Australia at the forefront of housing bubble

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Further evidence that the much-vaunted growth of the Australian economy is bound up with an international housing market bubble is contained in an International Monetary Fund (IMF) report released this week.

The IMF noted that in a number of countries house prices had risen to levels well beyond that which could be expected on the basis of income levels and other basic economic processes, thereby posing the risk of a sharp economic contraction.

In an essay devoted to the housing market, published as part of its World Economic Outlook report, the IMF pointed out that in Australia, Ireland and Spain house prices had risen by 50 percent and more since 1997, "increases that are difficult to explain in terms of economic fundamentals alone."

In these cases there was "a danger that higher interest rates could trigger a much larger downward adjustment in house prices, with considerably more severe consequences for real activity."

The report noted that while the house price boom had different explanations in different countries, the upward movement in the world's largest economies had become increasingly synchronised.

"Just as the upswing in house prices has been a global phenomenon, it is likely that any downturn would also be highly synchronised, with corresponding implications for global activity," it said. Even an "orderly correction" in those countries which had experienced a boom would weaken economic growth while "an abrupt price correction could have significantly more serious adverse effects."

The IMF's warnings were repeated in a report on the Australian economy published by the Reserve Bank of Australia (RBA). In its annual review of the financial system, the RBA said that, while house prices and mortgage lending had declined since 2003, credit was still growing strongly with the potential to cause economic instability.

While the growth in credit had fallen from an annualised rate of 21 percent in the second half of 2003 to 16 percent over the past six months, it continued to pose problems. "Standard measures of financial vulnerability of the household sector," the RBA noted, "including ratios of debt, house prices and interest payments to income, have recently reached record highs." Interest payments now consumed 9.3 percent of household disposable income, higher than the previous peak in the late 1980s when interest rates were much higher.

While citing "favourable outcomes to date", the RBA noted some "risks" for the economy as a whole.

"A pronounced fall in house prices or a deterioration in economic conditions could prompt a broad reassessment by the household sector of the structure of its balance sheet, leading to a sharp fall in credit growth and a period of unusually weak consumption."

On the other hand, it continued, if there was continued strong growth in the economy this could "again reignite the housing market, increasing the potential for a difficult adjustment in the future. How things might evolve in this area warrants close attention in the period ahead."

Treasurer Peter Costello, who in electioneering mode emphasises the "strength" of the Australian economy, offered a rare glimpse of reality when he said a big part of economic management over the next two years would be to ensure that the housing market did not "crash". In other words, far from the Australian economy exhibiting "sound fundamentals", as is usually claimed, it has become increasingly dependent on a property bubble.

The RBA pointed out that the increase in household indebtedness in recent years had led to an increase in the riskiness of banks' mortgage portfolios. It noted that while it was difficult to envisage a situation in which problems with housing loans would cause major difficulties in the Australian financial system, the change in the housing market was “posing some challenges for banks and other lenders.”

As growth in housing credit eased, this could lead to increased competition among banks seeking to protect their earnings and in this environment “it will be important that pricing is commensurate with risk.” In other words, banks and other lenders having seen profits grow rapidly in the boom, may expose themselves to greater risk as they endeavour to maintain profits and market share in conditions of a decline.

The RBA said that while the condition of the international banking system had been assisted by a stronger world economy, the situation was not without risk. Rising oil prices were one shadow, while another was the capacity of the market to handle the tightening of monetary policy in the United States where interest rates have begun to rise after being held down to record lows. The “market risks” in Australia were less pronounced, given that interest rates here had not fallen as far as those in the US but nevertheless “it is impossible for local markets to be quarantined from overseas events.”

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