjusting to rising costs may have significant social impacts on the families involved: whether the response is by buying a smaller, poorer quality or worse located dwelling, by delaying purchase, or, for sellers, reducing the sale price. These impacts may be harmful for those involved or may be beneficial (for example, saving the family from an overpriced financial commitment it is unable to meet).

Second, the response processes described above are relevant to first home buyers and changeover buyers rather than existing buyers trying to meet the monthly cost of their variable interest rate mortgage. Home loan lenders generally allow borrowers to extend the term of their loan rather than increase repayments if interest rates increase. However, in some instances (particularly in the early years of the loan), repayments barely cover interest and lenders want increased repayments rather

than allow an increase in the total amount owing. It is not known how often borrowers today allow a 'margin for safety' in case interest rates return to the levels of the late 1980s, or how much financial hardship results when families face either the high cost of moving (for example, stamp duty) or monthly repayments higher than they allowed for.

Families are active participants in housing markets (although not, it seems, sufficiently powerful to challenge the high margins and profits of the lending institutions) and respond to changes in a range of ways which often confound predictions.

Measures of affordability commonly relate average weekly earnings to average sale prices and fail to reflect the responses of the households who are actually prospective purchasers.

A number of more focused measures, such as the characteristics of borrowers, are needed to identify and monitor the impact of changing housing market conditions on families.