We could be pushing our luck

Long view

Philip Baker

In the 1960s, it was said Australia rode on the sheep's back, but the resources industry has grown so strongly over the past 10 years, it could be argued that the nation now relies more on the miner's shovel.

However, Australia's recent prosperity also has strong links to its housing market. Australian home prices are about 70 per cent above their long-term trend level. The annual *Demographia International Housing Affordability Survey*, released last month, shows the median house price in Sydney in 1981 was less than five times the median annual household income. It is now more than nine times the median income. Melbourne's median house price has risen from three times to more than eight times the annual median income.

In Britain, the median house price is about 5.1 times the average income and in the United States, house prices are just 2.9 times the average income.

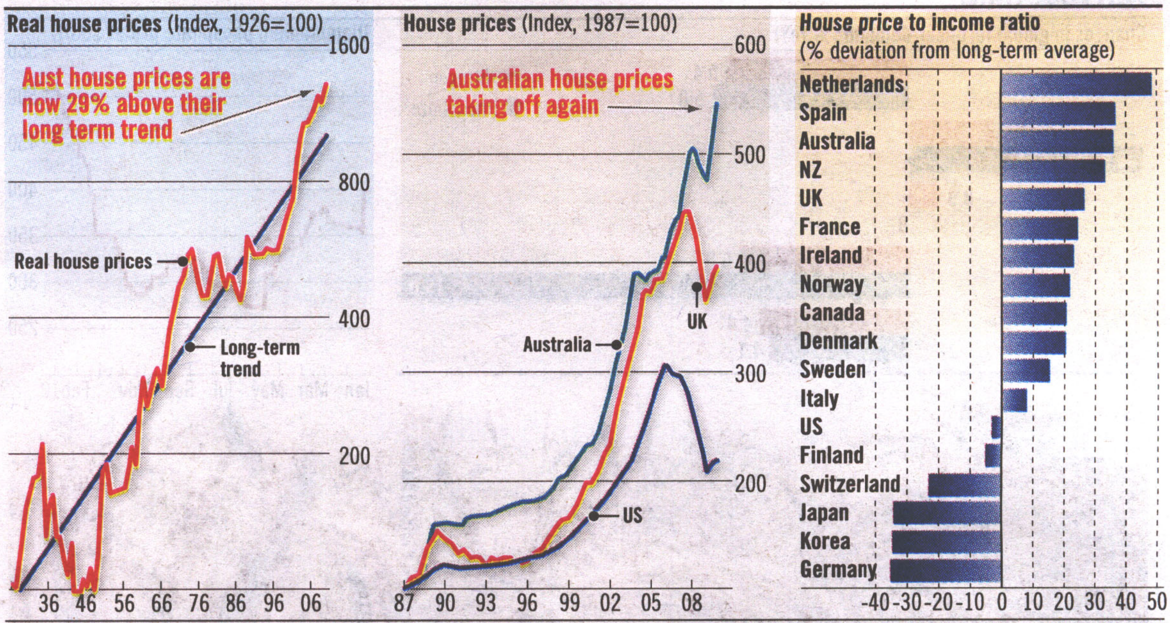
One of the lessons investors have learnt from the global credit crisis is that housing bubbles can contribute to financial vulnerability. Australia has long been known as the lucky country and has avoided the worst of the recent global credit crisis thanks to its proximity to China. As a nation, we also avoided the tech wreck, the accounting scandals of 2002 and the Asian crisis before that.

But are we pushing our luck?

Last week, BHP Billiton's outgoing chairman, Don Argus, warned that the big banks were becoming "giant building societies". Commonwealth Bank of Australia now has about 60 per cent of its lending book tied up in residential mortgages, and half of Westpac Banking Corp's book is linked to residential property.

Nominal house prices have not fallen since the '50s, but that's not to stay they can't. Over the past three years, US home prices have fallen by 30 per cent, says the S&P/Case-Shiller Composite Index. Over the past year, Australian house prices have risen by about 13 per cent, and since 2006 they have climbed about 30 per cent.

House of cards



SOURCE: ABS, AMP CAPITAL INVESTORS, CASE-SHILLER, NATIONWIDE, OECD

For sure, there are quite a few differences between the US and Australian housing markets.

For a start, Australia has floating rate mortgages, but in the US, rates are mostly fixed. In Australia we didn't experience the building boom that led to a chunk of fresh supply in the US. Australian banks also did not go down the subprime market to quite the extent US banks did and a fair chunk of the stimulus response during the crisis was aimed at the consumer. The Rudd government also raised the first-home buyer's grant and Australian banks were more prudent than their global peers in the lead-up to the crisis. But let's hope those first-home buyers can still afford the payments now interest rates have been rising since late last year. The US subprime market first started to unravel back in 2005 when borrowers struggled to meet their payments once the honeymoon arrangements rolled off.

One point in Australia's favour is the fall in the unemployment rate, which suggests strength in the labour market. But house prices are expensive.

Since 1930, the trend rate of growth in real house prices has been 3 per cent a year, which is in line with long-term real growth in the economy. But over the past 20 years, the trend rate for house prices has jumped and prices are now about 30 per cent above their long-term trend. The Organisation for Economic Co-operation and Development (OECD) says the ratio of house prices to incomes is about 35 per cent above its long-term average.

So how have investors paid for all this? Through debt of course. The rise in the ratio of house prices to incomes since 1990 has led to a rise in household debt. In 1990, the ratio of household debt to annual household disposable income was less than 40 per cent and at the low end of OECD countries. Now it is 155 per cent and at the high end of OECD countries. Little wonder there is talk of a bubble. Added to that is the fact that house prices are high relative to rents. The OECD says the ratio of house prices to rents in Australia is 58 per cent above its long-term average.

The gross rental yield for houses is just 3.5 per cent.

What is sparking talk of a bubble is that unemployment has fallen in recent times, down to about 5.3 per cent and nowhere near the 10 per cent forecasters expected it to be. The highest it got to was about 7.8 per cent. Interest rates are rising, but still below their previous high. The banks' standard variable rate is now averaging about 6.9 per cent, compared with the 2008 peak of 9.6 per cent.

Housing affordability improved dramatically into the middle of last year, mainly due to a 40 per cent collapse in mortgage rates. Rates are rising and maybe that takes some air out of the bubble. As the population is expected to reach 34 million by 2050, there appears to be a shortage of supply that will always help underpin prices.

Maybe we will keep on being lucky. It was Donald Horne who first observed that Australia was the "lucky country". But the second part of that famous quote said the nation was "run by second-rate people who share its luck". Horne said if Australia developed as a nation it could reap the benefits of economic and technological innovations that were developing in other countries at the time. He reckoned those countries were clever, Australia was just lucky.