Why our regulators are losing sleep over housing

ANALYSIS

By business editor Ian Verrender

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There's nothing like the threat of impending disaster to focus the mind.

Suddenly, everyone is in furious agreement about the state of the Australian housing market or, more particularly, the Sydney and Melbourne markets. It's a bubble.

The problem, as is usually the case with bubbles, is that no-one really wants it to deflate, let alone allow it to burst. The consequences are unthinkable. And all the action so far taken to slow it has failed.

It has become a monster that no-one knows how to dispatch with most politicians instead focussing on affordability rather than the potentially catastrophic impact of a rapid unwinding.

PHOTO: The problem with bubbles is no-one really wants it to deflate or allow it to burst.
(ABC News: Giulio Saggin)

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A year ago, the Reserve Bank was in denial. House prices were under control, it claimed. Growth had moderated. Nothing to see here. That's no longer the case.

The notes from its meeting last month contained this gem: "Recent data continued to suggest that there had been a build-up of risks associated with the housing market."

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That may sound like an offhand remark, nonchalant even. Nothing to get overly concerned about.

But in Central Banker speak, a language usually delivered in soothing tones designed to keep everyone calm, that's downright alarmist.

Since then, the clouds have become even darker, which no doubt will occupy the minds of those on the Reserve Bank board when they meet tomorrow. And that is after more than two years of attempts to curb demand by imposing lending restrictions on investor home loans.

On Thursday, research group Corelogic revealed an acceleration in Sydney and Melbourne home prices. In the past year, Sydney had soared 19 per cent. Melbourne was up 14 per cent.

If there was ever any doubt about the increasingly desperate response to the problem, the banking regulator, the Australian Prudential Regulation Authority, put paid to that on Friday when it launched a new clamp down on interest only loans.

What defines a property bubble?

The Treasury secretary says Sydney and parts of Melbourne have one, but what defines a property bubble? Business reporter Michael Janda explains.

"This increased scrutiny has been in response to an environment of heightened risks, reflected in an environment of high housing prices, high and rising household indebtedness, subdued household income growth, historically low interest rates, and soaring competitive pressures," it said.

There it is in a nutshell. And there's that term again; "heightened risk". The problem is, it has all come a little too late and the regulators now appear to be at panic stations.

Why we've never had a major bust

Australian housing has been expensive for 20 years and plenty of pundits have stuck their necks out with predictions of an imminent crash.

The Economist newspaper first called Australian housing a bubble in 2003 and has been doing so ever since. You can't fault it for consistency.

But the bubble has only continued to inflate. The more out of whack it gets with reality, the greater the chance of a painful bust which explains the increasing desperation of regulators to curb the enthusiasm.

It hasn't been a continuous boom. Back in 2011, Australian housing prices slid around 10 per cent in the aftermath of the financial crisis, a point that few acknowledge.

Around that time, your diarist was ridiculed by the bears for suggesting that the property market wouldn't implode; that an orderly retreat was on the cards.

If only the slide had been allowed to continue. The downturn then was cut short by the Reserve Bank, which deliberately attempted to fire up the housing market with its rate cuts in an effort to boost east coast construction, to soak up the rapid scale back of jobs in the west as the mining construction boom unwound.

Since the 1960s, we've experienced several housing market booms. But there's never been a catastrophic meltdown in the aftermath.

Even during the most recent recession 25 years ago, which followed a sharp uptick in real estate in the late 1980s, Australian property prices merely plateaued, repeating a pattern of previous downturns.

That was despite a massive hike in interest rates, when banks were charging 18 per cent or more for mortgages, elevated unemployment and a contracting economy.

One reason was that willing sellers simply retreated. They refused to accept a lower price and just hung on. That reduced supply of stock on the market kept prices elevated.

Even those in desperate financial straits, some of whom were laid off during the recession, did almost anything to maintain mortgage payments to avoid losing the family home.

If it looks like a housing bubble...

In one sense it doesn't really matter whether there is a housing bubble or not. Once buyers start believing there is, they have every incentive to wait before buying.

Housing boom to continue

SQM Research managing director Louis Christopher says Sydney and Melbourne home prices will keep surging in 2017.

From 1991 to 1997, Australian property went nowhere, a trend that didn't go unnoticed by the big four banks. It was a phenomenon that convinced them of the relative safety of property lending and they plunged headlong into it; to the point that they now are glorified building societies, where mortgages make up around 60 per cent of their business.

Most economists now hope history will repeat itself; that the boom will peter out, residential property will go into hibernation for a few years and that the affordability crisis will fix itself.

Why it's different this time

When the Howard government introduced a capital gains discount in 1999, Australian real estate roared back to life. Designed to promote longer term investment, the 50 per cent discount was given to anyone who kept an investment property or other asset for longer than 12 months. When coupled with the negative gearing incentives, cash poured into property.

That coincided with a sustained economic recovery and the advent of the greatest resources boom in mankind; one that would flood Australia with cash.

In addition, banking was becoming a global affair. Rather than just recycle domestic deposits to households, our financial institutions discovered the wonders of offshore wholesale funding markets. They borrowed huge amounts of cash offshore, brought it home, and lent it to us which is why we have a mountain of foreign debt.

All that extra cash pushed up the price of housing, and the more it cost, the more the banks shovelled in from offshore. It was a virtuous circle that transformed them into some of the world's most profitable institutions but their fortunes are now inextricably tied to Australian real estate.

Edge of a cliff? Housing in 2017

And if our regulators now openly talk about a bubble, just what sort of risk have our financiers placed themselves in?

Our labour markets also have changed. Gone are the days of steady employment where a worker may have just a handful of full-time jobs during their careers. The labour market has become more "flexible", which means employers can more easily lay off workers and most of the employment growth is in part time or casual work. That means incomes are less reliable.

There are plenty of forecasts around the Australian housing market in 2017 - and few are positive.

Those rising property prices have pushed household debt to eye-watering levels. Where once we were conservatively geared, Australians now are amongst the world's most indebted.

Australian mortgages have ballooned to just under $1 trillion. That's just for owner occupiers. Investors, many of whom have mortgages on the family home as well, owe a further $543 billion, according to figures released on Friday by the banking regulator.

In 2008, when it began compiling the numbers, the total value of all mortgages was less than half that, at $638 billion. No wonder the regulators are getting spooked.

The perfect storm

For a bust to occur, almost everyone agrees there would need to be upheaval in the economy, something that would cause in a big spike in unemployment that meant workers couldn't maintain their mortgage payments.

As one of the world's most trade exposed nations, any major global upheaval would filter through to us. We were saved in 2009 by a debt fuelled investment binge in China that pumped up our national income.

China now is experiencing its own problems and, just as it saved us during the GFC, could be a catalyst for trouble in the future, possibly as early as next year.

All the signs of a bubble

Australia's property market is showing all the signs of a bubble that could crash, taking the banks and economy with it.

With a workforce less secure than at any time in the past 80 years, corporations looking to cut costs could act more swiftly to reduce their workforce in the event of a major downturn. That's great for them but it could lead to a sharper than expected jump in mortgage defaults which then would pressure housing.

Our huge immigration program has been a major driver of economic growth in the past two decades. That's simply because more people, by definition, delivers a bigger economy. Should that slow, and housing demand falter, prices could come under pressure.

Let's also not forget that interest rates are at record lows. At some stage, they will rise and if wages don't rise at the same pace, large numbers of households will find themselves under water, again leading to greater default rates and lower house prices.

Then there's the supply side. East coast construction has been booming for four years, particularly apartments. Goaded on by government, which refused to fix the demand side by eliminating tax breaks such as negative gearing and capital gains tax discounts, the looming glut of apartments poses the biggest risk of all to Australian real estate.

In 2009, around 2,000 units a month were being built. That's now up to 12,000 a month, with the peak not due until some time next year.

It's entirely possible the property market will cope with this flood of supply, although some areas clearly will be impacted. What it won't cope with is a combination of a huge glut and anything that affects demand, whether that be a spike in interest rates or a jolt from China that pushes unemployment higher.

Heightened risk? That's putting it mildly.

Topics: housing, housing-industry, government-and-politics, business-economics-and-finance, australia

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