Is the Australian property market in 'bubble trouble'?

Presentation to the

Urban Development Institute of Australia (Queensland)

Saul Eslake
Chief Economist
ANZ Bank

Crowne Plaza Hotel
Surfers Paradise
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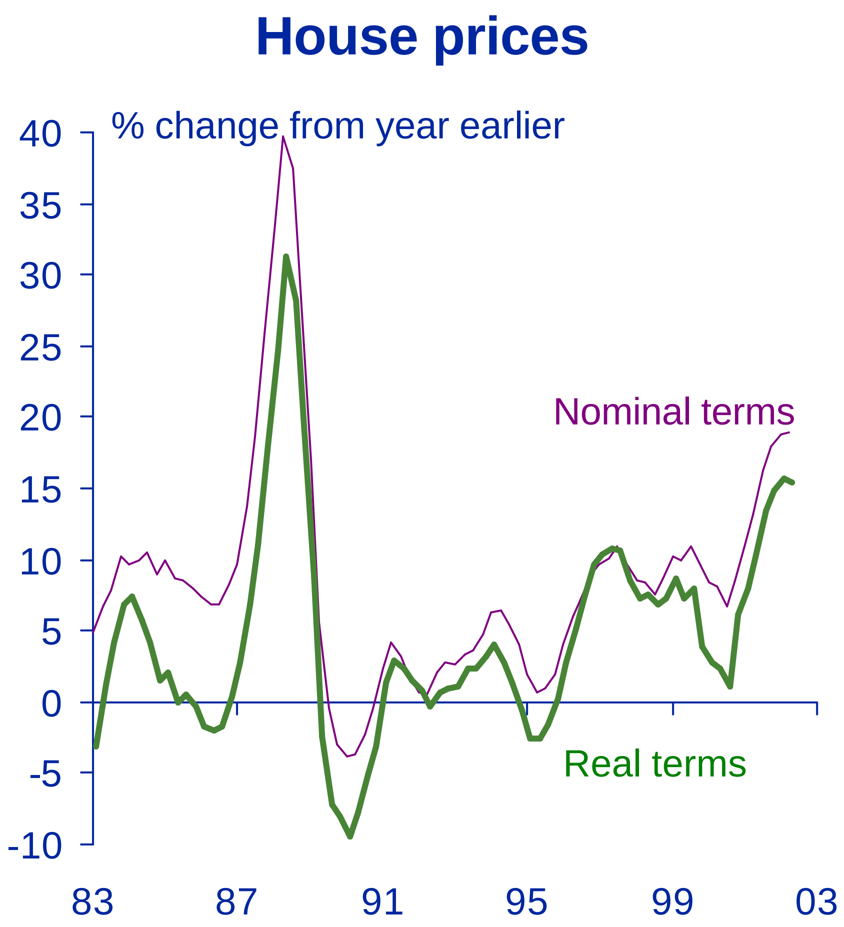
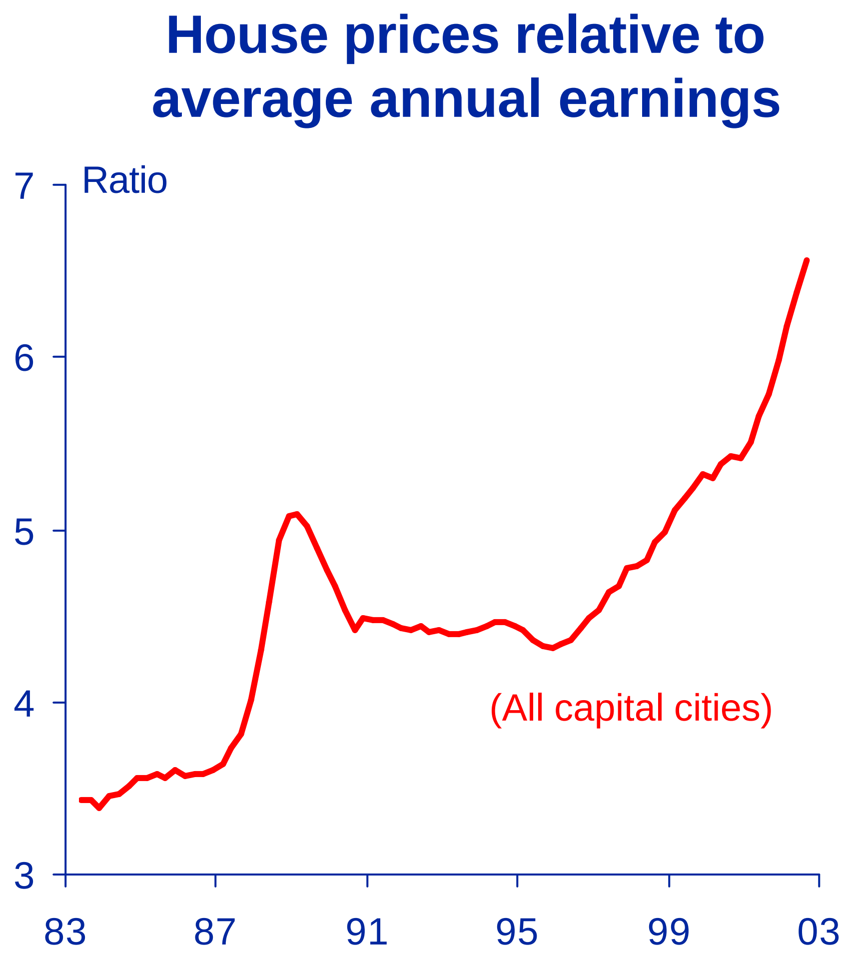
E-mail: eslakes@anz.com
or economics@anz.com

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

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

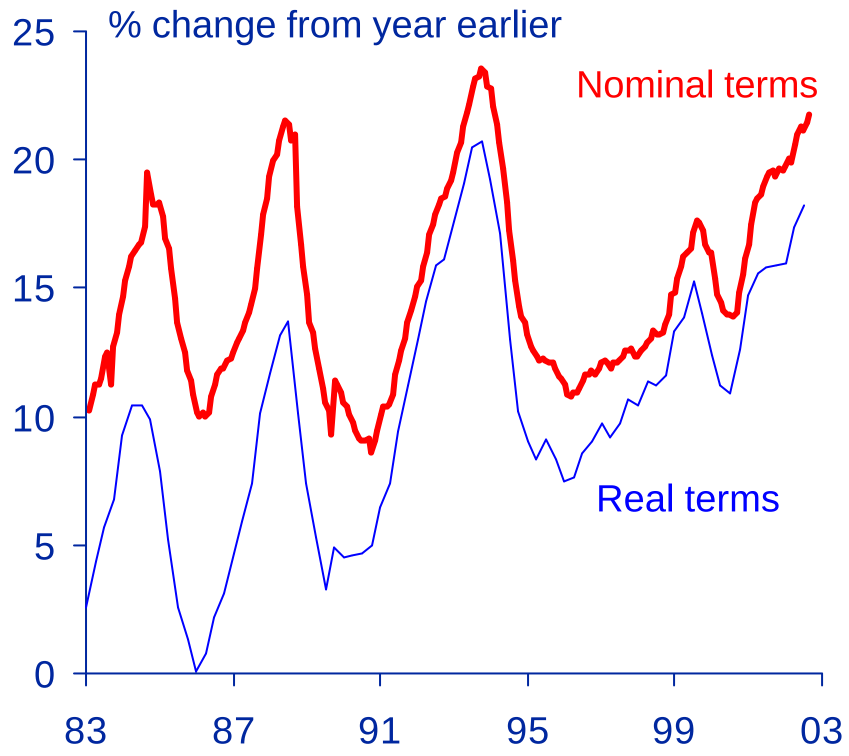




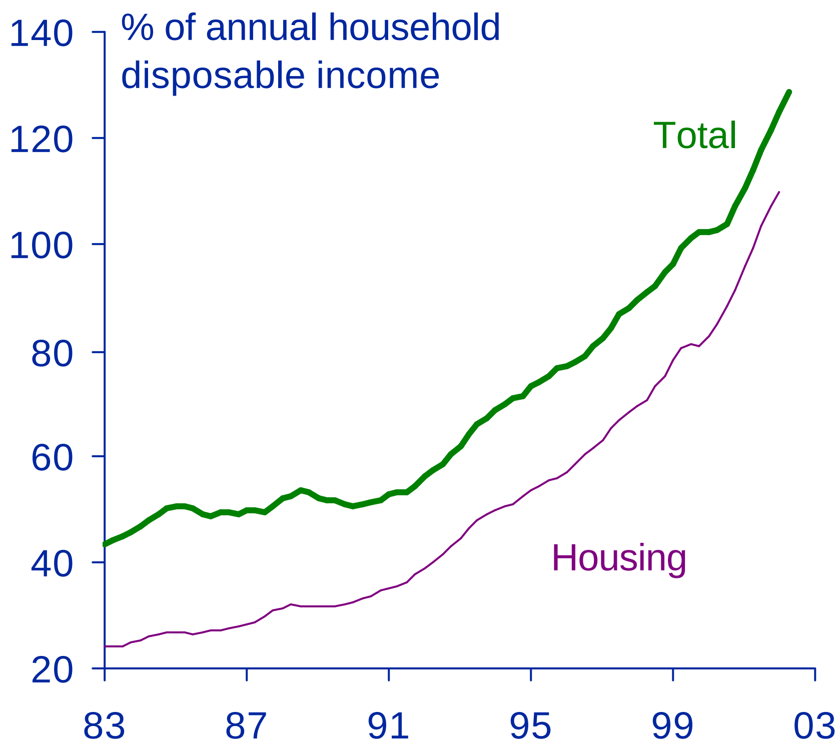
Sources: REIA; ABS; Economics@ANZ.

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

Borrowing by individuals for housing

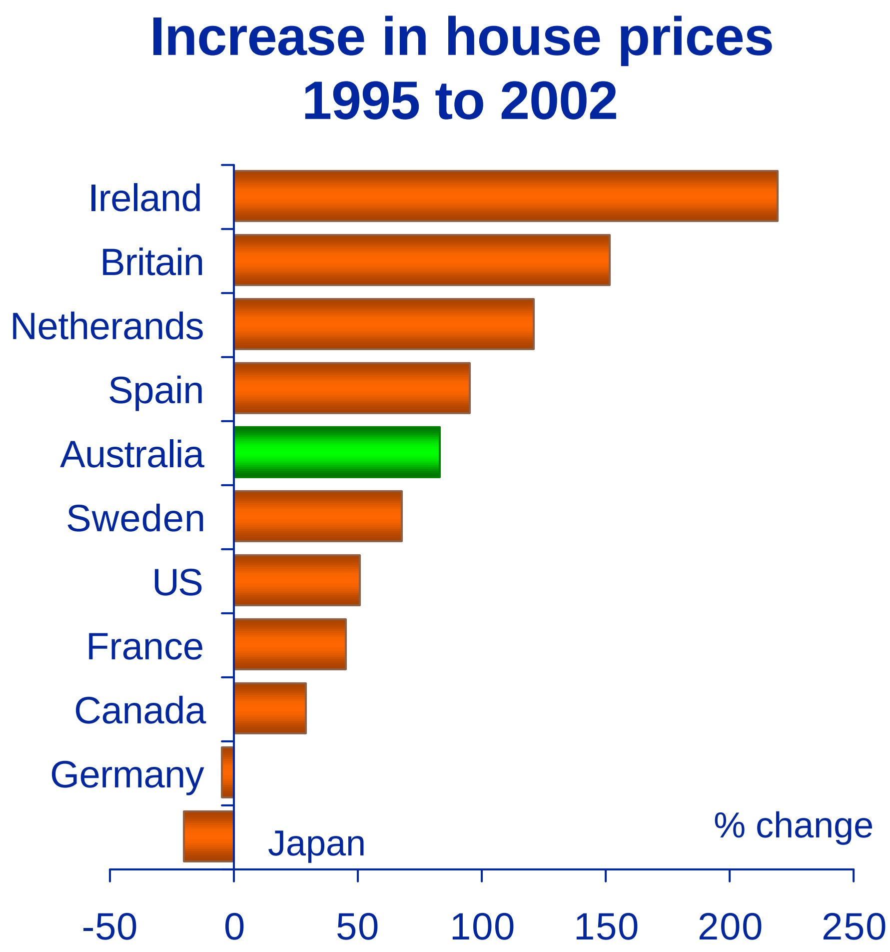


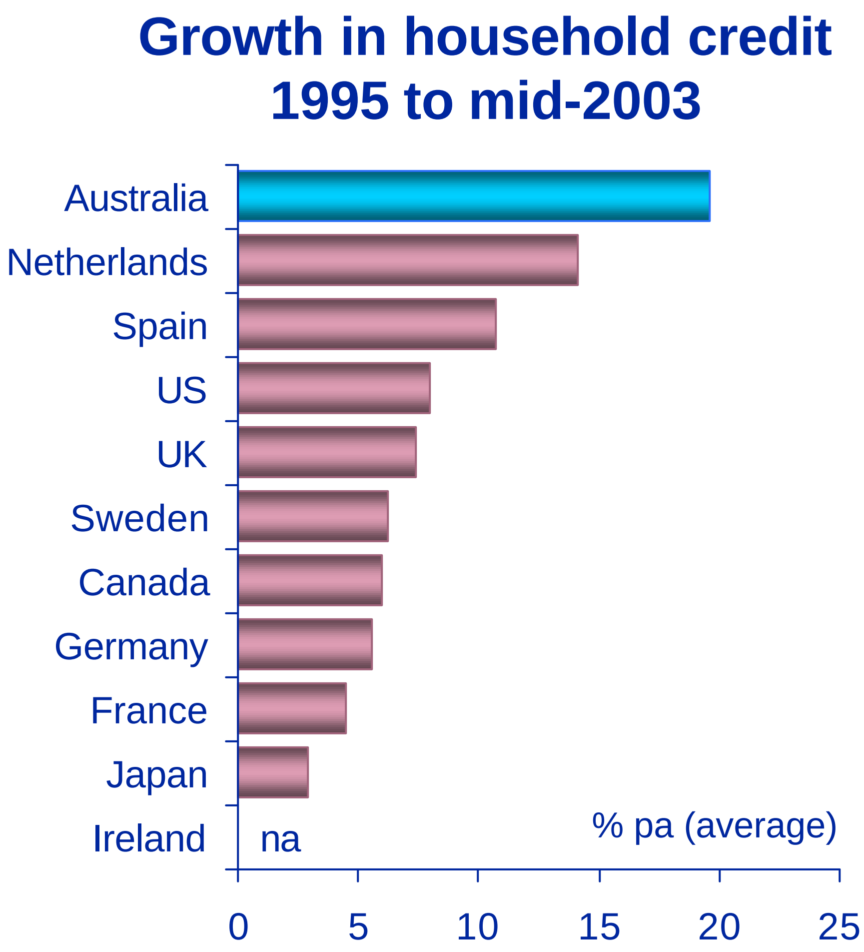
Household debt as a p.c. of disposable income



Sources: RBA; ABS; Economics@ANZ.

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

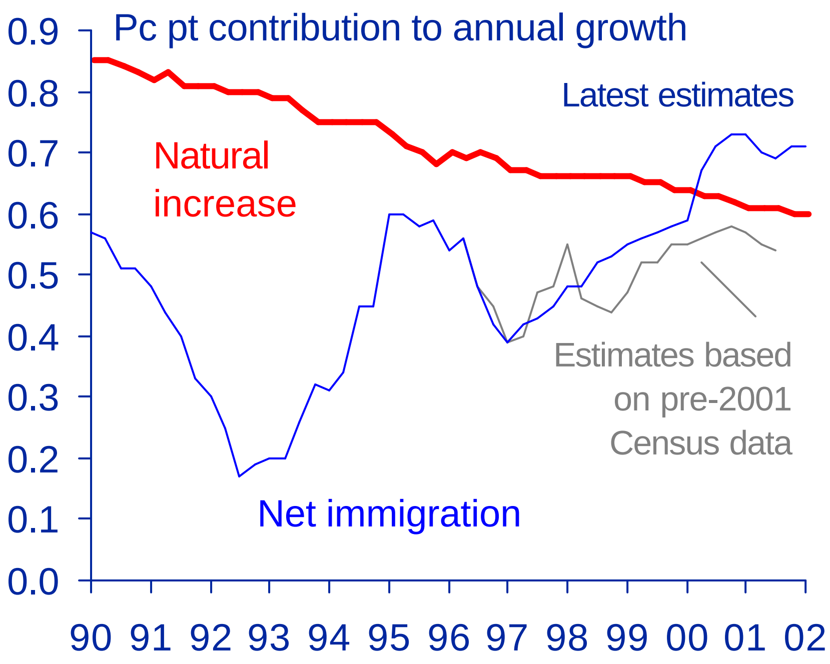
According to the IMF,

- **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.

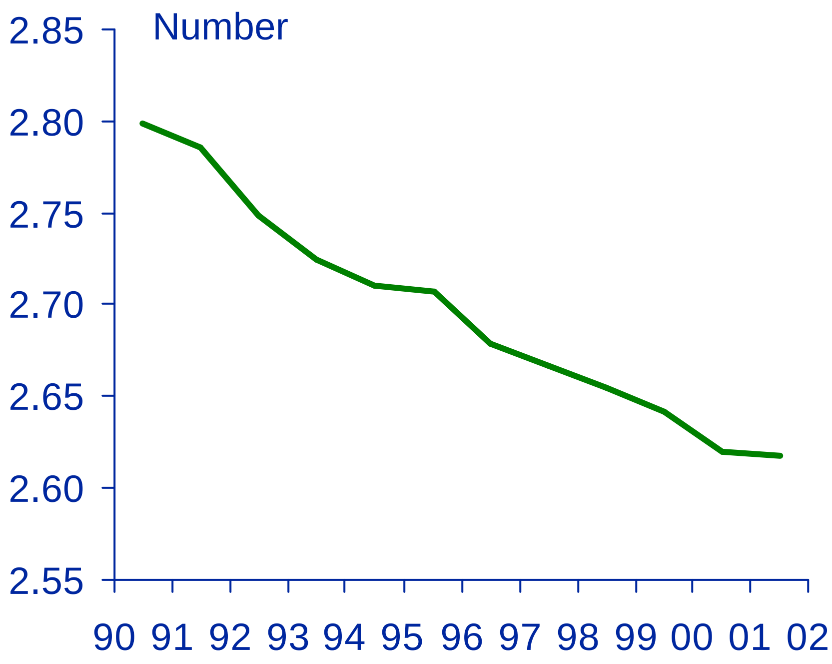
Immigration and falling average household size have added to 'fundamental' housing demand

Sources of population growth



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

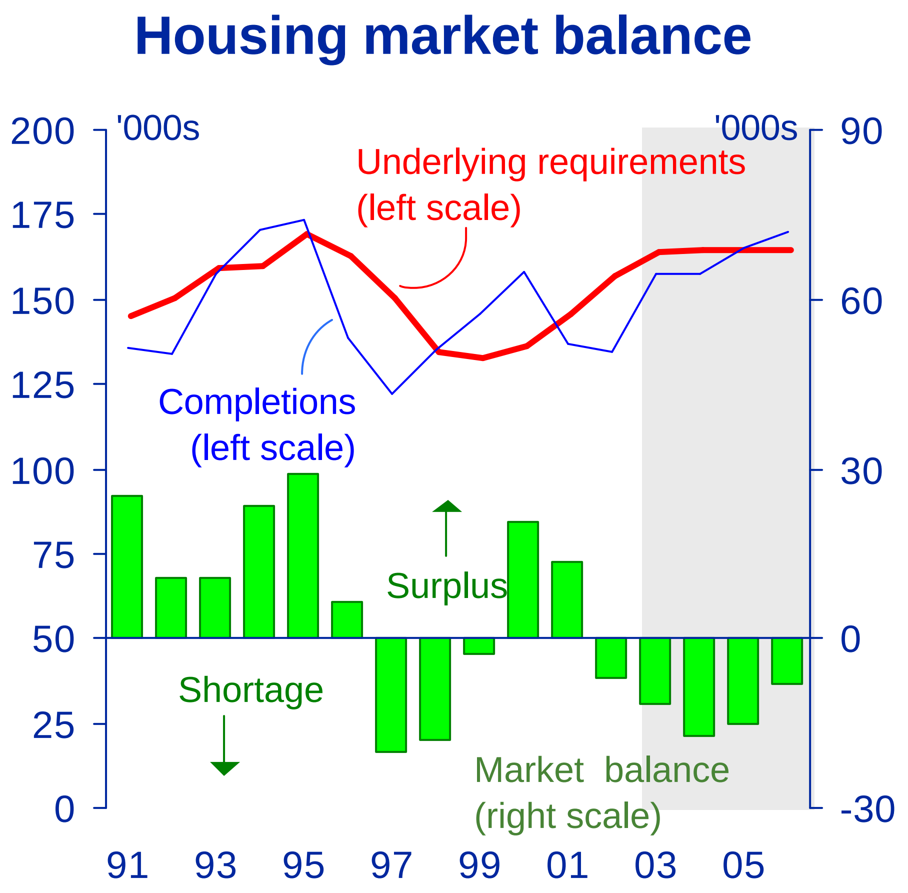
Persons per household



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

Sources: ABS; Economics@ANZ.

Upward revisions to population growth estimates mean there is no excess supply of housing



Note: 'Surplus' or 'shortage' is the cumulative difference between completions and underlying demand from an historical starting point. The direction of movements in this measure is more significant than the level. *Sources:* ABS; Economics@ANZ estimate and forecasts.

- **Estimates of underlying dwelling demand for the years ahead have risen sharply from 147,000 to 163,000 (much of which is attributable to ABS revisions to population growth)**
- **The housing market now has some pent-up demand, a condition expected to remain for several years**
- **National dwelling starts reached 174,000 in 2002 and are set to decline a relatively modest 10% to 156,000 in 2003 before rising again to 161,000 in 2004**

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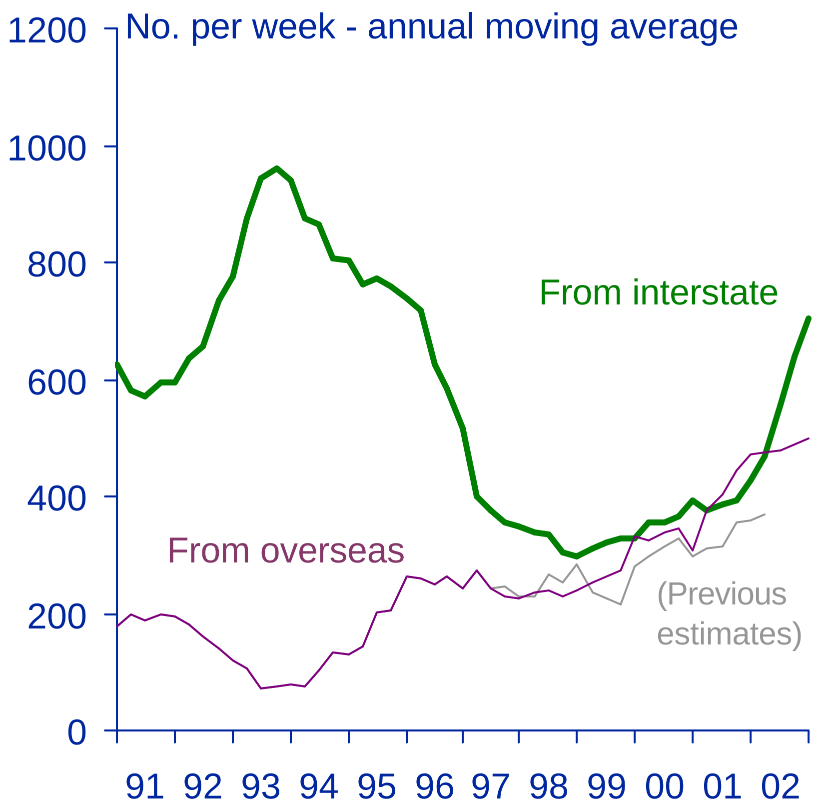
Migration to Queensland has picked up significantly over the past two years

Migration to Queensland



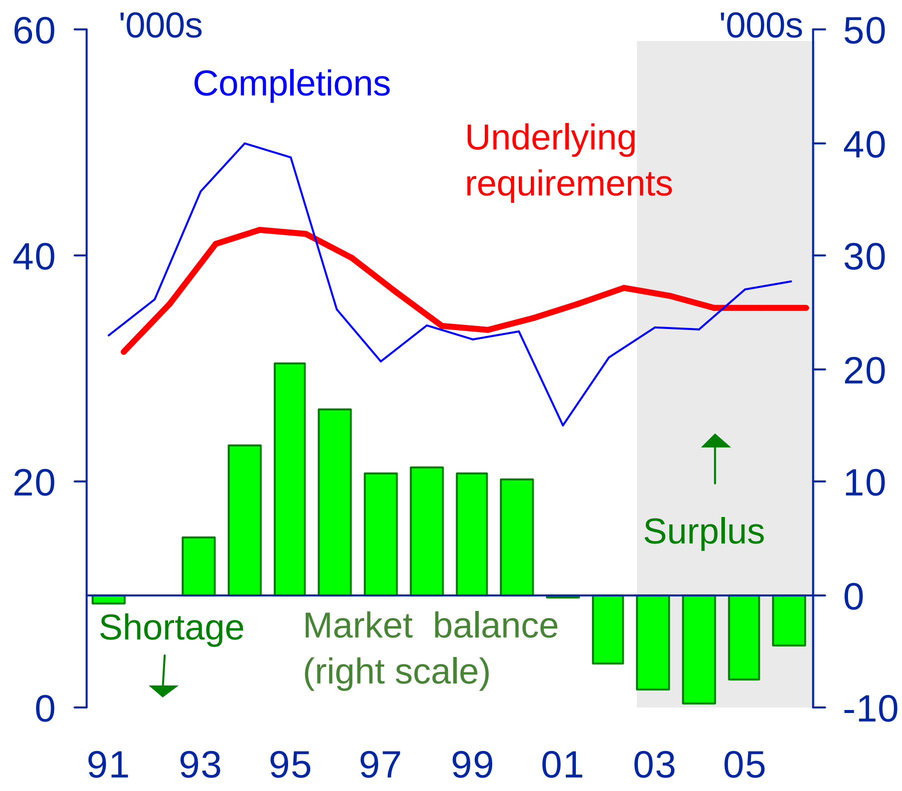
Sources: ABS; Economics@ANZ.

- **Overseas immigration to Queensland has been running at about 4,500 pa faster than suggested by pre-2001 Census estimates**
- **Queensland is now attracting about 19% of total overseas migration to Australia – up from around 15% during the 1990s**
- **Migration to Queensland from southern States has picked up dramatically – particularly at the expense of New South Wales**
- **As a result, Queensland's population is now growing at 2.4% pa – the fastest since the mid-1990s**

As a result Queensland is now likely to confront a shortage of housing for the next few years

- **Excess supply which had built up over 1990s has been absorbed**
- **Pent-up demand is likely to be a feature of the Queensland market - reaching around 10,000 units in 2004**
- **Queensland starts are expected to recover from 32,000 this year to 37,000 in 2004, a level which begins to reduce pent-up demand**

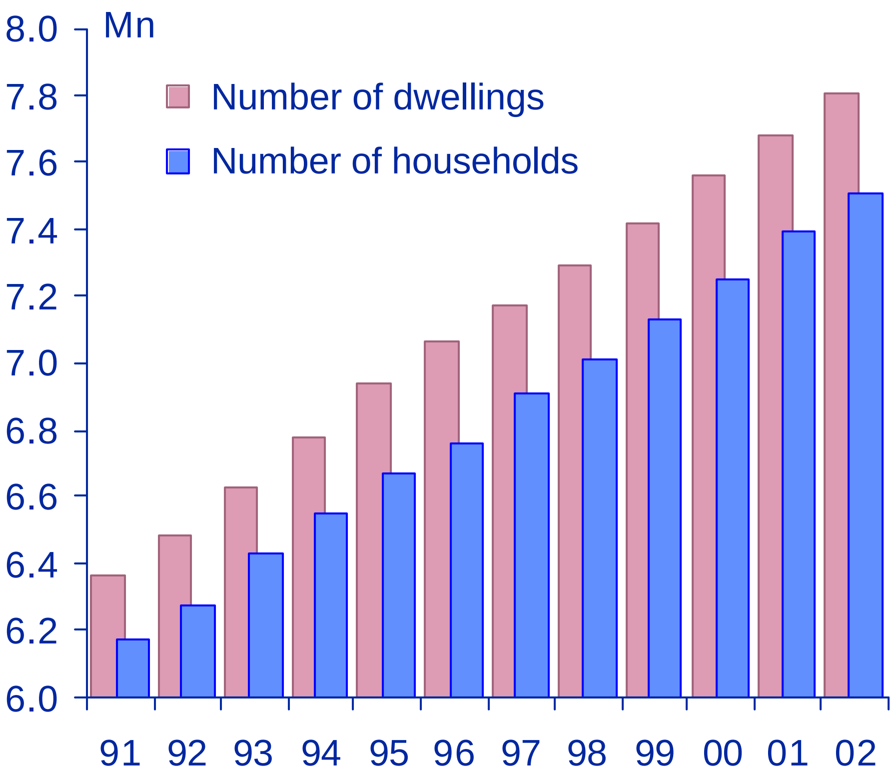
Queensland market balance



Note: 'Surplus' or 'shortage' is the cumulative difference between completions and underlying demand from an historical starting point. The direction of movements in this measure is more significant than the level. *Sources:* ABS; Economics@ANZ.

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

Number of households and number of dwellings

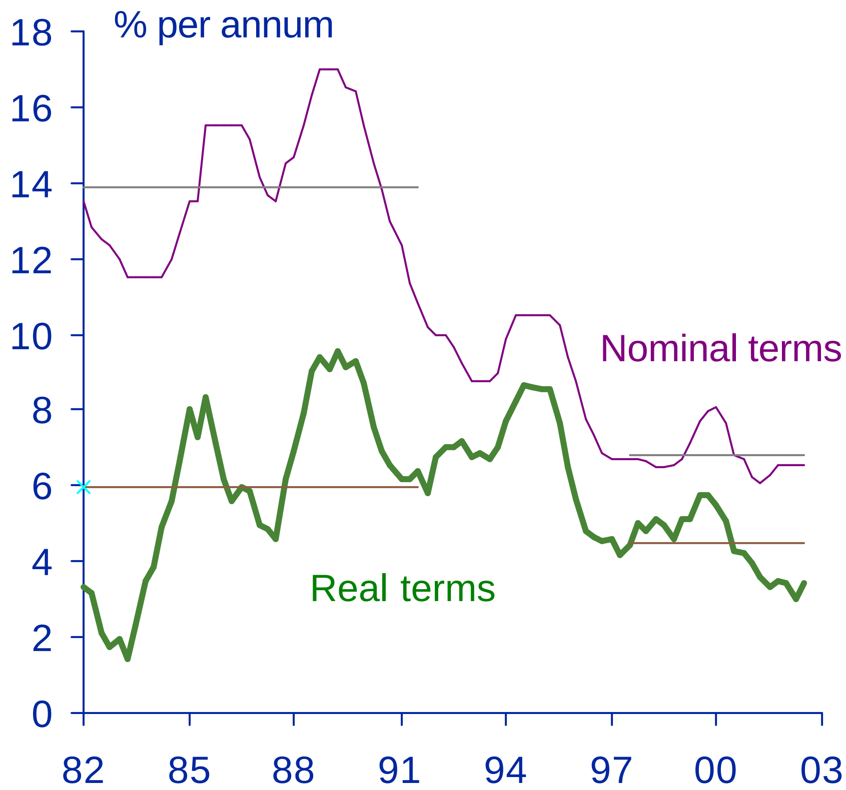


Note: Dwelling stock estimates for 1991, 1996 and 2001 based on census figures; other years interpolated using completions data. *Sources:* RBA; ABS; Economics@ANZ.

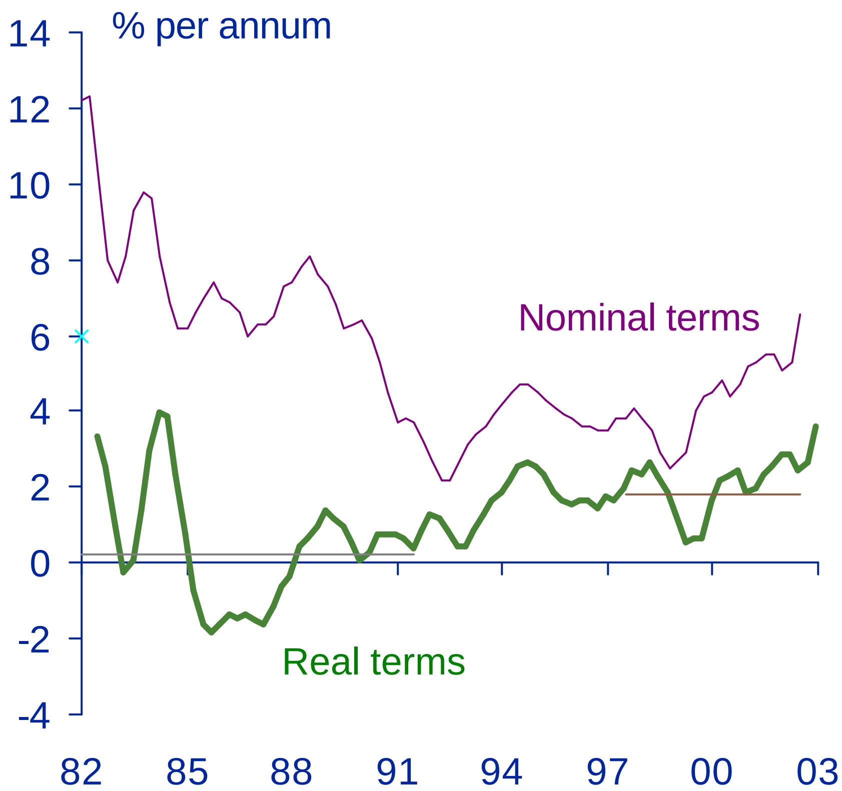
- **Over the ten years to 2001-02, the number of households rose by 1.34 million or 22%**
  - **faster than the increase in population (13.5%) because of falling average household size**
- **Over the same period, the stock of housing increased by 1.32 million or 20%**
  - **1.45mn new dwellings were 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

Standard variable mortgage rate



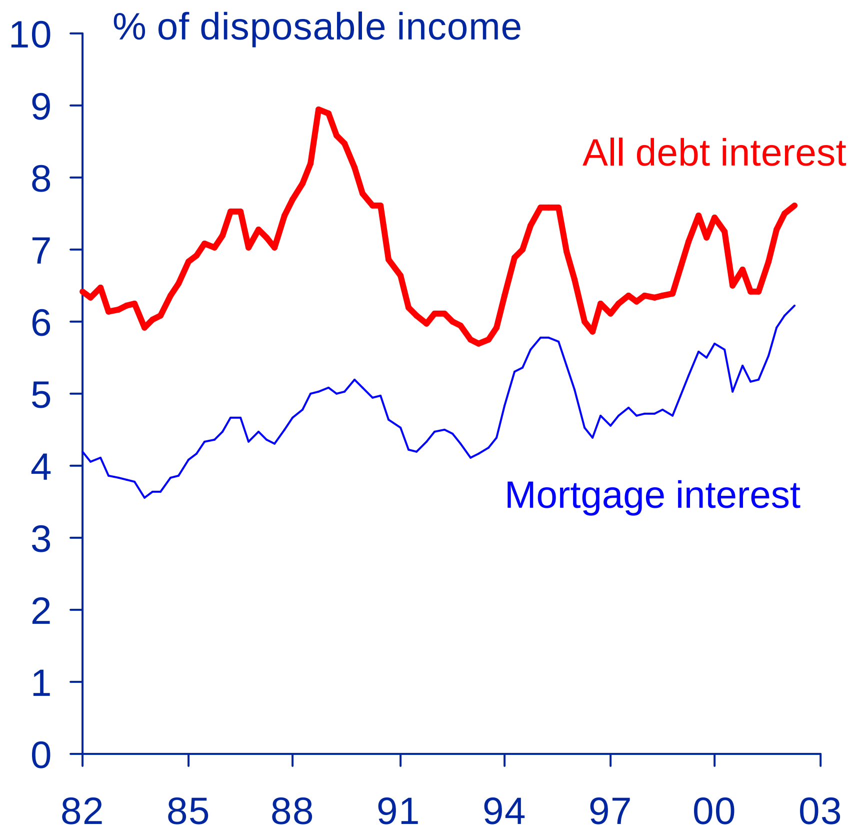
Average weekly earnings



Sources: RBA; Economics@ANZ.

Lower interest rates and higher incomes have enabled borrowers to service much higher debts

Interest payments as a share of disposable income



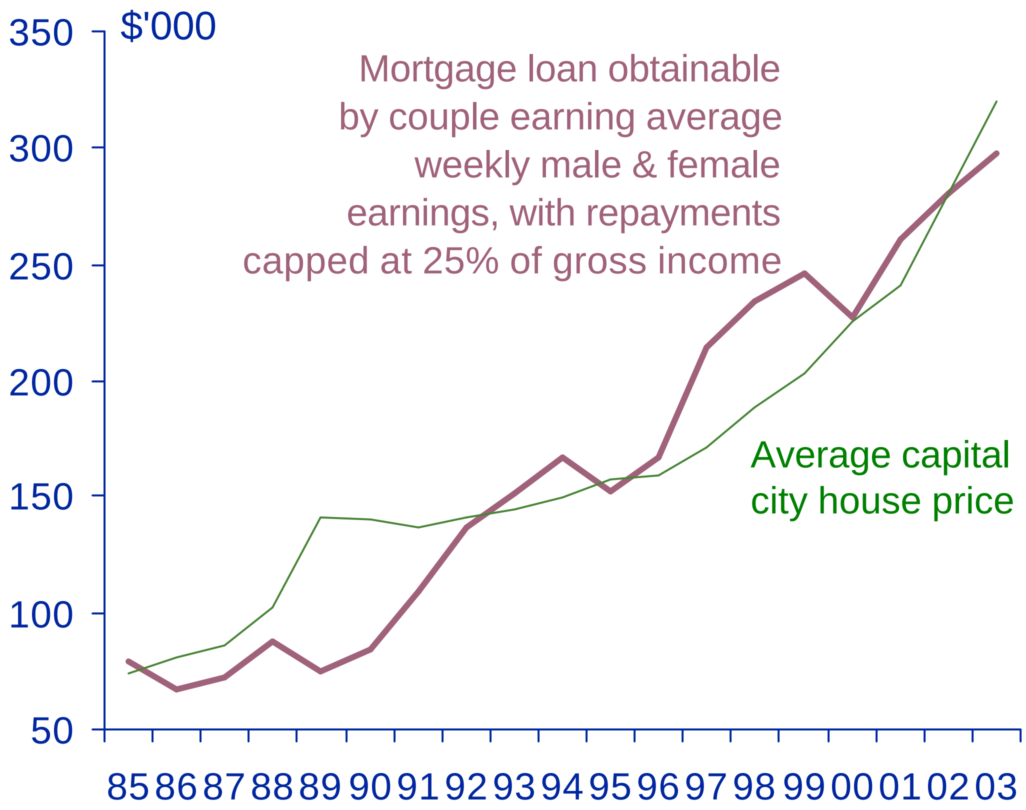
Sources: RBA; Economics@ANZ.

- **While debt has more than doubled as a percentage of household income, interest payments are below their late 1980s peak relative to income**
- **A recent RBA study of detailed household debt data* finds 'little evidence that Australian house-holds are now significantly more financially fragile than in the past'**
- **Aggregate household debt-servicing capacity may be now approaching a 'natural limit'**

* G. La Cava & J. Simon, "A Tale of Two Surveys: Household Debt and Financial Constraints in Australia", Research Discussion Paper 2003-08.

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.

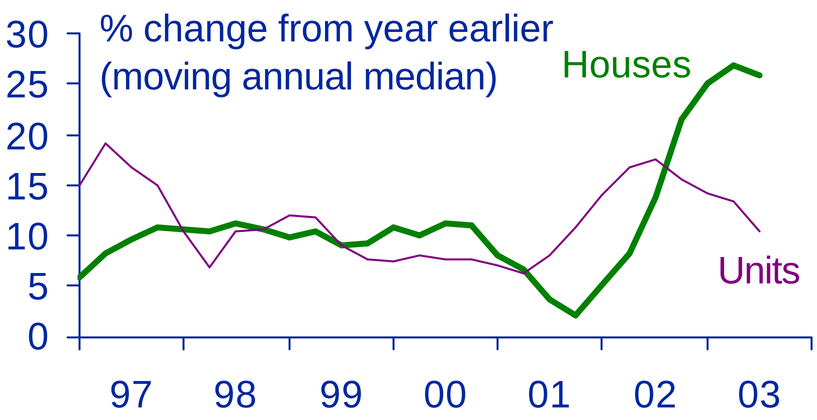
- **Over the past 12 years average incomes have risen by 63% while the mortgage rate has fallen by about half**
- **The borrowing capacity of an average-income household has risen by nearly 175% as a result**
- **With no net increase in the stock of dwellings this increase in 'purchasing power' has been 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>**

Based on these 'fundamentals', property prices should now be starting to level out

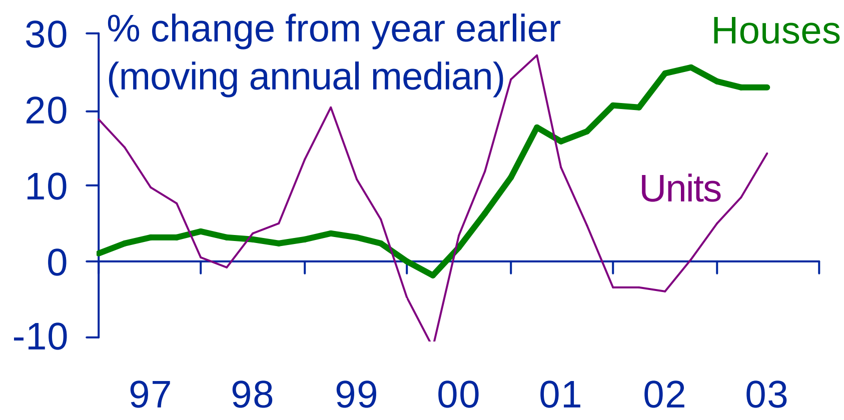
- Historically, periods of rapidly rising house prices have been terminated by sharp increases in interest rates (or, pre-1980s, interruptions to the supply of finance) combined with abrupt increases in unemployment
  - neither of which seems likely to occur in the foreseeable future
- However the big '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

In Melbourne, where the current boom started, prices do appear to be levelling off

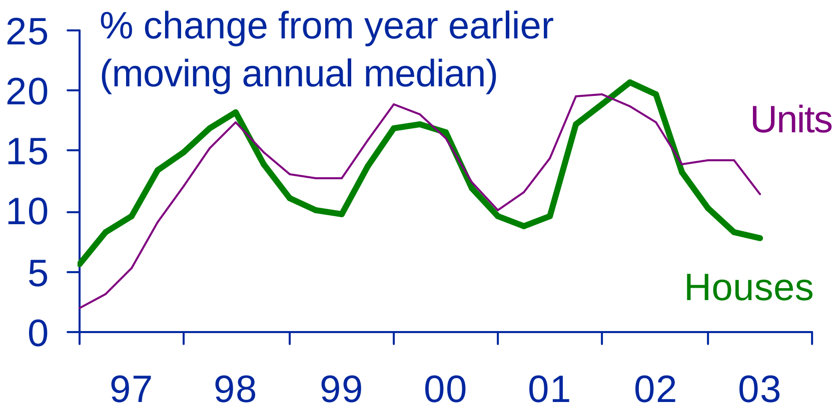
Sydney prices



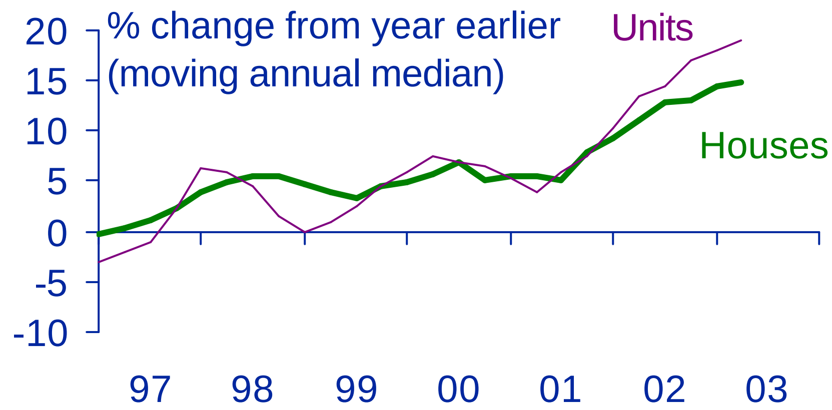
Brisbane prices



Melbourne prices



Other capitals prices



Sources: REIA; Economics@ANZ.

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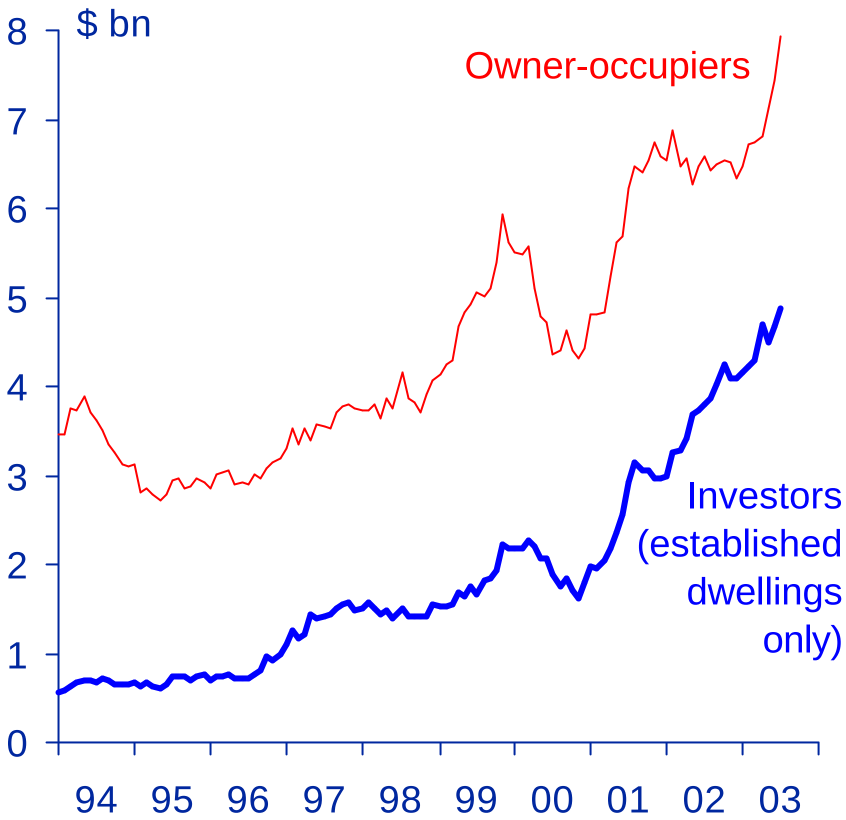
History suggests almost every bubble starts with a ‘justified’ shift in prices

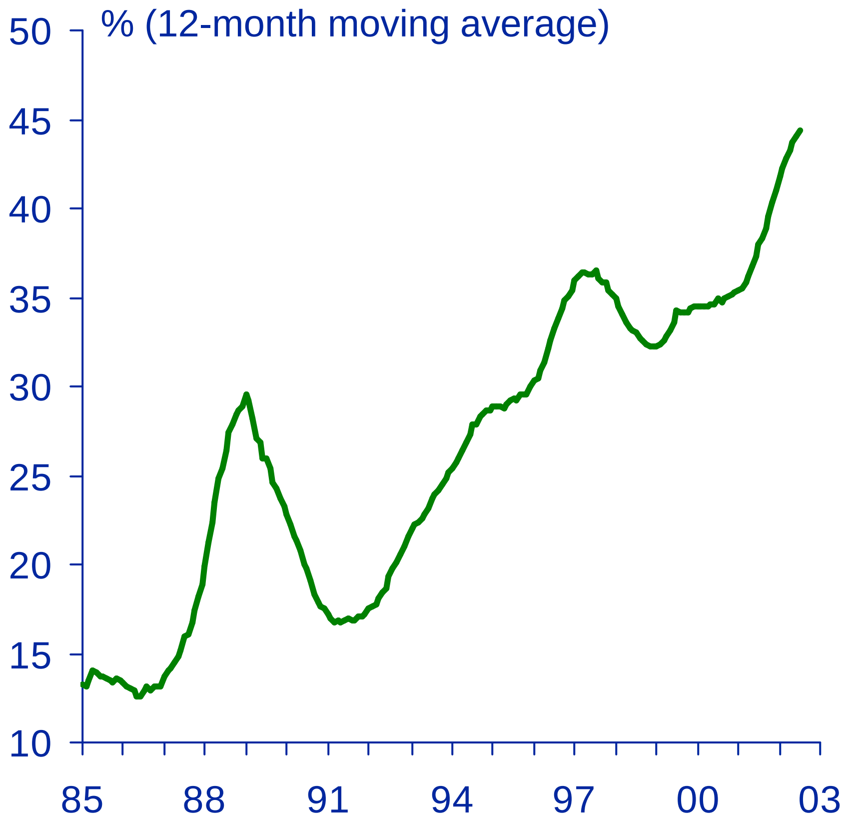
- ‘Bubbles’ occur when what begins as a fundamentally justified increase in the price of an asset becomes widely misperceived as a permanent increase in the rate of change of that price
  - attracting speculative investment, as opposed to ‘genuine’ demand
  - ‘bubbles’ attract new participants – as both promotors 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



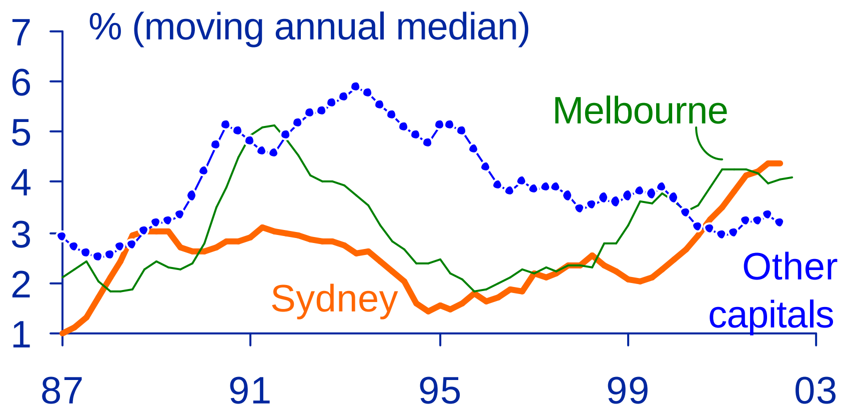
Investor loan approvals as a share of total housing finance



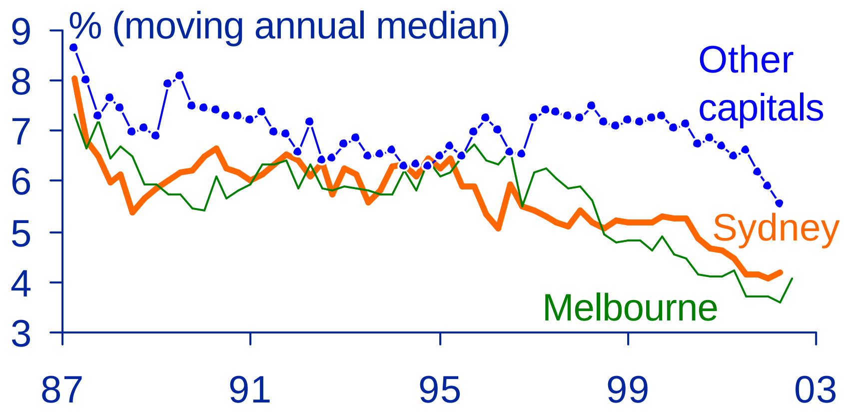
Sources: REIA; ABS; Economics@ANZ.

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

Rental vacancy rates



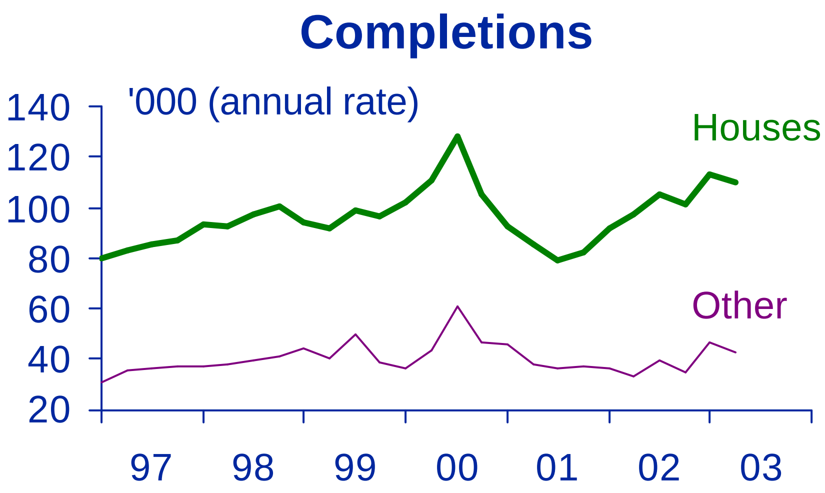
Rental yields - units

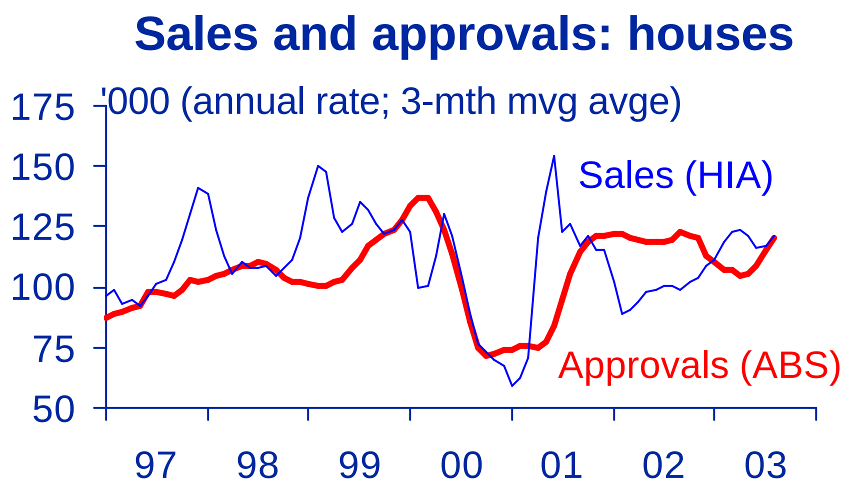


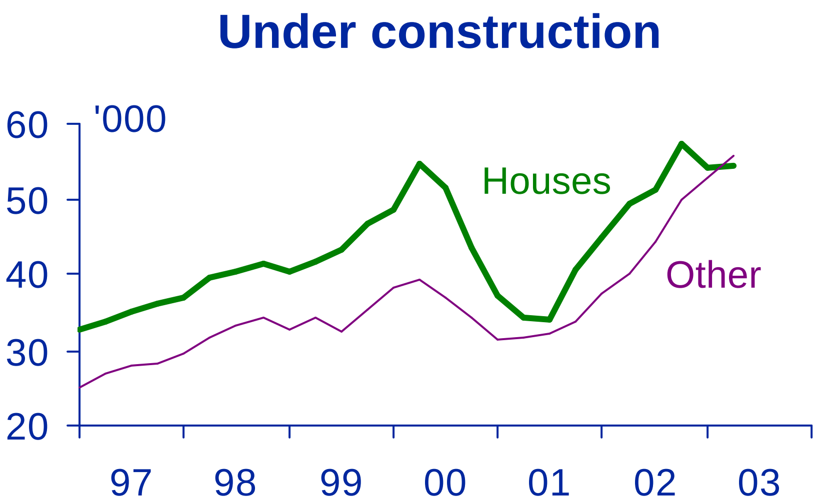
Sources: REIA; Economics@ANZ.

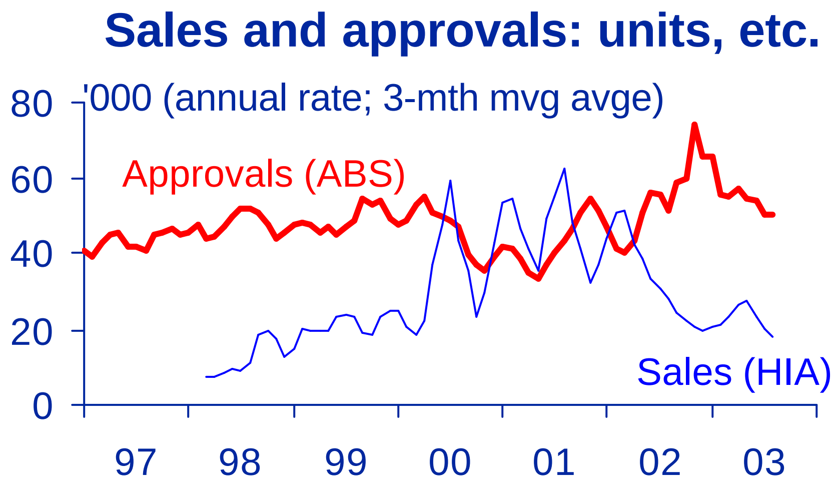
- **By definition, owner-occupiers face zero vacancy rates and rarely sell when faced with the prospect of declining house prices**
- **Owner-occupiers are thus an inherently stabilizing force in property markets – except during periods of rising interest rates and unemployment**
- **But investors may 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**

Looming short-term ‘over-supply’ of apartments may co-exist with shortage of other housing types





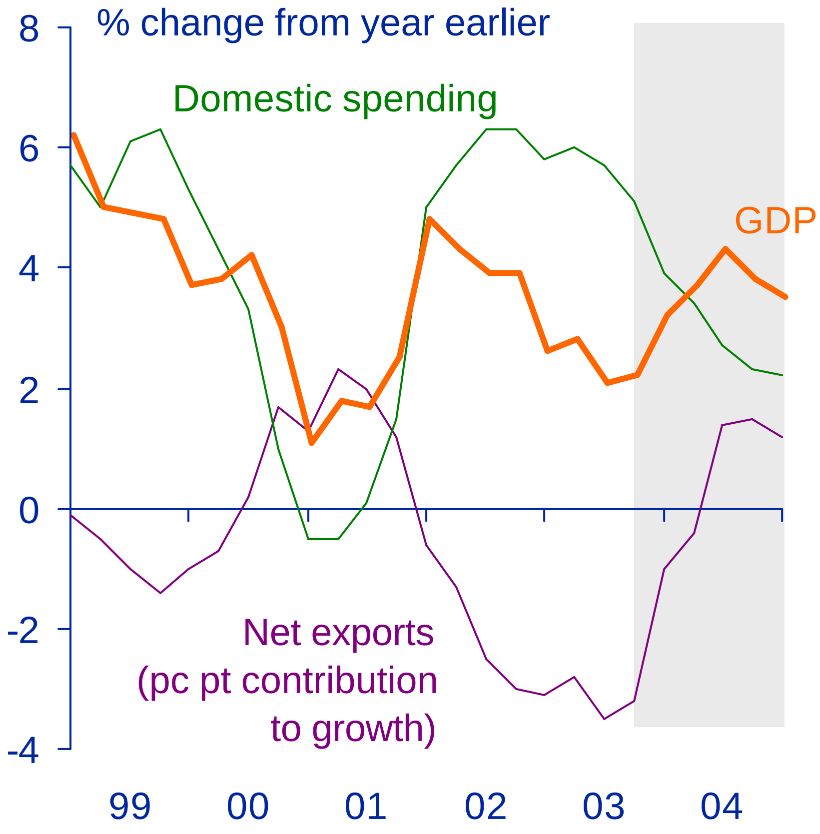




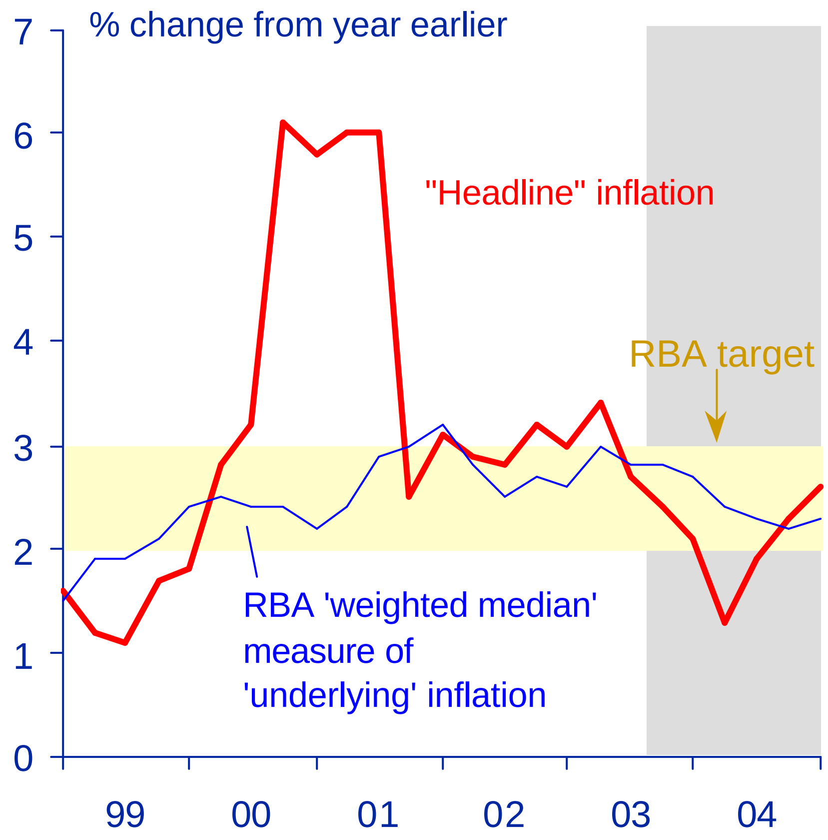
Sources: ABS; Housing Industry Association (HIA); Economics@ANZ. Data for private sector only.

Unbalanced growth has greatly complicated the Reserve Bank's job of setting monetary policy

Australian economic growth



Annual inflation rate



Sources: ABS; Economics@ANZ

The Reserve Bank is becoming more worried about rapid growth in debt and house prices

‘Currently, credit to the household sector is growing … well in excess of what could be considered sustainable in the medium to longer term. Much of this is … fuelling a rate of housing price increases of the order of 20-25% …

…. The risk presented by these developments is that, the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn’

– ***Statement on Monetary Policy*, 11 August 2003**

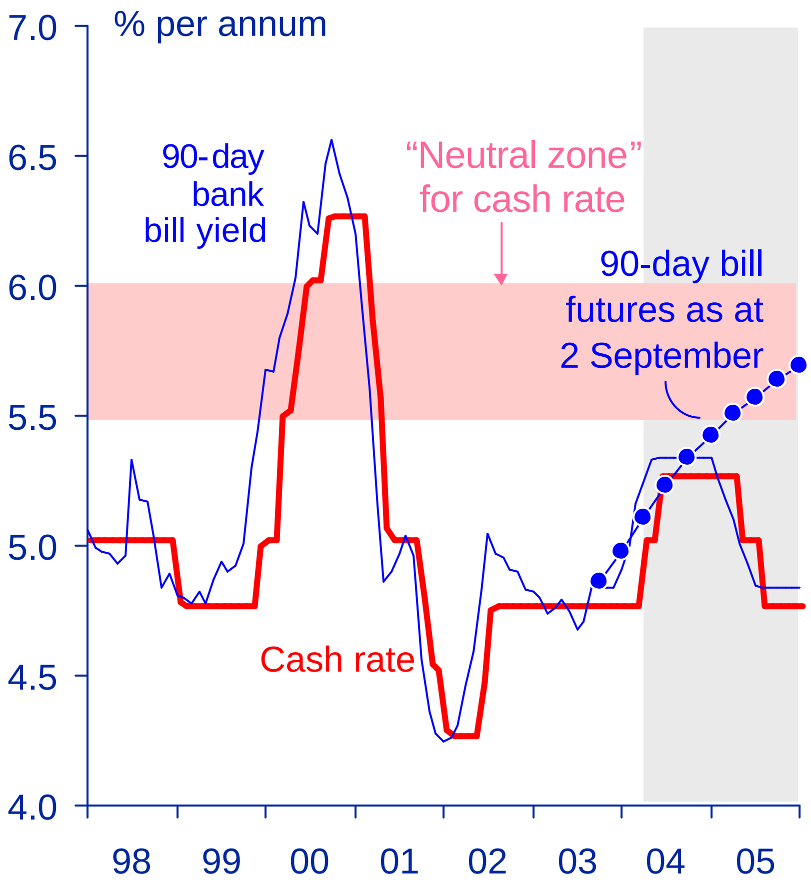
‘Over the past year or two, we have become less confident that a sensible one-time balance sheet adjustment should still be continuing …

… is there something occurring which is increasingly likely to be a misalignment, a subsequent reversal of which could prove to be disruptive? And if so, is there some monetary policy course which, while possibly involving some short-run cost to economic activity, would reduce the risk of a bigger loss … later?

– **Glenn Stevens (Deputy Governor), speech on 30 August 2003**

Interest rates will rise modestly next year, probably in the first half

Short-term interest rates



Sources: Reuters; Economics@ANZ.

- **The Reserve Bank has held off from raising interest rates over the past 12 months**
  - **reflecting its concern at the impact of drought and weak global growth**
- **With the global economy picking up and the drought largely over, the RBA will start giving greater weight to continuing rapid growth in credit**
- **The statement in their latest report that 'below trend growth and inflation below the target mid-point does not of itself' warrant lower interest rates' is very significant**
- **Two rate rises totalling ½ pc point are likely over the first half of 2004**
  - **unless credit growth slows decisively over the remainder over this year**

Other policies could help improve affordability – but some 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

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
  - constraints on the rate of growth of housing supply relative to growth in the number of households
- The 'price level shift' warranted by these factors has now largely occurred, so property prices should, in general, start to 'level out'
  - if they do, then the medium-term outlook for housing activity is very promising
- However there is a growing risk that this shift in the level of prices may continue beyond what is 'justified' by 'fundamentals'
  - the growing presence of investors in property markets may be a sign of mis-conceived expectations regarding future price rises
- Hence there is a (small but growing) risk that the boom of the past few years could be extended and ultimately end in a 'bust'
  - this risk is looming larger in the Reserve Bank's thinking
- Policy should focus on measures to improve housing supply
  - measures aimed at 'improving affordability' just lead to higher prices