Is the Australian property market in ‘bubble trouble’?

Presentation to

ANZ Queensland customers

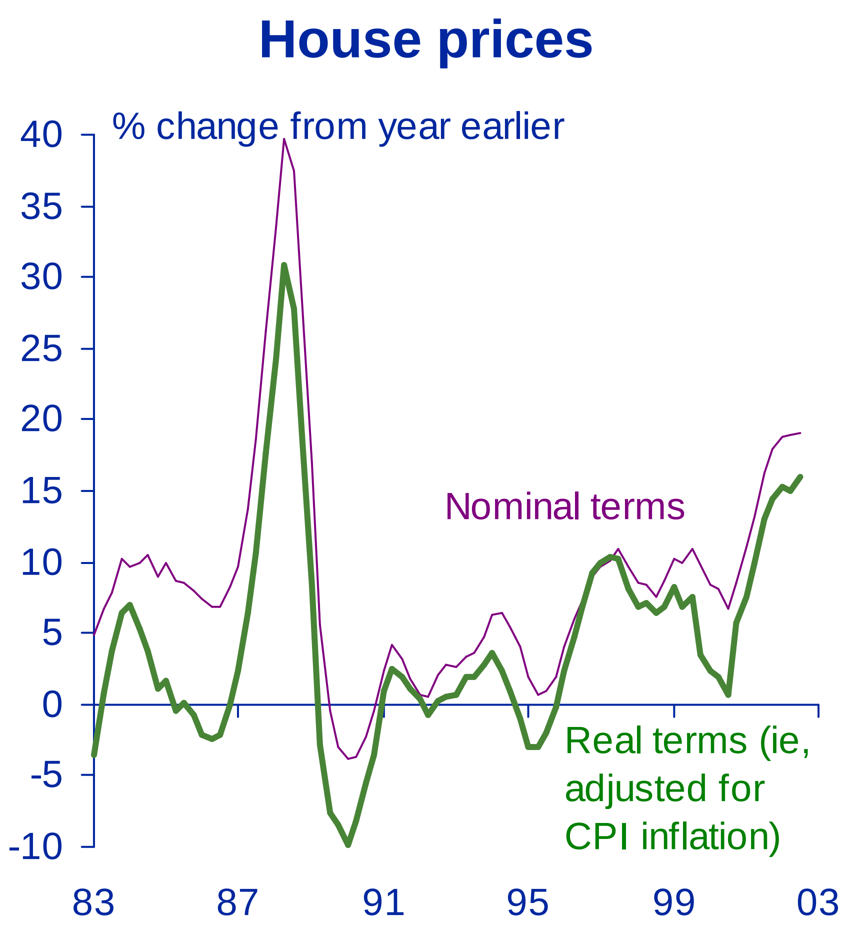
Saul Eslake
Chief Economist
ANZ Bank

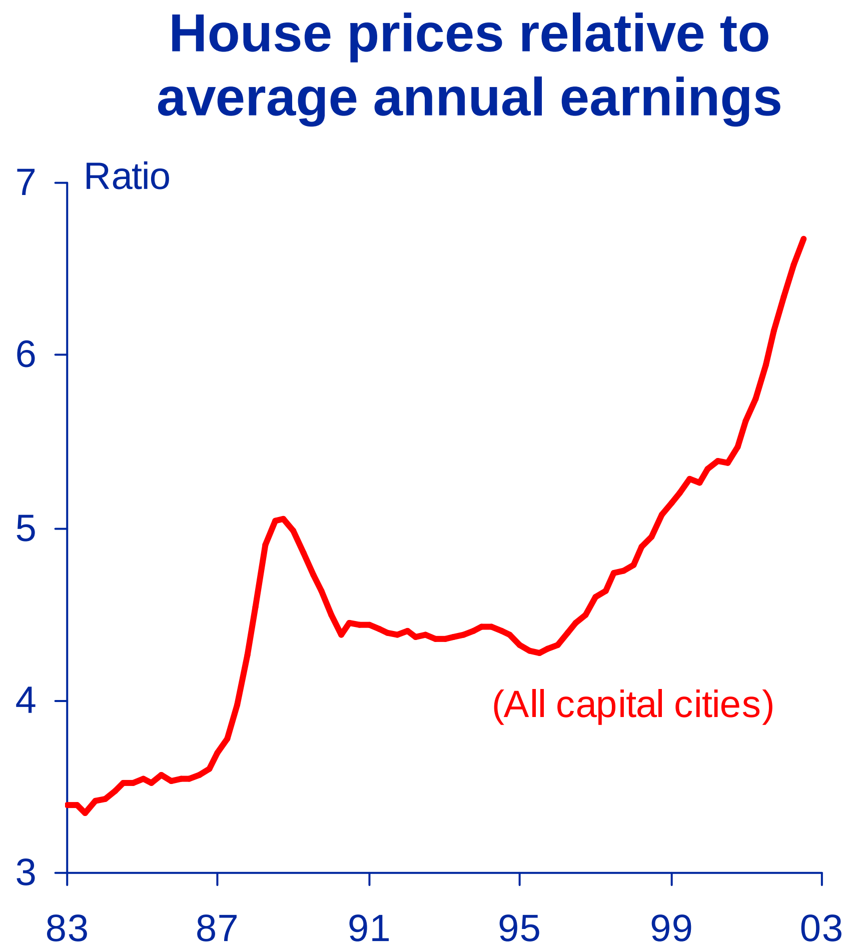
Brisbane
14 November 2003

E-mail: eslakes@anz.com
or economics@anz.com

Internet: http://www.anz.com/go/economics

Residential property prices have risen rapidly in absolute terms and relative to incomes

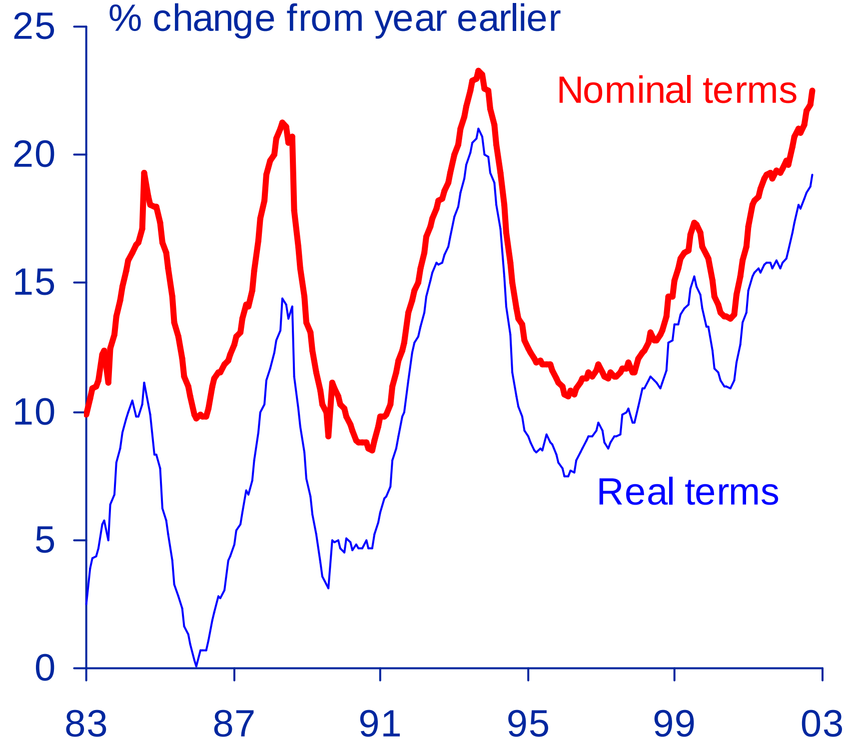




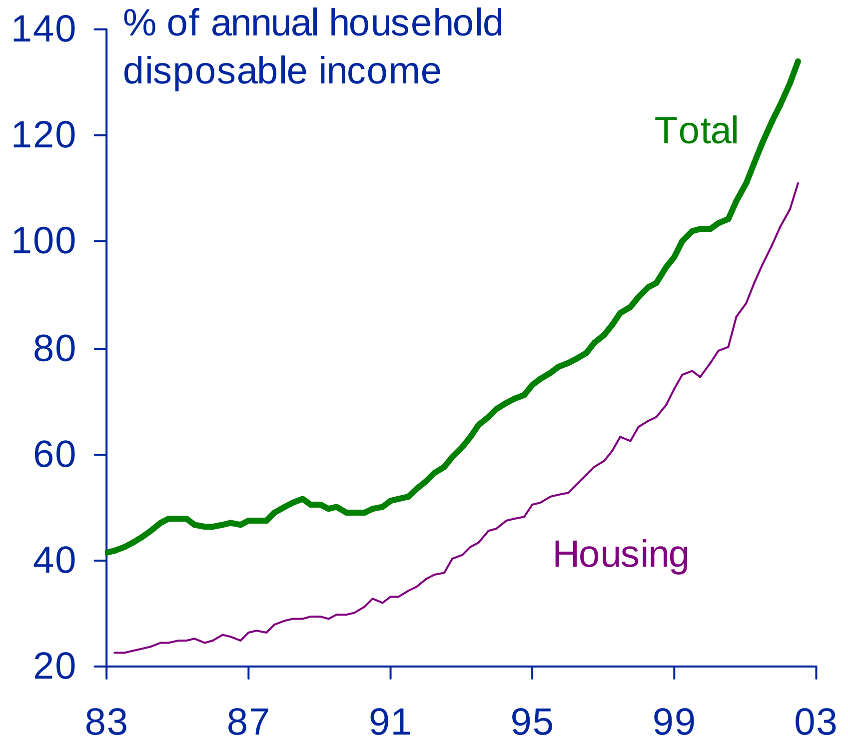
Sources: REIA; ABS; Economics@ANZ.

Rising property prices have been accompanied (driven?) by rapid growth in personal borrowing

Borrowing by individuals for housing



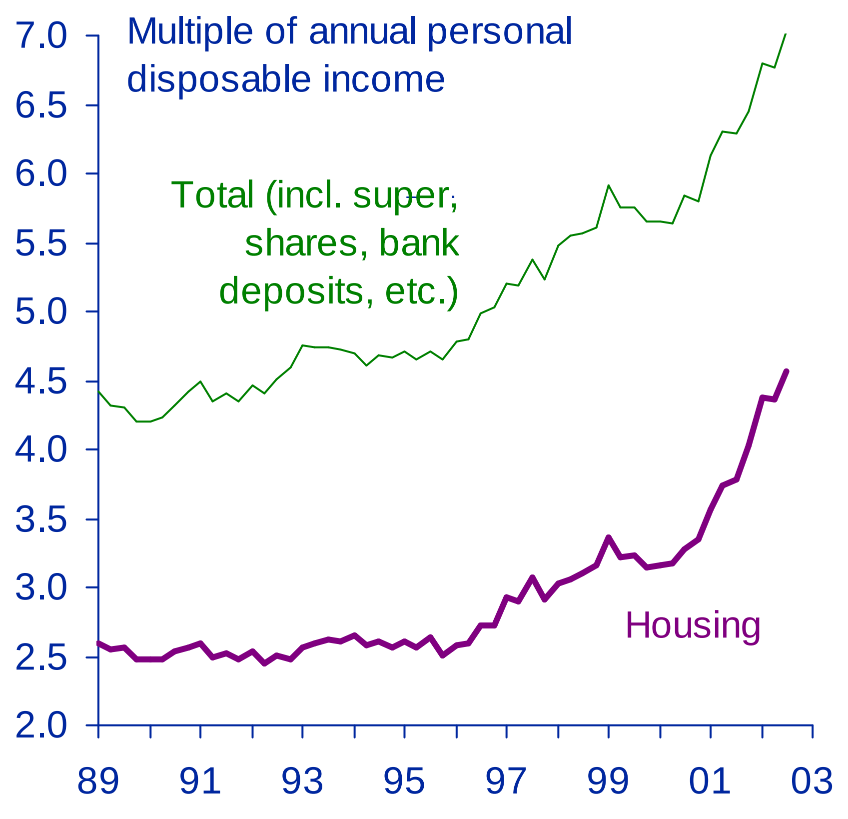
Household debt as a p.c. of disposable income



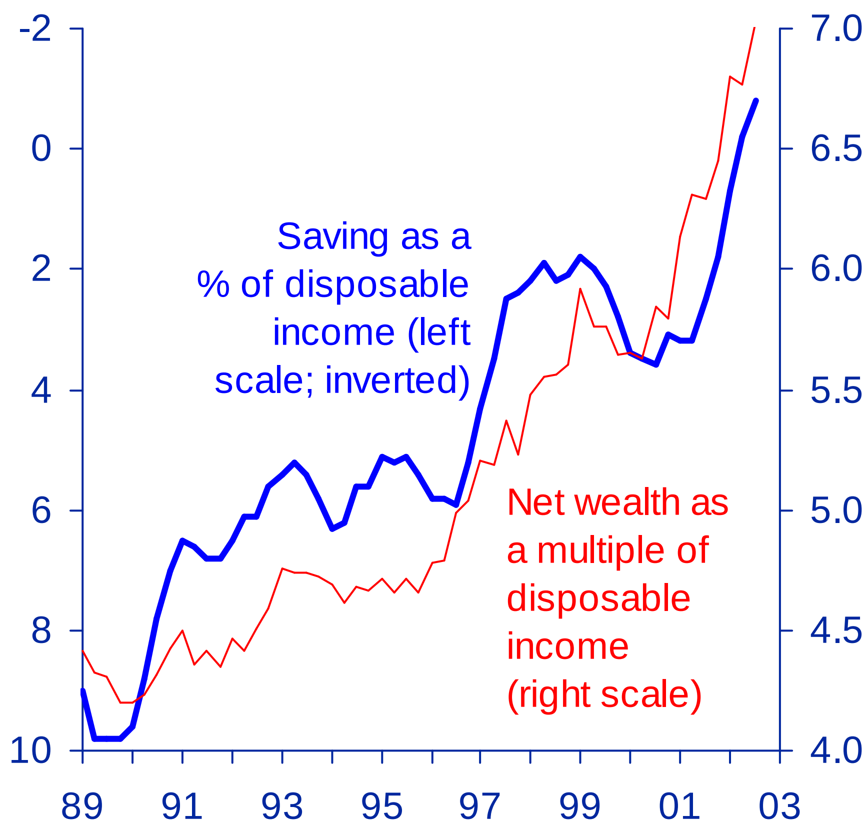
Sources: RBA; ABS; Economics@ANZ.

Gains in housing wealth has been a key reason for the resilience of the Australian economy

Australian household net wealth



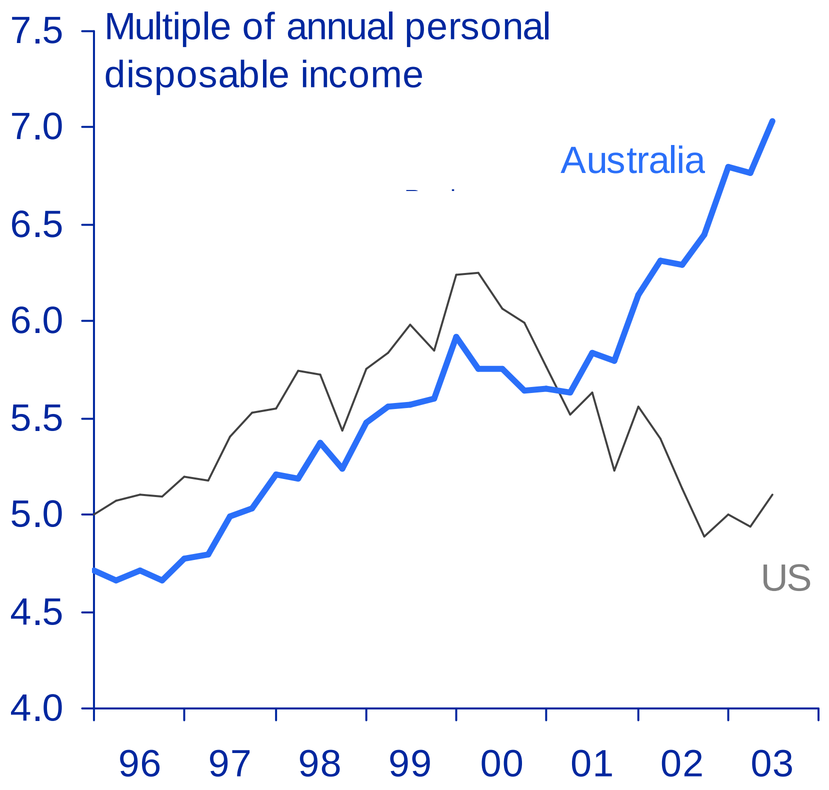
Household net wealth and saving



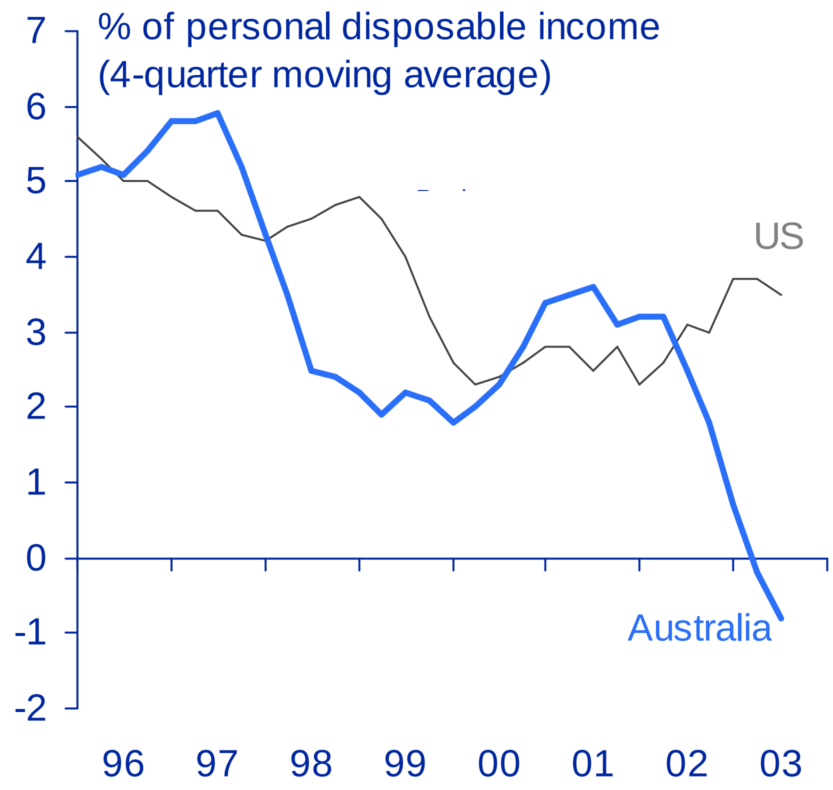
Sources: ABS; Economics@ANZ. 'Net wealth' is assets minus liabilities.
Household saving is shown as a four-quarter moving average.

For example Australia and the US have experienced quite contrasting 'wealth effects'

US and Australian household net wealth

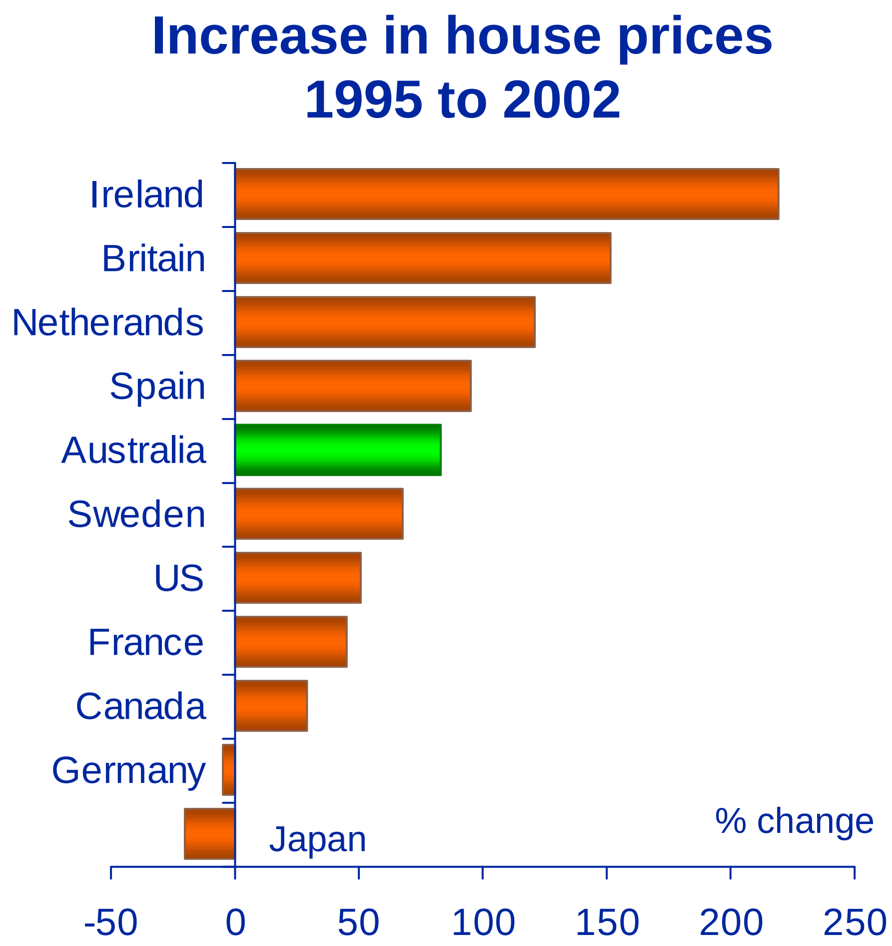


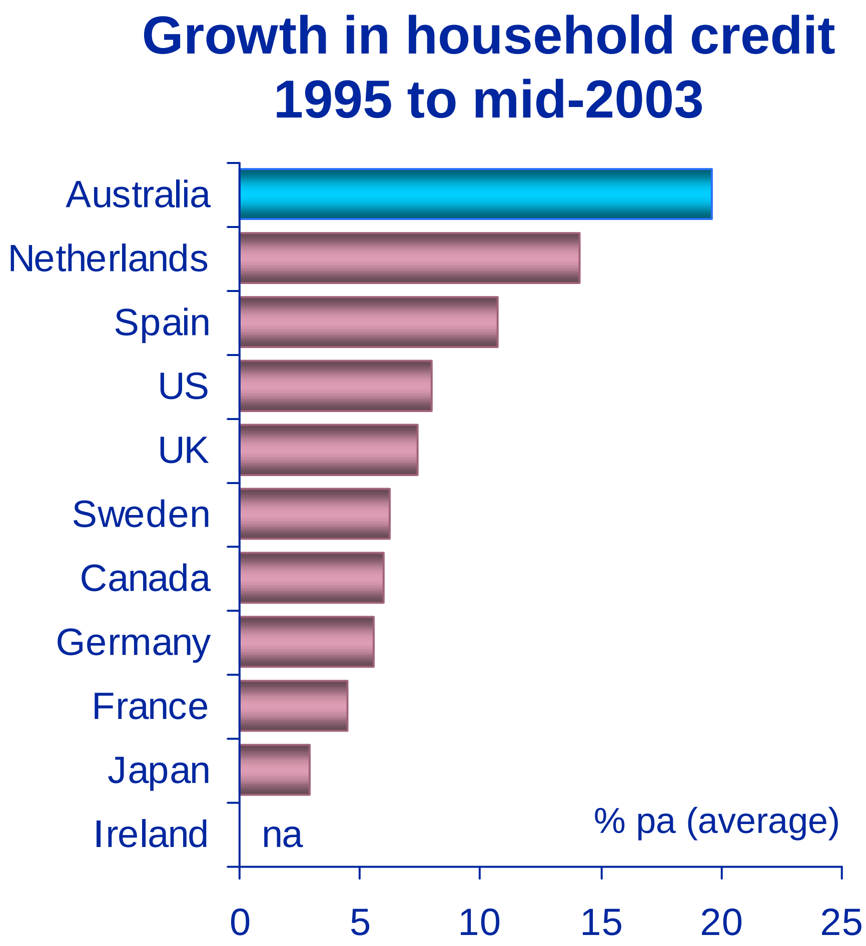
US and Australian household saving



Sources: US Federal Reserve; Australian Bureau of Statistics; Economics@ANZ

Australia is not the only country to have experienced these trends





Sources: The Economist, 31 May 2003; RBA, *Statement on Monetary Policy*, August 2003

The Economist says this represents a 'bubble' …

- 'Neither low interest rates nor population growth can justify recent house-price booms'
  - interest rates are low (argues *The Economist*) only because inflation is low – which simply shifts the profile of payments from the earlier to the later years of a loan – real rates are not particularly low
  - supply constraints are already factored into current prices and will not stop prices falling in future – 'just look at Hong Kong'
- 'Price-(rental) earnings ratios' for housing suggest that 'house prices in … Australia … are at least 30% too high'
  - low nominal interest rates do not justify higher p/e ratios to the extent that they simply reflect lower inflation
- The ratio of average house prices to average incomes 'is currently flashing red in … Australia'
- 'All of the countries where houses appear to be over-valued (incl. Australia) share another bubble-like symptom – an explosion in mortgage borrowing in recent years'

Source: "A survey of property", *The Economist*, 31 May 2003, p. 6.

… and that house prices in Australia (and other places) are likely to fall by more than 20%

‘Over-valuation’ and prospective house price movements according to *The Economist*

Country	% over-valuation relative to 1975-2002 average	% price fall forecast over four years
Australia	31	-20
Britain	34	-25
Ireland	42	-20
Netherlands	44	-30
Spain	54	-30
United States	15	-10

Source: “A survey of property”, *The Economist*, 31 May 2003, p. 10.

If *The Economist* is right, then the Australian economy could be in for very tough times

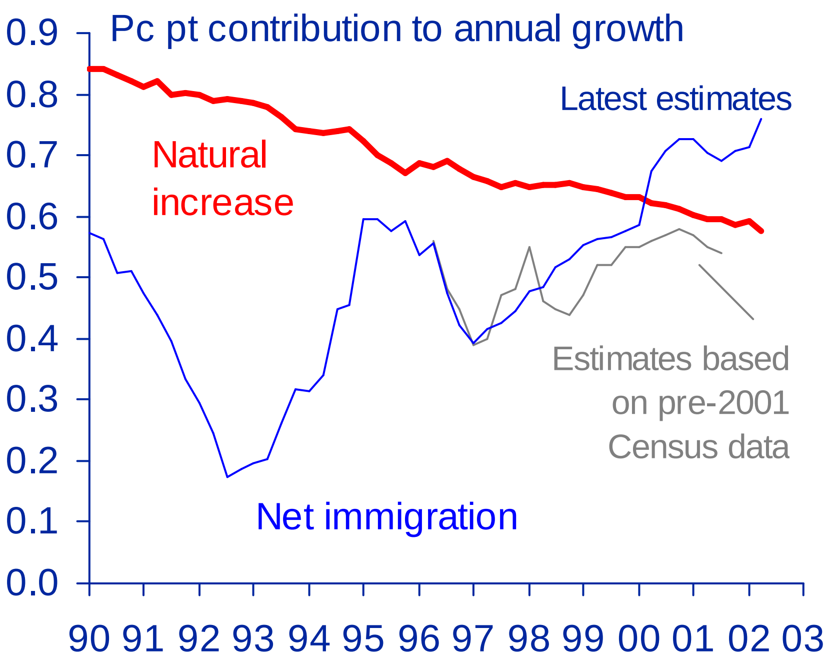
According to the IMF,

- **housing price booms are more likely to be followed by busts than equity price booms**
  - **over the post-war period, 40% of housing price booms in industrial countries ended in busts, compared with 25% of share price booms**
- **housing price busts involve smaller price declines than equity price busts, but last longer**
  - **housing price busts involved price declines averaging 30%, as against 45% for share price busts, but lasted for 4 years on average, compared with 2½ years for share price busts**
- **but the (adverse) effects on economic activity of a housing price bust are much greater**
  - **the output loss associated with a 'typical' housing bust averages about 8% of GDP, compared with 4% of GDP following a 'typical' share price bust**

Source: International Monetary Fund, "When Bubbles Burst", *World Economic Outlook*, April 2003.

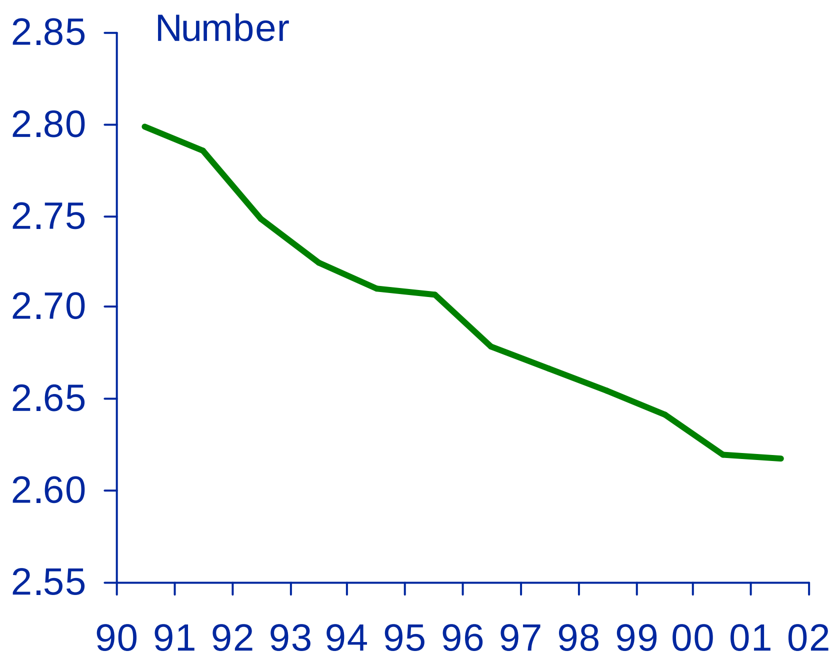
Immigration and falling average household size have added to 'fundamental' housing demand

Sources of population growth



Net immigration has exceeded 130,000 pa over the past two years – much more than previously recognized

Persons per household

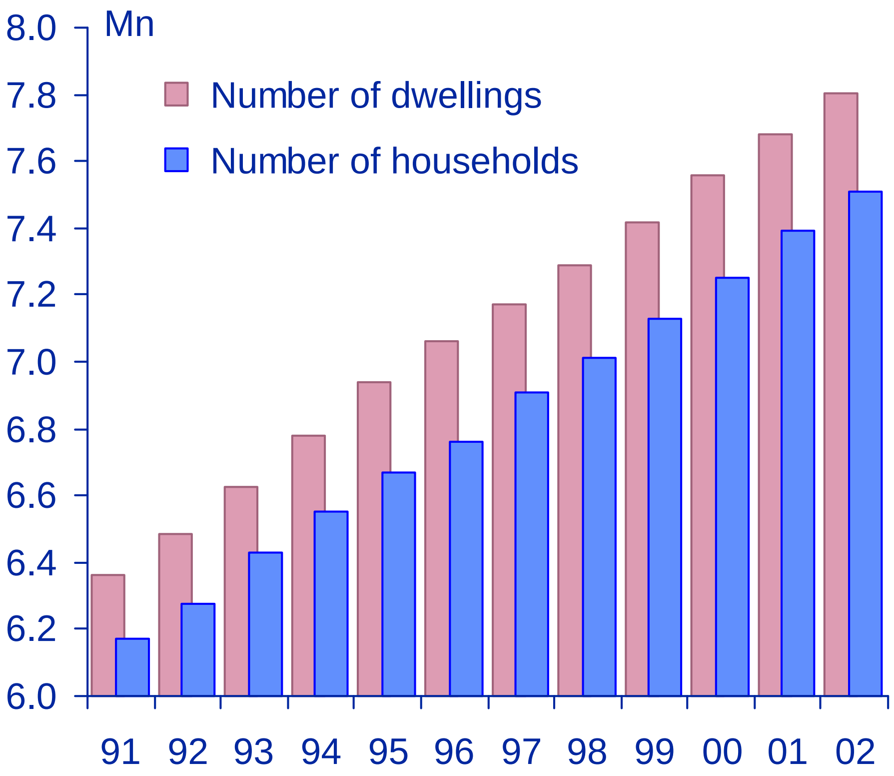


Falling household size has resulted in 500,000 more households than there would otherwise have been

Sources: ABS; Economics@ANZ.

However the supply of housing has barely kept pace with the increase in underlying demand

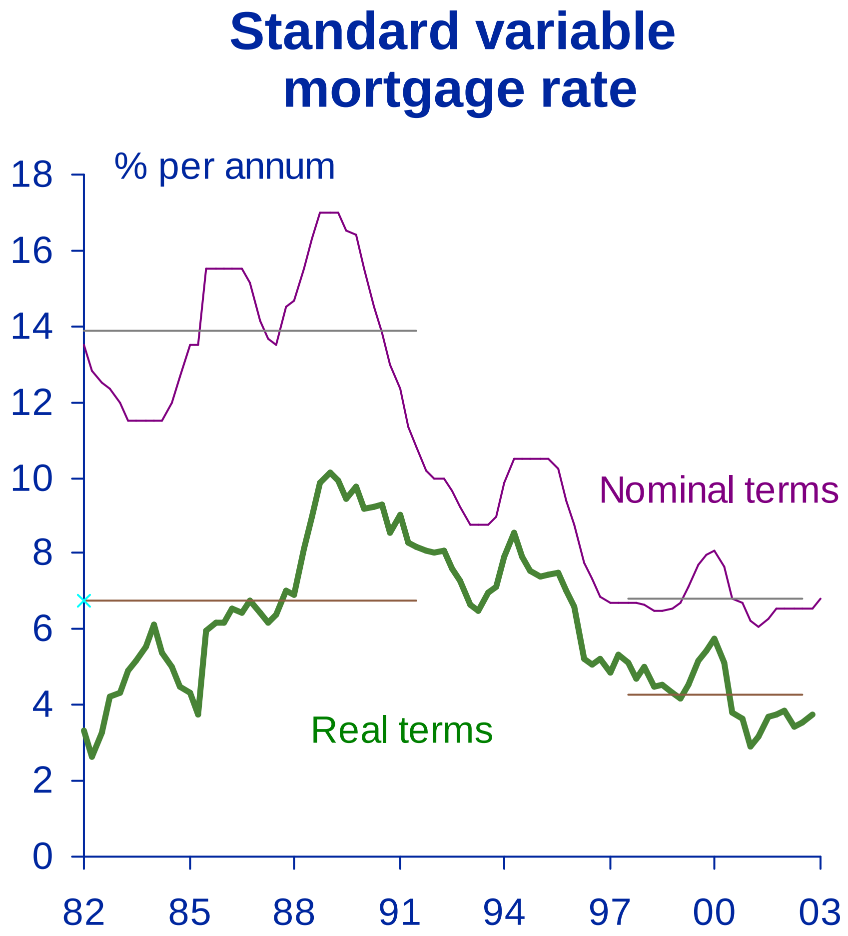
Number of households and number of dwellings

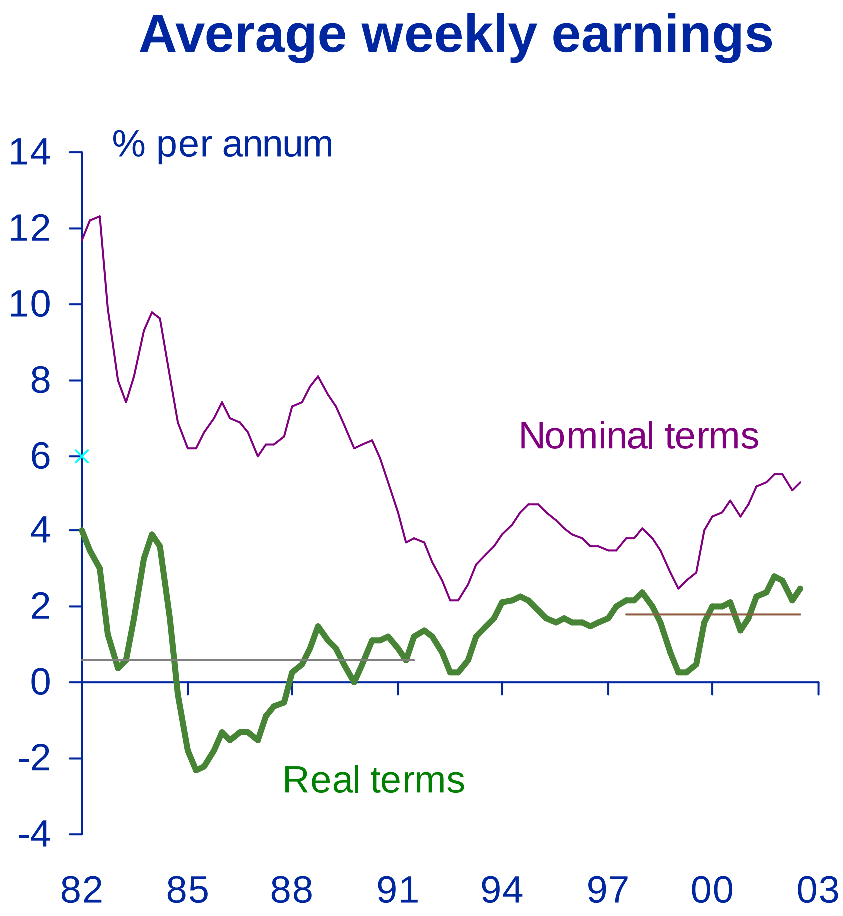


Note: Dwelling stock estimates for 1991, 1996 and 2001 based on census figures; other years interpolated using completions data. *Sources:* RBA; ABS; Economics@ANZ.

- **Over the ten years to 2001-02, the number of households rose by 1.34 million or 22%**
  - **faster than the increase in population (13.5%) because of falling average household size**
- **Over the same period, the stock of housing increased by 1.32 million or 20%**
  - **1.45mn new dwellings were completed during this period, but around 130,000 old dwellings were demolished**
- **In effect, the increase in the supply of housing over the past decade was only just sufficient to absorb the increase in the number of households requiring accommodation**

Over 1992-2002 mortgage rates halved and real incomes rose 7 times faster than during 1982-1992





Sources: RBA; Economics@ANZ.

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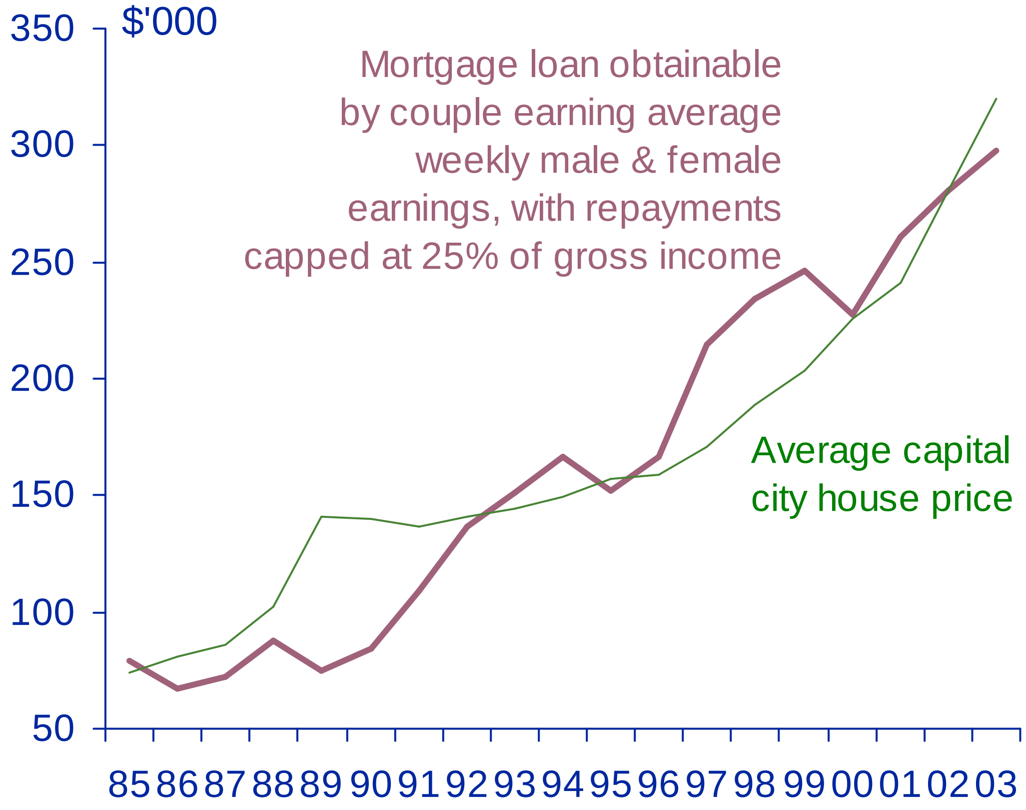
The rise in house prices over the past five years is thus 'fundamentally' justified, not a 'bubble'

Borrowing capacity and house prices

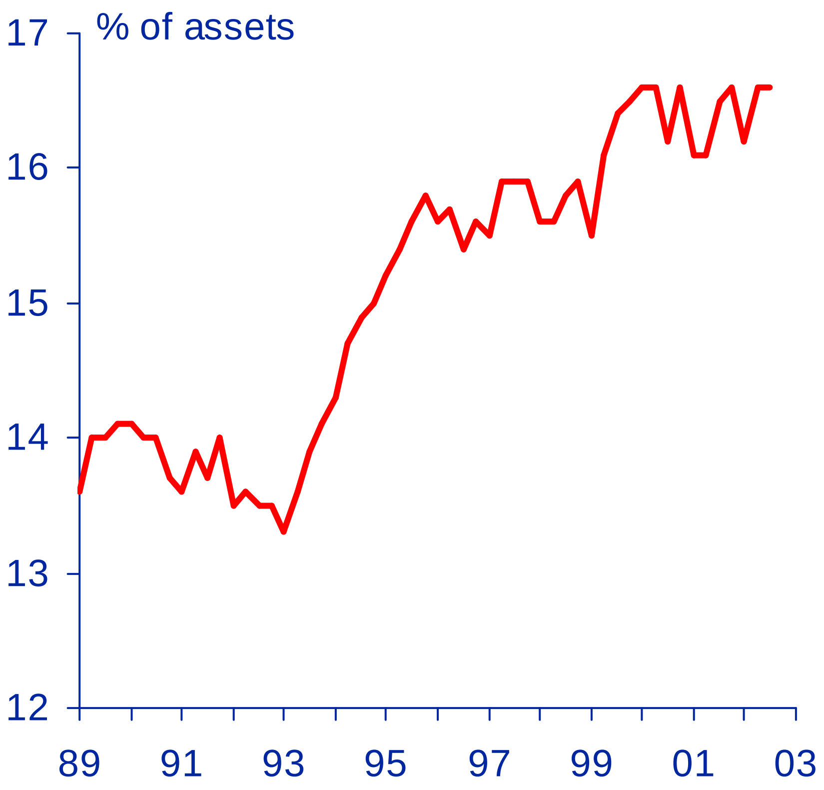


Note: data are for the June quarter each year.
Sources: ABS; REIA; Economics@ANZ.

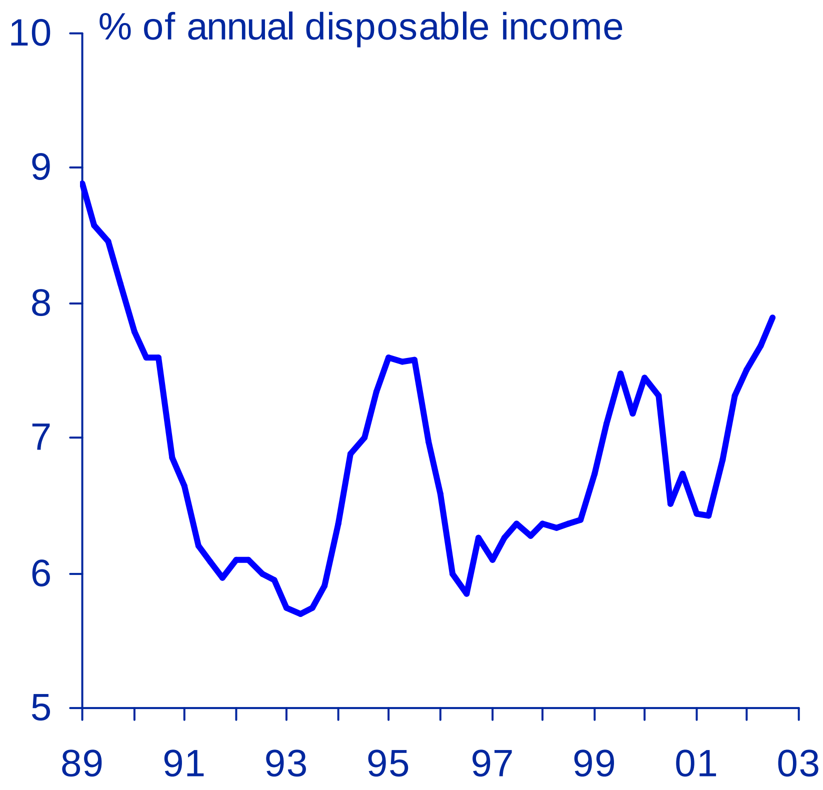
- **Over the past 12 years average incomes have risen by 63% while the mortgage rate has fallen by about half**
- **The borrowing capacity of an average-income household has risen by nearly 175% as a result**
- **With no net increase in the stock of dwellings this increase in 'purchasing power' has been capitalized into prices**
- **However, this is <u>one-time</u> shift in the <u>level</u> of house prices – <u>not</u> a permanent increase in their <u>rate of change</u>**

Using the same ratios bankers use to assess individual loans, debt doesn't seem unsustainable

Household debt as a p.c. of household assets



Household interest payments as a p.c. of disposable income



Sources: ABS; Economics@ANZ; RBA.

However the shifts which have 'justified' the rise in household borrowing are coming to an end

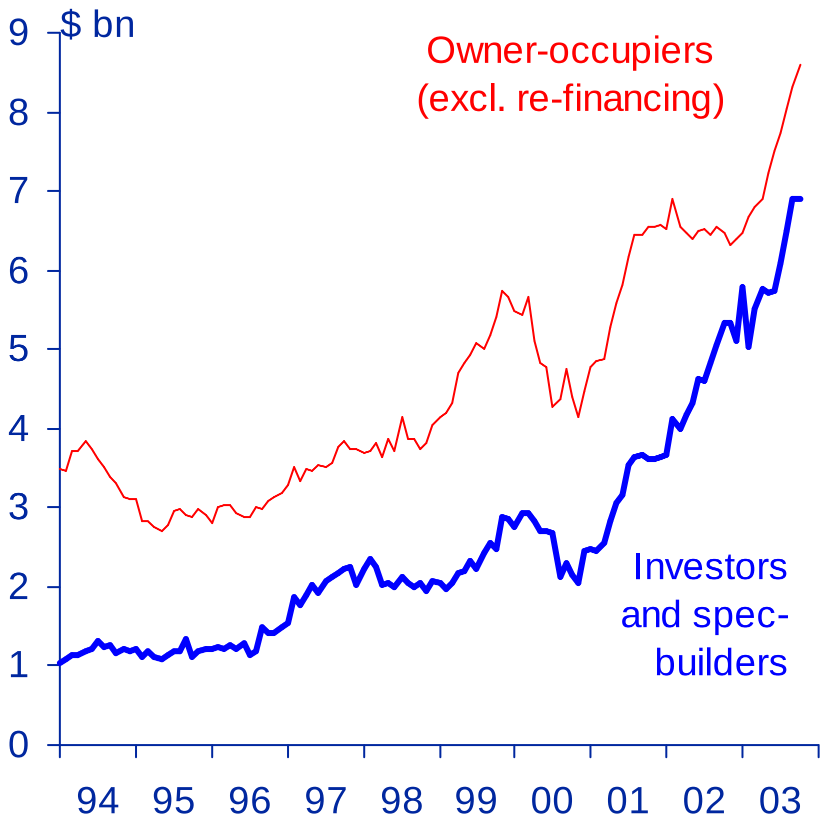
- Historically, periods of rapidly rising house prices have been terminated by sharp increases in interest rates (or, pre-1980s, interruptions to the supply of finance) combined with abrupt increases in unemployment
  - neither of which seems likely to occur in the foreseeable future
- However the big 'structural' downward shift in interest rates is now over
  - rather than trending downwards, interest rates will fluctuate around current levels in line with the ebbs and flows of the economic cycle
- Thus the 'level shift' in property prices has also (in principle) just about run its course
- Henceforth, property prices should (in principle) be driven by
  - growth in average incomes
  - trends in housing supply relative to the number of households (nationally and at the regional level) cycle
- However there is a risk that this transition may not occur smoothly

History suggests almost every bubble starts with a ‘justified’ shift in prices

- ‘Bubbles’ occur when what begins as a fundamentally justified increase in the price of an asset becomes widely misperceived as a permanent increase in the rate of change of that price
  - attracting speculative investment, as opposed to ‘genuine’ demand
  - ‘bubbles’ attract new participants – as both promoters and investors
  - … and new theories to ‘explain’ why things have changed forever (and why some people “don’t get it”)
  - ‘bubbles’ are usually also characterized by increasing leverage
- Some of these characteristics are beginning to become more apparent in parts of the Australian property market
  - investors now account for 44% of all new lending for housing
  - investor interest has been fuelled by the halving of the capital gains tax rate in 2001 (enhancing the appeal of ‘negative gearing’) …
  - … and by a cyclical swing in sentiment away from equities
  - there has been a proliferation of ‘fringe advisers’ who are subject to very little supervision or regulation compared with investment advisers in other areas

Investors have become increasingly important participants in the residential property market

Housing loan approvals



Investor loan approvals as a share of total housing finance

Sources: ABS; Economics@ANZ.

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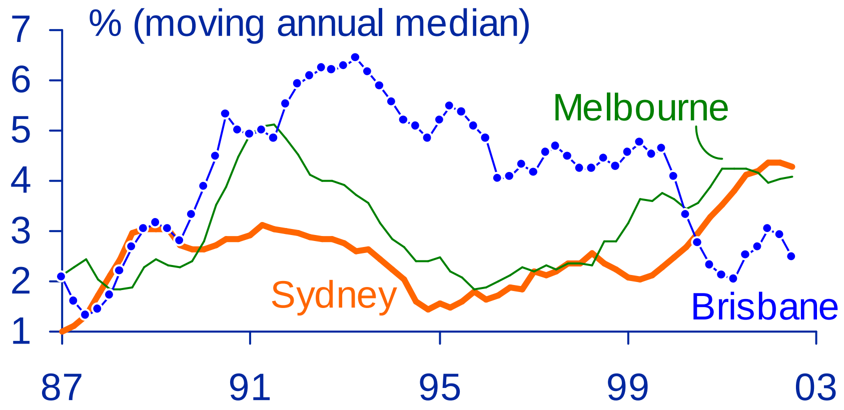
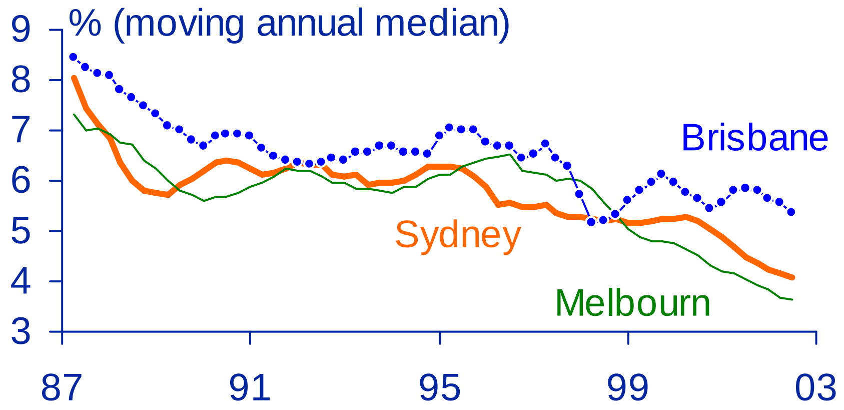
The growing investor presence in property markets may be a new source of volatility

Rental vacancy rates



Rental yields - units

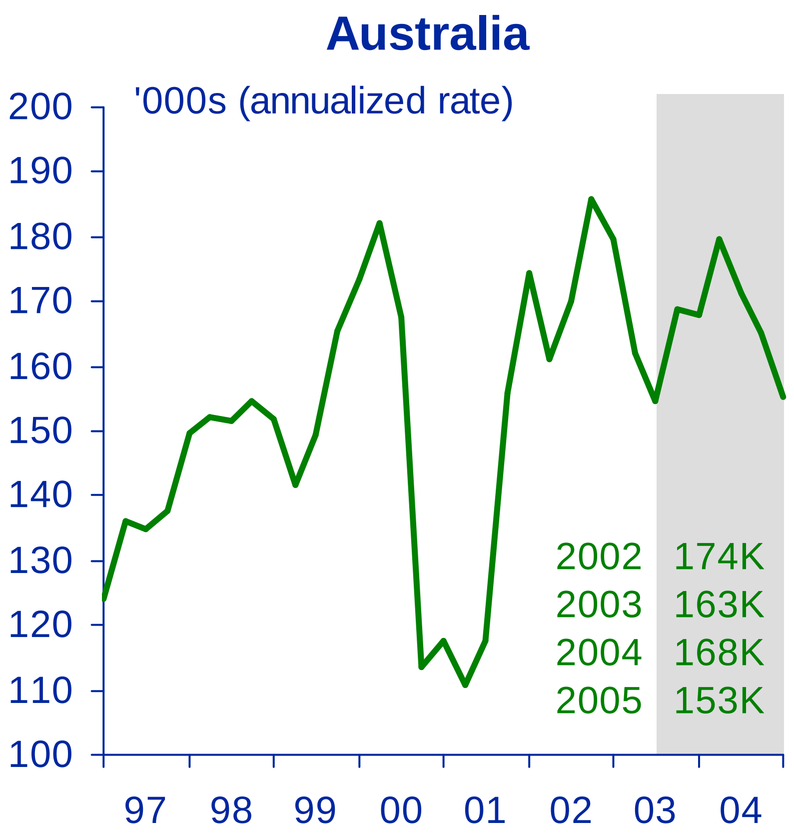


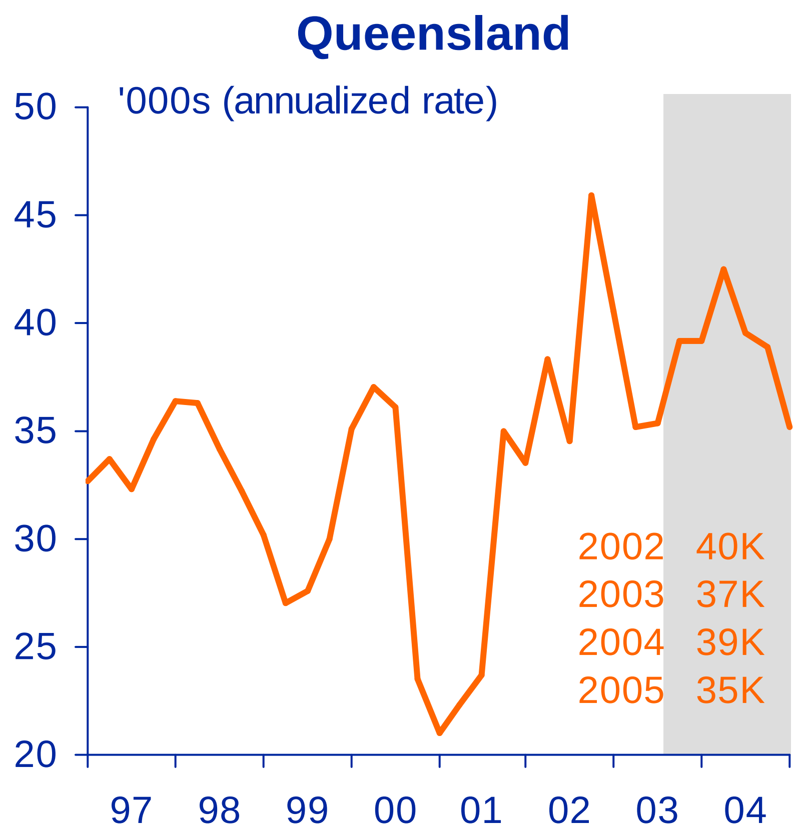
Sources: REIA; Economics@ANZ.

- **By definition, owner-occupiers face zero vacancy rates and rarely sell when faced with the prospect of declining house prices**
- **Owner-occupiers are thus an inherently stabilizing force in property markets – except during periods of rising interest rates and unemployment**
- **But investors may become net sellers in response to rising vacancy rates and 'earnings disappointments' – in the same way as investors in equities**
- **The enlarged presence of investors may thus have introduced a new source of volatility into property markets**

Housing activity will strengthen over the next 6 months ahead of a downturn in 2004-05

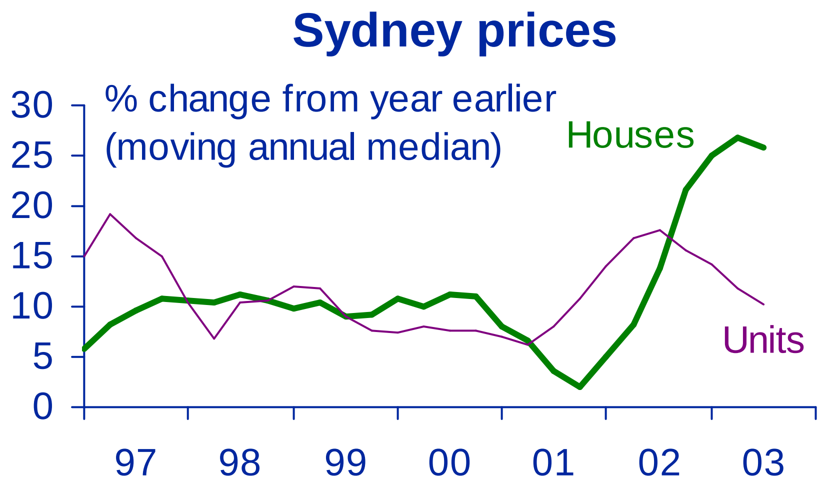
Dwelling commencements

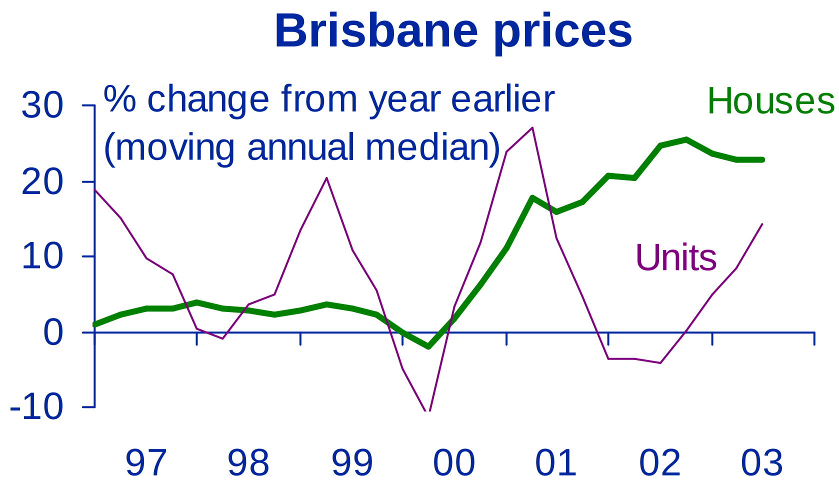


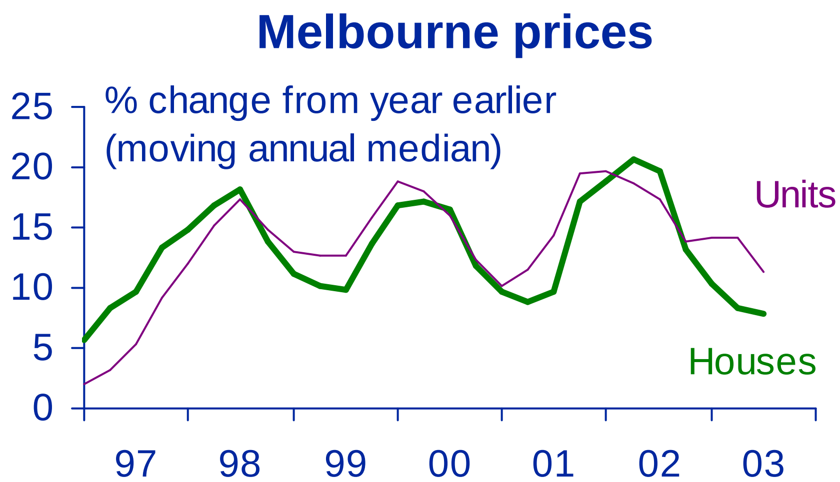


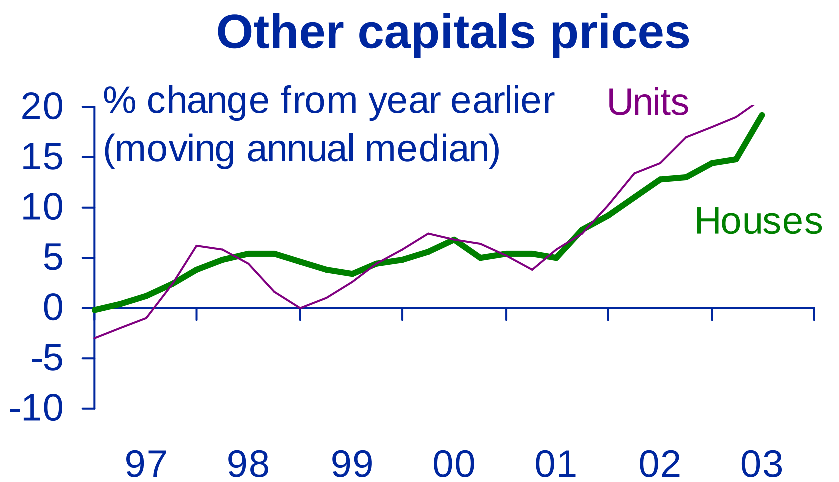
Sources: ABS; Economcis@ANZ.

Unit prices appear to be levelling off, at least in Melbourne and Sydney









Sources: REIA; Economics@ANZ.

Some policies could help improve affordability – but other suggestions would make things worse

Measures which should be considered

- Measures to increase land supply/speed development
  - land release programs
  - planning processes
- Reductions in taxes/charges for land development
  - will improve developer profits but may not necessarily increase land supply or reduce prices to ultimate buyers
- Reconsider tax incentives for investors
  - not true that suspension of negative gearing in mid-1980s 'caused' surge in rents
  - but probably not politically feasible

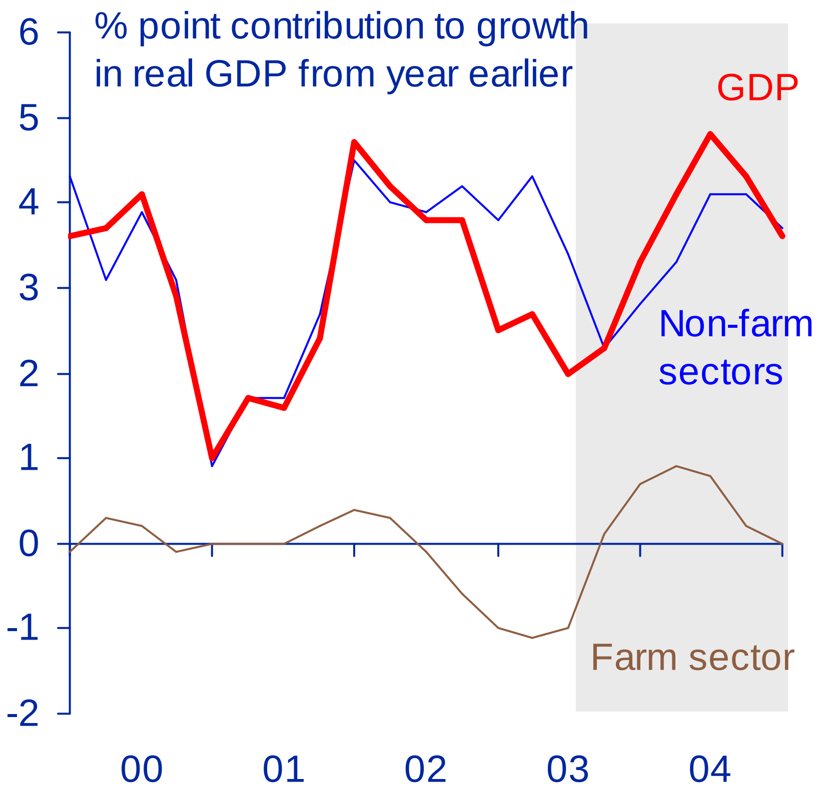
Measures which almost certainly wouldn't work

- Anything that enables Australians to buy more expensive houses …
- … results in more expensive houses
- Stamp duty concessions
  - except in very weak markets, would be capitalized into prices
  - there's an equity case for cutting stamp duty and paying for it by raising land tax, but it's probably not politically feasible
- Higher first home owner grants
  - except in very weak markets, would be capitalized into prices
- 'Shared equity' schemes
  - ditto

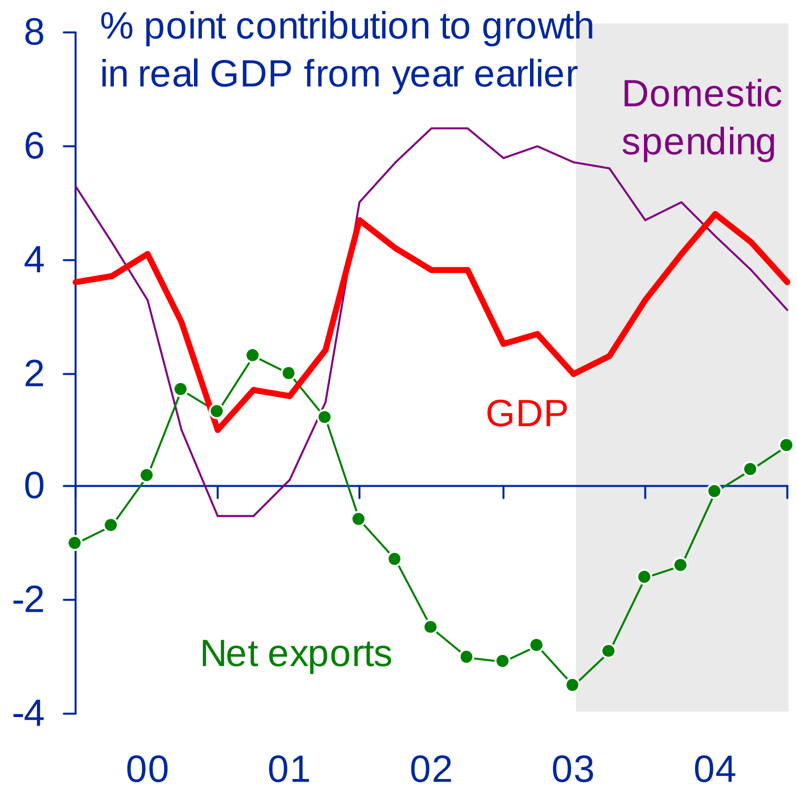
The Australian economy has passed its low point, and growth is now picking up strongly

Sources of growth in the Australian economy

Farm vs non-farm



Domestic vs external



Sources: ABS; Economics@ANZ

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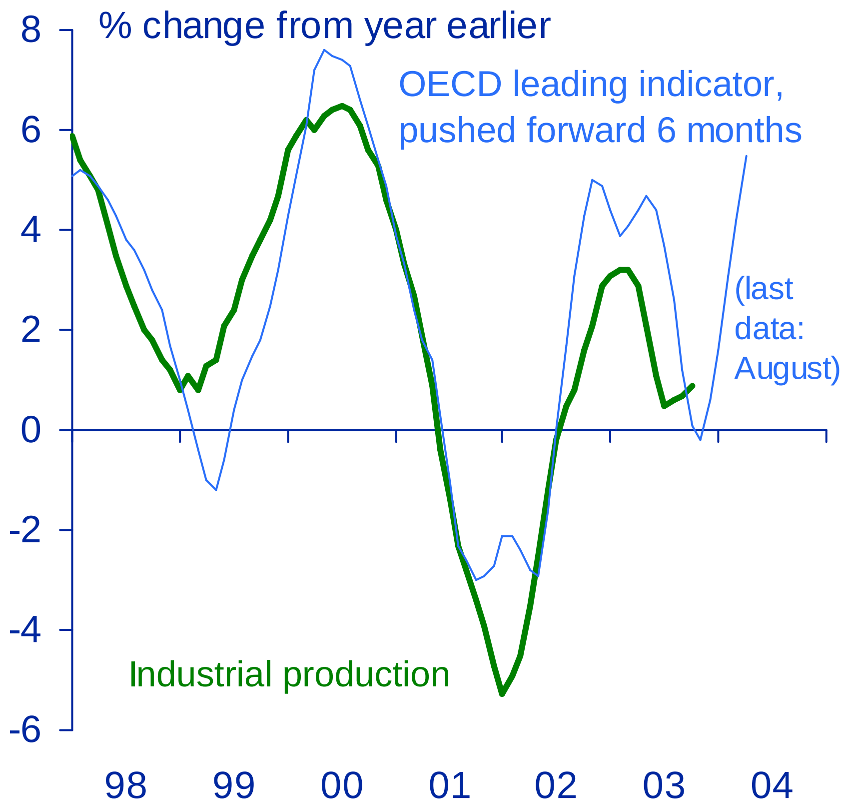
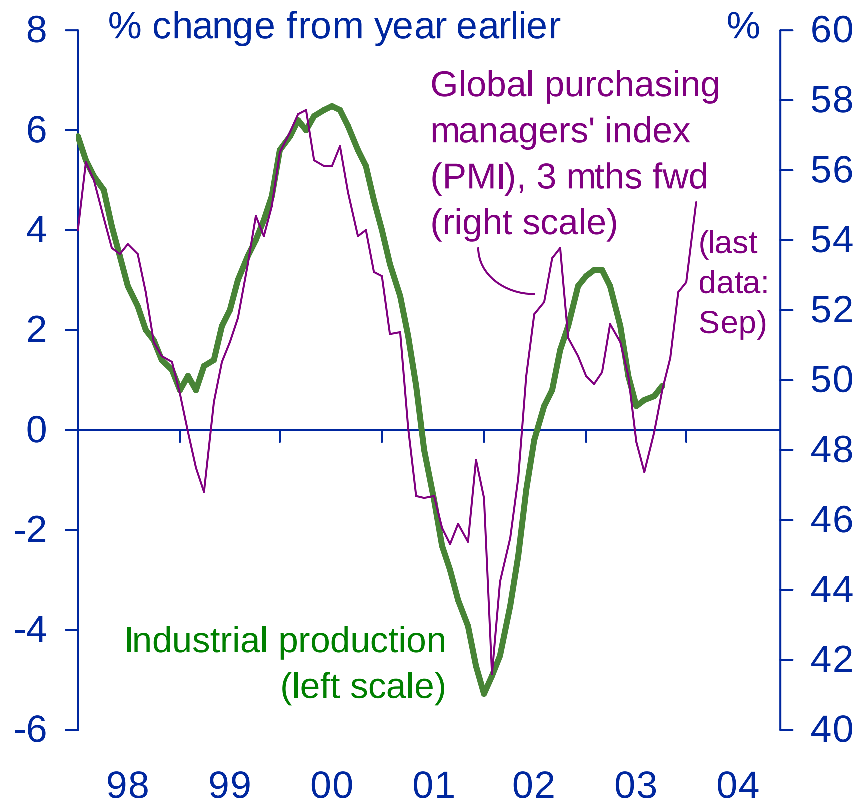
Leading indicators for the global economy are now signalling a strong rebound in growth

Leading indicators of global industrial production

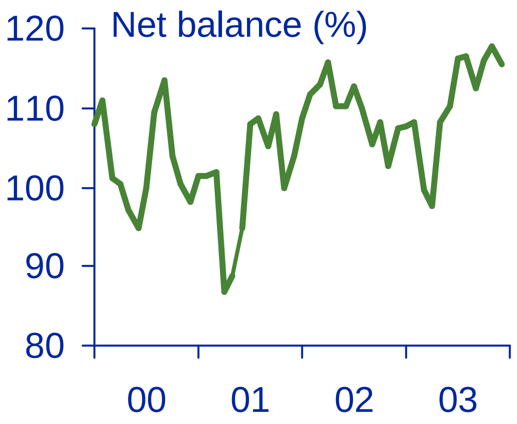




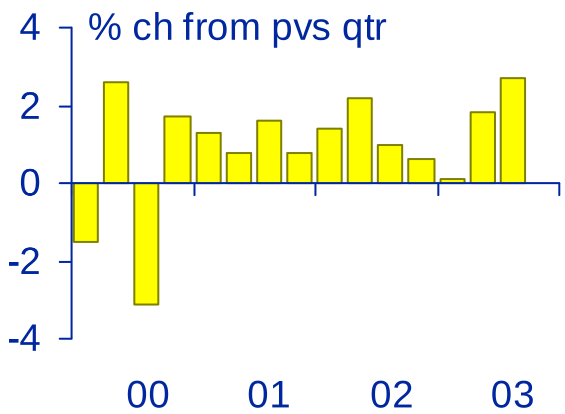
Note: Global IP series constructed by Economics@ANZ from data for 42 countries. Global PMI is a weighted average of PMIs for the US, Euro area, UK, Canada, Australia and (from January 1999), Hong Kong and Singapore. *Sources:* Datastream, OECD, ISM, CIPS, Reuters, NTC, AiGroup, Economics@ANZ.

Australia doesn't look like an economy in need of continued monetary stimulus

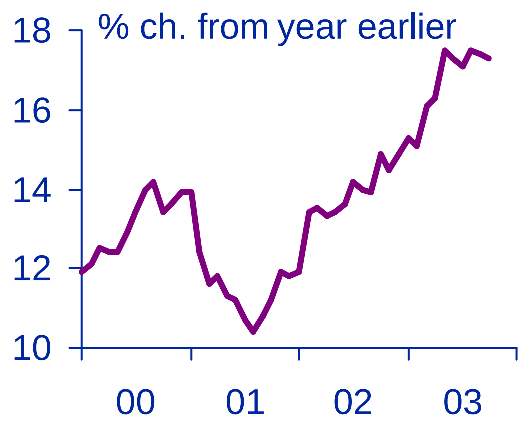
Consumer confidence



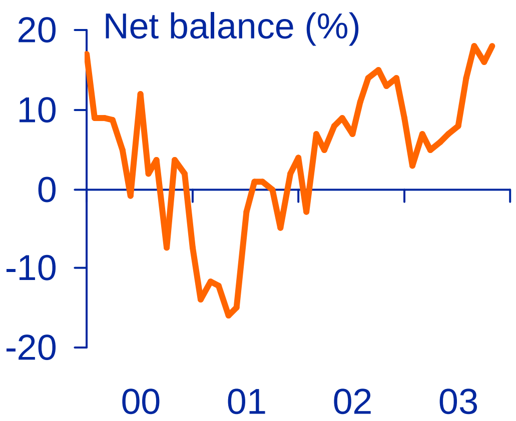
Retail sales



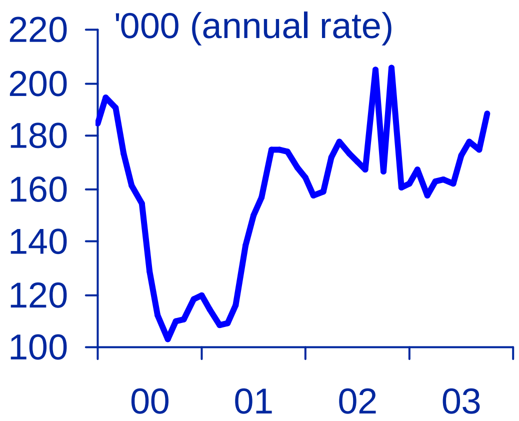
Personal borrowing



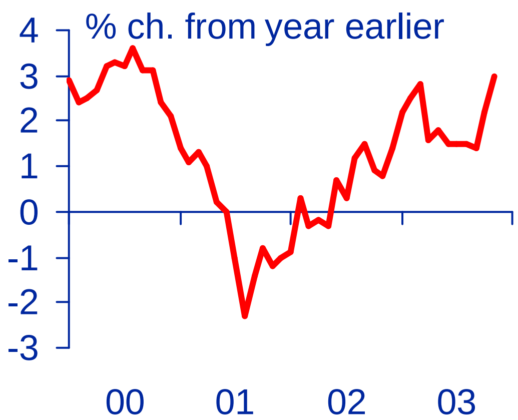
Business confidence



Dwelling approvals



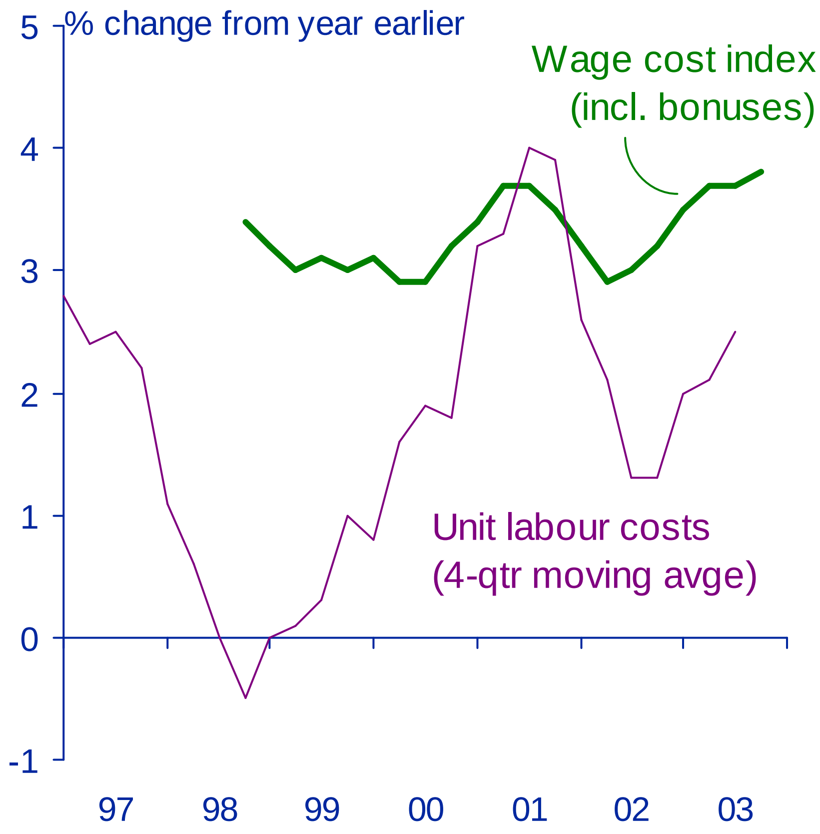
Full-time employment



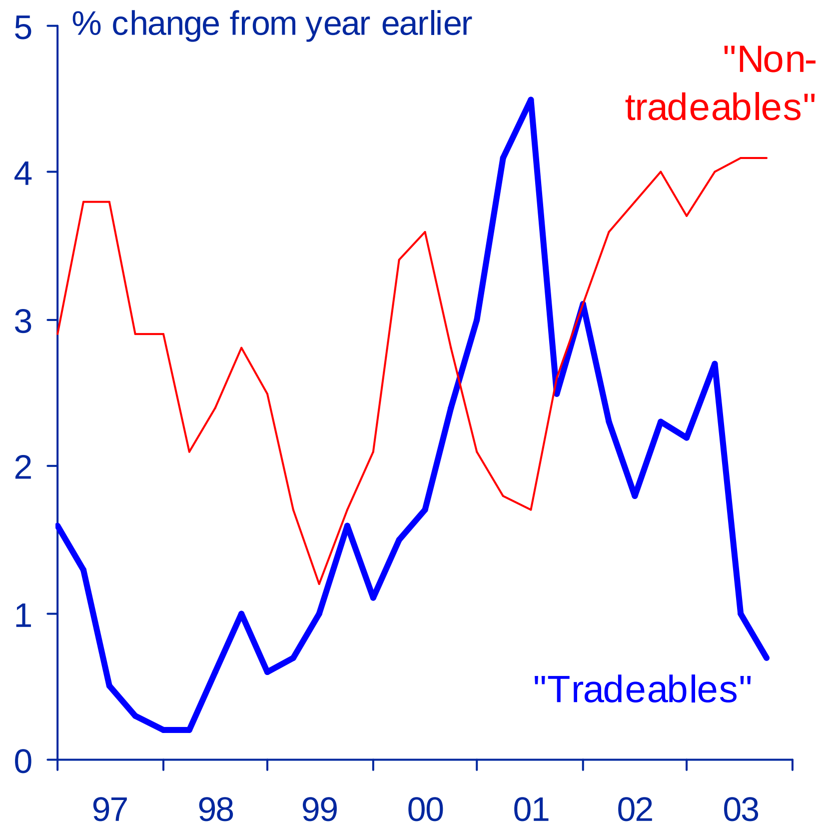
Sources: Westpac-Melbourne Institute; National Australia Bank; Reserve Bank of Australia; ABS.

The Reserve Bank is ‘alert but not alarmed’ about the outlook for inflation

Labour costs



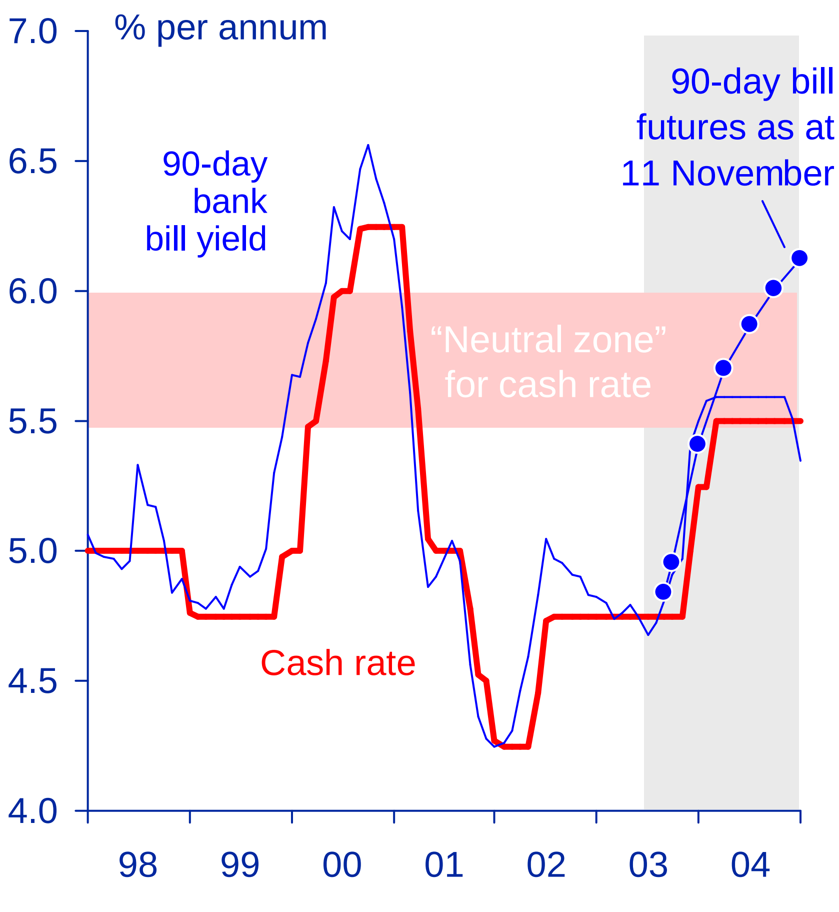
Consumer prices



Sources: ABS; Commonwealth Treasury.

The Reserve Bank will move monetary policy settings back to 'neutral', but not 'restrictive'

Short-term interest rates

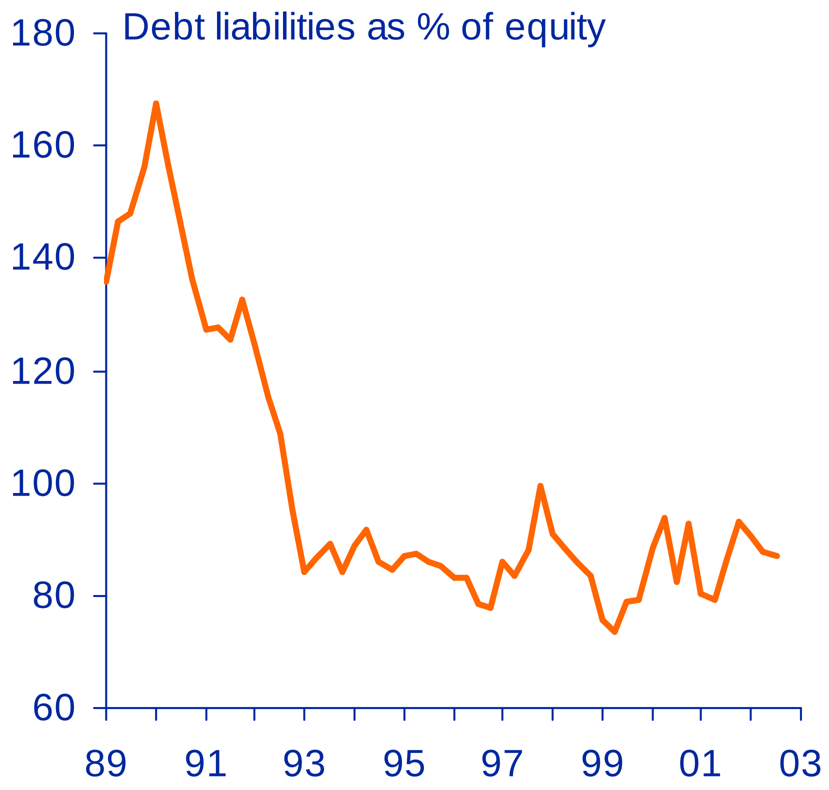


Sources: Reuters; Economics@ANZ.

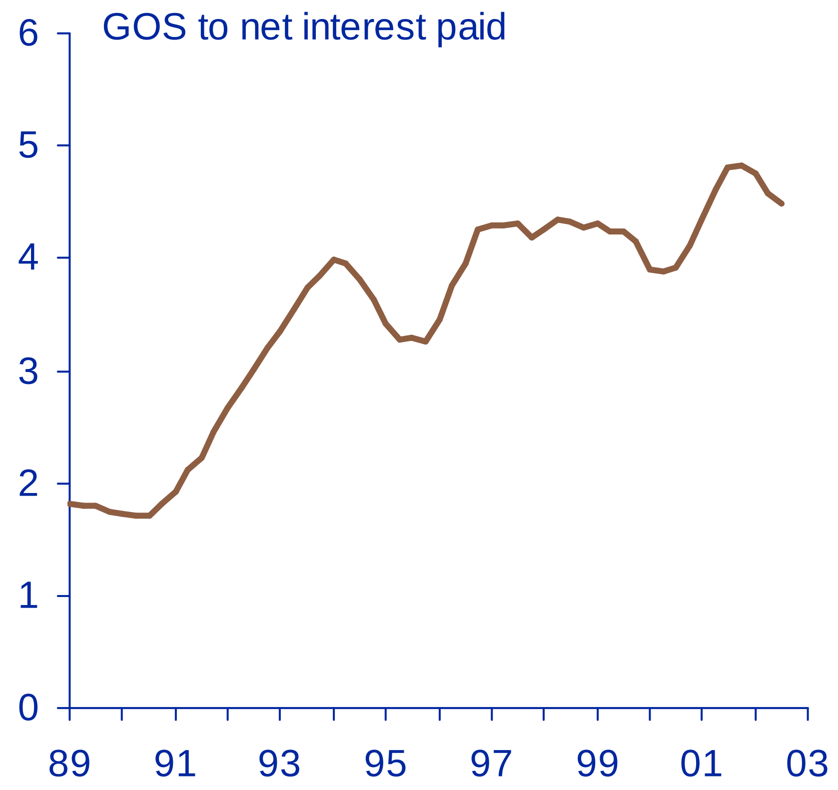
- **The Reserve Bank began moving monetary policy back to 'neutral' (cash rate of 5½-6%) in mid-2002 …**
- **… but was forced to shelve that intention by the renewed global downturn and the drought**
- **With both of those constraints now easing, the Bank is reverting to 'Plan A' – which means a cash rate of 5½% by Q2 2004 unless another economic shock intervenes**
- **The Reserve Bank is <u>not</u> targeting house prices, nor is it trying to slow the economy down**
- **However it does want to avoid exacerbating the risks associated with persistent rapid growth in household debt, by returning interest rates to 'normal' levels**

While households are now more sensitive to changes in interest rates, businesses are less so

Corporate sector debt-equity ratio



Corporate sector interest cover ratio



Sources: ABS; Economics@ANZ..

Summary

- Most of the rapid increase in residential property prices over the past few years is 'justified' by a combination of
  - greatly enhanced household borrowing capacity, and
  - strong growth in underlying housing demand relative to supply
- The 'price level shift' warranted by these factors has now largely occurred, so property prices should, in general, start to 'level out'
- However investors, acting on the mistaken belief that the rate of change in house prices has permanently increased, could push prices well above levels justified by 'fundamentals'
- Hence there is some risk that the boom of the past few years could be extended and ultimately end in a 'bust'
  - at the moment this risk is concentrated in particular market segments
- The Reserve Bank is seeking to minimize this risk by returning interest rates to 'neutral' now that the downside risks to Australian economic growth are fading
  - but the Reserve Bank is not in the business of 'bubble-pricking'
- Policy should focus on measures to improve housing supply
  - measures aimed at 'improving affordability' just lead to higher prices