Why there is unlikely to be a large across-the-board fall in Australian house prices as there has been in the United States

A number of analysts have for some time been predicting that Australian house prices will drop substantially. For example Associate Professor Steve Keen of the University of Western Sydney suggests that house prices in Australia could drop by 'as much as 40%'[1]. Morgan Stanley's Gerard Minack has been reported as forecasting that they could fall by 50%[2].

Not only do I *hope* these predictions will be proved wrong, I also *think* they will be. They (and others) are of course wholly correct in pointing out that Australian house prices are very high (relative to incomes), both by historical and international standards, and that Australians have accumulated a lot of debt (again relative to incomes) in the process of pushing house prices to where they are. And house prices have already fallen significantly in some other countries – notably the US and Britain - where both house prices and household debt have previously risen by similar proportions as they have in Australia.

Despite these undeniable similarities, there are nonetheless some important differences between the Australian and American housing and mortgage markets.

First, Australia does not have a physical excess supply of housing. America does, because unlike us, it actually built more new dwellings than it required to meet growth in underlying demand. In Australia, the reverse has happened: we haven't built enough dwellings to meet underlying demand, which has been pushed up by rising levels of immigration. As a result, we actually have a significant backlog of unmet underlying demand for housing (as also indicated by the upward pressure on rents in recent years). Reflecting this, the IMF's *World Economic Outlook* released last week specifically acknowledges that 'if some country-specific factors are taken into account, the results [of a cross-country study of the extent to which house prices could be explained by 'fundamentals' by IMF researchers] do not produce evidence of a significant overvaluation of [Australian] house prices'[3].

Second, Australia does not have a huge supply of existing dwellings for sale at any price hanging over the market because of the huge increase in foreclosures that has been the primary source of downward pressure on American house prices. Mortgagees in possession will sell at any price because they don't want to keep the house, they want to get at least some of their money back as soon as possible. That is now happening on an unprecedented scale in America. But it isn't happening, and in my view is unlikely to happen, in Australia.

One reason for that is that there has been far less imprudent lending here than in America. "Non-conforming" loans (the closest thing we have to sub-prime) represent around 1% of all mortgages outstanding in Australia, as against around 15% in the US; while "low-doc" and "no-doc" loans account for around another 7% in Australia compared with about 15-20% of American mortgages being "Alt-A" which is their equivalent of "low-doc" or "no-doc".

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[1] As reported in *Sunday Age*, 12 October 2008, p. 5.
[2] On ABC-TV's *Lateline* programme, 18 March 2008: see http://www.abc.net.au/lateline/content/2007/s2193467.htm
[3] IMF 2008, *World Economic Outlook* (Washington DC, October), p. 17, note 4).

More generally, the Reserve Bank of Australia was one of the very few central banks which did not make the mistake (which the US Federal Reserve under Alan Greenspan in particular did make) of keeping interest rates too low for too long in the first half of the current decade, after the risk of recession and deflation in the aftermath of the bursting of the "tech bubble" had subsided. That's why proportionately far fewer Australians than Americans were enticed into taking out mortgages that they couldn't hope to be able to service when interest rates returned to more "normal" levels.

Secondly, mortgage lending in America is typically "non-recourse": that is, in the event of default, the lender can take possession of, and sell, the property against which the mortgage is secured, but cannot make any claims against any other assets or income which the defaulting borrower may have.

That means that when an American borrower finds him- or herself in a position where he or she can't (or even doesn't want to) keep up the repayments on a mortgage which may be worth more than the home, it can be quite rational for him or her to "walk away". Yes, he or she will have a bad credit rating, and may never be able to get a mortgage again: but many of the borrowers were in this position to begin with - that's why they got "sub-prime" mortgages in the first place.

By contrast, in Australia the generally applicable legal position is that lenders can go after a defaulting borrower's other assets and income, if any, in order to make up any shortfall remaining when a foreclosure sale results in proceeds which are less than the outstanding debt. That, together with the generally greater social stigma which the Australian culture attaches to default, provides a powerful incentive to Australian home buyers to avoid default if possible.

And that is one reason why default rates on Australian mortgages have remained vastly lower than on American ones - even though the interest rates which Australian borrowers have been paying have generally been somewhat higher than those paid by American (or British) homebuyers.

Because there are proportionately far fewer dwellings in foreclosure, and thus “on the market” for whatever price someone is willing to pay for them, in Australia than in the US, there has been far less downward pressure on house prices here than in the US.

And provided (and this is an important proviso), unemployment in Australia does not spike sharply higher (as it did in the early 90s) this is likely to remain the case - especially now that interest rates are falling, and falling a lot. If mortgage defaults rose only a little while interest rates were high and rising, provided unemployment remains low, why should mortgage defaults start rising when interest rates are falling?

Here's the simple but critical point: house prices will only fall significantly if lots of owners have to sell them for whatever price that they can get.

It *is* increasingly true that vendors are finding that they can't get the prices they would like. Sometimes they find that if they really do want to sell, they may have to settle for less than they had hoped. But the more common reaction, among the vast majority vendors who are not selling because they have to, is not to sell, and to remain in the property for longer.

Turnover drops, perhaps sharply; real estate agents' incomes decline, and State governments experience shortfalls in revenue from stamp duty. But *prices* don't fall sharply across the board.

There will of course be exceptions to this generalization. Here are three.

First, in areas where non-traditional mortgage lenders (whose customers included a larger proportion of more marginal borrowers, and who in cases lent on higher loan-to-valuation ratios, and who in general are much quicker than banks or building societies to foreclose in the event that a borrower falls behind in his or her mortgage repayments) had a larger market share than the national average, there are likely to be relatively more "forced sales", and house prices are more likely to decline in such areas. Western Sydney is the prime example.

Second, prices of premium properties in the most expensive suburbs of Australia's major cities could experience large declines. That's because prices of such properties are often determined by how much money a particular purchaser who desperately wants to live in a particular house or in one of those suburbs has access to and is willing to throw at it, rather than reflecting any objective assessment of its intrinsic value. There are clearly going to be fewer people in that position now, as a result of the global financial crisis. And some people who were in that position and who have also had large debts secured against share portfolios or their business interests may be forced sellers.

Third, areas in which investors have been a particularly large share of the market may experience price falls if sufficient of them give up any hope of eventual capital gain or are unwilling or unable to sustain the negative cash flows associated with their investments (even with the tax subsidy provided by "negative gearing").

But these are exceptions to the general rule. Provided, again, that unemployment remains low so that the overwhelming majority of home-buyers remain able to service their mortgages, there will not be the excess of forced sellers over willing buyers required by definition to produce a generalized fall in house prices.

Of course, it may also be a long time before house prices start rising again.

The key proviso in all of this is that unemployment doesn't rise sharply, so that a large number of home borrowers don't find themselves unable to keep up their mortgage repayments despite their wish to do so. I'm not suggesting that unemployment won't rise at all: clearly, and unfortunately, it will, and by more than the Government forecast in this year's Budget.

However I would suggest there are two good reasons to believe that unemployment *won't* rise by anything like as much as it did during the recessions of the early 1980s or early 1990s.

First, Australian employers are under much less pressure from high levels of business debt and high interest rates, or from steeply rising real labour costs, than they were on either of those two occasions.

And secondly, employers are aware that, as a result of demographic changes, one of the biggest challenges they are likely to face over the medium term is a shortage of labour, rather than an excess of it.

Hence, unless they believe that Australia is facing a deep or protracted recession, they are more likely to be willing to 'hoard' labour – that is, to keep their employees on their payrolls even at some short-term cost to profits – than they have been during previous downturns.

This, incidentally, would be much more 'socially responsible' on the part of employers than cutting prices in order to 'share' some of their profits with customers. Cutting prices in current circumstances would increase the risk of *deflation* – that is, outright falls in the general level of consumer prices – something which is one of the key differences between a 'depression' and a 'recession', and something which is much more difficult to reverse than a conventional recession.

Together with appropriate reductions in interest rates, it would help ensuring that Australian home-buyers were able to continue servicing their mortgages, reduce the risk of rising mortgage delinquencies and defaults, and minimize the risk of sharp and destabilizing falls in house prices.

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