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Australian economics comment

Housing booming, not bubbling

Australia's housing price boom continues. But, just because prices are rising, does not mean there is a bubble. Indeed, the recent increase in prices is roughly in line with what should be expected, given that mortgage rates are at 50 year lows. It is also largely by design, with the RBA seeking to rebalance growth, partly by lifting the housing market. More importantly, credit growth has, so far, been only modest. If there was one lesson from the global financial crisis and its forebears, it is that: it's the leverage that matters! Nonetheless, interest rates may soon have to rise, to prevent excess exuberance entering the market.

Housing prices have risen by +11% over the past year and by +16% since their trough in May 2012. Importantly, this follows a decline of -8% in the 18 months to May 2012, so they are actually only +7% higher than their most recent peak. Perhaps more tellingly, they have grown by only +4.5% a year, on average, in the past five years and this is the same as their average over the past decade. This rate of growth has been in line with growth in household disposable incomes over that time. Bottom line is: housing prices are now rising after having fallen - so the upswing in this cycle looks quite normal at this stage.

Nonetheless, they are rising and this has prompted some commentators to (once again) suggest that there could be a danger that the housing market becomes overly exuberant and that Australia could see a destructive housing price fall. As yet, we do not share this concern. Indeed, we have long had the view that Australia does not have a housing bubble and this view has not changed. Our arguments have for this are grounded in both a view on demand and supply of actual housing and for housing finance.

On housing supply and demand, available estimates still suggest Australia has an undersupply rather than an oversupply of housing. Here is the basic arithmetic. Population growth is currently 400,000 people a year and the average household size is around 2.5 persons a household. So, to meet new population demand we would need to be building at least 160,000 dwellings, and probably more like 175,000 dwellings, if around 10% are built to replace demolished buildings. But last year there were only 148,000 dwellings built. Doing the same arithmetic over the past five years implies a cumulative shortfall of housing. New population demand has been for around 825,000 dwellings but only 760,000 houses have been built in the past five years. Unlike Spain and the US before the global financial crisis, Australia has an undersupply of housing, not an oversupply.

On finance, while household debt is fairly high in Australia, as we have long argued, most of the debt is held by households that can afford to continue to service it. Almost 75% of household debt is held by the top 40% of income earners. The latest statistics on the distribution of debt also remind us that there are very few household with both very high loan-to-valuation (LVR) ratios and high servicing burdens – mortgages where the LVR is over 80% and the servicing burden is over 50% of income account for only 3.5% of all mortgages in Australia. There are few very vulnerable households.

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But wait, there's more. Australia also has full-recourse mortgages, which gives new borrowers the right incentives to exercise caution in the leveraging decisions. Australia has no sub-prime. Low documentation loans account for less than 1% of new loans on the latest statistics. Loans in arrears have been falling over the past year, not rising, despite the fact that the unemployment rate has continued to edge higher. Plus, the tax system favours pre-payment of home loans and the average mortgage in Australia is pre-paid by a full 24 months, which gives households a significant buffer against job or income loss!

Of course, if the current run-up in housing prices persists, these features could change and more risk could enter the system. The recent run-up in housing prices has been supported by strong growth in new loan approvals (+24% y-o-y). But, offsetting this has been a ramp up in pre-payments by existing mortgage holders, such that housing credit growth is only growing at +5.8% y-o-y.

Another concern could be that the run-up in new housing loan approvals has been driven by investors, which, on its face, might suggest speculative activity. But we also know that Australian housing investors typically already have equity in an owner-occupied dwelling and tend to be higher income households. If they did see a capital loss at some point it is unlikely to be systemically important. They also tend to have lower LVRs than owner-occupiers (only 10% of investors have LVRs over 90%, versus 16% of owner-occupiers), reflecting that they typically start with greater equity. They generally have more skin in the game and are less financially vulnerable than first home buyers.

The RBA's recent financial stability review recently diagnosed that Australia's housing boom as 'warranting continued close observation'. This is a hint that they have started to manage the boom. As they have done in previous cycles, RBA officials are now starting to point out, in public, that buyers should not expect that the housing market is a one-way bet. Similar tactics were employed in previous housing price booms, particularly during the 2002/03 episode (see Bloxham, P., Kent, C. and Robson, M. (2010) '*Asset prices, credit growth, monetary and other policies: An Australian case study*', NBER working paper 16845).

But we see the RBA as highly unlikely to do introduce so called 'macro-prudential tools' to manage Australia's housing boom. Indeed, recent published internal work from the RBA sees a senior official from the RBA quoted as suggesting that these sorts of tools are a 'state of mind' – that is, they ought to be unnecessary if prudential regulation is already working as it should. In short, the RBA's approach seems to be that, if you get your micro-prudential settings right and you get your interest rate settings right, you don't need macro-prudential tools.

With the broader economy rebalancing away from mining investment-led growth, towards the domestic economy; inflation already passed its trough; and, early signs that the labour market is improving, the RBA may soon decide it has little reason to keep its cash rate at its current historical low level. Again this would be a normal response to a cycle in the economy, with the RBA not typically leaving its cash rate at very low levels for a long time. We expect the RBA to lift rates before the end of the year, a little ahead of current market pricing.

Of course, the mere expectation of higher interest rates would start to help to manage the current housing boom. A shift in the RBA's stance from neutral to a mild tightening bias, if it were in arrive in coming months, could help temper the current housing boom.

For previous work on why we do not see a housing bubble in Australia see here:

Bloxham, P. and Richardson A. (2013) '*Downunder digest: Australia's housing boom: No bubble yet*', 8 October

Bloxham, P. and Richardson A. (2013) '*Downunder digest: Australia's household debt: Why we are not worried*', 21 November

Disclosure appendix

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