



# PMI residential property overview

Australia JULY 2006



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# Introduction

The PMI Residential Property Overview and Quarterly Updates produced in conjunction with key forecaster BIS Shrapnel are designed to provide you with an overview of current property market trends in Australia. These reports are just one of our range of Online Business Tools available on our website designed to help you grow your business.



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# Executive Summary

After peaking over late 2003 and early 2004, the residential markets across the eastern states continued to slow, with minimal price rises, and even price declines in some cities, evident over the course of 2005. Deteriorating affordability caused by the strong price rises of recent years appears to be the key influence on prices, with housing affordability at its worst level since the boom of the late 1980s.



In calendar 2005, solid price growth only occurred in Perth and Darwin which until recently were more affordable than the eastern states. In these states residential prices have been underpinned by stronger demand generated by the booming resources-driven economy, which until recently, were more affordable than the eastern states.

Continued solid economic conditions have prevented any more significant decline in residential prices. High net overseas migration is driving strong underlying demand at the national level, while unemployment remains low. First home buyers are starting to come back into the market in greater numbers (albeit from a very low base), and general lending activity to owner occupiers began to improve in the second half of 2005, although investor activity continues to remain weak.

The 0.25 percentage point rise in interest rates in May 2006 may impact on some purchasers buying at the margins. However, we do not expect that the finances of highly geared home owners are yet strained enough for a significant level of forced sales to come onto the market.

Despite solid wages growth in this period, further interest rate rises are expected to be adverse for housing affordability, dampening any mild recovery. Only modest price growth, or small declines in prices are expected across all capitals over 2006/07 and 2007/08, before lower interest rates and improving economic conditions see the early stages of a period of stronger price growth emerge in 2008/09. Table 1 outlines the price expectations for each capital city.

**“Solid economic conditions have prevented any more significant price declines ”**

**Table 1:** Median house prices by capital city

Quarter ended June	Sydney		Melbourne		Brisbane		Adelaide		Perth		Hobart		Canberra		Darwin	
	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var	\$'000	% Var
1996	220.0	3.3	155.0	3.3	130.0	0.0	111.5	-1.1	127.0	-0.8	112.0	6.7	158.0	3.9	168.0	-6.7
1997	241.0	9.5	179.0	15.5	134.0	3.1	114.9	3.0	135.0	6.3	105.0	-6.3	155.0	-1.9	178.0	6.0
1998	272.0	12.9	208.0	16.2	139.0	3.7	120.3	4.7	143.3	6.1	107.0	1.9	160.0	3.2	180.0	1.1
1999	296.0	8.8	232.0	11.5	145.0	4.3	125.0	3.9	148.5	3.6	115.0	7.5	158.0	-1.3	176.0	-2.2
2000	337.0	13.9	264.0	13.8	155.0	6.9	135.0	8.0	157.8	6.3	130.0	13.0	184.0	16.5	190.4	8.2
2001	364.0	8.0	302.0	14.4	160.0	3.2	148.4	9.9	165.7	5.0	120.3	-7.5	203.0	10.3	187.0	-1.8
2002	452.0	24.2	330.5	9.4	185.0	15.6	170.0	14.6	185.7	12.1	130.0	8.1	227.6	12.1	200.0	7.0
2003	519.0	14.8	355.0	7.4	235.0	27.0	220.0	29.4	210.2	13.2	180.0	38.5	320.0	40.6	206.0	3.0
2004	552.0	6.4	365.0	2.8	307.3	30.7	250.0	13.6	255.0	21.3	252.0	40.0	372.4	16.4	255.0	23.8
2005	528.0	-4.3	360.0	-1.4	312.5	1.7	275.0	10.0	295.0	15.7	260.0	3.2	352.5	-5.3	279.8	9.7
Forecasts																
2006	517.0	-2.1	370.0	2.8	330.0	5.6	277.0	0.7	360.0	22.0	270.0	3.8	360.0	2.1	334.0	19.4
2007	508.0	-1.7	377.0	1.9	340.0	3.0	280.0	1.1	371.0	3.1	273.0	1.1	364.0	1.1	344.0	3.0
2008	495.0	-2.6	385.0	2.1	350.0	2.9	283.0	1.1	377.0	1.6	276.0	1.1	368.0	1.1	344.0	0.0
2009	504.0	1.8	400.0	3.9	371.0	6.0	290.0	2.5	370.0	-1.9	282.0	2.2	376.0	2.2	330.0	-4.1

Source: R.E.I.A, BIS Shrapnel

- After rising by a substantial 57% between June 2001 and March 2004, affordability in Sydney reached a very challenging level. There has been a correction in the Sydney market with median house prices declining by 4% over 2004/05, and deteriorating further to reach a median house price of \$517,000 by December 2005. With interest rates on an upward trend, affordability is likely to remain a concern in the Sydney market, and prices are expected to weaken further. Sydney's forecast median house price of \$517,000 at June 2006 represents a 2% decline for the 2005/06 year. With interest rates expected to rise over 2006/07, prices are forecast to weaken by a further 2% over the year to June 2007, and by a further 3% over 2007/08, as the higher interest rates also have the effect of slowing the economy. A forecast reduction in interest rates over 2008/09, and the first signs of the next economic upswing are likely to see the return to

price growth in the Sydney housing market, with a 2% rise expected over 2009.

- The affordability measure for Melbourne has remained relatively steady since 2000, suggesting that house values in Melbourne are generally fully priced. Consequently, price growth in Melbourne is likely to be limited to rises coinciding with wages growth after an allowance for the rising interest rate environment. The forecast median house price for Melbourne of \$370,000 at June 2006 represents a 3% increase for the year. As interest rates rise through 2006/07, it is forecast that there will be a rise in the median of 2%, and a further increase of 2% in 2007/08. Price growth is expected to pick up slightly (4%) as part of an upturn in 2008/09, as interest rates decline and economic activity starts to improve.

- Although a significant stock deficiency continues to exist across Queensland, house prices in Brisbane appear to have reached their affordability limits. This is reflected in median house price growth slowing to only 1% in 2004/05. Median price growth has picked up slightly in 2005/06 with Brisbane's forecast median house price of \$330,000 at June 2006 representing a rise of 6% for the year, and it appears that households are adjusting to higher price levels in Brisbane. Despite rising interest rates, the high stock deficiency is likely to continue to place some upward pressure on prices while economic growth remains strong. Price growth is consequently expected to be positive in 2006/07 and 2007/08. As interest rates move into a downward trend through 2008/09, price growth in Brisbane is forecast to accelerate to 6%.
- Although Adelaide recorded a 10% increase in its median house price in



2004/05, price growth in the six months to December 2005 was a minimal 1%. It is forecast that Adelaide's median house price will reach \$277,000 by June 2006. With interest rates forecast to rise further in 2006/07, and an excess of dwelling stock, existing price growth over the next three years will be minimal in the Adelaide market, rising by 1% in each of 2006/07 and 2007/08. A slight improvement in price growth to 3% is forecast for 2008/09, as interest rates edge down.

- In comparison to the slowing of price growth in the eastern capitals, Perth's median house price increased by 16% in 2004/05 and by a further 14% in the six months to December 2005—driven by relatively attractive affordability, strong underlying demand and a booming economy. Further solid growth is expected in 2006, although it is anticipated that affordability issues have begun to emerge. A median house price of \$360,000 at June 2006 is forecast and will represent a 22% rise for the year. However, after the strong growth of previous years, and rises in interest rates over the subsequent twelve months, price


growth is likely to slow to 3% in 2006/07 and to continue to decline by a further 2% over 2007/08. With most of the current round of resource investment projects beginning to run their course, it is expected that there will be a more significant slowing of the economy in Western Australia as spending drops back from current record levels. This will result in net interstate migration inflows falling back from their high levels. Weaker demand in an environment of house prices being potentially regarded as over valued in a long term sense, is expected to lead to Perth's median house price declining by 2% in 2008/09.

- Median house price growth slowed to 3% in Hobart in 2004/05, after a 78% increase over the two years to June 2004. The main driver of the increased demand, net interstate migration inflow has since declined to almost zero and is likely to revert back to an outflow in the long term. Price growth has remained soft in the second half of calendar 2005. The median house price forecast to be \$270,000 at June 2006, representing an annual increase of 4%. As interest rates rise over 2006/07, growth in Hobart's median house price is forecast to slow to 1% and remain at this level in 2007/08, before a slight increase of 2% in 2008/09.

- Canberra's median house price declined by 5% to \$352,500 in the year to June 2005. Declining affordability after a period of strong price growth in previous years appears to have impacted on prices, which had moved up to be on par with Melbourne. Price growth is forecast to continue to remain limited over the next three years, particularly as interest

rates rise in the short term. A forecast median house price of \$360,000 by June 2006 reflects an annual increase of 2%. As higher interest rates impact on affordability, the median house price is anticipated to rise by only 1% in each of 2006/07 and 2007/08, before picking up to 2% in 2008/09 as interest rates begin to ease.

- Darwin's median house prices continue to show solid growth, following up a 24% rise in 2003/04 with a further 10% increase in 2004/05 and 17% increase over the six months to December 2005. The Northern Territory has benefited from a boom in mining and resources investment, and this has resulted in the net interstate migration outflow improving from 3,400 in 2002/03 to a zero impact in 2004/05. Price growth for 2005/06 is forecast to end at 19%. Further rises in interest rates in 2006/07 are forecast to slow price growth to 3% for the year. However, with the current boom in resources investment forecast to begin to taper off from 2007/08, the Darwin residential market will be particularly affected given its small size. Prices are forecast to remain static in 2007/08, before declining by 2% in 2008/09.



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# Economic Outlook

The Australian economy has shown signs of picking up after the setback to growth last year. Although calendar 2005 saw a significant slowdown in GDP growth, the economy is still carrying good underlying momentum with both domestic and world demand rising solidly.



“A key issue facing the economy is the pace in growth of domestic demand”

Indeed, the most important shift over the last year hasn't been the slowdown so much as the change in the composition of growth domestically, with the housing and consumer booms that led the way through 2003 and 2004 giving way to a phase of business-led growth that is set to add another significant leg to the cycle.

The key issue facing the economy is the pace of growth in demand and its effect on Australia's productive sector, which is struggling to keep up. In effect, a long period of under-investment in Australia's infrastructure and productive capacity is finally hitting home. The general pattern of strong demand and tight capacity is likely to continue to shape economic activity over the next two years. Effort to bring new investment through quickly is expected to see strong rises in capital spending driving another leg to the current upswing cycle in domestic demand. However, pressures are inevitably likely to result in higher imports, inflation and interest rates. The main question is the timing of these developments.

The second half of 2005 represented a weaker than expected outcome for the economy. In particular, the slowdown in consumer spending that was apparent in late 2004/early 2005 has continued through 2005 with consumers taking a more cautious approach to their finances.

GDP growth was 2.5% in calendar 2005, constrained by limited growth in the final six months of the year. It appears, however, that this figure is concealing strong domestic demand. The increase in total spending in the economy (Gross National Expenditure), ran at a substantial 4.1% in the same period, with the remainder of domestic demand being picked up by rising imports.

Since then, domestic demand growth has recovered somewhat. Spending by the household sector has improved, with an improvement in the value of retail sales and household credit growth.

Employment growth has remained solid and the unemployment rate has dropped back to 5% as at May 2006.

This improved momentum in the household sector has caused the RBA to undertake another pre-emptive strike against inflation. Interest rates were raised by 0.25% in May 2006. The latest reading on inflation showed that the headline rate was at the upper end of the RBA target range of 2–3%, but that this was boosted by the impact of higher oil prices. Nevertheless, the rate of price growth for domestic activity remains high, with some offset provided by much weaker growth for traded goods such as electronic equipment.

Furthermore, there is strong momentum in the business sector, with construction and investment in plant and equipment showing solid growth over the past six months. These trends are expected to continue over the next year, which is likely to sustain further expansion in employment. Table 2 indicates the percentage change and forecasts for a range of key economic indicators.

**Table 2: Economic indicators**

Year Ended June	2003	2004	2005	2006	Forecasts		
					2007	2008	2009
<b>EXPENDITURE ON GDP</b> (at average 2002/03 prices)							
Consumption							
– Private Consumption	3.6	5.5	4.2	3.0	3.8	3.0	2.6
– Government	3.4	3.6	3.6	3.8	4.5	3.8	2.5
Private Investment							
– Dwellings	15.0	4.0	-1.5	-1.7	-2.2	-0.5	6.9
– Real Estate Transfer Exp.	4.9	-2.0	-16.7	-2.5	1.1	-1.9	14.7
– New Non-Dwelling Construction	28.1	8.2	7.7	15.6	6.5	-2.4	-6.5
– New Equipment	16.7	14.7	15.4	16.1	7.2	0.0	-3.6
– New Business Investment (+)	18.2	12.7	11.7	14.8	7.3	-0.3	-3.9
New Public Investment	3.4	4.2	4.3	3.9	5.1	3.0	0.7
<b>Gross National Expenditure (GNE)</b>	<b>6.2</b>	<b>6.3</b>	<b>4.1</b>	<b>4.5</b>	<b>4.4</b>	<b>1.8</b>	<b>1.4</b>
<b>GDP</b>	<b>3.2</b>	<b>4.0</b>	<b>2.5</b>	<b>3.1</b>	<b>4.0</b>	<b>2.8</b>	<b>2.7</b>
Inflation & wages (Jun on Jun)							
CPI	2.7	2.5	2.5	3.2	3.1	3.0	2.0
Average Weekly Earnings	6.5	2.8	5.9	5.1	5.9	4.2	3.9
Employment (%)							
– Employment Growth (May on May)	2.5	2.0	3.4	1.5	2.9	0.7	0.6
– Unemployment Rate (May, sa)	6.2	5.5	5.1	5.0	4.6	5.1	5.4
Interest Rates (% at 30 June)							
– Cash Rate	4.67	5.49	5.66	5.90	6.40	6.20	6.00
– Housing (variable)	6.55	7.05	7.30	7.55	8.05	8.05	7.80

Source: BIS Shrapnel, ABS Data, RBA





Economic growth is expected to remain solid. Now that the housing market has come off its peak, business investment has taken over as the key driver of economic growth. There is rising investment in the resources sector, as businesses prepare to meet rising demand off the back of the booming Chinese economy. Further growth in investment is expected to come from a major round of public infrastructure projects just getting underway and the upturn underway in non-residential building.

Labour markets will be a key source of inflationary pressure. Unemployment is already running near historic lows. As growth picks up again, rising employment is expected to push the unemployment rate below 5% in 2006/07, which represents a 30 year low in the unemployment rate. Widespread labour shortages are expected to push wages growth up sharply to over 6% in 2006/07, providing the main impetus for a predicted pick-up in price inflation.



With these pressures forecast to remain in the economy until the effects of stronger investment in production alleviate some of the bottlenecks at major ports, the pieces are in place for the CPI to rise beyond the Reserve Bank's targeted 2–3% range. In response, further rises in the cash rate may occur.

It is predicted that the RBA will undertake further tightening in monetary policy, with the cash rate raised by 0.5% during 2006/07, pushing the standard variable mortgage rate to a peak of 8.05% by June 2007.

Interest rates are forecast to then be on hold during 2007/08. As economic growth slows in 2007/08, monetary policy is likely to be loosened in September quarter 2007, which would lower the variable mortgage rate to 7.8% by June 2008.

### **Interest Rates**

After rate rises in December quarter 2003 the RBA waited to assess the impact and left the cash rate unchanged at 5.25% during 2004. It had become evident that the rate hikes had substantially dampened the growth in credit, particularly lending for purchase of residential property, and residential property price growth slowed rapidly, with small declines evident in some markets. There were also declines in dwelling approvals in the second half of 2004, which followed the weaker rate of turnover in residential property. Furthermore, retail sales growth slowed rapidly in the second half of 2004, which indicated that household spending was dampened by the weakening residential property market.

However, interest rates in 2004 remained comparatively low by historical standards and growth in domestic demand was strong, as the unemployment rate was low and wages growth solid. Despite weaker dwelling approvals and retail sales, employment growth was very strong in the second half of 2004. Concerned at the potential for a tightening labour market to ignite an acceleration of wages growth, the RBA implemented a further 0.25% increase in the cash rate to 5.5% in March 2005. This move brought the standard variable

housing rate to 7.30%. The impetus for this decision was concern over pressure on Australia's productive sector, particularly in labour markets, increasing the potential for a future rise in inflation. As at December 2004, headline CPI stood at 2.6%.

Over the next fourteen months, any rate increases were put on hold as the RBA waited to assess the impact of its March 2005 rise, the extent of an apparent slowdown in consumer spending and a tentative easing in inflationary pressure. During which time, rising world oil prices forced the CPI to the 3% threshold in September 2005 quarter. While baseline CPI eased back to 2.8% in the final quarter of calendar 2005, by March 2006 it had risen again to 3.0%.

In May 2006, the RBA deduced that the March 2005 rate increase was insufficient to keep price growth at an acceptable level and opted to tighten the cash rate by a further 0.25%. In its press statement, the RBA justified this decision by pointing to a range of factors including; international commodity price growth which is expected to strengthen export earnings and have expansionary effects on income and spending; a favourable domestic spending outlook and overall credit growth; and capacity constraints driving up inflation, with reference to wage and raw material price growth.

The Reserve Bank's job looks to be far from over. Tight capacity, lower productivity growth and a steady pick up in wages growth are expected to push inflation significantly higher despite slower growth in demand. Further interest rate rises are likely to be on the agenda

through 2006/07, with a rise of 0.5% expected. These measures are expected to draw the housing variable rate up to 8.05% by June 2007, the highest level since the second half of 2000.

No further movements are forecast for 2007/08, as the RBA observes a further slowing in household spending.

The weaker economic environment, driven down by a sharp decline in Gross National Expenditure, is expected to induce an interest rate cut in the first half of 2008/09. This move will be undertaken by the RBA in an attempt to reignite domestic demand.

# Residential Demand

The residential markets across the eastern states have continued to slow, with minimal price rises, and even price declines in some cities, evident over the course of 2005, primarily as a result of deteriorating affordability after the strong price rises of recent years.



**“Deteriorating affordability is continuing to impact residential markets nationally”**

However solid economic conditions have prevented any more significant decline in residential prices. High net overseas migration is driving strong underlying demand at the national level, while unemployment remains low. First home buyers are starting to come back into the market in greater numbers (albeit from a very low base), and general lending activity to owner occupiers began to improve in the second half of 2005, although investor activity continues to remain weak.

The 0.25 percentage point rise in interest rates in May 2006 may impact on some purchasers buying at the margins. However, the finances of highly geared home owners are not expected to be strained enough for a significant level of forced sales to come onto the market.

The outlook over the next 12 months is not uniform across the capital cities:

- Markets such as Perth and Darwin are experiencing strong demand and booming economic conditions due to substantial resource investment spending. However, increasing price levels suggest that affordability constraints are also likely to come to the fore. Although some significant price growth could continue through to the end of the year, it is likely to slow as the population’s capacity to pay higher prices diminishes.

- Price growth over the next 3 years will be minimal across all of the remaining major city markets, as the effects of interest rate rises in the short term, and affordability constraints overall have a moderating effect on any upward pressure on price growth.

## Home loan activity

### Owner occupier loan activity

Trends in finance for owner occupation in both new and established dwellings indicate that after peaking in 2001/02, the market weakened over 2002/03 (Table 3). While the number of loans for new dwellings recovered in 2003/04, both sectors edged down marginally in 2004/05. In the first three quarters of 2005/06, the financial loans for owner occupation have shown a strong recovery.

At the national level, finance for new dwellings edged down in the final three quarters of 2004/05, but has recovered strongly over the last two quarters to March 2006. The number of home loans approved for new dwellings had risen by 9% over the twelve months to March 2006, compared to the same period last year. Similarly, finance for established dwellings rose substantially, up 11% over the nine months to March 2006 after consecutive declines over the past three financial years.

In 2004/05, finance activity for owner occupation showed the largest percentage declines in New South Wales, Queensland and the Australian Capital Territory. Tasmania recorded a strong decline in loan approvals for established dwellings, but an increase in new dwelling loan approvals. Conversely, South Australia experienced a moderate fall in new dwelling loan approvals, but an increase in established dwelling loan approvals. All other states showed strengthening home loan activity over the course of 2004/05; the most notable of which was the continued growth in loan approvals in Western Australia and the Northern Territory.

**Table 3:** Number of home loans approved for owner occupation  
- % change on previous year

State	New Dwellings				Established Dwellings			
	2002/03	2003/04	2004/05	9 mths to Mar 06	2002/03	2003/04	2004/05	9 mths to Mar 06
New South Wales	-20	5	-11	7	-8	-6	-10	11
Victoria	-19	6	0	8	-4	-6	6	9
Queensland	-16	9	-11	9	3	0	-6	11
South Australia	-10	5	-5	3	-1	4	6	4
Western Australia	-11	23	7	14	0	1	13	16
Tasmania	5	9	13	-1	-1	-8	-11	9
Northern Territory	9	28	46	20	-10	21	38	27
A.C.T.	10	-9	-14	9	9	-18	-19	15
Australia	-16	9	-4	9	-3	-3	-1	11

Source: ABS Data

**Table 4:** Number of loans to first home buyers

State	Annual Average 1996/97 to 2001/02	2002/03	2003/04	2004/05	12 months to March 2006
New South Wales	33,664	28,791	24,785	27,337	33,085
Victoria	30,341	23,984	21,303	28,178	33,018
Queensland	22,396	24,389	20,193	19,894	24,588
South Australia	7,524	6,822	6,150	6,419	7,410
Western Australia	16,207	12,775	12,393	16,060	17,382
Tasmania	2,043	2,273	1,611	1,635	2,066
Northern Territory	1,043	763	964	1,481	1,839
A.C.T.	2,012	1,509	1,001	1,140	1,400
Australia	115,229	101,306	88,400	102,144	120,788

Source: ABS Data

Loan activity as shown in Table 3 has improved across all of the states over the first three quarters of 2005/06. Nationally, loan approvals for new dwellings rose by 9% compared to the nine months to March 2005. Growth was strongest in the Northern Territory and Western Australia, but a strong recovery also occurred across all of the eastern states. With regard to established dwelling loan approvals, the national number increased by 11% over the nine months to March 2006, compared with the same period in 2005. As with new dwelling loan approvals, this growth was

concentrated in the Northern Territory and Western Australia, but growth in New South Wales and Queensland was in line with the national increase.

Loan approvals for first home buyers declined by 13% in 2003/04, but recovered by 16% in 2004/05 as shown in Table 4. This growth has continued through the first three quarters of

**Table 5:** Total residential home loan activity

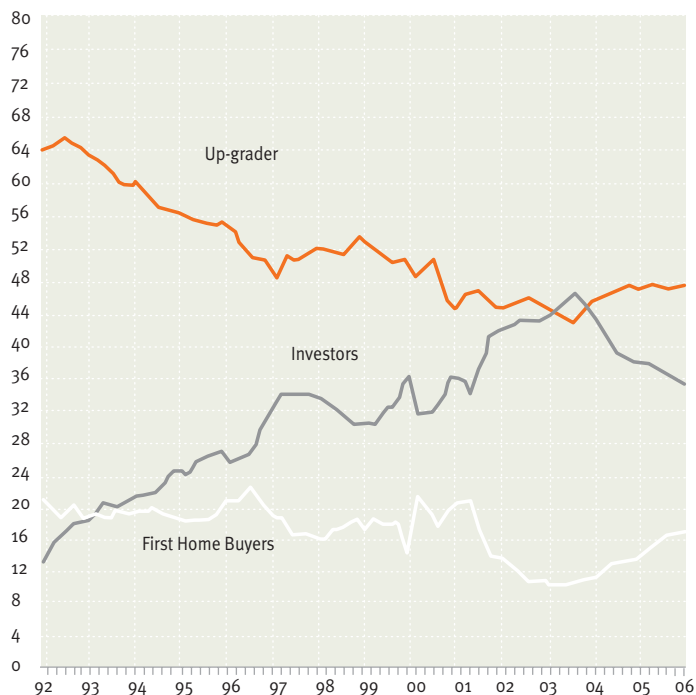
Year	Loans for owner occupation \$million	% change	Loans for investment \$million	% change
1993/94	44,374	27.2	10,657	66.9
1994/95	40,307	-9.2	11,413	7.1
1995/96	37,994	-5.7	11,885	4.1
1996/1997	41,829	10.1	16,496	38.8
1997/1998	48,156	15.1	21,446	30.0
1998/1999	55,360	15.0	21,822	1.8
1999/2000	67,278	21.5	28,458	30.4
2000/2001	63,435	-5.7	27,505	-3.3
2001/2002	84,331	32.9	43,163	56.9
2002/2003	88,642	5.1	57,653	33.6
2003/2004	100,283	13.1	71,010	23.2
2004/2005	104,926	4.6	60,274	-15.1
Mar 2006*	81,869	14.8	44,696	0.1

\*=9 months to March and change over corresponding period 1 year earlier

Source: ABS

2005/06, rising by 27% compared with the twelve months to March 2005. At the state level, the strongest growth over the year to March 2005 occurred in Tasmania at 41%, closely followed by Victoria and the two territories where the number of first home buyers increased by 33%. The number of loan approvals to first home buyers in Victoria has been particularly strong over the past two years due to changes in the First Home Bonus scheme. The entitlement was reduced from \$5,000 to \$3,000 from 1 January 2006, and is scheduled to cease in July 2007. These changes are likely to have generated a pull-forward effect on first home buyer numbers for Victoria in the second half of 2005.

**Chart 1:** Proportion of residential loans attributable to investment property(%)



**Investor loan activity**

Investor activity has remained low, with the value of loans to investor purchasers in the nine months to March 2006 up only 0.1%, almost on par with that of the corresponding period in the previous year. Similarly, the level of investor finance has fallen to 35% of total residential purchaser activity in the March quarter 2006, after peaking at 46% two and a half years earlier.

By state, the value of commercial loan approvals have increased significantly over the past five years in Western Australia due to the high level of net interstate migration. Over the year to March 2006, the value of commercial loans in Western Australia peaked at \$7.76 billion, due to a 48% increase in the nine months to March 2006.

**Table 6:** Deficiency of stock and building activity

State	Demand for Housing				Building Activity Dwelling Commencements			
	Deficiency of Stock (est.)			Average Annual Underlying Demand for Dwellings (2005/06 to 2010/11)	2005/06 (estimate)		2006/07 (forecast)	
	Number of Dwellings ('000)*		June '06 % of Average Annual Underlying Demand		Number	Annual % change	Number	Annual % change
	As at June '05	As at June '06						
NSW	5.3	14.8	31	47,400	30,650	-18.0	31,650	3.3
VIC	-14.0	-17.8	-46	38,600	38,350	-6.5	35,400	-7.7
QLD	37.0	40.7	95	43,000	37,800	-1.6	38,350	1.5
SA	-6.9	-9.7	-114	8,500	10,300	-1.9	9,100	-11.7
WA	-1.2	-2.1	-10	21,300	25,500	11.9	24,550	-3.7
TAS	0.9	0.7	32	2,200	2,490	-11.5	2,350	-5.6
ACT	-2.5	-2.0	-118	1,700	1,400	3.9	1,500	7.1
NT	-1.6	-2.2	-96	2,300	1,650	-32.8	1,650	0.0
Aust	16.9	22.4	14	165,000	148,140	-5.5	144,550	-2.4

\* A negative means stock surplus. Dwelling commencements include conversions. Source: BIS Shrapnel

In the eastern states, the value of investment loans has remained weak over the first three quarters of 2005/06. This trend is quite pronounced in New South Wales (-7%) as high property prices have translated to low yields for investors. The value of loans in Victoria declined by 5%. This decline is further compounded by price growth and illustrates the decreased investor confidence in Victoria due to low yields from an already saturated market. The value of loan approvals in Queensland remained static in the nine months to March 2006, as investors have felt the pinch from weak growth in property prices and rising construction costs.

This dichotomy indicates that while overall investment lending for residential property has remained static in the nine months to March 2006, the balance of lending has shifted clearly from the eastern states to the nation's more affordable markets. This switch in overall composition of investment has contributed to residential price growth in Perth and Darwin.

## Supply and Demand

Over the last five years to 2006, the average annual underlying demand for new dwellings in Australia is estimated to have been 157,000, which is significantly above the previous high of 147,100, during the 1991–1996 period. This high level of underlying demand is largely a result of increased overseas migration and a higher level of dwelling demolitions (necessitating a replacement dwelling).

It is expected that net overseas migration will average around 123,800 people per annum over the four years to 2008/09, compared to a low average of 94,800 per annum over the five years to 1999/2000, and 114,600 over the five years to 2004/05. The average underlying demand for new dwellings is estimated to increase from 157,000 per annum over the 2001/02–2005/06 period, to 165,000 per annum over the five years to 2010/11. Net overseas migration is expected to rise steadily from 110,100 in 2004/05 to a

forecast of 135,000 by 2007/08, as the economy approaches a cyclical peak. In 2008/09, domestic economic conditions are expected to weaken and consequently net overseas migration is likely to decline sharply to 110,000 persons.

Dwelling commencements increased by 3.4% in 2002/03 to 169,900. Other dwellings were the main contributor to this increase with residential investment activity surging as investors, wary of an uncertain equities market, elected to put their money into the better performing residential market at the time. Total dwellings commenced rose by a further 1.1% in 2003/04 to a peak of 171,800. Growth was led by a 5% rise in private house commencements, which was mostly countered by a 5% decline in private other dwelling starts as investor interest began to fade.

Following the peak in dwelling commencements in 2003/04, private house starts declined by 11% in 2004/05, and coupled with a 5% decline in private other dwelling starts, total dwelling commencements in Australia declined by 8.8% in 2004/05. Dwelling commencements are anticipated to decline by 6% in 2005/06 and are expected to fall short of underlying demand. The downward trend in dwelling commencements is expected to continue through 2006/07 (-2%), despite mounting underlying demand.

Table 6 shows the demand for housing and building activity for 2005/06 and forecasts for 2006/07.

Australia's stock deficiency is expected to show a modest increase between June 2005 and June 2006 as underlying demand has been slightly stronger than dwelling completions. Dwelling construction is expected to continue to be below underlying demand in 2006/07 resulting in a strong increase in the stock deficiency; this increase is expected to be concentrated in New South Wales and Queensland, offsetting rises in the excess dwelling stock in Victoria and South Australia.

## Rentals

Rental growth in Melbourne and Sydney has fallen below the rate of inflation from around 2000, as vacancy rates crept up past the 3% mark, due to strong investor purchaser activity, and the first home owners grant encouraging tenants to move to home ownership. Despite more recent declines in vacancy rates in both

**Table 7: Annual rental growth and vacancy rates**

As at June	Sydney		Melbourne		Brisbane		Adelaide		CPI
	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Growth (%)
1997	4.0	2.6	3.6	2.0	0.6	4.2	1.0	2.6	0.3
1998	4.3	2.6	4.0	1.7	0.5	4.7	1.7	1.9	0.7
1999	3.8	1.8	2.2	3.6	0.6	5.4	1.9	2.5	1.1
2000	4.2	2.2	2.9	3.5	0.9	5.2*	2.1	4.5	3.2
2001	4.2	3.3	2.6	3.9	2.2	2.2*	2.9	3.6	6.0
2002	2.5	4.6	2.6	3.8	2.4	4.1	3.0	3.6	2.8
2003	0.4	4.4	1.7	3.9	3.5	2.3	3.7	2.8	2.7
2004	2.2	3.6	1.6	3.6	4.6	2.3	3.0	1.9	2.5
2005	1.4	2.5	1.5	2.6	4.4	2.3	2.8	1.8	2.5
2006*	2.1	2.0	1.3	1.8	5.8	1.5	3.2	1.7	3.2

As at June	Perth		Hobart		Canberra		Darwin		CPI
	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Rental growth (%)	Vac. rate (%)	Growth (%)
1997	1.4	2.7	1.3	6.2	-1.0	4.3	2.0	5.8	0.3
1998	1.9	2.5	-0.4	6.9	-1.5	2.9	0.8	14.1	0.7
1999	1.9	2.4	-0.3	8.3	0.8	1.0	0.1	14.1	1.1
2000	2.3	3.0	0.2	4.1	5.7	2.3	-2.9	6.4	3.2
2001	1.7	4.2	2.2	2.0	4.2	3.0	-0.6	9.0	6.0
2002	2.0	4.5	2.4	2.3	5.7	3.6	0.2	5.0	2.8
2003	1.3	4.5	3.1	2.8	4.9	3.5	1.1	7.1	2.7
2004	2.6	3.3	5.0	2.2	7.4	4.3	1.9	5.5	2.5
2005	2.3	2.5	3.3	2.5	3.7	2.2	3.2	1.9	2.5
2006*	3.4	1.4	4.5	2.2	2.4	1.8	3.8	3.3	3.2

\* as at March Source: ABS and REIA

these capitals, rental growth has remained subdued.

Rental growth in Adelaide as seen in Table 7 has been strong, rising above inflation to 3.7% in the June quarter 2003. The rate of growth has since slowed, but remained ahead of inflation on average. Rental growth increased by a solid 3.2% in the March quarter 2006.

Between 2001 and 2003, high vacancy rates above 4% resulted in rental growth in Perth that was below the inflation rate, reaching a low of 1.3% in June 2003. As vacancy rates subsequently declined,

rental growth increased, and rose to a peak of 3.4% in March quarter 2006.

The strongest rental growth over the last four years has been in Brisbane and Hobart with each of these capitals experiencing historically low vacancy rates as at March 2006. Darwin and Canberra have also experienced declining vacancies with Darwin now showing rental growth above inflation. While Canberra's rental growth was particularly strong over the 6 years to 2005, growth more recently has slowed.

## Trends in Migration

### Net overseas migration

The Federal Government increased the intake of migrants for 2004/05 with an extra 5,000 places created in the skilled category, pushing the total to 120,000. This change was in addition to an extra 1,000 places being made available in the humanitarian intake for refugees, for a total of 13,000 in 2004/05. Despite this, the preliminary estimate of net overseas migration for 2004/05 was 110,100 persons.

Further to this, on April 14 2005, the Federal Government announced plans to further boost Australia's intake of skilled overseas migrants in 2005/06 by 20,000. This increases the government's non-humanitarian target for overseas migration to the 130,000 to 140,000 range. The target for 2006/07 is unchanged from the number for 2005/06.

In addition to the Federal Government's boosted official migrant intake, strong economic conditions and increased employment opportunities are expected to encourage long term visitors to Australia over the next two years. As shown in Table 8, the forecast is for net overseas migration to rise from 110,100 in 2004/05 to 120,000 in 2005/06, 130,000 in 2006/07 and 135,000 in 2007/08 which will be the highest level since the height of the economic boom in 1988/89. However, net overseas migration is forecast to drop back to 110,000 in 2008/09 as an expected economic downturn is likely to result in lower inward migration and a higher outflow of long term visitors, due to rising unemployment. Overseas migration is



expected to drop back further beyond the forecast period as economic conditions remain weak.

New South Wales is expected to continue to be the initial location for approximately 34% of overseas migrants over the next four years. While this is relatively high in comparison to other states, it is well below the 45–46% share of the mid 1990's and below the average of 36% for

**Table 8:** Net overseas migration (000's)

Year Ended June	NSW	VIC	QLD	SA	WA	TAS	ACT	NT	Aust.
1997	37.3	21.1	12.6	3.1	12.3	0.3	-0.1	0.5	87.1
1998	31.8	19.3	12.5	3.2	12.0	0.0	-0.2	0.6	79.2
1999	41.1	24.7	13.7	2.7	13.4	0.2	-0.2	1.0	96.5
2000	43.7	27.0	17.5	3.8	14.0	0.4	-0.1	0.9	107.3
2001	58.6	35.3	21.0	2.8	16.3	0.1	0.7	0.9	135.7
2002	44.4	20.3	26.5	2.8	15.0	0.3	0.7	0.7	110.6
2003	44.9	33.8	22.8	4.7	18.0	0.7	0.3	0.2	125.3
2004	29.8	25.0	25.4	4.3	13.6	0.7	0.6	0.5	100.0
2005	36.7	32.3	17.1	6.7	16.5	0.7	0.4	-0.3	110.1
Forecast									
2006	40.8	31.2	23.4	6.0	17.4	0.6	0.4	0.2	120.0
2007	44.2	33.8	25.4	6.5	18.9	0.7	0.4	0.3	130.0
2008	45.9	35.1	26.3	6.8	19.6	0.7	0.4	0.3	135.0
2009	37.4	28.6	21.5	5.5	16.0	0.6	0.3	0.2	110.0

Source: BIS Shrapnel, ABS

**Table 9:** Net interstate migration ('000s)

Year Ended June	NSW	VIC	QLD	SA	WA	TAS	ACT	NT
1997	-10.7	-6.2	19.6	-3.3	4.7	-3.3	-2.5	1.8
1998	-12.2	-0.3	17.4	-2.0	3.2	-3.6	-2.0	-0.5
1999	-13.1	2.5	16.7	-1.6	0.3	-3.3	-0.5	-1.0
2000	-14.3	5.2	18.5	-3.5	-2.2	-2.6	-0.1	-0.9
2001	-16.3	5.2	20.0	-2.4	-3.1	-2.1	0.4	-1.6
2002	-24.4	4.4	31.2	-1.6	-4.4	-1.5	-1.0	-2.6
2003	-31.8	0.0	39.2	-1.5	-2.8	1.9	-1.6	-3.4
2004	-30.4	-2.3	36.7	-3.2	1.3	2.5	-2.4	-2.1
2005	-25.7	-2.4	31.5	-3.5	1.5	0.2	-1.6	0.0
Forecast								
2006	-24.0	-5.0	27.0	-3.0	5.0	0.0	-1.0	1.0
2007	-24.0	-7.0	27.5	-3.0	6.0	-0.5	0.0	1.0
2008	-19.0	-9.0	27.5	-3.0	4.0	-1.0	0.0	0.5
2009	-17.0	-9.0	27.0	-3.0	3.0	-1.5	0.0	0.5

Source: BIS Shrapnel, ABS

the past five years. The other initial destinations of overseas migrants in 2005/06 are expected to be Victoria with approximately 31,200 persons (26%), Queensland with approximately 23,400 (19.5%), and Western Australia with approximately 17,400 (14.5%).

The state capitals absorb the majority of each state's overseas migrants. For example, Sydney receives over 90% of New South Wales' overseas migrants, while over 90% of Victoria's overseas migrants are located in Melbourne. The exception is in Queensland, where around 60% of overseas migrants go into Brisbane and 25% into the remainder of South East Queensland.

### Net interstate migration

The dominant interstate flow is the resettlement of people from New South Wales to Queensland. In 2002/03, as shown in Table 9 the population outflow from New South Wales of 31,800 persons was the highest outflow in thirteen years. This was driven by the strong growth in Sydney house prices, which encouraged 'empty nesters' and 'retirees' in particular to cash in on significant capital gains in their property and pocket the difference when they moved to more affordable parts of the country. Likewise, affordability posed a barrier to home ownership for some first home buyers who were priced out of the Sydney market. Consequently, these first home buyers looked to other states for more affordable alternatives. However, Brisbane's house price growth considerably outperformed that of Sydney in 2003/04 and 2004/05, with the affordability advantage held by Brisbane

narrowing significantly. This has led to a lower net outflow from New South Wales to 30,400 in 2003/04 and 25,700 in 2004/05. This dynamic is likely to continue to reduce the net outflow from New South Wales over the next four years. The net outflow is expected to steadily decline to around 24,000 per annum over the two years to 2006/07, then 19,000 in 2007/08 and 17,000 in 2008/09.

Victoria's net interstate migration inflow slowed to zero in 2002/03, and posted its first net interstate outflow in five years in 2003/04 of 2,300, rising marginally to 2,400 in 2004/05. The outflow is forecast to rise to 5,000 in 2005/06 and peak at 9,000 in 2007/08 and 2008/09, as increasing numbers of residents move interstate for employment opportunities or opt for more affordable housing in other parts of the country.

The price advantage of residential property in South East Queensland and the more attractive climate and lifestyle offerings provided the catalyst for a rise in the net inflow into Queensland to 39,200 in 2002/03. The inflow eased slightly in 2003/04 to 36,700 as its affordability advantage over other eastern states began to diminish. This decline became more pronounced in 2004/05, when the net inflow eased back to 31,500 persons.

Modest growth in median Queensland house prices, above that of Sydney and Melbourne, in 2005/06 and 2006/07 is expected to further diminish the states affordability advantage. However, a robust Queensland economy will continue to support inflows to the state. It is expected that the net interstate migration

inflow will drop to 27,000 in 2005/06, with a mild improvement expected in 2006/07 and 2007/08 as economic conditions in Queensland are likely to be resilient. Net interstate migration is forecast to remain at around 27,000 persons in 2008/09.

Western Australia sustained four consecutive years of net interstate migration outflows up to, and including, 2002/03. The outflow has since reverted to a net interstate migration inflow with the state recording a gain of 1,300 in 2003/04, which rose to 1,500 in 2004/05. This reversal is the result of the comparative affordability of housing in Perth relative to other capital cities and the strong job prospects being offered as a consequence of the state's surge in mining activity. The inflow is expected to gather momentum over the two years to 2006/07 as these factors continue to attract people from other states. The inflow is estimated at 5,000 in 2005/06 before increasing to 6,000 in 2006/07. As economic conditions weaken, net interstate migration inflow is likely to be moderate in 2007/08 to 4,000 before easing further to 3,000 in 2008/09.

The Northern Territory recorded a significant turnaround in its net interstate migration in 2004/05. After posting net interstate outflows in each of the seven years to 2003/04, the Northern Territory has recorded a zero impact from interstate migration in 2004/05. This marks a considerable improvement over the net outflow of 2,100 recorded in 2003/04. Interstate migration is expected to further improve over the following two years to an inflow of 1,000 in both 2005/06 and 2006/07. In line with weaker economic

conditions the inflow is expected to be moderate in 2007/08 and 2008/09.

After a long term departure of residents to other states, Tasmania recorded a moderate net migration inflow in 2002/03 of 1,900, down from 3,400 from the previous year. It seems likely that the pressures of housing affordability in Victoria and New South Wales were the driving force behind this shift, as the change has been characterised by an increased inflow of persons into Tasmania as opposed to reduced numbers of people leaving the state.

Net interstate migration into Tasmania peaked at an inflow of 2,500 in 2003/04, before dropping back to an inflow of 200 in 2004/05. Net interstate migration is expected to drop back to a zero effect in 2006/07. Strong price growth over 2003/04 and 2004/05 has considerably eroded the affordability advantage the state holds. In line with expected weaker economic conditions, Tasmania's interstate migration is forecast to revert to an outflow of approximately 500 in 2006/07, approximately 1,000 in 2007/08 and approximately 1,500 in 2008/09.

In the Australian Capital Territory a stagnant level of interstate migration is expected over the next three years, while South Australia is forecast to continue to experience a consistent net interstate migration outflow of 3,000 per annum, which is likely to limit future price growth.

# Sydney



## State of play

Strong growth in demand has underpinned growth in construction activity (44% increase in dwelling approvals in 2001/02), and a 24% increase in Sydney's median house price from \$364,000 in June 2001 to \$452,000 by June 2002.

The subsequent erosion of the stock deficiency, combined with rising vacancy rates, reduced investor interest in residential property and growth in Sydney's median house price slowed to 15% over 2002/03. Construction activity continued to slow over 2003/04, however it remained above underlying demand, resulting in the emergence of a stock surplus. This had the effect of further slowing the growth in Sydney's median house price, which rose by only a further 6% to \$552,000 in 2003.

By June 2004, Sydney's home loan affordability had reached its worst levels since the late 1980s when interest rates were above 15%. The decline in housing affordability over the first half of this decade has been caused by the rapid price growth in a low interest rate environment. The lack of affordability in Sydney kept potential buyers out of the market, consequently either staying at home longer, renting or buying in a more affordable part of the country.

In April 2004, the New South Wales Government removed stamp duty for first home buyers purchasing a dwelling for less than \$500,000 (saving up to \$18,000 in stamp duty costs) on a sliding scale up to \$600,000. This provided a small boost to activity at the less expensive end of the

detached housing market and in units, however the impact has not been substantial as many first home buyers had already entered the market to take advantage of the original Federal Government's First Home Owner's Grant. The number of first home buyers, which declined substantially over 2002/03 and 2003/04, is starting to recover but was still below the long term average during the year to March 2006.

Further to the removal of stamp duty costs for first home buyers, the New South Wales Government also introduced a 2.25% stamp duty on the sale of an investment property. However, with the change of Premier in August 2005, this tax was subsequently abolished and with little investor interest in the market, has had little outward impact on house prices.

Over 2004/05, with little pressure on prices in the market, Sydney's median house price declined by 4.3% to \$528,000. With only a slight improvement in affordability, Sydney's median house continued to decline moderately by 1.9% and 0.2% respectively over the September and December quarters of 2005.

Dwelling construction, particularly for new houses, has reached an extremely low level by historical standards, and with demand expected to recover and exceed recent levels, the stock deficiency is expected to rapidly increase. This situation is largely a consequence of the limited land supply which has resulted in owner occupiers being increasingly priced out of the market for new detached dwellings.

The difficult affordability of land has led to knockdowns accounting for around half

of all new detached house approvals. Medium and high density dwellings, while also being more affordable, have become more attractive to the increasing number of smaller households (lone persons, empty nesters and retirees), and delayed the effects of rising land costs on total dwelling supply in Sydney. As Sydney enters an extended period where dwelling supply is significantly below underlying demand, there is expected to be a substantial and extended adjustment to residential rents.

## Forecast

Negative sentiment towards the rental market, as well as low expectations of capital gains has continued to constrain the new investor market. The value of commercial loans for residential property, which declined in New South Wales by a considerable 23% over 2004/05 (in part due to the uncertainty regarding the introduction and then removal of the 2.25% vendor stamp duty) continued to decline over the six months to December 2005.

The low level of affordability in the Sydney residential market, combined with the recent 0.25% increase in housing interest rates, is expected to compound the current slowdown in dwelling activity to a level significantly below demand. As a result Sydney's stock surplus is expected to revert to a modest deficiency by June 2006, however prices are expected to remain flat between December quarter 2005 and June quarter 2006 (\$517,000), representing a decline of 2.1% over 2005/06 as affordability and low investor sentiment remain issues.

Despite some pent-up demand, the current climate of negative sentiment and

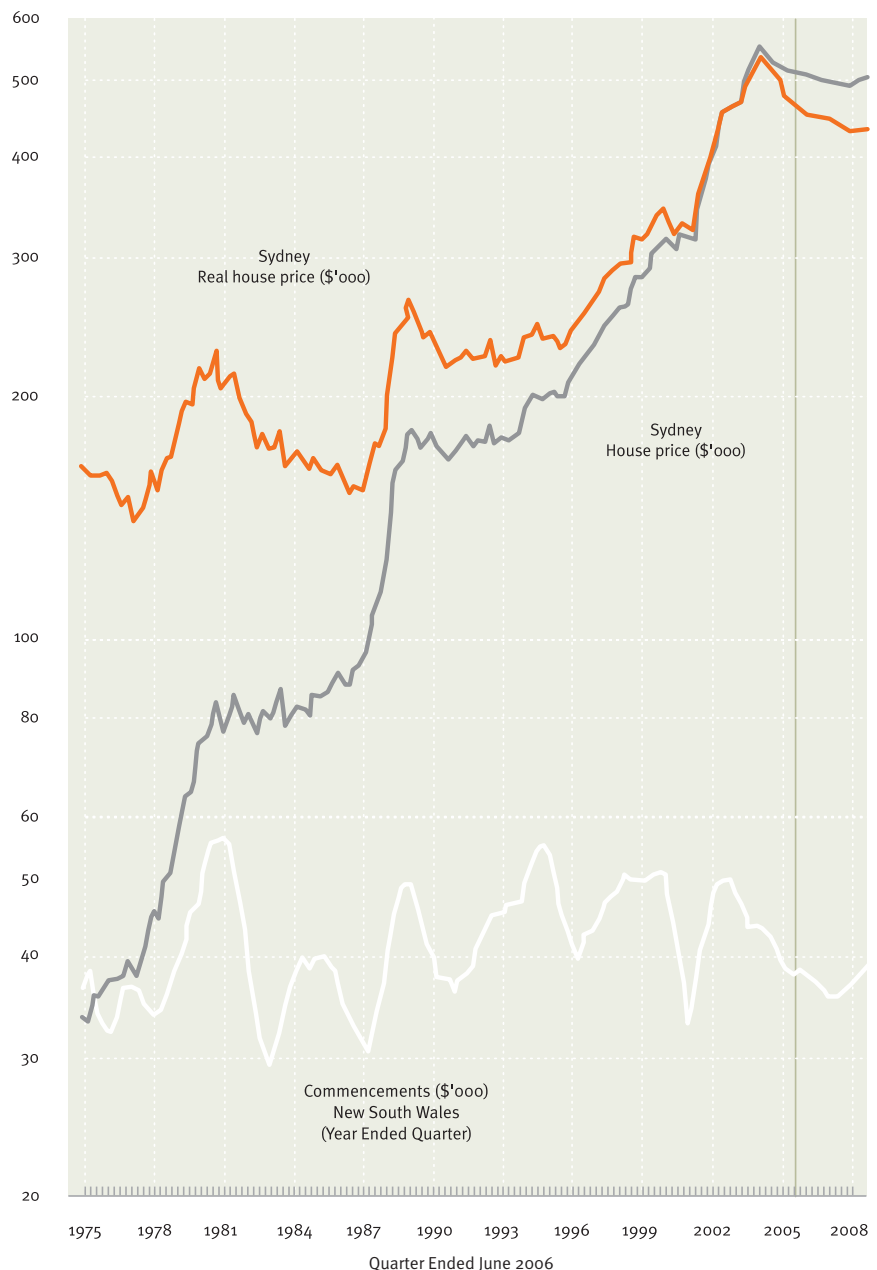
## “Rapid price growth in a low interest rate environment has compounded affordability issues”

affordability constraints will continue to dampen the Sydney property market. A further 0.50% rise in interest rates is expected in 2006/07 which will prolong the downturn in prices across 2006/07 and into 2007/08.

Economic conditions are then forecast to slow through calendar 2008 as a result of the combined effects of higher interest rates on consumer spending, as well as the end of the current round of business investment weakening as many projects currently underway are completed. Sydney’s median house price is expected to bottom out in 2007/08 at \$495,000, representing a total decline between June 2005 and June 2008 of 6.3%. In real terms this represents a 15% decline in Sydney’s house prices.

Strengthening economic conditions are forecast to support house price growth and with interest rates trending downward, the next upturn is forecast to begin. With affordability improving over each of the four years to 2009, pent-up demand is expected to start to be released. Over the year to June 2009, Sydney’s median house price is forecast to increase by 1.8% to \$504,000.

Chart 2: Sydney dwellings - Prices and activity



# Melbourne



## State of Play

The slowing of price growth in Melbourne occurred as Victoria's stock deficiency fell from a peak of 18,600 dwellings in June 1998, to a balanced position as at June 2003. Dwelling completions continued to outstrip underlying demand and by June 2005, Victoria's dwelling stock is estimated to have been in excess by 14,000 dwellings. This has removed some of the pressure on the residential property market with Melbourne's median house price rising by a modest 1% year on year, to \$375,000 at December 2005.

As well as the impact of the increasing stock excess, house price growth has also been hampered by weaker investor demand due to relatively lower yields over the past three years compared to historical levels. Over the two years to December 2004, demand from first home buyers experienced a sustained correction following a period of increased activity generated by the First Home Owners Grant and First Home Bonus scheme. Demand from this sector has shown signs of improvement during 2005, though this result has been skewed by a reduction in the First Home Bonus from January 2006.

The increased activity from the first home buyer sector of the market has not placed significant pressure on prices. Vacancy rates hovered between 3 to 4% during calendar 2004, but fell below the balanced market rate of 3% in 2005, dropping to 1.8% at March 2006. This suggests that the excess stock in the market is now beginning to be absorbed. Despite this, rental yields have remained relatively low compared to the returns on investment properties in other state

capitals, and with little prospect for capital gain, demand from investors is expected to remain weak.

In addition, housing affordability in Melbourne has been eroded by the strong price growth recorded in the seven years to June 2003. Although the pace of property price growth has slowed over the past two years, the 0.75% rise in interest rates between November 2003 and March 2005 caused a further marginal deterioration of housing affordability in 2003/04 and 2004/05.

## Forecast

Over the first three quarters of 2005/06, the property market in Melbourne has improved marginally, with an increase in the number of home loans for owner occupation offsetting the decline in commercial loan approvals. Therefore prices are expected to recover in 2005/06 from the decline in 2004/05 and it is likely that the median house price will increase by 3%, year on year, to \$370,000 by June 2006.

Underlying demand is expected to increase over the next four years, as more Melbourne residents approach retirement age. Retirees tend to form households with fewer occupants which creates upward pressure on demand for dwellings.

Melbourne is expected to experience steady price growth in 2006/07. Although with the economy forecast to rebound from a slowdown that occurred in 2005/06, further interest rate increases are expected in 2006/07 which is likely to limit property price growth.

Since the introduction of the Victorian Government's \$5,000 cash grant to first

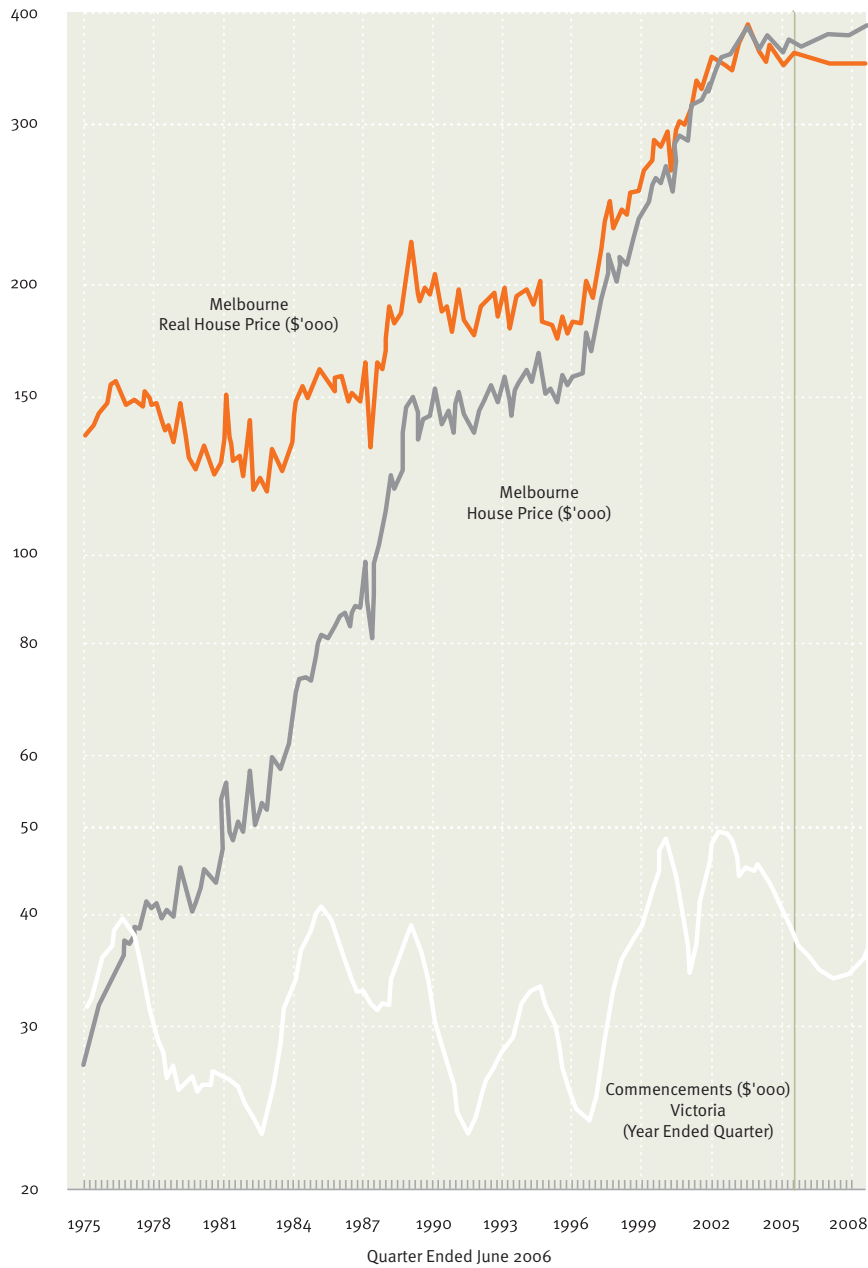
home buyers in Victoria in early 2004, there has been an improvement in demand from this sector. The number of loans to first home buyers increased by 33% in the twelve months to March 2006 compared to the same period one year earlier, which brought the number above the long term average. This level of demand is however expected to edge back due to the reduced entitlement from January 2006 and eventual cessation from June 2007, at which point whatever pressure it may have placed on prices at the lower end of the market is likely to disappear. Indeed, if the grant has been the primary driver of the recent demand growth from first home buyers, then a correction is likely to take place following the cessation of the grant. In response to these opposing factors, nominal house prices are expected to increase by just 2% to \$377,000, which corresponds to a 1% decline in real terms.

A similar outlook of stable property prices is forecast for 2007/08. By 2007/08, the interest rate increases are expected to be felt by the market, creating a climate characterised by weaker economic activity and slower price growth. Over the year to June 2008, nominal house price is forecast to grow by 2.1%.

By 2008/09, dwelling investment is expected to enter a major recovery period. Although population growth is expected to slow, tight vacancy rates and a lower level of dwelling stock is expected to place moderate pressure on property prices. The median house price in Melbourne in 2008/09 is forecast to increase by 4% in nominal terms, or 2% in real terms to \$400,000.

# “Stock excess and weakened investor demand is contributing to stagnant price growth”

Chart 3: Melbourne dwellings – Prices and activity



# Brisbane



## State of Play

Very strong price growth between 2001 and 2004 reduced affordability to levels not seen since the end of the 1980s and on a level considerably closer to that of Melbourne. As a result interstate migration declined in 2004/05, and, with the net overseas migration more than halving, underlying demand declined considerably. This reduction in demand is reflected in the substantial declines in home loans for owner occupation (-12%) and for investors (-16%) in Queensland, as well as the continued decline in the number of first home buyers (down 18% over 2003/04 and 2004/05). Over 2004/05 the growth in Brisbane's median house price slowed to 1.7% with the median house price at \$312,500 at June 2005.

This decline in demand below the fall in new construction, has absorbed some of the stock deficiency. Nevertheless, the stock deficiency is still high. As at June 2005 the stock deficiency was estimated at 11,300 dwellings in Brisbane and we therefore expect price pressures to remain in the Brisbane market. This is highlighted by the median house price in Brisbane rising to \$320,000 as at December quarter 2005. This represents a 3.6% increase over the same quarter a year earlier.

The significant level of stock deficiency has also been reflected by Brisbane's residential vacancy rate. This remained below the natural market level of 3% over 2004 and reflected a significantly tight market with an average of 2% over 2005, the second lowest of all the capital cities.

As at December 2005, Brisbane's residential vacancy rate was 2.1%, and this has been reflected in strong rental growth in excess of inflation over the March quarter 2006.

## Forecast

Underlying demand is expected to benefit from the net interstate migration inflow continuing to remain high, while also benefiting from a strong recovery in net overseas migration into Queensland, as strong economic growth sees overseas migration into Australia continue to rise.

With home loans to owner occupiers and first homebuyers increasing over the nine months to March 2006, demand is already showing signs of a recovery. With price pressure still evident, Brisbane's median house price is forecast to rise to \$330,000 as at June 2006, an increase of 5.6%.

While strong underlying demand has helped to support the market, affordability constraints have resulted in purchasers stepping back from the market, and new dwelling commencements are estimated to have edged down in 2005/06. As demand continues to strengthen, the high stock deficiency is expected to grow.

Underpinned by a substantial deficiency of dwelling stock, dwelling commencements will continue to improve; however not by a high enough rate to meet demand. The stock deficiency in Brisbane is expected to continue to rise and peak at 17,800 dwellings by June 2008. This is equivalent to 90% of average annual underlying demand.

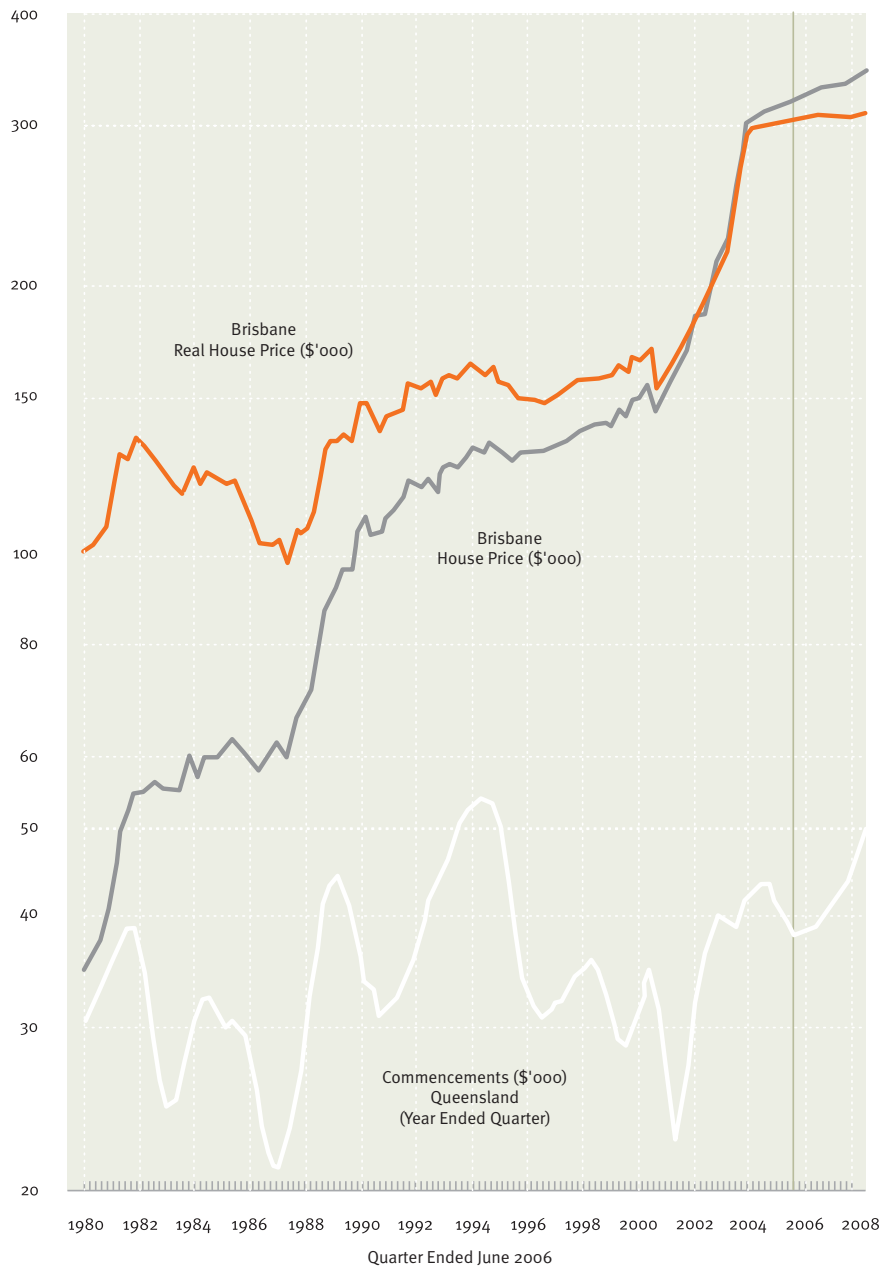
The 0.25% rise in interest rates in May 2006 is likely to create some short term declines in sentiment, which is expected to have a moderating effect on residential market conditions, and with a further interest rate rise anticipated in 2006/07, the effects of such a high stock deficiency is likely to be dampened. As a result Brisbane's median house price is expected to grow by 3% over 2006/07 to \$340,000 and by a further 3.2% over 2007/08 to \$351,000. This rate of growth would be associated with close to steady conditions for housing affordability.

Subsequently, some of Brisbane's stock deficiency is expected to be absorbed as construction activity starts to outpace demand. However with a stock deficiency remaining substantial, and affordability improving, Brisbane's median house price growth is forecast to strengthen to 5.7% over 2008/09, representing a forecast median house price of \$371,000 at June 2009.

Over the three year period from 2006 to 2009, Brisbane's median house price is forecast to rise by 12%, or 3% in real terms, and compares favourably with the decline in real house prices that is forecast to take place across some of the capital cities analysed in this report.

# “Slowing migration trends and affordability issues are impacting the Brisbane market”

Chart 4: Brisbane dwellings – Prices and activity



# Adelaide



## State of Play

Adelaide's median house price growth slowed in 2005. After five years of substantial growth between 1999/2000 and 2003/04 totalling 100%, the growth slowed substantially in 2004/05. Indeed, with an increasing stock surplus in South Australia, the median house price in Adelaide has stalled to remain flat over the most recent September and December 2005 quarters (\$275,000 and \$278,000 respectively).

With the recent increase of interest rates by the Reserve Bank of Australia and the rapid increase of house prices, home loan affordability in Adelaide has reached levels not seen since the high interest rate days of the late 1980s.

Loan activity for new dwellings has strengthened in the nine months to March 2006. The number of home loans for owner occupation of new dwellings was up by 3% on the corresponding period in the previous year in South Australia. This is a vast improvement from the 5% decline over the year to 2004/05.

After declines in 2003/04, first home buyer activity has also started to recover in South Australia, with home loan activity in 2004/05 increasing to approximately 6,400 loans. The early signs for 2005/06 appear to be another increase of first home buyer activity, with the twelve months to March 2006 showing a rise of approximately 15% over the 2004/05 figure.

Over the 2001 to 2004 period, population growth picked up as South Australia experienced a rise in its share of Australia's net overseas migration inflow, as well as an improvement in net interstate migration, which fell from a net outflow of 3,500 in 1999/2000, to a net outflow of 1,500 in 2002/03. Higher underlying demand contributed to the upturn in new dwelling activity, although new dwelling commencements in South Australia exceeded underlying demand in recent years.

Commencements over the year to 2004/05 were well above underlying demand. Consequently, the excess dwelling stock in South Australia increased from a low 400 dwellings in June 1999 to an estimated 6,900 dwellings as at June 2005.

In contrast, the Adelaide rental market is particularly tight indicating investors now have less of a presence in the market and new rental supply has slowed. Adelaide's residential rental vacancy rate since early 2003 improved dramatically to remain well below the balanced market level of 3%, falling to 1.7% in March quarter 2006. Rental growth has also been stronger during this period, remaining above or at the level of inflation. Consequently, while the South Australian market has a developing oversupply of dwellings, it is likely that much of it is concentrated outside of Adelaide.

## Forecast

With the median house price in Adelaide moving only marginally during most of calendar 2005, house prices in Adelaide are forecast to remain relatively stable over the forecast period with the potential for further price growth limited. The overall picture for Adelaide appears to be a city that has reached a price 'ceiling'. The next few years are forecast to be significantly affected by interest rate movements and relative home loan affordability.

A substantial number of dwelling completions, together with weak population growth constraining underlying demand, is likely to keep price growth in the Adelaide market more subdued in the longer term, until the stock surplus has been sufficiently absorbed.

In addition, the recent 0.25 percentage point increase in interest rates announced by the Reserve Bank in May 2006, tied with the prospect of further rises, is also likely to have an impact on price growth. Price growth is forecast to slow to almost a standstill. Adelaide's median house price in 2005/06 is forecast to increase by a minimal 0.7% from the previous year, to \$277,000, representing a 2.5% decline in real terms.

Despite this, the prospect of higher rental yields coming from sufficient growth in rents and relatively strong economic conditions will dampen some of the interest rate effects. This is expected to result in the median house price in Adelaide to increase by a marginal 1% over 2006/07, to \$280,000.

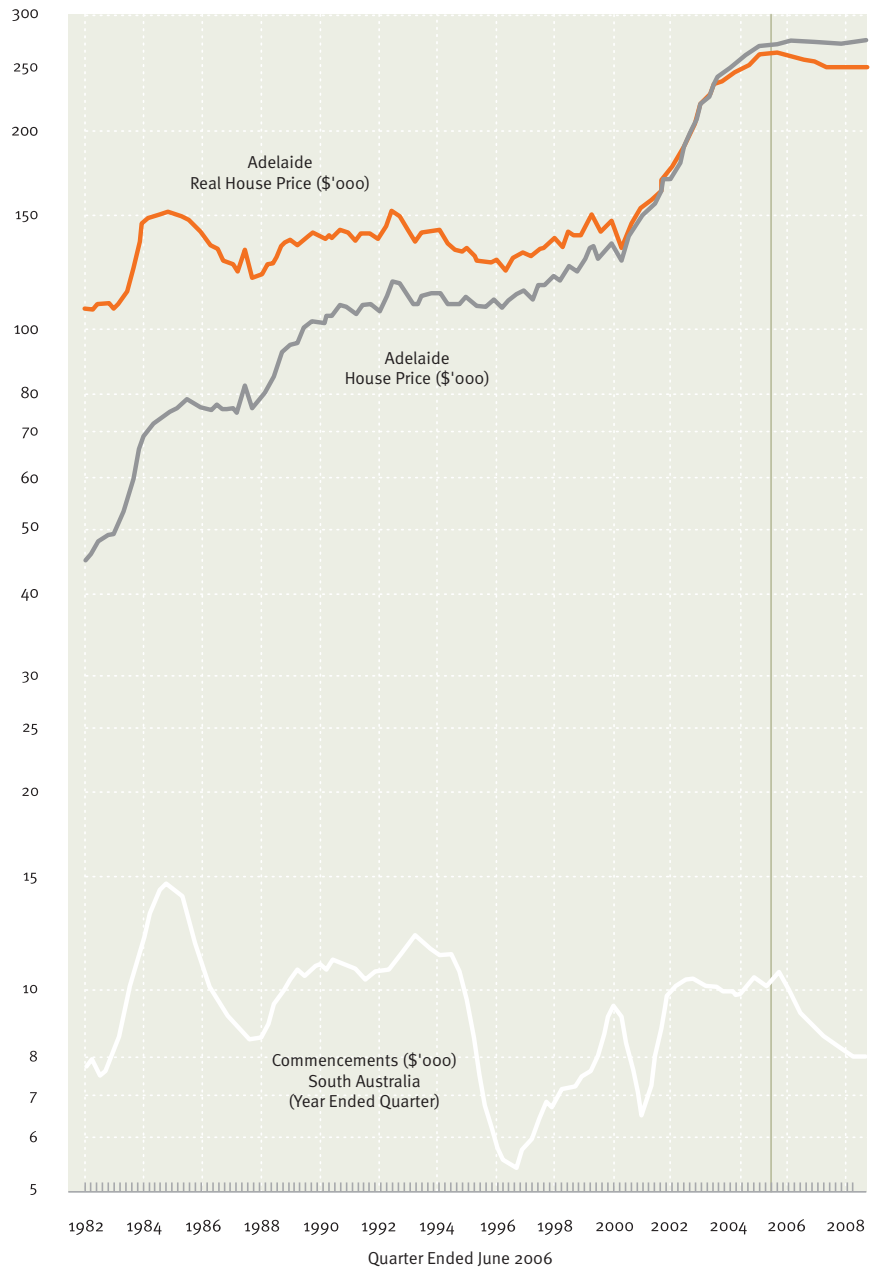
## “Investor activity has decreased leading to a tighter rental market”

By 2007/08 however, interest rates are forecast to stabilise, but the effects of an increasing stock excess is likely to hamper growth in house prices. House prices in Adelaide are forecast to increase by a further 1% over the course of 2007/08, reflecting a decline of 2% in real terms.

By 2009, the weaker economic environment, driven by a sharp decline in national expenditure, is forecast to provoke an interest rate cut in the latter half of 2008. This move, which is hoped to reignite domestic demand, is expected to provide some financial relief from property owners already experiencing poor affordability nationwide.

Although this increase is not expected to fuel another rapid increase in price growth, it is expected to provide some minor stimulus to a somewhat flat property market in Adelaide. The result is likely to see house prices in Adelaide during 2008/09 increase by a marginal 2.5% to \$290,000, representing the first positive increase of 0.5% in real terms since 2004/05.

Chart 5: Adelaide dwellings – Prices and activity



# Perth



## State of Play

The residential property market in Western Australia is largely supported by the substantial inflow of people through both overseas and interstate migration. Western Australia captures a disproportionate number of Australia's overseas immigrants and, together with Queensland, is one of the only states that normally experience a long term net interstate migration inflow.

Western Australia's consistent dwelling construction levels and steady price growth have been driven by construction levels running closely in line with underlying demand. This has resulted in a relatively balanced market. Higher net overseas migration inflow and the reversal of the net interstate migration outflow to an inflow of residents almost kept pace with construction activity resulting in a slight stock surplus of 1,200 dwellings.

In contrast, Perth's vacancy rate reflected a tightening of the market. After being in excess of 4% over most of the period between 2001 and 2003, it moved into balance, averaging 3.0% over 2004, and then tightened further to 1.6% by December 2005. This has fuelled price growth in Perth, which continued to show robust growth over 2004/05, rising by a further 15.7% to reach a median house price of \$295,000 by June 2005.

Employment growth has been maintained at a very strong level. Following a 3% rise in 2004, employment in Perth surged by 4.6% in 2005. The strength of employment growth has contributed to the expansion in demand for residential

property. Compared to the eastern states, Western Australia is still experiencing strong residential activity. Loans for owner occupation as well as first home buyers have continued to increase since 2002/03, while investor loans have shown particularly strong growth since 2001/02. As residential price growth in Perth has remained strong, and the Perth market has remained relatively affordable, investor attention has shifted to this market, with the construction upturn in Perth lagging those in Sydney and Melbourne by about two years.

## Forecast

Underlying demand is expected to continue to strengthen over 2005/06, as the net interstate migration inflow rises further due to increased mining and resources investment attracting residents from other states. In addition, Western Australia is also expected to benefit from increased overseas migration driving stronger demand in 2005/06, as economic growth gathers momentum.

Strong investor activity has accelerated in the nine months to March 2006, with the value of loans to investors increasing by a substantial 48% over the same nine months a year earlier. In addition the number of loans to owner occupiers for established dwellings and new dwellings has increased over the nine months to March 2006 by 16% and 14% respectively compared to the same period a year earlier. This strong level of activity is reflected in the median house price in Perth reaching \$336,000 by the December quarter 2005, already 14% higher than 6 months earlier. Over the following six months to June 2006,

Perth's median house price is forecast to rise to \$360,000 or by 22% over the full year to June 2006.

With population and employment growth expected to remain strong into 2006/07, underlying demand for residential property in Perth will continue to be supportive of the market. The key issue is when affordability will reach a critical point, so that growth in the median price slows. This affordability ceiling was reached in Brisbane during 2004, and in Adelaide in 2005.

Affordability is expected to emerge as a constraint on price growth in Perth during 2006/07. Recent calculations indicate that affordability in Perth is likely to reach a level on par with Brisbane and Melbourne by June 2006. Subsequently, price growth is expected to slow to just 3.1% in 2006/07.

An important element of the outlook for Perth is the projected rise in dwelling completions. Dwelling completions in Western Australia rose from 18,500 in 2003/04 to 19,300 in 2004/05 and are set to rise further to 22,900 in 2005/06 and 25,100 in 2006/07. This trend of increase in completions is likely to add significantly to the stock of dwellings, and should result in a higher vacancy rate for rental properties over the course of 2006 and 2007.

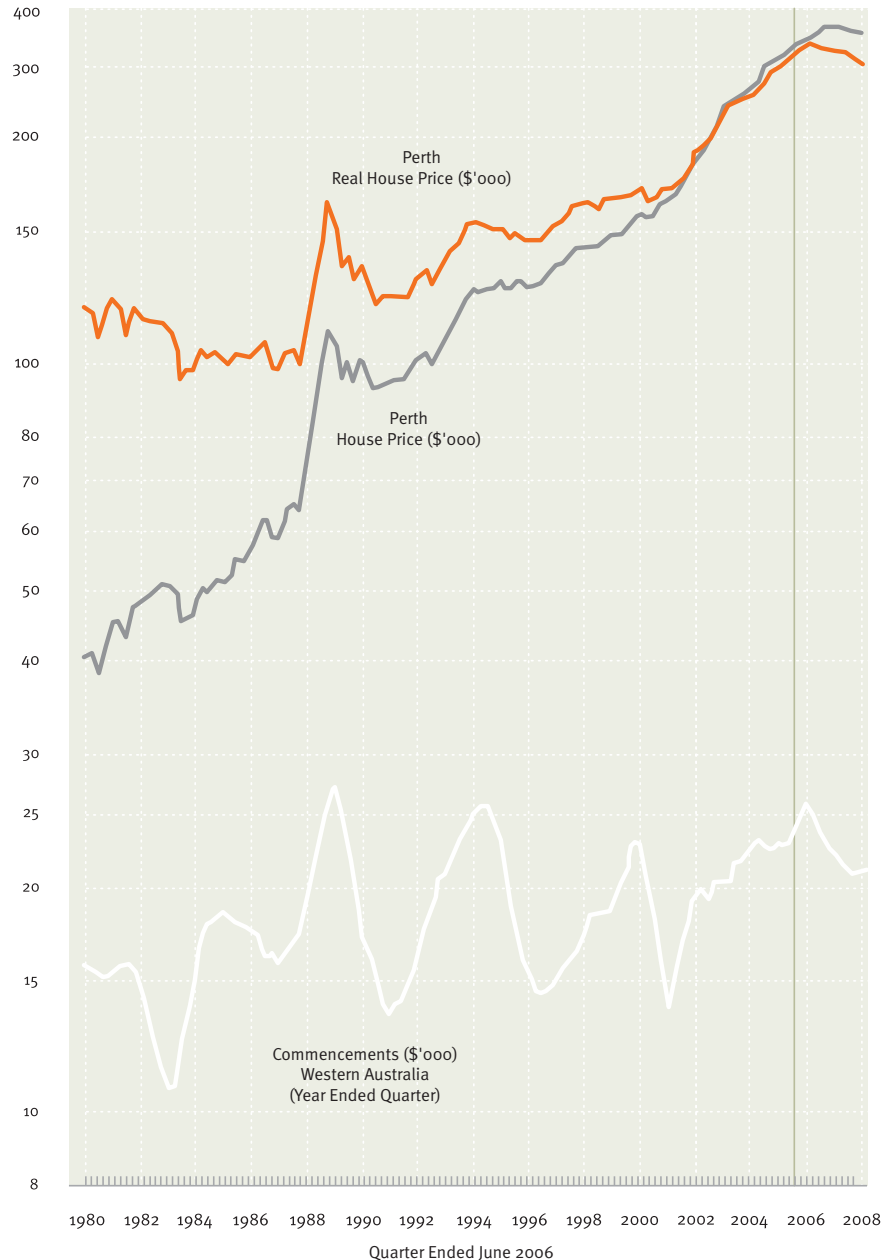
Subsequently, a major round of infrastructure projects are forecast to be completed, significantly impacting on the Western Australian economy. The current phase of investment in the mining and infrastructure sectors is expected to peak in 2007, and be followed by a decline in

## “Strong resources-led growth has contributed to steady price growth”

investment spending (but production will rise following on from the investment phase). The investment phase is likely to be the more labour intensive process, and once investment turns down, employment growth in Western Australia is expected to moderate in 2008 and 2009. With declining overseas and interstate migration impacting on demand, growth in Perth’s median house price is expected to slow further by 1.6 per cent to \$377,000 by June 2008, before declining by a moderate 1.9% to \$370,000 by June 2009.

Between June 2005 and June 2009, Perth’s median house price is expected to increase by a total 25%, which will reflect a rise of 13% in real terms.

Chart 6: Perth dwellings – Prices and activity



# Hobart



## State of Play

In June quarter 2005, the preliminary figure for net interstate migration inflow into Tasmania declined substantially to just 200 persons. Tasmania's net interstate migration inflow is expected to gradually decline in the near future, as the strong price growth, which Hobart experienced over 2002/03 and 2003/04, erodes the affordability advantage the state once held.

The drop off in interstate migration has resulted in some marginal softening in underlying demand over 2004/05, down from its peak in 2003/04. In turn, the stock deficiency has continued to remain positive, up marginally to approximately 700 dwellings in 2004/05.

This decrease in underlying demand coupled with the erosion of Hobart's affordability has resulted in a slowing in Hobart's price growth in the six months to December 2005. In September quarter 2005, the median house price in Hobart increased by approximately 4% to \$266,000, an increase of a marginal 1% in real terms over the previous year. This minimal growth continued into December quarter 2005, with the median house price increasing by approximately 4%.

Hobart's residential vacancy rate has remained below the balanced market rate of 3% since 2000. Most recently, the vacancy rate has remained relatively steady at 2.2% in the March quarter 2006. The pressures on dwelling stock due to high levels of underlying demand, and the sale of what were previously rental properties into the owner-occupier

market, are considered the influential forces behind this firm market.

The high levels of over 50s, the largest concentration of Tasmania's interstate migrants, typically will purchase properties to occupy rather than rent, intensifying demand on affordable property aimed at owner-occupiers. This has limited the proportion of properties built for investment purposes and has therefore kept the supply of rental property relatively low.

This has been evidenced in the number of loans for owner occupation, where recent data shows loans for established dwellings in Tasmania increasing by approximately 9% in the July 2005 to March 2006 period over the same period in the corresponding year. Loans for new dwellings over the same period have declined marginally by approximately 1%. In comparison, the value of investment loans for the purchase of property for rent/resale (investment) has, over the July to March 2006 period, shown little change over the same period in the corresponding year (-0.7%).

## Forecast

Underlying demand is forecast to weaken from current levels, as Tasmania's net interstate migration inflow begins to fall to zero in 2005/06 before reverting to an outflow in 2006/07. This outflow for Tasmania is expected to continue into the foreseeable future to approximately 1,500 persons by 2008/09. Annual average underlying demand over the period 2005/06 to 2010/11 is forecast to decrease marginally to 2,200 persons.

In addition, as underlying demand is expected to fall slightly below dwelling construction activity over the forecast period, the stock deficiency is estimated to decline to 700 dwellings at June 2006.

The most important factor to consider however is relative affordability of the Hobart residential property market in comparison to the other capital cities around Australia. Over the past three years Hobart's affordability has been the biggest driver of the residential market, and with affordability in Hobart pushed to its limits, very little scope for further price growth is anticipated. This tied with the latest increase in interest rates (and the likelihood of further rises) is expected to significantly dampen any price growth. In 2005/06, Hobart's median house price is expected to increase by a marginal 3.8% to \$270,000.

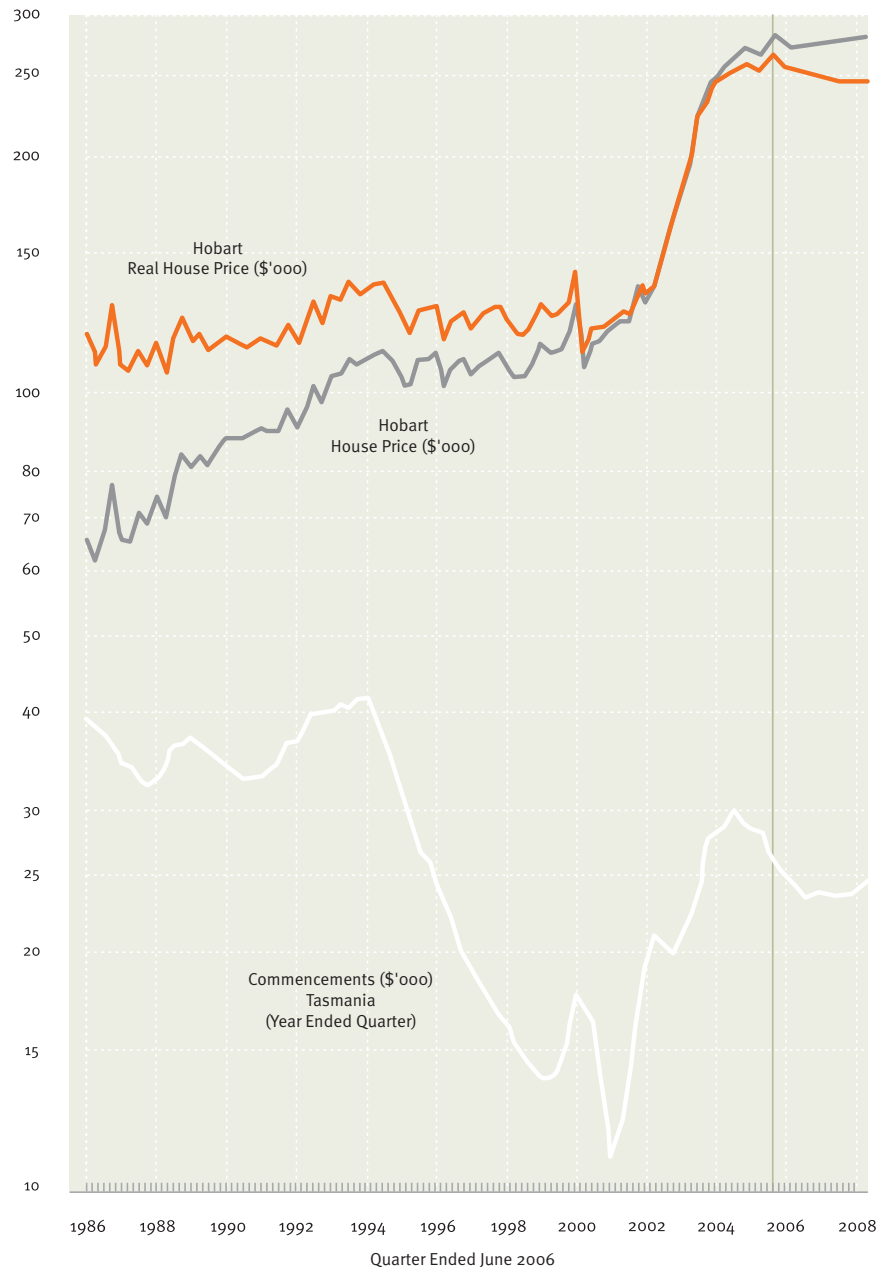
The pressure of rising interest rates towards the end of 2006/07 is expected to limit further price growth to 1.1% in that year. This will take the median house price to \$273,000, and represents a 2.3% decline in real house prices.

## “A reduction in migration has softened underlying demand”

An important element of the outlook for Hobart is the projected decrease in dwelling completions. Dwelling completions in Tasmania are forecast to decline in 2005/06 and 2006/07. This decline will keep dwelling stock relatively stable in relation to underlying demand, and result in vacancy rates for rental properties to likewise remain relatively low. As a result, Hobart’s median house price is expected to increase by a marginal 1.1% in the twelve months to June 2008, keeping the median at \$276,000, representing a decline of 1.9% in real terms.

As interest rates stabilise and affordability improves marginally, the median house price in Hobart is expected to rise by 2.2% to \$282,000 in 2008/09.

Chart 7: Hobart dwellings – Prices and activity



# Darwin



## State of Play

The median house price increased by 10% over 2004/05 to be \$280,000 at June 2005. The median house price then surged to a preliminary figure of \$328,000 as at December 2005. This strong increase was due to a smaller net interstate migration outflow in 2003/04 and 2004/05, fuelling stronger underlying demand.

Darwin typically has a higher vacancy rate than the other capitals, a consequence of the lower population, where even small moves in net interstate migration can have a significant impact. Recently vacancy rates have declined substantially from the 9% to 13% range up to 2001 down to 5.5% at June 2004. The vacancy rate was then reported to be very low at 1.9% at June before rising to 3.3% in the March quarter 2006.

This trend towards relatively lower vacancy rates is partly due to an improvement in net interstate migration from an outflow of 2,100 in 2003/04, to a zero outflow in 2004/05, as mining and resources investment picked up. In addition, employment growth accelerated to 3.5% over the year to December 2005. Average weekly earnings in the Northern Territory increased by 9.7% over the year to August 2005, with average weekly earnings only marginally below that of New South Wales. This growth underlines the contribution of the mining and infrastructure investment boom in the Northern Territory to the residential property market. Hence, overall economic conditions are very buoyant in the Darwin market at present.

## Forecast

With population and employment growth expected to remain strong into 2006/07, underlying demand for residential property in Darwin will continue to be supportive of the market. The key issue is when affordability will reach a critical point, slowing median price growth. This affordability ceiling was reached in Brisbane during 2004, and in Adelaide in 2005.

Affordability is likely to emerge as a constraint on price growth in Darwin during 2006/07. Recent calculations indicate that affordability in Darwin is expected to reach a level on par with Adelaide by June 2006. Subsequently, we expect that price growth is likely to slow to just 3.0% in 2006/07.

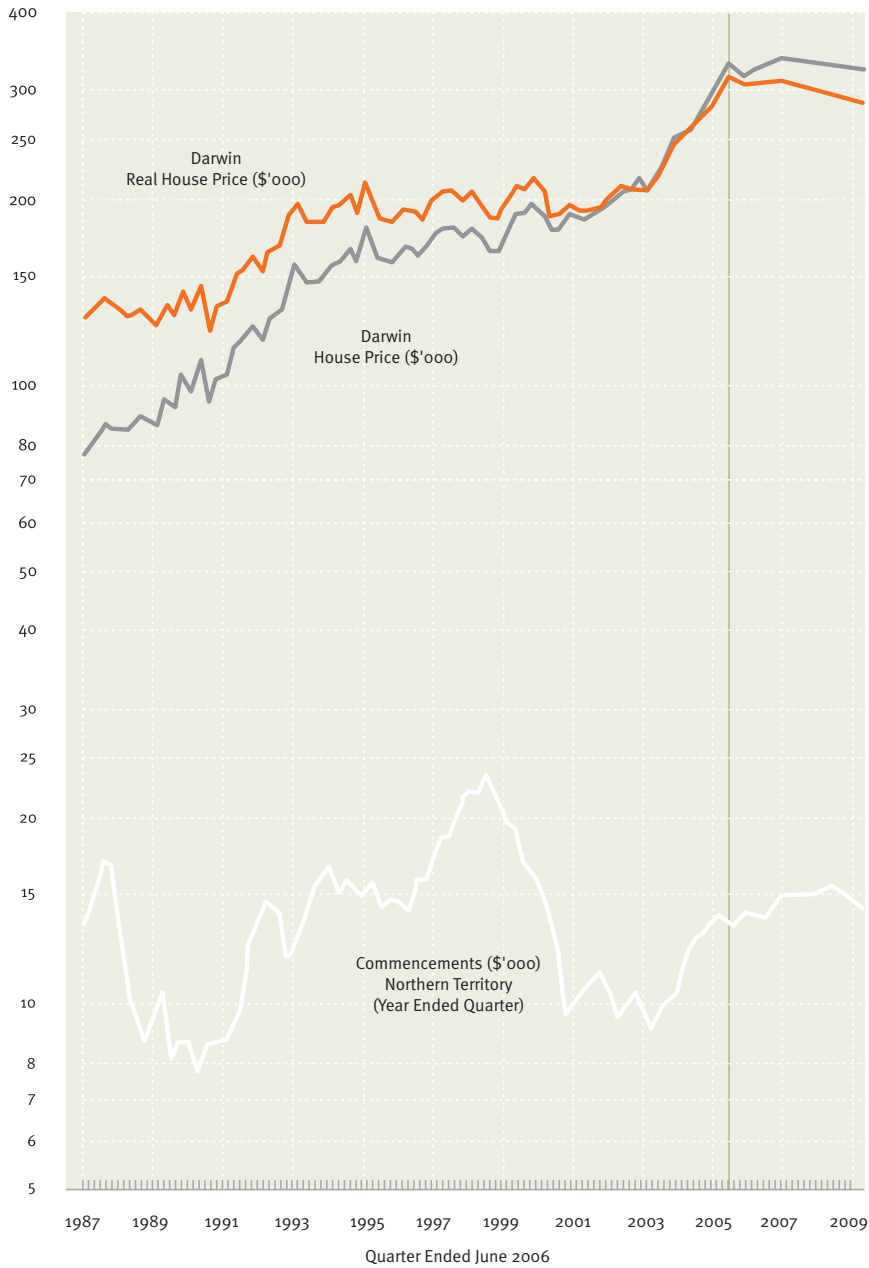
An important element of the outlook for Darwin is the projected rise in dwelling completions. Dwelling completions in the Northern Territory rose from 910 in 2003/04 to 1,050 in 2004/05 and are set to rise further to 1,200 in 2005/06 and 1,400 in 2006/07. This trend increase in completions is anticipated to add significantly to the stock of dwellings, and result in a higher vacancy rate for rental properties over the course of 2006 and 2007.

The median house price is forecast to be steady in 2007/08, and then decrease by 4% in 2008/09. The current phase of investment in the mining and infrastructure sectors is expected to peak in 2007, and be followed by a decline in investment spending (but production will rise following on from the investment phase). The investment phase is likely to

be the more labour intensive process, and once investment turns down, employment in the Northern Territory will decline in 2008 and 2009. In previous periods of a weak labour market, the Darwin median house price has decreased (1995/96 and 2000/01). This can happen because the Darwin residential market is not as deep or liquid as the markets in other cities. As a result, a 4% dip in the median house price to \$330,000 in 2008/09 is forecast.

“Vacancy rates have declined substantially putting upward pressure on house prices”

Chart 8: Darwin dwellings – Prices and activity



# Canberra

# SALE



## State of Play

The surplus of dwelling stock in the Australian Capital Territory was estimated to have swelled to 2,500 dwellings by June 2005. The interstate population outflow of 2,400 is expected to decline to an estimated outflow of 1,600 in 2004/05 and as a result, underlying demand is expected to improve. In the near future, building activity is expected to run slightly below underlying demand for the next few years, with the stock excess projected to decrease to an estimated 2,000 dwellings by June 2006.

As a result the median house price in Canberra has remained relatively stable, with a marginal increase of less than 1% in September quarter 2005 and a 5.1% increase in December quarter 2005, bringing the median house price to \$368,000. The recent RBA decision to increase interest rates will provide an interesting scenario for the Canberra market, as affordability in Canberra has declined marginally from the recent high of 2003/04.

Residential rents in Canberra declined from 1994 to 1998 by an average of 2% per annum. The recovery in 1998/99 (+1%) was the start of a strong upturn in rentals, with significantly larger increases of 4–7% per annum recorded between 1999/2000 to 2003/04 and most recently a modest increase of 4% in 2004/05. This also reflects the strong price growth of earlier years, and the relatively low vacancy rate, which has edged below the balanced market rate of 3%; the latest figure being 2.4% for March quarter 2006.

## Forecast

After a period of excess stock and declining real prices in the mid to late 1990s, strong growth was apparent in Canberra in the five years to June 2004. However, there appeared to be a degree of overshooting in property prices, with the median dropping in 2004/05. While the median price rebounded in December quarter 2005, we think that this was an aberration. A 2% rise to \$360,000 over the year to June 2006 is predicted. There is little upside for Canberra's residential property market in 2006/07 or 2007/08. Affordability remains above the average level of the past fifteen years, and with interest rates forecast to rise by 0.5% in 2006/07, price growth is likely to be constrained.

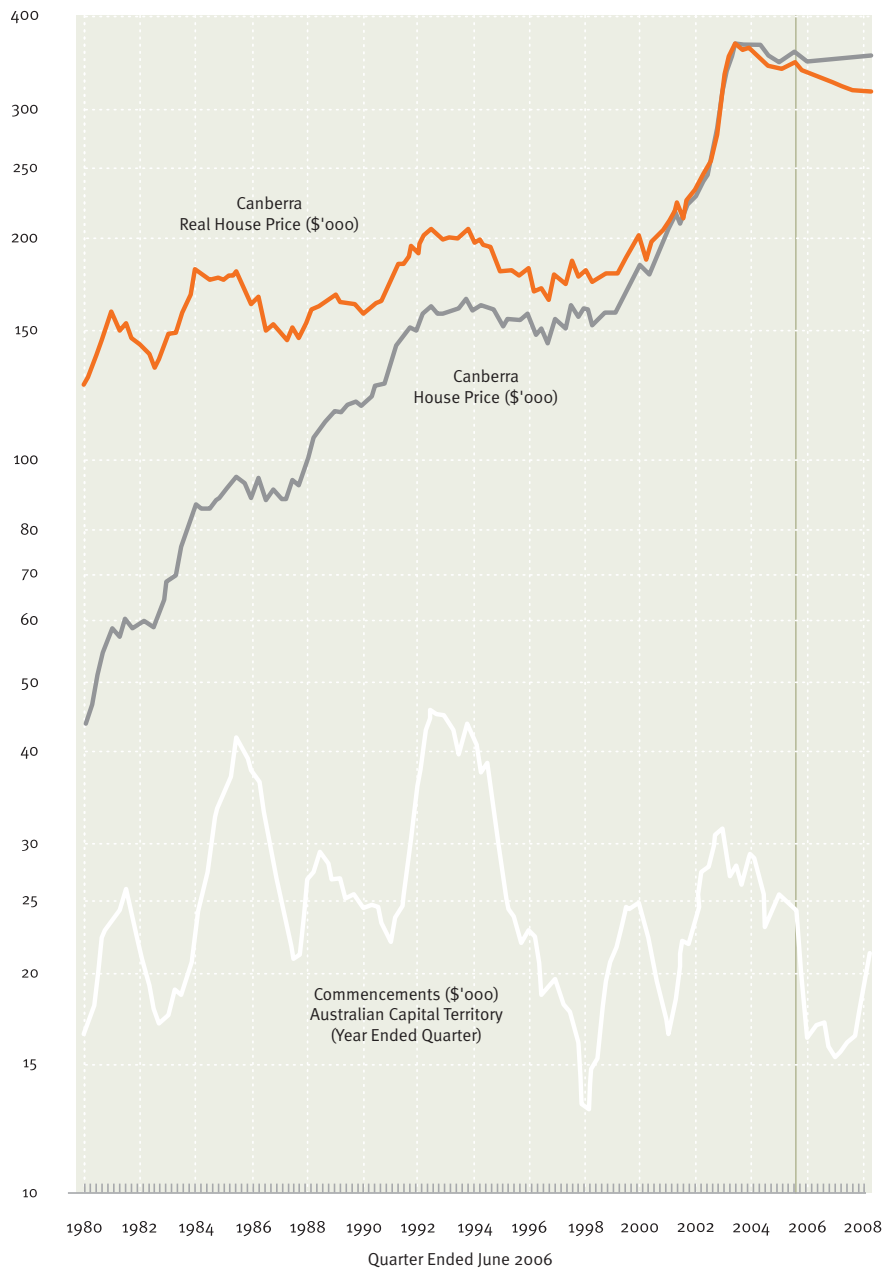
A positive factor for the city should be the level of population growth, which is forecast to pick up over the next four years. The Federal Budget identified plans to raise Commonwealth Sector employment, which would partly offset an expected reduction in ACT government employment. Overall, net interstate migration is forecast to become more favourable going forward. On the other hand, strong dwelling completion activity will place some strain on the volume of residential property for sale. In this environment, a 1% rise in the median house price in 2006/07 and 2007/08 is forecast.

Growth in residential property prices is forecast to improve slightly to 2.2% in 2008/09. Affordability is likely to remain an issue at the start of 2008/09, with

only a slight improvement projected over the financial year. As a result, price growth is expected to remain subdued. Canberra's dwelling stock surplus, which is expected to diminish in 2006/07 and 2007/08, should drive this slightly higher price growth.

# “Increasing population growth should assist the recovery of property prices”

Chart 9: Canberra dwellings – Prices and activity



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