Flashnote

HSBC Global Research

Macro
Australian Economics

Downunder Digest

Housing boom or bubble?

- **Nation-wide housing prices are up 24% over the past three years, but these gains have been uneven across the country**
- **Sydney housing prices have risen 39%, Melbourne by 22% and prices in the rest of the country are only up 10%**
- **We have few concerns about a nation-wide bubble, but the Sydney market has an exuberance that is worrisome**

The blunt instrument problem

The RBA continues to face a tricky balancing act. Low interest rates are needed to continue to support the rebalancing of growth, as mining investment continues to fall. But, interest rates have now been low for quite some time and they are starting to drive potential asset price bubbles in some parts of the economy.

The key problem relates to the fact that the RBA's cash rate is, and always has been, a blunt instrument. Low interest rates are having their strongest effect on housing prices, which is flowing through to a residential construction boom and a pick-up in durable goods sales. However, the transmission of this effect to business investment and hiring – which is what the central bank would really like to see – has, so far, been weak.

Housing prices are also rising unevenly across the country. Sydney prices are up 39% in the past three years, while prices are 22% higher in Melbourne and only 10% higher elsewhere. More even housing price growth would be preferred. Although the trends in Sydney and Melbourne are what should be expected, given that these cities have the least exposure to the mining sector, at the same time, this is how 'bubbles' can form. What looks like a strong growth story, based on fundamentals (think: the IT bubble of the early 2000s), sees rising investor interest and, at some point, prices rise ahead of fundamentals. The market gets exuberant, as investors begin to believe that prices can only go up.

The Sydney housing market is showing some of these more worrisome traits and has been for some time now (see '*Downunder digest: Australia's housing boom may get bubbly*', 10 February 2015). Investors continue to dominate the Sydney market, prices are rising at 15% y-o-y and auction clearance rates are around record highs.

To try to deal with this issue, the authorities have been tightening prudential settings (to sharpen the instrument). Concerns about the housing market are also likely to have been a key reason why the RBA has been reluctant to have an explicit 'easing bias', despite below-trend growth and the central bank's desire to see the AUD fall further.

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1. National housing prices are up 25% since mid-2012

Source: RP-Data Core-Logic

2. National upswing not excessively ahead of incomes

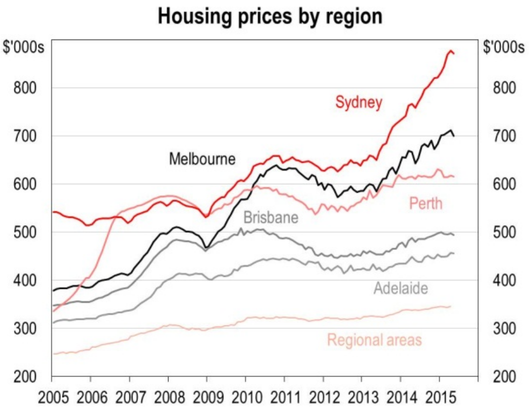
Source: ABS; RP-Data Core-Logic

No national bubble, but Sydney's exuberance is worrisome

A housing boom is a part of the plan to rebalance Australia's growth as mining investment falls. When the mining boom was at its height, back in 2011 and 2012, the housing market was being held back by high interest rates which helped to make way for the mining boom without excessive inflation. Then, to stimulate activity in the non-mining sectors, the RBA cut its cash rate from a peak of 4.75% in 2011 to its current record low of 2.00%. As a result, house prices have risen by 24% in the past three years (Chart 1).

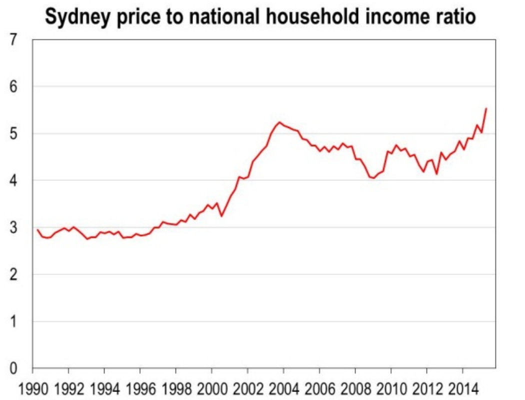
At this pace, housing prices have significantly outpaced household disposable income growth. But, from a national perspective these gains do not appear excessive. Indeed, the housing-price to income ratio is only now just reaching its previous peak levels (Chart 2). However, the national story hides some more worrisome regional trends. Sydney housing prices have risen by 39% over the past three years, much faster than the other cities (Chart 3). Housing prices are also still rising in Sydney at a 15% y-o-y rate. Although comprehensive state-level income statistics are not available on a time-series basis, it is likely that the Sydney housing price gains are outstripping income growth. Sydney housing price gains are running well ahead of national household disposable income growth (Chart 4).

3. Housing price gains are uneven and led by Sydney



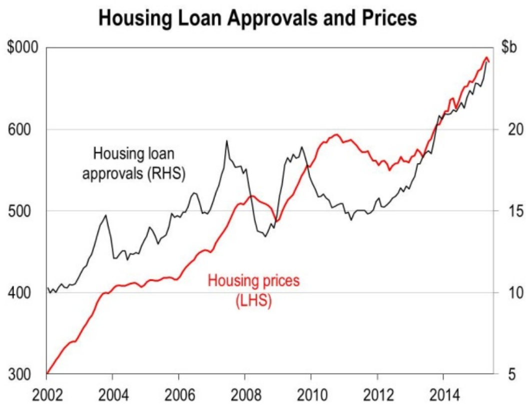
Source: RP-Data Core-Logic

4. Sydney rapidly outpacing national household incomes



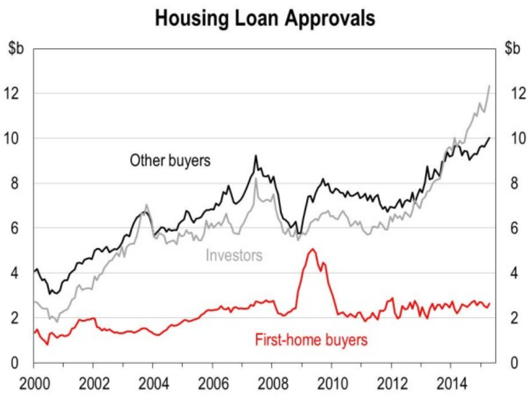
Source: ABS; RP-Data Core-Logic

5. Local borrowers are the key drivers of housing price rise



Source: ABS; RP-Data Core-Logic

6. Investors are the main drivers of new borrowing



Source: ABS

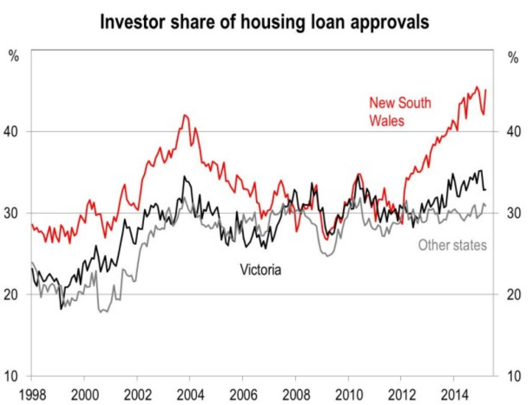
Local investors and foreign demand driving the market

As is part of the plan, the main driver of Australia's housing price boom continues to be low interest rates. As a result of low interest rates, housing loan approvals have risen by 67% since their trough in mid-2011 and are currently rising at a 14% y-o-y rate (Chart 5). It is also clear that the main driver of the ramp up in housing prices continues to be investors, rather than first home buyers or repeat purchasers for owner-occupation (Chart 6). This is more unexpected. Investor loan approvals have risen by 112% since their trough in 2011, while loans to repeat buyers are up 47% and first home buyer loan approvals have only risen by 13%.

Again, there are significant divergences in the trends across the states. The New South Wales (NSW) market, which is mostly Sydney, is being largely driven by investors (Chart 7). The investor share of new housing loan approvals in NSW has remained around record levels for the past six months or so.

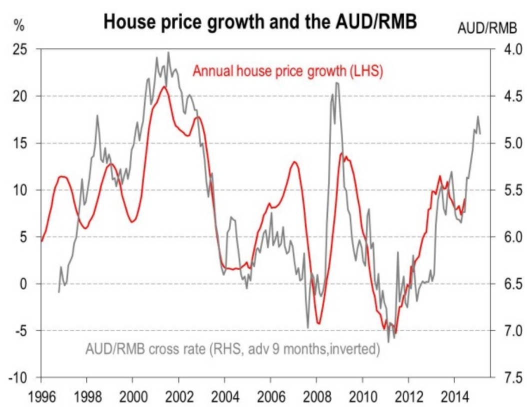
Although investors in Australia's housing market tend to be lower risk borrowers, increased investor interest can provide a tell-tale sign that the market is overly exuberant. In Australia, investors tend to have lower loan-to-valuation ratios than owner-occupiers, to be older households with equity in an owner-

7. Investors account for a large share of Sydney activity



Source: ABS

8. Lower AUD making foreign investment more attractive



Source: ABS

occupied dwelling and have higher incomes than first home buyers. This tends to make them a safer risk for lenders. However, investors are also typically involved in the housing market on the expectation of capital gains. A high level of investor involvement is therefore a signal of a growing speculative dynamic that may be worrisome. If this begins to feed on itself, with expectations of capital gains starting to drive further capital gains, a bubble could form.

The other driver of the Sydney and Melbourne housing markets has been significant foreign investor interest, particularly in the apartment markets. Again, estimates of foreign investment flows are imprecise. This largely reflects that it is difficult to define a 'foreigner' in Australia's context. Keep in mind that 28% of Australia's population was born in another country, that there are 200k new migrants each year and around 500k foreign students in the country at any point in time.

Nonetheless, there are some data available from the Foreign Investment Review Board (FIRB), as genuine foreigners require FIRB approval for real estate purchases. The FIRB report that approvals for foreign investment in real estate rose from 12,025 in FY2012/13 to 23,428 in FY2013/14. Although this a significant rise (95%), it still only leaves measured foreign approvals comprising around 5% of all dwellings turned over in that year. It remains that case that interest rates and local buyers are the dominant drivers of the housing market.

However, the recent fall in the AUD, could mean that foreign interest in the housing market continues to rise. There is some evidence that a potential driver of increased foreign interest in Australia's housing market has been the recent depreciation of the AUD, particularly against the RMB (Chart 8). Further falls in the currency could continue to support this growing foreign interest.

Authorities are sharpening the prudential tool

As the RBA's cash rate setting is a blunt instrument, further fine-tuning is largely being left to the prudential regulator. Indeed, the RBA appears to be increasingly focused on managing the real economy, leaving the role of managing the financial cycle to the prudential regulator (as we discussed in detail here: *Downunder Digest: Australia's evolving approach to macropru*', 20 May 2015).

The Australian Prudential Regulatory Authority (APRA) already requires that all new mortgages pass a serviceability test at an interest rate of 7.00% and that lenders should not grow their investor housing lending at a faster rate than 10% a year, or they could face closer scrutiny if they do. In a recent speech, the Chairman of the APRA, Wayne Byrnes, made it clear that the prudential regulator had been turning up the dial further on its regulatory settings. As a result, most of the major banks have reduced discounts on lending rates to housing investors over the past month.

It also seems likely that concerns about the housing market have been a key reason why the RBA has been reluctant to have an explicit 'easing bias', despite below-trend growth and the central bank's desire to see the AUD fall further.

9. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2014	2015	2016	Q414	Q115e	Q215e	Q315e	Q415e	Q116e	Q216e
%*										
AUSTRALIA										
GDP	2.7	2.6	3.0	2.5	2.3	2.4	2.9	3.3	3.5	3.2
Consumption	2.5	3.1	3.2	2.8	3.0	3.0	3.2	3.2	3.2	3.3
Public consumption	2.0	1.9	1.6	2.0	2.2	2.2	1.6	1.6	1.7	1.6
Investment	-2.5	-1.4	0.5	-2.9	-3.1	-3.1	0.3	0.5	0.8	0.4
- Dwelling	7.9	7.2	6.9	8.1	4.1	6.0	9.8	8.9	9.4	7.9
- Business	-4.8	-3.2	-1.9	-4.2	-3.5	-3.9	-2.9	-2.3	-2.0	-2.3
- Public	-4.2	-4.6	1.4	-9.8	-9.1	-10.1	1.2	1.0	1.0	1.0
Final domestic demand	1.2	1.7	2.2	1.1	1.3	1.2	2.2	2.2	2.3	2.2
Domestic demand	1.2	1.6	2.2	1.0	1.7	0.8	1.6	2.2	2.3	2.3
Exports	6.7	7.7	7.8	7.2	4.9	9.0	7.8	8.9	9.2	8.2
Imports	-1.7	1.0	4.3	-2.6	-0.1	-0.9	1.0	4.2	3.8	4.0
GDP (% quarter)	--	--	--	0.5	0.9	0.8	0.8	1.0	0.9	0.5
CPI**	2.5	1.8	2.8	1.7	1.3	1.6	1.9	2.4	2.9	2.9
Trimmed mean**	2.7	2.4	2.8	2.4	2.3	2.2	2.5	2.5	2.8	2.8
Unemployment rate	6.1	6.4	6.2	6.2	6.3	6.4	6.5	6.4	6.3	6.2
Labour price index	2.6	2.6	2.9	2.5	2.3	2.5	2.6	2.6	2.6	2.7
Current A/C (%GDP)	-2.8	-2.3	-1.9	-2.4	-2.2	-2.4	-2.4	-2.3	-1.9	-1.9
Terms of trade	-7.5	-6.2	-1.7	-10.8	-8.9	-7.1	-4.6	-4.0	-3.9	-2.0
Budget balance (%GDP)	-3.1	-2.5	-2.4							
Capital city house prices	9.2	7.7	6.1	6.8	7.6	7.7	8.0	7.6	7.0	6.4
Private sector credit	5.1	6.6	7.1	5.6	6.1	6.4	6.8	7.0	7.2	7.3
USD/AUD (end period)	0.78	0.72	0.70	0.82	0.75	0.74	0.73	0.72	0.71	0.71
Cash rate (end period)	2.50	2.00	2.75	2.50	2.25	2.00	2.00	2.00	2.00	2.00
%*										
NEW ZEALAND										
GDP	3.2	3.0	2.8	3.5	3.4	3.2	2.7	2.7	2.6	2.8
Consumption	3.3	3.8	2.4	4.1	4.8	4.2	3.3	2.9	2.5	2.4
Govt consumption	3.6	1.9	1.6	3.3	2.4	1.8	1.8	1.6	1.6	1.6
Investment	9.4	9.8	5.9	10.5	10.0	10.7	9.6	9.2	8.1	6.6
Final domestic demand	4.8	4.9	3.1	5.5	5.6	5.3	4.6	4.2	3.7	3.3
Domestic demand	4.9	4.7	3.0	5.5	6.0	4.4	4.6	4.0	3.5	3.2
Exports	0.9	-0.5	2.3	-1.7	-4.2	0.2	0.8	1.6	2.3	2.6
Imports	7.4	5.1	3.1	6.1	5.4	3.9	5.2	5.8	5.1	4.1
GDP (% quarter sa)	na	na	na	0.9	0.8	0.5	0.5	0.9	0.7	0.7
CPI	1.2	0.8	2.1	0.8	0.1	0.4	1.0	1.7	2.4	2.4
Unemployment rate	5.7	5.3	4.9	5.8	5.8	5.4	5.2	5.0	4.9	4.8
Labour price index	1.8	2.2	2.4	1.8	1.8	2.1	2.3	2.3	2.4	2.4
Current A/C (%GDP)	-3.4	-4.3	-4.3	-4.8	-4.5	-4.4	-4.2	-4.0	-4.3	-4.4
Budget balance (%GDP)	-1.1	-0.3	0.1							
NZD/USD (end period)	0.78	0.70	0.68	0.78	0.75	0.71	0.70	0.70	0.69	0.68
Cash rate (end period)	3.50	3.00	3.00	3.50	3.50	3.25	3.25	3.00	3.00	3.00

Source: ABS, RBA, HSBC forecasts
*unless otherwise specified; **includes the effect of the carbon tax from Q312 and its removal from Q314

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