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Answer 1

The IMF article on Australian housing prices have discussed over the debate on overpriced housing market of Australia. This article have analysed both arguments and counter arguments against the over valuation concept of housing market. However, the main emphasis has been given on the counter argument. It has been stated that housing prices in Australian market has developed in comparison to the other OECD countries. All probable reasons for rising property prices have been discussed in this article. The valuation methods used in the analysis is deviation of prices from historical long term trend and price to income ratio. These valuation methods explain that housing prices increased nearly 20 to 25% in past few decades (Mohommad, et al., 2015). However, it has been contradicted that historical trend method used in housing price valuation is not appropriate. As the equilibrium price in the housing market is different for different countries. The level of income, consumption patterns and standard of living are different among people. At the initial stage, when demand and supply elasticity are high and market are not saturated, prices increase at a faster rate and slowed down at the consequent stages (Valadkhani & Smyth, 2016). Therefore, it is wrong to take deviation from historical trend as a measurement of valuation. Rather it has been suggested to use changes in prices instead of absolute prices for this valuation.

Another central argument for the housing market boom has been assigned to the demand from foreign market for investment purpose. External demand creates addition pressure on the market of property in Australia. However, it needs to be stated that housing prices are not equally distributed all over the country. Disparities are seen across region as housing prices are high in the cities and business centre and low at the peripherals. Financial market in Australia is not so vulnerable that fluctuation in the housing market price can impact the macroeconomic variables significantly. Strong monetary policy of RBA controls the money supply and demand through change in cash rate such that banking institutions can remain solvent even in the crisis situation.

Answer 2

Melbourne is an important city in Australia and an important centre for service sector development. Therefore, demand for property is greater in this city in comparison to other markets. However, price growth in Melbourne market has slowed down due to the rapid growth in Sydney housing market (Scutt, 2017). Before reaching to the conclusion on this debate raised in the article, both the arguments can be discussed. The argument in favour of the overvaluation concept is that the housing prices in the Australian market have risen in a rapid pace in comparison to other economies. This price has risen even at the rate greater than the income growth. Price of a product needs to rise according to the rise in demand, which is determined by the income. Hence, the growth in product price is indirectly influenced by the growth in average income level of the population (Kishor & Morley, 2015). As depicted by Favilukis, et al. (2017), in a country like Australia, where unemployment rate is high, demand for housing or real estate must not be so high from the domestic market. Hence, a high price-income ratio signifies over valuation of the real estate in Melbourne housing market.

Most of the arguments contradict with the overvaluation argument. Firstly it has been stated that the undervaluation or over valuation estimation is problematic as the initial equilibrium housing price differs across country. Therefore, starting from a low housing price, faster growth of housing price is not ‘overshooting’, but it is ‘catch-up’ with the prices in other progressive countries. Therefore, comparing absolute housing price is problematic. The next argument states that explanation for high price-income ratio in housing market is not significant due to presence of regional disparity. Housing prices in the cities are greater than the rural areas in Australia. In the cities, income of the people is greater than income in the rural areas. With the increase in the income, demand for housing rises and the prices proportionately (Ji & Otto, 2015). This indicates regional disparities in the price-income ratio although shows national level rise in this ratio.

The next argument is that it would not be correct that rising housing price is an overvaluation as the equilibrium prices of real estate has itself increased based on demand and supply condition in the international and domestic market. As population rises, demand for housing increases and hence, change in demand raises equilibrium prices of housing (Fox & Tulip, 2014). Moreover, financial liberation and low interest rate in Australian financial market have made the access of the credit for owning home easier. As land is naturally fixed, supply in the real estate market for owning land cannot be increased (Myers, 2016).This article has also mentioned that supply constraints from policy side such as planning, geographical constraints makes the development of real estate sluggish. Hence, rise in demand with sluggish supply causes the housing prices to rise sharply. As seen in the figure 1, initial equilibrium price is P_1 and supply is Q_1 in the property market. Due to growth in demand for property, demand curve changes from D1 to D_2. As there is very little shift in the supply curve towards right to S_2, excess demand in the market pushes the prices of property upward. Accordingly, sale in the market also rises with the price.

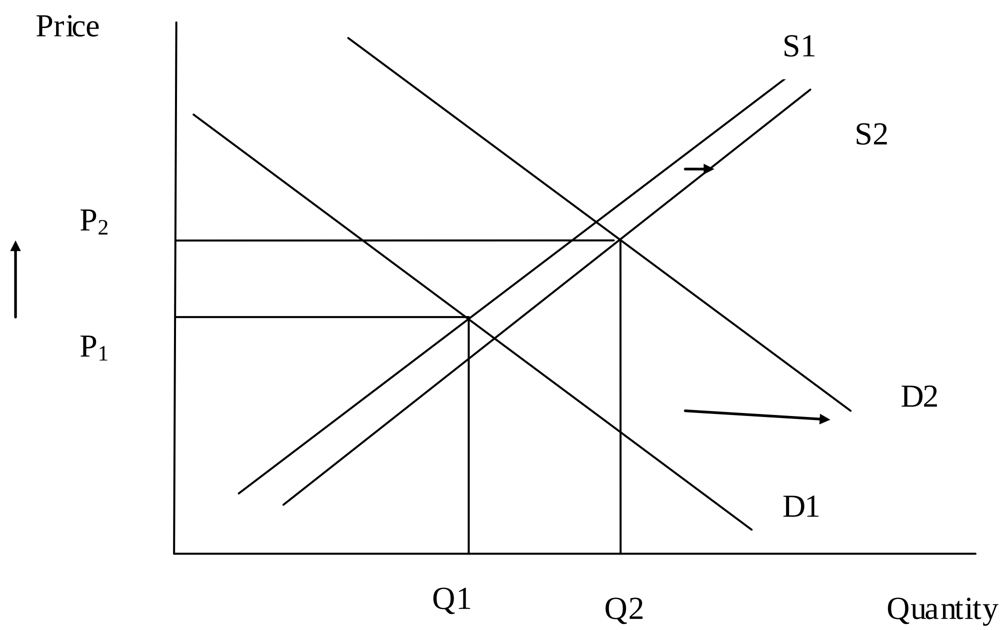

Figure 1: Effect of change in demand

Source: created by author

Another argument against the over valuation concept is that the overvaluation problem is for the cities like Sydney and Melbourne only and not for the entire country. It has been mentioned that the property prices has been rising in these cities in the post GFC period. As per the market survey of Moody, average household spending on mortgage in Sydney is 35% of the monthly income. Moreover, investment demand for infrastructure development, foreign investment demand is greater is capital cities than other regions of Australia. It is noticeable that foreign investors own a house to invest in this market and to for staying there. Nevertheless, this demand from external market raises prices in the cities and the domestic middle or low income households fails to own a house in the domestic market (Winter, 2013).

Overvaluation generally arises due to speculation in the housing market regarding future price. However, it has been argued that lending standards and asset quality in the financial market of Australia. Hence, the asset price movement is systematic and the loan to value ratio is steady in this market. Mortgage interest rate is not so high in the financial market and thus the loan repayment structure encourages borrowers to repay loan earlier before imposing any penalty (Bianchi, et al., 2016). As seen in the figure 2, the NPA to gross loan in the banking sector has been declining since 2010 in Australia. Therefore, it indicates that banks are able to recover the loan at the early stage for majority (Fu, et al., 2014). Low interest rate reduces loan burden upon borrowers and make the payment easier.

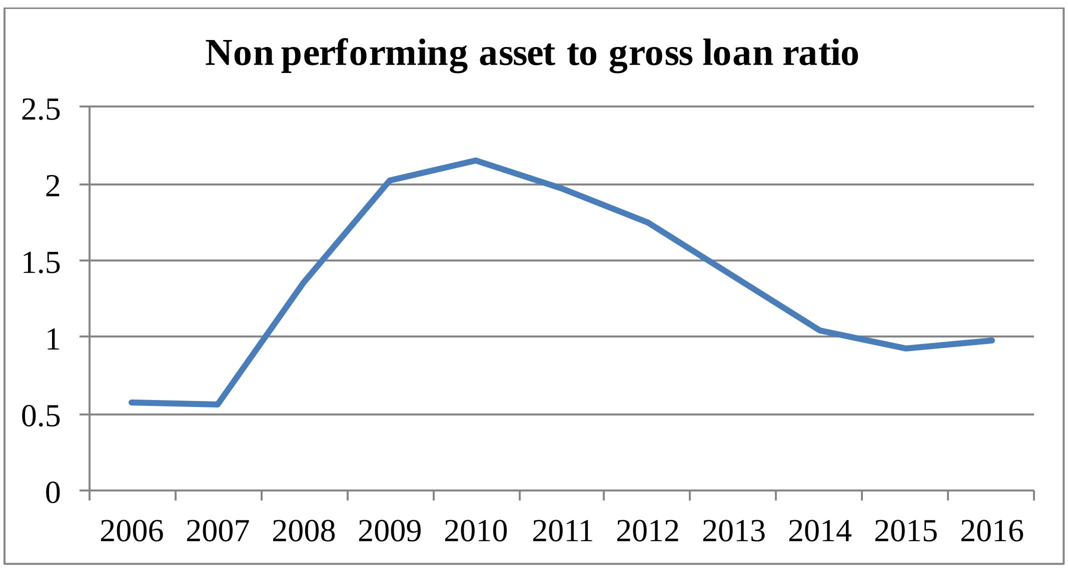

Figure 2: NPA to gross loan ratio in Australian banks

Source: (WorldBank, 2017)

It has also been argued in the article that the household debt is concentrated among the wealthy and high income group population. It is unlikely for the low income group to afford housing or property in the cities due to unaffordable price range. Hence, most of the demand comes from high income class or business groups. It has been mentioned that households from above two income deciles hold approximately 70% of the household debt, whereas below two deciles of the income group hold only 10% of the debt (Mohommad, et al., 2015). Hence, speculation for asset price movement cannot be said to be unsystematic.

Moreover, it has been argued that the financial structure of Australia is not so vulnerable that the banking system would fail due to the overvaluation of assets. RBA controls the monetary policy with strong hand by controlling the cash rate. When GDP growth is strong, aggregate demand for money and inflation rise in the economy, RBA restricts credit flow by raising cash rate (Bolt, et al., 2014). Higher rate of interest discourages borrowers by making loan repayment costlier (Myers, 2016). A strong control over the money and capital market makes the impact of bank failure lesser the real effect on the economy in aggregate. It has been argued that when the wealth of households fall, they would cut their consumption proportionately. Therefore, investment and consumption are also likely to fall to reduce real GDP. However, if the banking institutions remain sufficiently solvent by securing strong contingency reserve, drop in housing prices has less impact on the macroeconomic variables (Kishor & Morley, 2015).

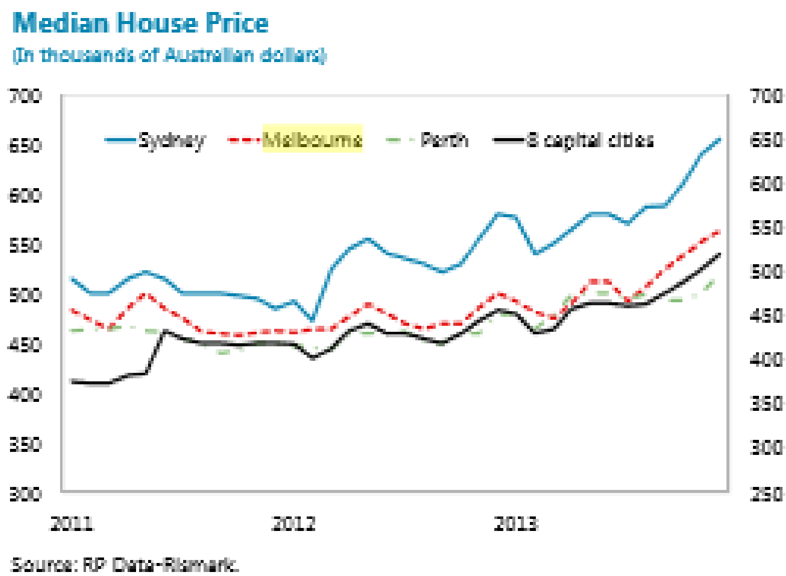

Figure 3: Median housing price

Source: (Mohommad, et al., 2015)

Therefore, from the analysis, it can be stated that the question rose in the IMF report regarding the overvalued housing prices of Melbourne is not true. Based on the above analysis and data, it is seen that the rise in housing prices is in the capital cities due to demand and supply factors. Speculative demands are not solely responsible for this rise. Wage rate in Australia is predominantly high and that high income group mainly reside in the capital cities or in the surrounding areas. Therefore, demand for housing is greater in the cities than regional areas. As supply in the property market is constrained by the policy side and natural factor, supply is less elastic than demand. Hence, as demand increases, prices are likely to increase to shift the equilibrium prices in the both national and international level. Moreover, the measurement process of housing valuation across countries is not flawless and standard. There are differences in the parameters. Hence, considering all the factors, it can be stated that housing prices of Melbourne cannot be said to be overvalued.

Answer 3

This section seeks to examine the effect of new stamp duty surcharges on the foreign buyers in the housing market of Melbourne. In Victoria region, stamp duty for foreign purchaser has increased from 3% to 7% (Utz, 2016). The effect of hike in stamp duty is examined below considering Melbourne housing market perfectly competitive. As stated by (Myers, 2016), a perfectly competitive market is characterised by a large number of buyers and sellers. In a perfectly competitive market, all the buyers have perfect knowledge about property price and their quality. In a property market, the purchasers in domestic market and foreign market both have perfect information about the market (Favilukis, et al., 2017). Moreover, another characteristic is that the developers cannot manipulate the price of property and the price is determined by the market force. Demand and supply of a particular good determined the amount of supply in the market and its price. Each developer makes profit in this market based on their cost of operation and revenue structure.

a. The impact of tax can be presented through a diagram. As discussed by (Gerathy, 2016), hike in stamp duty would affect both buyers and sellers. However, the magnitude of impact would depend on the relative magnitude of the responsiveness of the buyers and sellers. Initial effect of stamp duty is imposed on the sellers. Hence, the cost of selling property increases from the end of property developers. As a result, sellers are unable to sell the previous amount of property at the previous price.

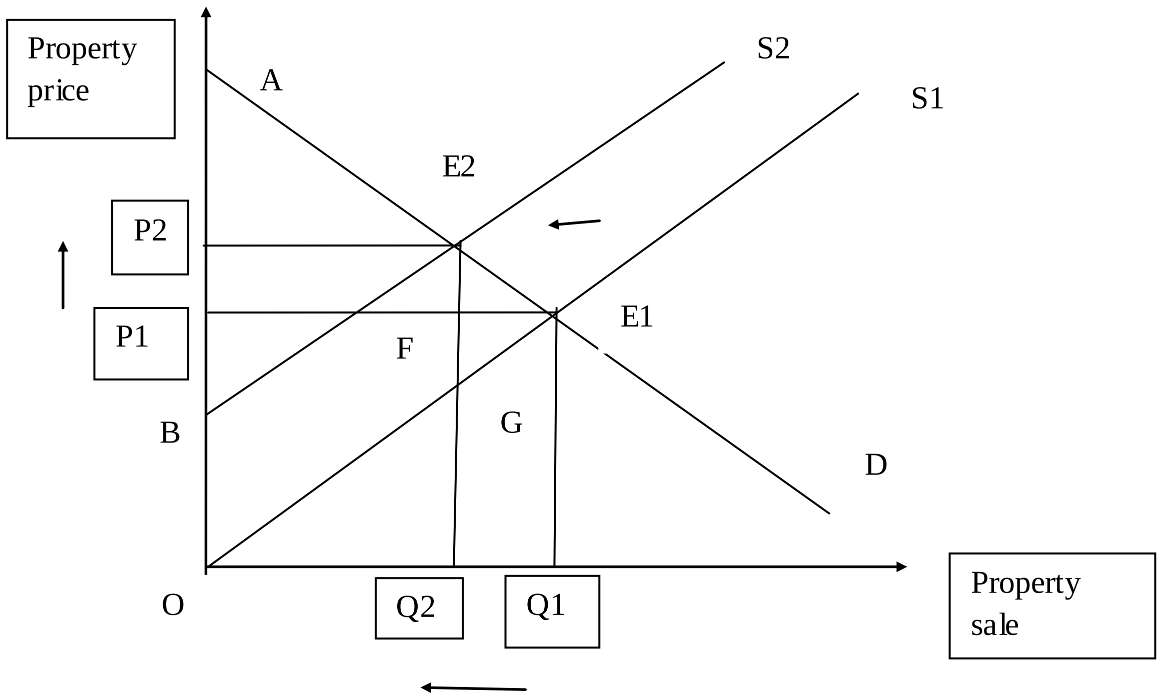

Figure 4: Effect of stamp duty

(Source: created by author)

As the demand for property is more elastic than supply, incidence of tax is less upon the buyers. Sellers reduced the supply in the market due to hike in tax. Buyers have alternative option for investment. Due to increase in tax, foreign buyers can opt for investment in other markets and may withdraw investment from the Melbourne property market. However in the view of (Property Council of Australia, 2015), sellers are unable to avoid the taxes completely and supply curve shifts upwards by the amount of tax. The equilibrium point shifts from Point E1 to E2. Price increases from P1 from P2 and quantity sold reduces from Q1 to Q2.

Initially producer surplus was P_1E_1O and after tax imposition, the producer surplus becomes P_2E_2B. The area of the triangle decreases signifying that stamp duty reduces the producer surplus due to less elasticity in the perfectly competitive market. P_1E_1A and it changes to P_2E_2A. As seen from the diagram, both producer surplus and consumer surplus decreases due to increase in foreign buyer's stamp duty. Total surplus or social welfare reduces in the short term. Social welfare reduces as it creates deadweight loss in the economy. As price increases in the short term, some buyers who have alternative option for investment would shift and hence, level of investment may fall (Fu, et al., 2014). Stamp duty initially increases government revenue, which can also be expended for improvement in social welfare. As the hike in foreign stamp duty discourages foreign buyers, this may increases opportunity for domestic buyers for the investment. These surcharges can reduce the additional demand from external market, however, total surplus cannot be increased as some buyers are deprived and leaving the market due to hike in price (Ji & Otto, 2015).

b. Increase in stamp duty for the foreign buyers leads them to pay extra money on the Australian property. As price would increase for them, demand from foreign buyers is likely to fall. It may thus restrict the foreign investment to enter into the market. Therefore, cash flow in the economy is likely to decrease. Therefore, investment is likely to damage. Decrease in investment reduces capital formation in the economy. In one hand government revenue is used for improvement in social security. On the other hand, the foreign investment in the private property market increases level of investment, which would be reduced after the surcharges (Bianchi, et al., 2016). In total, there are two components of aggregate expenditure that are private investment (I) and government expenditure (G). Stamp duty hike would increase G but reduces I. The impact of social welfare depends on the relative magnitude of both effects. In the view of Winter (2013), investment in housing market is a large source capital flow whereas government has other source of income. Considering both effects it can be stated that stamp duty on foreign buyers cannot increase social welfare.

c) Increase in stamp duty on foreign buyers raises the tax revenue of city government as the tax is the source of income of the local government.

Answer 4

Three housing market stabilising policies

Housing market in Australia is largely influenced by the foreign investment in this market. The supply constraint and variability in demand influences the price fluctuation in this market. As mentioned by Kuttner & Shim (2013), three policies can be discussed in this respect. Those three policies are general credit policies, specific credit policies and housing related taxation policies.

Firstly, the general credit policies include changes in reserve requirements, capital structure and liquidity of the banks and limit to the growth in credits. All of these policies target to control the entire economy and not only the housing market. Banking institutions have to keep a proportion of the deposit as reserve with the Reserve Bank of Australia. Increase in reserve ratio restricts the credit growth in the economy. The ability of lending of the commercial banks decreases when RBA increases reserve ratio. Money supply is restricted which further reduces the demand for money to invest in property (RBA, 2017). Winter (2013) argued that foreign investors are attracted to the Australian market to make investment as the interest rate is high. Therefore, low interest rate induces domestic investment for infrastructure development, while discourages foreign investors to invest in this market.

Housing targeted specific credit policies include controlling loan to value ratio, debt to income ratio, increasing risk weight for banks for the housing market. These techniques are demand side techniques to restrict credit growth. Restricting housing loan growth through maximising loan to value ratio is policy instrument. Another effective policy is zero loans to value ratio. Dalen, et al., (2014) cited that in 2012, China applied the measure to prohibit banks to disburse loans to the buyers purchasing houses for second or third time. This policy is equitable in terms of social welfare as other people without home ownership can get an opportunity to buy the property. This policy can restrict foreign buyers from investing in the market without imposing stamp duty. Debt service ratio makes the buyer to pay a specified maximum proportion of the monthly income as loan repayment. This policy can restrict multiple purchases.

Another policy is housing related taxes such as capital tax, wealth tax, and subsidy. Taxes can be imposed and increased for the buyers for the second times or more than that. Subsidies can be given to the first time domestic buyers. However, one disadvantage in this case is that there may be multiple buyers from a single family (cdn.americanprogress.org, 2013). Supply side can be controlled through investment in infrastructure by reducing regulatory constraint in the supply side.

Best policy option

Every policy discussed above ahs advantages and drawback. However, among the three policies, the best policy measure would be specific credit policy as it has direct effect on the buyers. As suggested by Kuttner & Shim (2013), loan to value ratio, debt service to income ratio and limiting bank exposure as a percentage of the total capital structure can be effective policy measures. Zero loans to value ratio that restricts multiple purchases, can limit the excess demand from the wealthier population and help to stabilise prices in the housing market.

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