How much of a threat is housing to the Australian economy?

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One of the features of the Australian economic commentary landscape over the past two decades has been the regular flow of dire warnings from foreign observers of an imminent collapse in Australian housing prices.

The widely-read and respected magazine *The Economist* has been a regular source of these, from at least as early as 2003 (when it forecast a 20% fall in Australian property prices over the following four years), up to as recently as May last year.

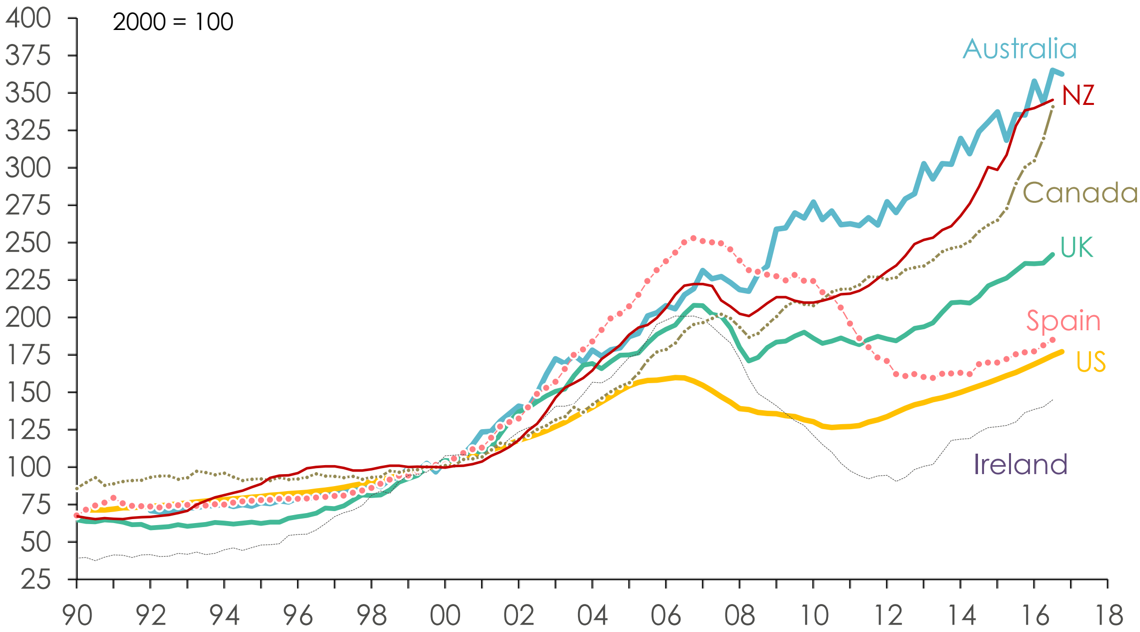
Citigroup's Willem Buiter, SocGen's Albert Edwards, GMO's Jeremy Grantham, American-based demographer Harry Dent and perennial uber-bear Marc Faber, among others, have at different times over the past decade drawn attention to the 'over-valued' Australian housing market, and forecast imminent or eventual sharp declines, often with serious usually with sequences for the stability of the Australian banking system and for the broader Australian economy.

They've often been joined by locals, including Steve Keen, Lindsay David, Jonathan Tepper of Variant Perception and Bronte Capital's John Hempton.

None of these and other dire predictions have, as yet, been validated by subsequent events.

That doesn't mean that they have been entirely without foundation, however. There's no denying that residential property prices in Australia's largest cities – and in particular, Sydney and Melbourne – have risen dramatically since the 1990s, and that they are now very high by both historical and international standards (Chart 1).

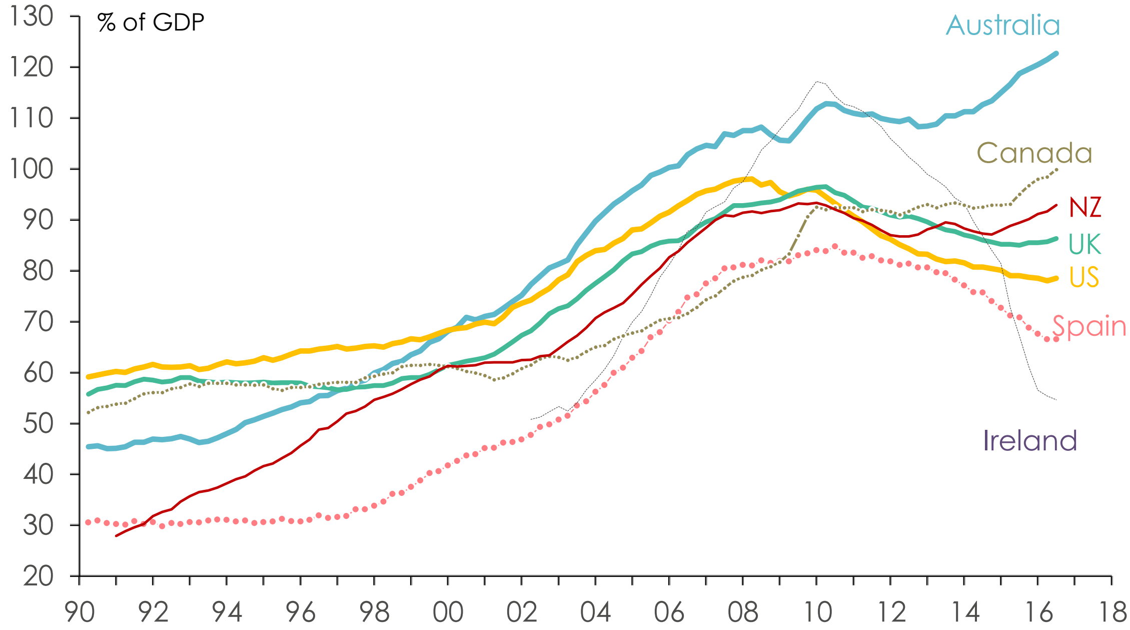
Chart 1: Residential property prices – Australia and selected other countries



Sources: CoreLogic; Bank for International Settlements.

Nor is there any denying that this inflation in Australian house prices has been accompanied by a similarly striking increase in household debt – an increase which, moreover, has continued almost unabated over the past 25 years, in contrast to the experience in some other countries (Chart 2).

Chart 2: Household debt – Australia and selected other countries



Source: Bank for International Settlements.

The substantial increase in Australian household debt has been both a cause and a consequence of the rise in property prices over the past quarter of a century.

Lower interest rates, more readily available credit, and distortions in Australia's tax system have enabled and encouraged households to take on more debt in order to acquire property – which, combined with the strong 'underlying' demand for housing associated with a rapidly growing population has driven property prices inexorably higher. As a result, those wanting to acquire property – whether as owner-occupiers or as investors – have been obliged to take on more debt, in order to fulfil their aspirations.

The ongoing inflation of Australian residential property prices is by no means the unalloyed Good Thing which politicians, real estate agents and many others typically claim. Yes, it has been a source of increased wealth for many Australians. But it has also been a source of greater inequality, especially between those who own property and the increasing proportion of Australians who don't. The home ownership rate at the most recent Census, in August 2016, was lower than at any Census since 1954. One of the core assumptions on which Australia's retirement income system rests – that the vast majority of retired people will own their homes outright, and as a result have very low housing costs – is becoming increasingly invalid.

Against that background, I think it *is* a Good Thing that, in most of Australia's capital cities, housing prices appear to have peaked, and in some cases have begun to decline.

However, none of this makes it likely, probable, or inevitable that Australia will, sooner or later, experience a housing 'crash' of the sort repeatedly foretold by commentators such as those mentioned earlier.

Housing prices aren't subject to the law of gravity – there's nothing in either theory or practical experience which says that, when it comes to property markets, What Goes Up Must Come Down.

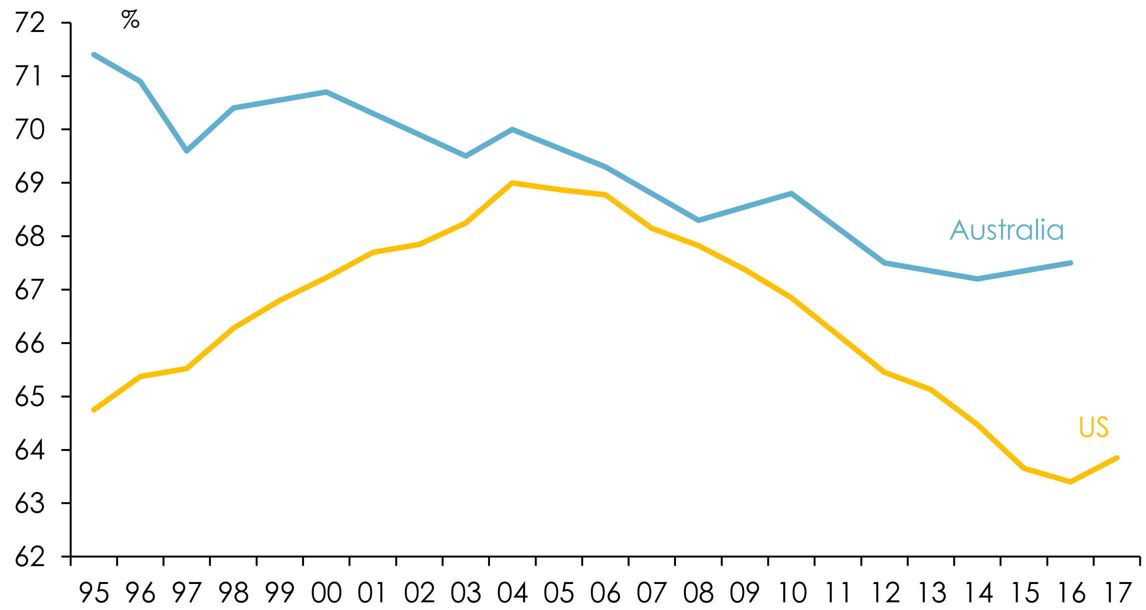
The experience of those countries which *have* experienced a housing price 'crash' – such as the US, Ireland and Spain (see Chart 1 above) – tells us that there are two 'pre-requisites' which have to be satisfied in order that something like this takes place.

The first is that there has to be a sufficiently large number of 'forced sellers' – that is, property-owners who are *have* to sell their properties, at whatever prices buyers are willing to pay, because they can no longer keep up the financial obligations associated with remaining as owners.

That usually happens when, during a boom, a large cohort of marginal borrowers manage to acquire properties, but become unable to keep up their mortgage repayments because interest rates or unemployment (or both) rise sharply.

That was certainly the case in the United States, where one of the defining characteristics of the pre-crash housing 'bubble' was the proliferation in 'sub-prime' lending. That allowed many people who had hitherto been unable to access mortgage finance to become home-owners, thus leading to a rise in the home ownership rate – something which was widely acclaimed in the US at the time. (Chart 3).

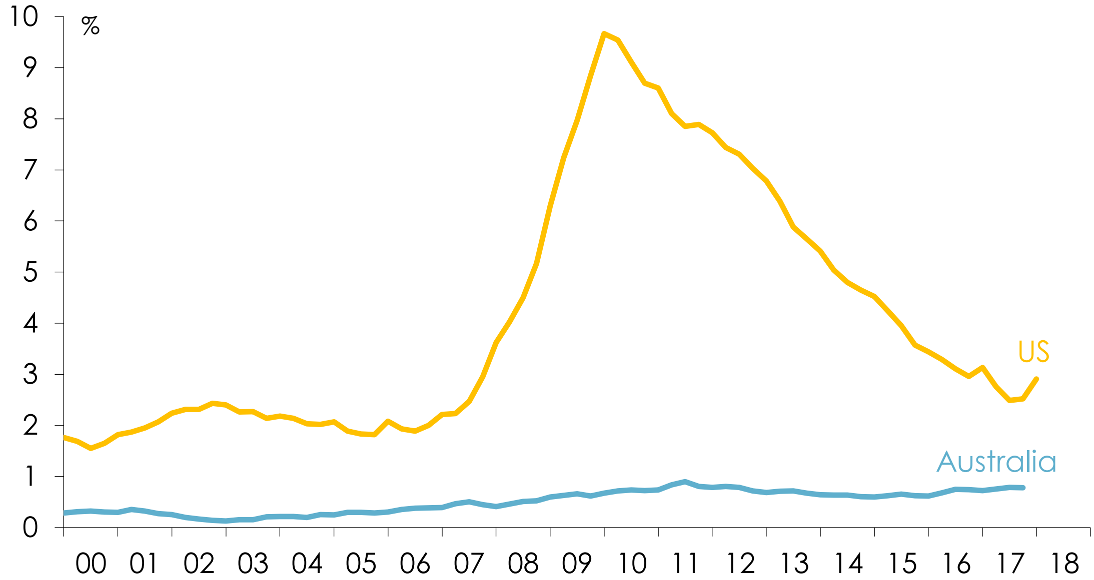
Chart 3: Home ownership rates – United States and Australia



Sources: ABS; US Department of Commerce.

But it also meant that, when the concessional introductory terms on which many of these loans were granted began to expire, and when the general level of US interest rates started to rise, a large number of these new home-owners, and others who had been pure speculators, began defaulting on their loans – something made easier in the US by the widespread use of 'non-recourse mortgages' – leading in turn to a significant increase in the number of 'forced sales' of properties, putting significant downward pressure on prices (Chart 4).

Chart 4: Mortgage delinquency rates – United States and Australia



Note: Series for Australia is banks' 'past due' and (after September 2003) 'impaired' mortgages; for US is all mortgages 'seriously delinquent'. *Sources:* APRA and RBA; Mortgage Bankers' Association of America.

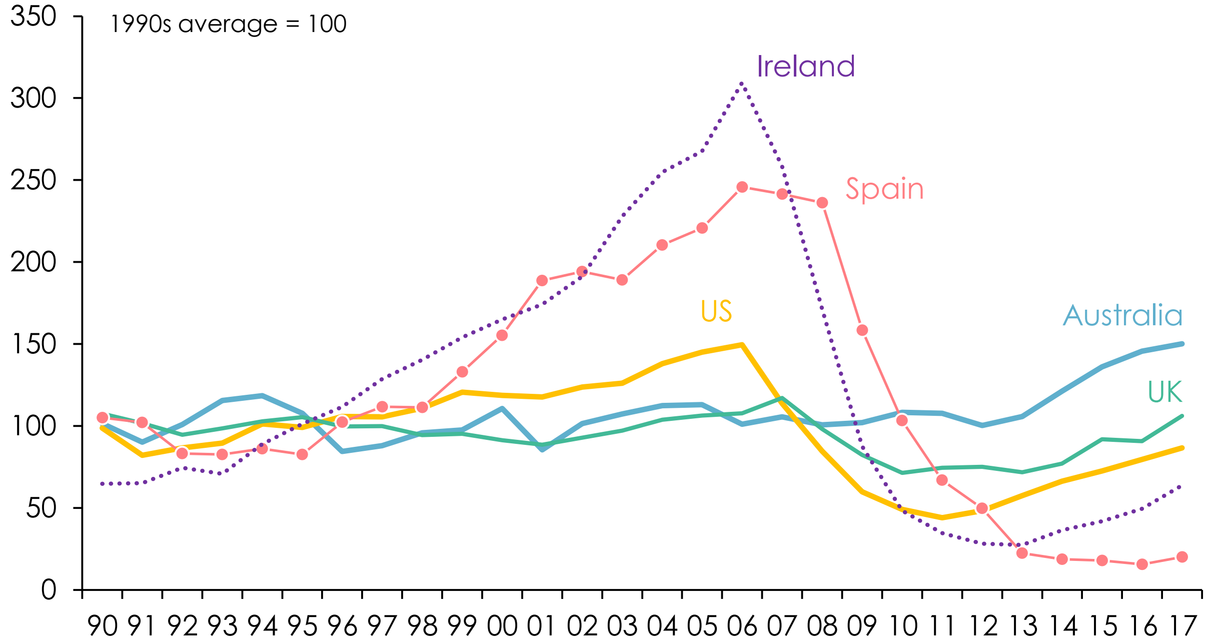
By contrast, in Australia, as noted earlier, the home ownership rate has been declining since the early 1990s (Chart 3); while mortgage delinquencies have always been much lower in Australia than in the US (Chart 4), even during the years immediately before the onset of the financial crisis, when the standard variable mortgage rate peaked at 9.6%, far higher than mortgage rates ever rose in the US during this period.

Australia's legal system makes default a much less 'easy' option (for borrowers) than it is in the US. More importantly, although they've been by no means faultless, Australian mortgage lenders have been much more prudent in their lending practices than their American counterparts, and Australian regulators have been much more effective in regulating lending practices than their American peers. And, as the Reserve Bank has repeatedly pointed out, most recently in a speech by Assistant Governor Michelle Bullock, a large proportion of Australian borrowers have used the recent period of record low interest rates to build up 'buffers' against future interest rate increases.

The second 'pre-condition' which international experience suggests is required for there to be a housing price 'crash' is for there to be a significant 'excess supply' of housing, as a result of new dwelling completions having exceeded the growth in the 'underlying' demand for housing by a wide margin over an extended period.

That was certainly the case in the US during the years leading up to their housing 'bust' – and it was an even more prominent characteristic of the booms in Spain and Ireland (Chart 5).

Chart 5: Housing completions – Australia and other selected countries



Note: 2017 data for Australia, UK and Ireland are first three quarters at annualized rates.
Sources: ABS; US Commerce Department; UK Office for National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office.

But it didn't happen in the UK – which hasn't so far had a 'housing bust'. And it hasn't thus far happened in Australia, notwithstanding the record level of dwelling completions in recent years, on anything like the scale that it did in Ireland and Spain, or even the US. Moreover, the increase in dwelling supply which has occurred in Australia in recent years has been overwhelmingly concentrated in apartments – whereas completions of detached dwellings (which still accounts for the bulk of the housing stock in Australia) have been very little changed from historical norms.

Of course, if mortgage interest rates were to rise sharply in Australia at some point in the future, then it's conceivable that a sufficiently large number of property owners could become 'forced sellers'. However, it's in part for precisely that reason that the Reserve Bank is unlikely to engineer a sharp rise in interest rates – as would be required for mortgage rates to rise sharply enough to prompt a wave of 'forced' selling.

And if Australia's immigration intake were to be lowered sharply – thereby significantly reducing the 'underlying' demand for housing – that could lead to the emergence of a large enough 'excess supply' of housing to exert meaningful downward pressure on property prices, if it were also accompanied by a significant volume of sales. However, while there have certainly been calls from some quarters for a substantial reduction in Australia's immigration programs, these don't appear to have attracted widespread support.

In short, while it would be foolish to say that there is *no chance* of a 'housing bust' in Australia – and I'm *not* saying that – it does seem a low-probability scenario. And it's certainly not one on which bond investors should be basing their portfolios, anticipating a renewed fall in interest rates in a desperate attempt to stave off, or mitigate, the consequences of a 'housing bust'.