



The Real Estate Institute of Australia
**Australian House prices: Bursting the
Bubble Myth**

*Prepared by the Real Estate Institute of Australia
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Australian House Prices Bursting the Bubble Myth

Introduction

In the aftermath of the U.S. housing crisis, there has been speculation by some analysts as to whether or not Australia's residential property market is experiencing a housing bubble, focusing their attention on the house price-to-income ratio in Australia and generally observing that it is high compared to other countries and, more importantly, that it is at levels similar to those in the US before prices crashed. Prompting such speculation is the observation that since 2003 the price-to-income ratio in Australia has been more than 40 per cent higher than the long term average. The most notable proponent of an imminent US style housing crash in Australia has been Jeremy Grantham, the chief investment strategist of Boston based fund manager GMO.

This paper indicates that the house price-to-income ratio is not an accurate and sufficient indicator of housing overvaluation, and that other house-price determinant fundamentals need to be considered.

Further, the speculation ignores the role the U.S residential finance system played in the housing bubble and the differences in lending practices between Australia and the U.S. Unlike the U.S, the regulatory provisions of the residential finance system in Australia results in the financial institutions behaving prudently and avoiding excessive risks.

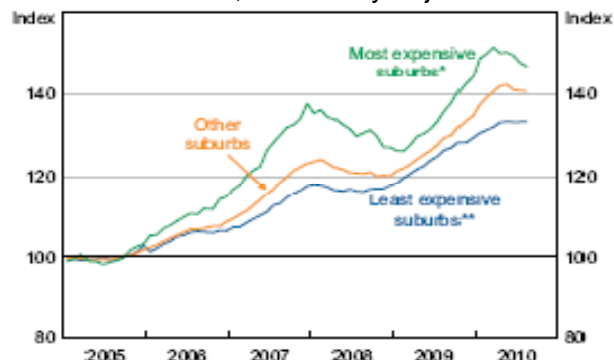
House price-to-income ratio

The house price-to-income ratio, which is generally calculated using average income, is not an accurate and sufficient indicator of housing overvaluation as it is an average measure that covers the whole population, whereas house prices are determined by a set of buyers whose incomes, and thus the ability to service loans, are most likely to be higher than the population average income¹.

Chart 1 shows that price increases in the most expensive suburbs have been greater than those of other suburbs, in particular the least expensive ones. This suggests that the growth of dwelling prices observed in Australia over the last five years has been mostly driven by dwelling prices in the most expensive suburbs, where commonly home buyers are higher income earners. The use of the averages in the house price-to-income ratio does not pick up the distributional differences.

¹ Recent House Price Developments: The Role of Fundamentals (2006). *OECD Economic Papers*.

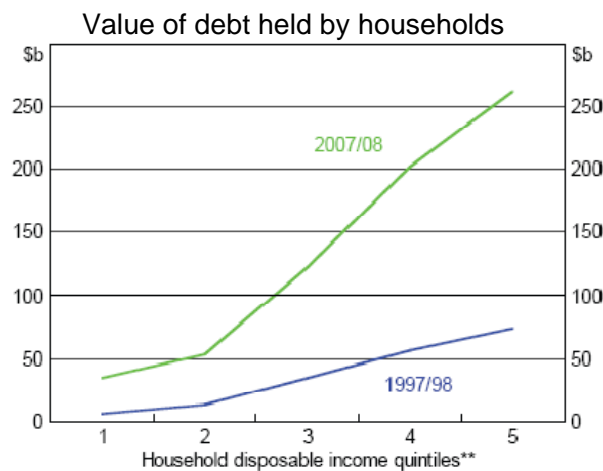
Chart 1: Capital City Dwelling Prices
2005=100, seasonally adjusted



Source: RBA

Chart 2 which indicates the distribution of debt by income, shows that the largest increases in owner occupied debt over the past decade has been at the upper end of the income distribution². This provides further supporting evidence that the average household's vulnerability has not changed dramatically since the increase in the average house price-to-income ratio.

Chart 2. Owner-Occupier-Debt



Source: RBA

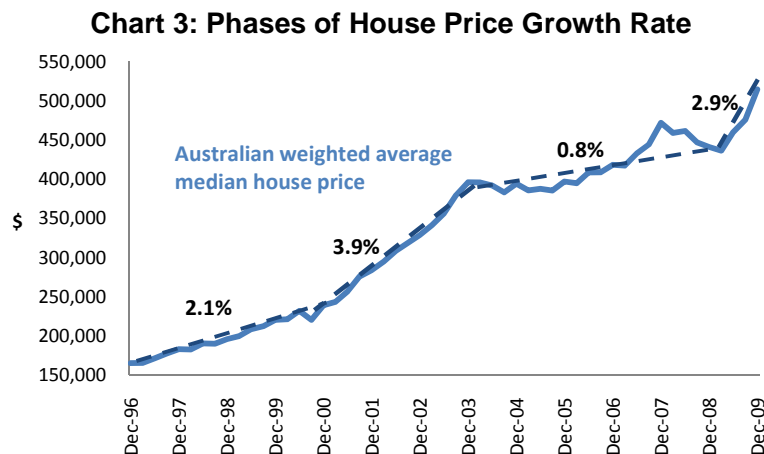
Australian house prices and the fundamental influences

Chart 3 which shows Australian weighted average median house prices, indicates that around the upward trend there have been four distinct phases:

- December 1996 to September 2000, house prices quarterly average growth rate was 2.1 percent
- September 2000 to December 2003, house prices quarterly growth rate accelerated to 3.9 percent

² Bartellino, R (2010). Aspect of Australia's Finances. Reserve Bank of Australia

- December 2003 to December 2008, house prices quarterly growth rate decelerated to 0.8 percent
- December 2008 to December 2009, house prices quarterly growth rate accelerated again to 2.9 percent.



Source: REIA

These four phases relate to movements in mortgage rates, returns from the stock market, as well as median family income. As seen in Table 1, changes in mortgage rates, stock returns and income all influence house price growth.

Table 1: Mortgage Rates, Stock Returns and Phases of House Prices Growth Rate

Phase	House Prices quarterly average growth rate (%)	Monthly average mortgage rates (%)	Average annual stock returns (%)	Median Family Income quarterly average growth rate (%)
Dec96-Sep00	2.1	7.0	9.8	0.9
Sep00-Dec03	3.9	6.8	0.1	1.3
Dec03-Dec08	0.8	7.8	11.4	1.1
Dec08-Dec09	2.9	6.1	-13.6	1.5

Source: REIA calculations, Cannex, ASX, ABS

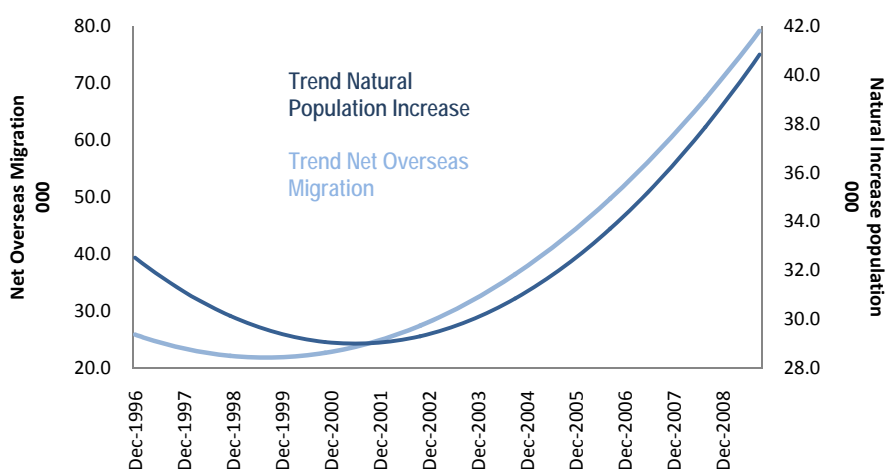
Over the period September 2000 to December 2003, the quarterly average house price growth rate increased to 3.9 percent while the monthly average mortgage rates fell to 6.8 percent, and average annual stock returns declined to 0.1 percent. Similarly, in December 2003 to December 2008 the quarterly average house price growth rate declined drastically to 0.8 percent while average stock returns rose significantly from 0.1 percent to 11.4 percent, and monthly average mortgage rates increased 1.0 percentage points. In the last phase, average annual stock returns decreased severely from 11.4 percent to 13.6 percent, and monthly average mortgage rates fell by 1.7 percentage points, whereas the house price growth rate accelerated to 2.9 percent.

During 2010 average monthly mortgage rates and average annual stock returns have risen to 7.1 percent and 3.5 percent respectively. This, along with the removal of Government incentives, has caused the deceleration of the quarterly average house price growth rate to 1.8 percent.

In addition to this house prices have been underpinned by a chronic housing shortage brought about by large population growth and constraints on housing supply. Chart 4 shows the increase in population growth from both natural growth and migration since the beginning of the present decade. From September 1995 to September 2002 natural population growth declined 16.9 percent, but from September 2002 to September 2009 natural population grew by 51.8 percent. Trends in migration have also shown significant change.

Between 1995 and September 2002, net overseas migration grew by 2.7 percent. However, during September 2002 to September 2009 net migration increased by 142 percent.

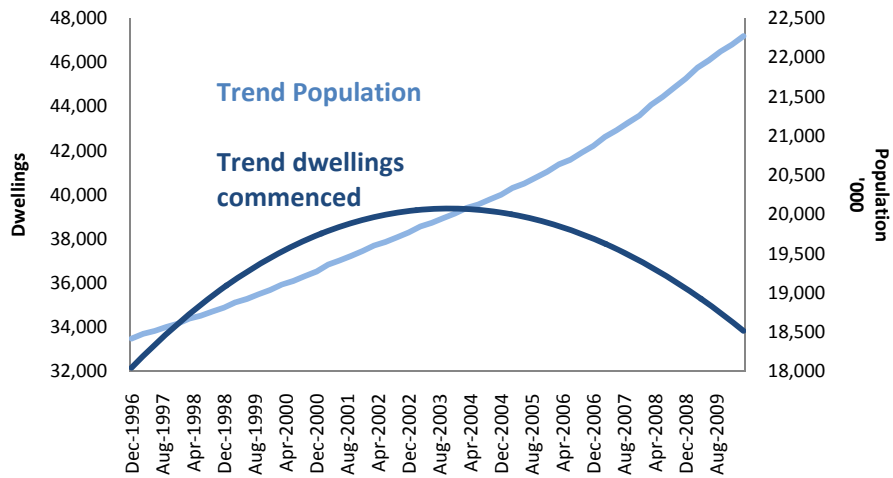
Chart 4: Trend of Natural Population Increase and Net Overseas Migration



Source: ABS

Chart 5 illustrates the trend in the population and dwellings commenced from December 1996 to March 2010. While the population showed an upward trend over the entire period, the number of dwellings commenced exhibited an upward trend from December 1996 to September 2003, but since then, it has shown a downward trend. With recent housing approvals declining this gap can only be expected to widen.

Chart 5: Trend in the number of dwellings commenced and population



Source: ABS

This has put upward pressure on house prices. According to the National Housing Supply Council (NHSC), the estimated dwelling gap for June 2009 was 178,400 and is expected to increase by 72.6 percent to 308,000 by 2014.

Table 2: Cumulative Demand-Supply Gap in Australia

Date	Cumulative Demand-Supply Gap
2010	202,400
2011	228,300
2012	254,800
2013	281,600
2014	308,000

Source: NHSC

Some aspects of the residential finance system in the U.S. and Australia

In the US excessive demand for housing finance by borrowers with poor borrowing capacities was aided by residential finance institutional arrangements, regulation and mortgage characteristics. This, consequently, led to the housing bubble and financial collapse in the U.S. By contrast, in Australia, the institutional arrangements and lending practices prompt financial institutions to behave prudently.

Table 3 outlines the characteristics of housing loans also in the U.S. and in Australia. The table shows that in the US riskier mortgages are very common.

Table 3: Mortgage Characteristics

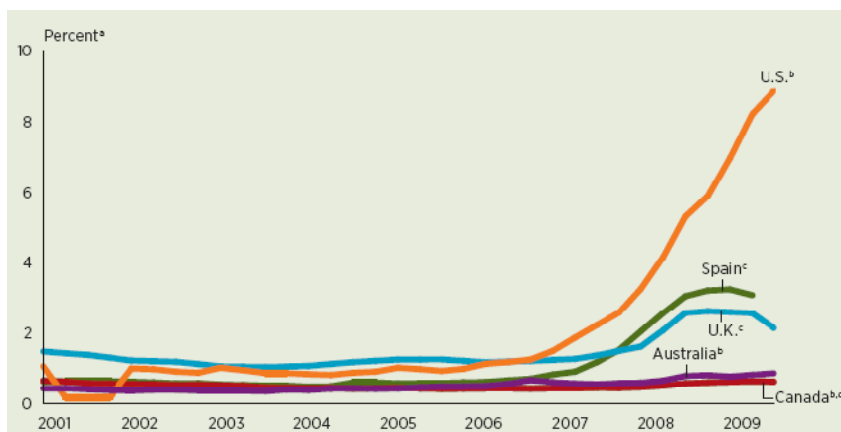
United States	Australia
Subprime loans	Non-conforming loans
Negative amortisation loans	No
Mortgages not full recourse	Mortgages full recourse
More flexible regulation on mortgage loans	Stronger regulation on mortgage loans
High use of securitization in the financing of housing	Low use of securitization in the financing of housing

Source: RBA

According to the RBA, in Australia non-conforming housing loans represented only around 1 percent of the mortgage market compared to around 13 percent in the U.S, where negative amortisation loans are also very common. In Australia where mortgages are “full recourse” lenders’ incentives to offer risky loans as well as households’ propensity to take out loans they cannot repay are reduced.

These differences contributed to the relative strong performance of housing loans in Australia compared to the US as shown in Chart 6. In Australia non-performing loans in Australia were less than 1.5 percent even during the on-set of the financial crisis.

Chart 6: Non-performing housing loans



Source: Research Institute for Housing America

A further difference between the financial systems of the two countries is the presence in the US of Government Sponsor Enterprises (GSE) and the “*implicit guarantee*” they hold. This generated the perception in the market place that all risks brought about by providing housing loans to borrowers with poor repayment capacity would be covered by the Federal Government³. GSEs held most of the mortgages issued by financial institutions. In 2007, the year when the crisis began, GSEs possessed 90 percent of these securities. This, coupled with the high participation financial institutions have in the “*shadow banking*” system⁴, lead to excessive risk practices in the U.S.

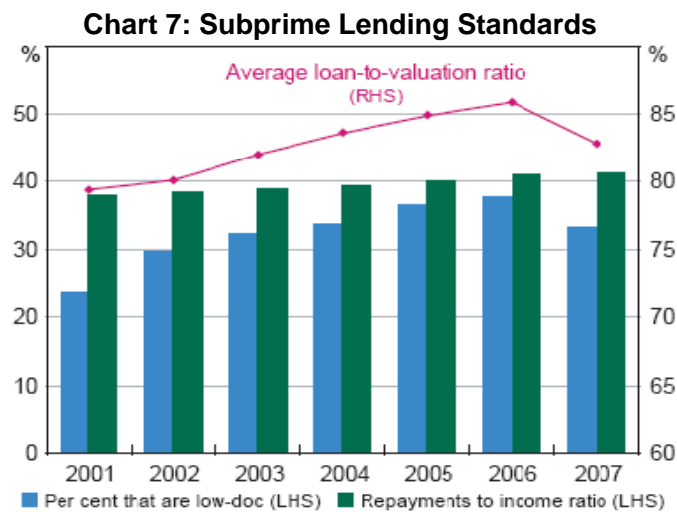
Australia’s financial system differs from the U.S in that there are no GSEs and banks, which provide around 90 percent of housing loans, obtain their funds mainly from deposits, short-

³ Carmassi, J, Gros, D and Stefano Miccossi (2009). *The Global Financial Crisis: Causes and Cures*.

⁴ Reserve Bank of Australia (September 2010). *Financial Stability Review*.

term and long-term wholesale debt⁵. The absence of this “*implicit guarantee*” mitigates Australian banks’ excessive risk behaviour. In addition, according to the RBA financial institutions that are not prudentially regulated constitute around 50 percent of the U.S financial system while in Australia they just represent 20 percent⁶.

As Chart 7 shows, average loan-to-valuation (LTV) ratios in the US increased simultaneously with the proportion of low-documentation loans, indicating that borrowers with undocumented income, no collateral and repayments requiring the bulk of income needed only a small deposit. In 2006, the LTV ratio reached a level above 85 percent, the proportion of low-documentation loan nearly 40 percent and the repayments to income ratio around 80 percent.



Source: RBA

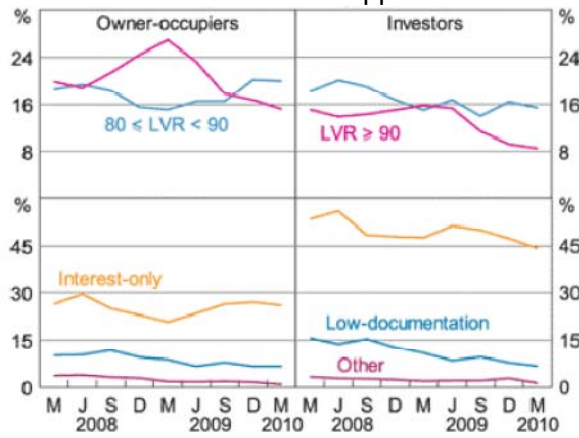
In comparison to the U.S, as shown in Chart 8, in Australia the proportion of loans with a LTV ratio above 90 percent has been below 30 percent and those with a LTV of between of 80 and 90 percent has been around 25 percent of new loan approvals. Similarly, the proportion of low-documentation loans in Australia is very low compared to that of the U.S. In Australia low-documentation loans have been below 15 percent of the total and the monthly home loan repayments were slightly above 30 percent of income⁷.

⁵ Brown, Davies, Fabbro and Tegan Hanrick (2010). Recent Developments in Banks’ Funding Costs and Lending Rates. Reserve Bank of Australia.

⁶ Financial Stability Review (September 2010). Reserve Bank of Australia.

⁷ REIA Deposit Housing Affordability Report, June quarter 2010.

Chart 8: Banks' Housing Loans Characteristics
Share of new loan approvals



Source: RBA

Conclusion

An analysis of the factors influencing Australia's house price movements and the lending practices of Australia's financial institutions suggests that a US style housing bubble in Australia is unlikely. Four house price growth rate phases have been identified and associated to changes in mortgage rates, stock returns and family income. The financial system regulation in Australia leads financial institutions to behave more prudently and to avoid excessive risks, contrary to their US counterparts.

REIA Secretariat
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