Australian property bubble could be heading for a bust

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Australia's growing property bubble, especially in and around the country's largest city, Sydney, could be on the way to bursting, with far-reaching social, economic and financial consequences.

That conclusion emerges from two recent reports on household indebtedness and the dependence of the country's four major banks on lending for property, and a warning issued yesterday by the Reserve Bank of Australia (RBA).

Last week, Barclays bank's chief Australian economist, Kieran Davies, issued the findings of research showing that private sector debt had risen to 206 percent of gross domestic product (GDP), up from 191 percent before the global financial crisis. This ratio placed Australia in the top 25 percent of the most leveraged countries.

When it came to household debt, Australia had the leading position, at 130 percent of GDP. Household debt includes credit cards, overdrafts and personal loans, but the largest component is mortgage debt.

The mortgage debt level could climb further if the Reserve Bank cuts its base interest rate below its already historic low of 2.25 percent. Any reduction in interest rates fuels an increase in house prices, forcing home buyers to take on increased mortgages and leaving them exposed to even small rate rises in the future.

Davies warned that the household debt level was a "vulnerability" in the event of another global financial shock, although he did not expect any immediate problems because interest rates would remain low in 2015. In other words, as long as cheap money continues to flow, house prices and mortgage debt will keep escalating.

In its analysis, Lazard, a global financial advisory and asset management firm, warned of potential financial instability and the growing exposure of the four major banks to the housing market.

Lazard analyst Phil Hofflin said record household debt in the property market could be a "worrying" scenario. He noted that the median price for houses in the inland country town of Wagga Wagga was higher than for Chicago.

Recalling the impact of the US mortgage crisis of 2007–2008, he said: "What happened in the US in terms of wealth effect when property fell could be worse here because property dominates Australians' balance sheet … and because property prices are so high in the first place."

Hofflin was involved in recapitalising the Westpac bank after it ran into problems during Australia's last recession during the early 1990s. He warned that, taking into account rental yields, costs and taxes, residential property was trading at 60 times earnings, four times the value used by investors to assess shares.

Bank lending has shifted during the property boom. In 2000, banks' lending to business matched their home lending. By 2010, for every $1,000 of home lending, only $600 was lent to businesses. This trend has continued since then. House mortgages now comprise about two thirds of the money owed to the banks.

Mortgage lending has proved to be highly profitable and the major banks' share prices have risen accordingly.

Bank capitalisations are now equal to 35 percent of the Australian stock market, a figure Hofflin said he had never seen before. Globally, bank capitalisations average about 9 percent of stock markets. Even in the Japanese property boom that began to collapse in 1990, the figure was two thirds of the current Australian level.

In its latest Financial Stability Review, the Reserve

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Bank of Australia also voiced its concerns about "speculative demand" in the housing market, fuelled by the supply of cheap credit. It said that new lending to property investors had risen by 150 percent in New South Wales over the past three years, with strong growth in the neighbouring state of Victoria.

This forms a marked contrast to the rest of the economy. For the first time in 50 years, businesses are about to record their third annual decline in investment. According to an Australian Bureau of Statistics survey, mining investment is expected to fall by 20 percent in 2015–16.

While a sharp decline was expected in mining, the 21 percent predicted drop in manufacturing investment was not. In fact, the various economic models produced by the Treasury department and the RBA assume that increases elsewhere in the economy will compensate for the lower mining investment decline. Clearly this is not happening.

The RBA faces an acute dilemma. On the one hand, the drop in business investment, coupled with ongoing rate-cutting by the world's major central banks, is creating pressure to further reduce its base rate. On the other hand, any rate cut will further inflate the property bubble.

The RBA also pointed to a surge in commercial property prices, which was out of line with fundamental economic conditions, and could lead to a sudden decline. "The risk of large re-pricing and associated market dislocation in the commercial property sector has increased," it said, adding that there were clear signs of oversupply in some markets.

Commercial property lending, while dwarfed by the housing market, posed a "disproportionately large risk to banks" and was responsible for episodes of stress in the banking sector, both in Australia and internationally, the RBA said.

Speaking at a business lunch yesterday, ANZ banking group chairman David Gonski said conditions in financial markets were "quite scary." Urging the RBA not to cut interest rates again, because that would further boost share and property prices, he said: "There is no doubt in my mind that risk is being put as somewhat secondary at times by investors in relation to the search for yield."

A major downturn in any sector of the financial markets could rapidly set in train processes leading to a recession—the first in Australia for almost a quarter of a century—resulting in an escalation in unemployment. The social consequences will be far-reaching. Working class families, often relying on two incomes to repay mortgages of hundreds of thousands of dollars, will be thrust into poverty virtually overnight.

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