

# Australia Has Poor Housing Supply Not a Bubble

September 2010

## Key Points:

- **Commentary around the existence of a housing bubble in Australia overlooks significant differences between our housing market and economy compared to those overseas.**
- **Australia has an undersupply of housing, lower starts per capita than countries such as the US had pre-global financial crisis, and we are in a different point in the business cycle to those countries in which housing has collapsed.**
- **Australians remain highly capable of meeting their debt servicing obligations, the labour market is performing strongly and economic growth is expected to accelerate.**

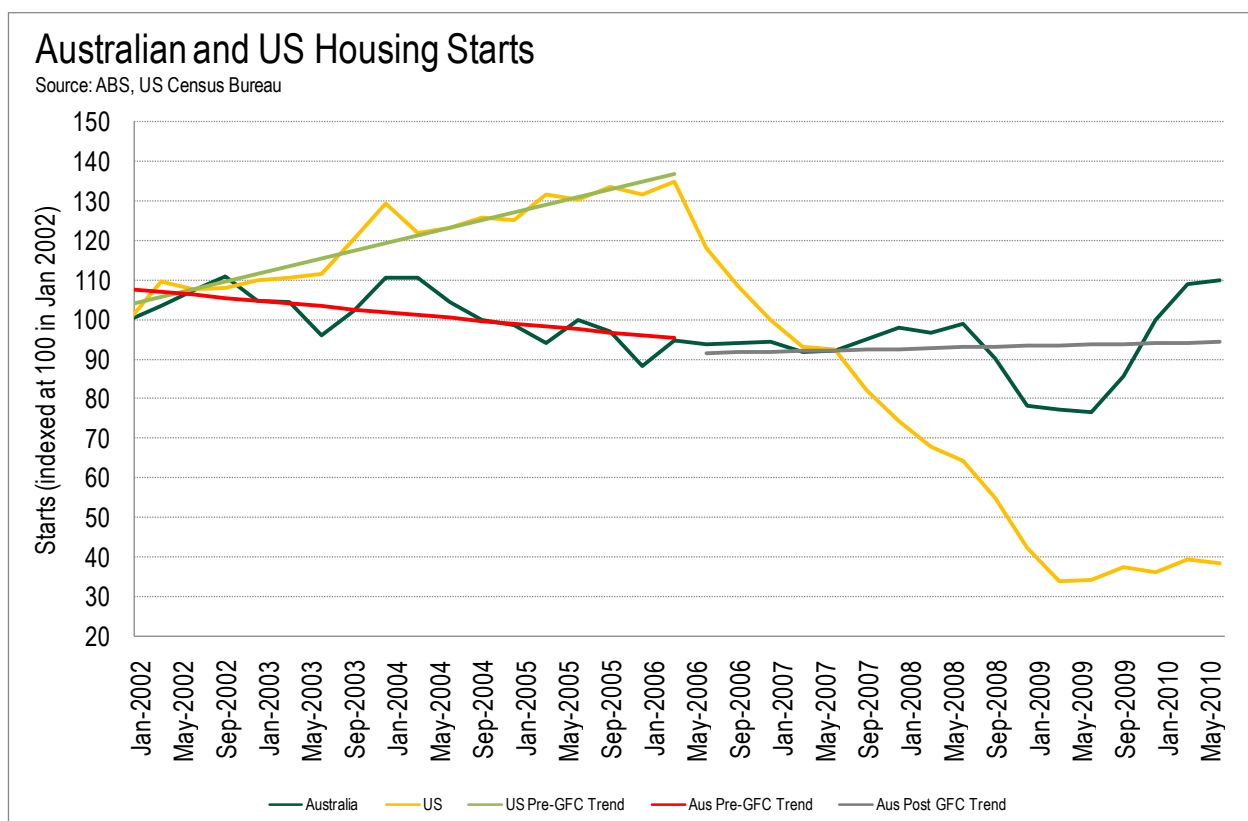
Since early in 2010, a handful of economic analysts, mainly based outside of Australia, have been 'selling' the idea that Australia is in the midst of, or will soon find itself facing, a housing bubble. Such talk harms consumer confidence, unsettles the housing market, and has a negative impact on the wider economy.

The current talk of a housing bubble in Australia is particularly problematic as it appears misdirected, perhaps because it is based upon a lack of in-depth understanding of the Australian housing market. Both the Australian housing market and the Australian economy are very different to those overseas in terms of economic and demographic fundamentals, and market structure. For starters, Australia has a large and growing undersupply of housing, a fact well understood by our most reputable economic institutions including the Reserve Bank and estimated by the National Housing Supply Council, a body set up by the Commonwealth Government to concentrate on measuring the housing supply gap and to examine the causes of, and the ways in which we might address, the critical undersupply of housing in Australia.

Importantly, Australia's housing price growth has been driven by the interaction of this inadequate supply with the strong demand for housing which has been underpinned by population growth, historically low interest rates, and the rewards of a strong economy including solid labour market outcomes. This is a natural 'equilibrium' outcome in a market where the supply side is restrained by a range of persistent obstacles, including lack of readily available land, high taxation, inadequate skilled labour, inefficient planning and approvals processes, and major problems with current systems to fund supporting infrastructure. And this is why all tiers of government have at least been talking about the need to fix the market on the supply side.

It is also worth noting the current situation in Australia is very different to that which existed in the US – in the US the supply-side of the housing market has been very responsive with a strong up-trend in supply in the years before the housing crash (see chart below). In Australia it is the undersupply of dwellings that is causing escalating prices and, somewhat ironically, it will be the outlook for persistent undersupply that will prevent us from seeing a crash in our housing market.





Further, the underlying demand for Australian housing continues to grow rapidly, mainly on the back of strong population growth and other demographic changes such as a downward trend in the size of the typical Australian Household.<sup>1</sup>

The fact that Australia is unlikely to see a crash in its housing market is further evidenced in our economic fundamentals as:

- the Australian economy is on an upswing after being one of only three OECD countries to avoid a recession during the global financial crisis;
- the Australian labour market continues to perform strongly with solid growth in employment and an unemployment rate that stands at 5.1 per cent, a rate which is around half that of the US; and
- we continue to trade strongly with the Asian nations, the part of the world economy that is recovering from the GFC in a robust fashion, and which underpins the demand for a major portion of Australia's exports, particularly mineral commodities.

As is also the case when we examine the pricing fundamentals of the housing market:

- vacancy rates continue to be tight;
- debt-to-income ratios show that, despite higher prices, Australians have debt obligations which they can readily meet and accordingly the rate of loans in arrears remains very low; and

<sup>1</sup> Notwithstanding more recently an increase in household size, primarily due to younger Australian's being forced to live at home for longer due to low entry level housing affordability.

- while 2009/10 was a year of strong housing price growth, there is evidence that housing price growth is slowing, meaning that the market is already working to ‘engineer’ a soft-landing.

It is also worth noting that institutions such as the Reserve Bank do not subscribe to the view that Australia has a housing bubble.

These issues are explored in more detail below.

***Unlike in the US, Australian housing supply is unresponsive...***

In any well-functioning market, supply should respond efficiently to an increase in demand. This is not the current situation in the Australian housing market where, despite strong demand, annual housing supply has fallen in New South Wales and has been relatively flat across the rest of the country. Some of the factors that suggest Australia’s housing supply is not responding well include that:

- the growth in completed dwellings is not keeping pace with growth in the population;
- the price of land, rather than real construction costs, is a major driver of escalating house prices, which can only occur if constraints are acting to stop land from being used more intensively or in a timely manner;
- Australia has a relatively inelastic housing supply compared to other OECD countries which means that any increase in housing prices is met with a subdued response in terms of new housing being constructed<sup>2</sup>; and
- the number of persons per household has increased in recent years, reversing a declining trend, as many of those aspiring to enter the housing market have little option but to share with others (including children who are forced by high prices to delay purchasing their own home and stay at home until later in life, or move back into the family home to escape unaffordable weekly rents).

This situation can be seen clearly in the chart above which shows that US housing starts were trending up prior to the crash which preceded the GFC. Conversely, Australian starts were trending down and only very recently has the level of starts returned to the level they were at seven or eight years ago, and even then it has been only due to stimulatory fiscal and monetary policy.

Between April 2000 and July 2009 the US had 1.7 housing starts per each additional member of the population. In Australia this figure was only 0.5 over the same period. The wide-spread use of non-recourse loans in the US has been one driver of this massive difference in housing starts per growth in the population, and again highlights an important difference to the Australian situation.

***...and this has led to Australia having a substantial housing supply gap***

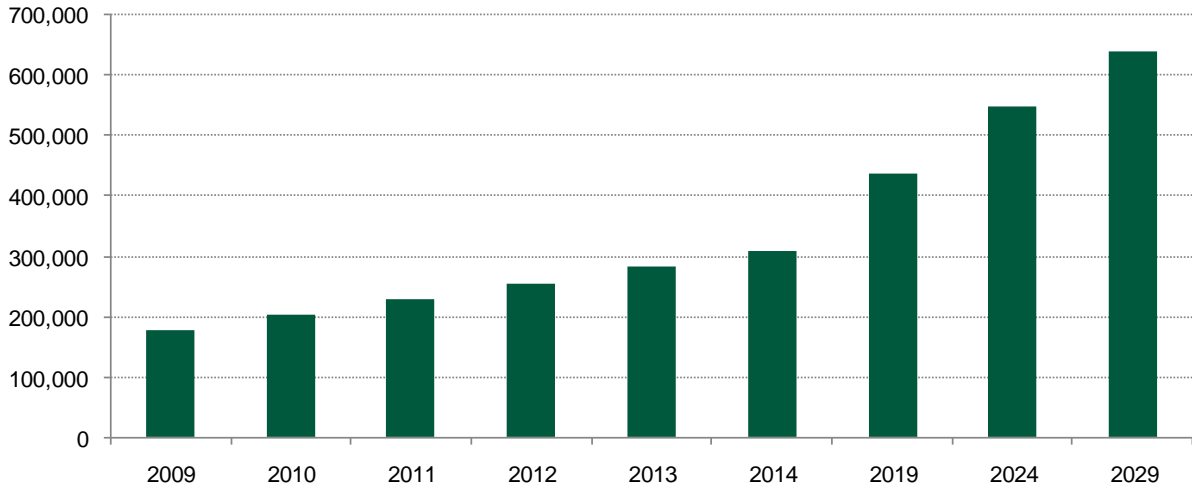
The inability to build much beyond 160,000 houses in any given year has left Australia in a markedly different situation to many overseas markets. The NHSC estimates that at end-June 2010 the gap between the underlying demand for, and supply of, housing was more than 200,000 dwellings. Perhaps more worrying is that the NHSC projects that on current trends this gap could grow to exceed 600,000 dwellings by 2029.

---

<sup>2</sup> Source: OECD Housing Markets: A Progress Report 2010. The OECD estimates the long run elasticity of Australia’s housing supply to be around 0.5 (inelastic) compared to Canada at around 1.2 (elastic) and the United States at around 2 (highly elastic).

### Gap between housing supply and underlying demand (no. of dwellings)

Source: National Housing Supply Council

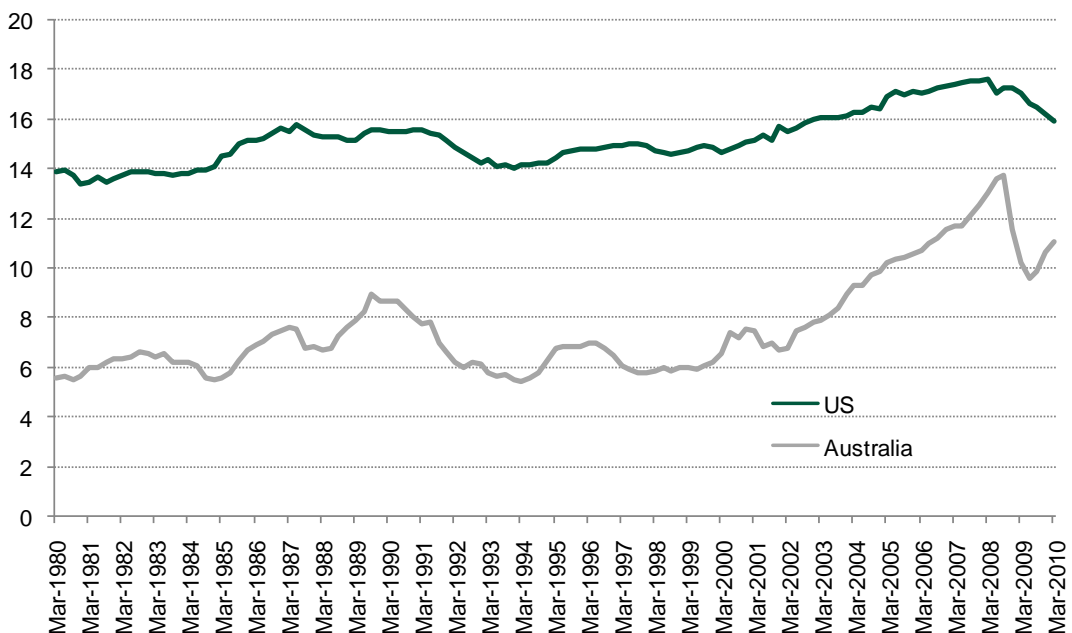


### Australia's ratio of debt servicing payments to disposable income suggests we remain very able to service our loans...

While it has shortcomings, the ratio of debt servicing amounts to disposable income is used as an indicator of the ability of consumers to service debt. As the chart below shows, for Australia this ratio has been climbing since around 2001, driven by housing prices and interest rates, but it remains a full five percentage points below that of the US (even following the US housing crash). Moreover, with expectations of slower or flat house price growth going forward this ratio should improve further in the near future.

### Ratio of interest payments to disposable income (%)

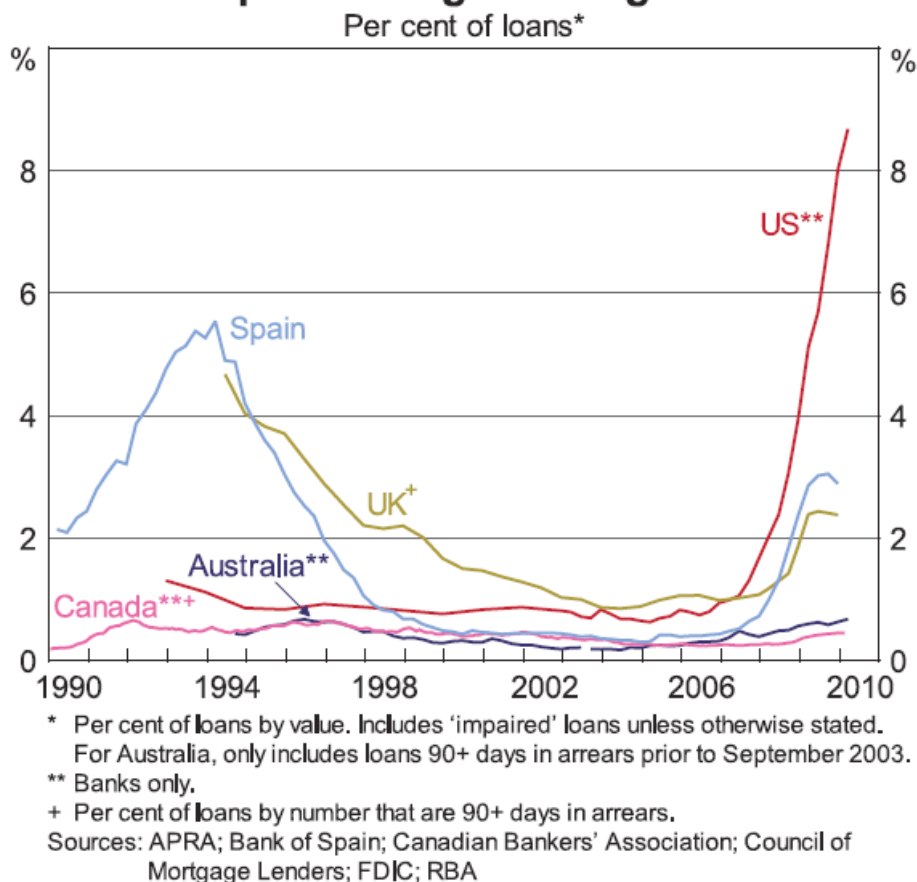
Source: RBA and Fed Reserve



**...and this is reflected in a very low level of arrears on loans in Australia**

Australia's default rate on loans remains low by international standards. Currently our default rate stands at around 0.5 per cent while the US default rate is well over 8 per cent (see chart below, sourced from the RBA). Even prior to the US housing collapse and the GFC, Australian defaults were running at around half the rate of US defaults, and well below most other comparable developed countries including the UK.

**Graph 6**  
**Non-performing Housing Loans**  
Per cent of loans\*

**Australia avoided a recession and growth is now accelerating...**

Australia was one of only three OECD countries that managed to avoid dipping into recession during the GFC. And we continue to grow – in the June quarter 2010 Australia grew by 1.2 per cent for the highest annual rate since early-2008. The consensus is that this growth will accelerate, with Treasury forecasting growth of 3 per cent in 2010-11 and 3.75 per cent in the following year.

This is quite different to the situation which prevailed in the US just prior to the collapse of its housing market. At that point in time the US economy was slowing and looking for a soft landing (which it didn't get). In contrast, Australia is in a very different point in the business cycle to those economies that saw their housing markets collapse around the time of the GFC.

**...so what would happen if Australia did have a housing bubble?**

Moreover, if we were to (incorrectly) assume that there was a bubble in the Australian housing market, there is every possibility it would deflate in an orderly fashion. The usual reasons for any asset bubble

popping are unemployment, recession or oversupply. In the Australian situation there is a (growing) undersupply of housing; economic growth is accelerating; and the labour market is performing strongly.

Finally, it is important to note that talking down the prospects that Australia has (or may in the near future develop) a housing bubble is not just self-interest by organisations such as the HIA. It is in nobody's interest to have a crash in the housing market with the accompanying loss of confidence and the large negative consequences for the wider economy.