The residential housing bubble to cause a recession?

Tim Farrelly | farrelly's | 15 September 2015 |

It happened in the US, Spain and Ireland, too – a bursting of the residential property bubble followed by a major recession. Wise men from far away arrive in Australia and New Zealand and smile knowingly at the locals naiveté. "We didn't think it would happen to us either," they say, "it's just a matter of time before your bubble bursts and then, lookout..."

There are two aspects to this story. The first is that residential property prices are set to crash and the second is that such a crash will cause a recession. But neither are foregone conclusions. It is useful to trace the linkages in order to understand cause and effect.

In the US, Ireland and Spain, the residential property bust was preceded by rapidly rising prices and frenzied overbuilding. According to farrelly's estimates, there was two to three years' worth of excess residential property supply in the US from 2001 to 2006. In Ireland and Spain, it was more like five and seven years of excess supply, respectively. This does not just happen. It normally requires very aggressive and often irresponsible lending to home buyers and developers. When prices start to fall, supply outstrips demand, sellers head to the exits, new construction comes to a screaming halt, and the banks start counting their losses. New construction, normally around 3% of GDP but around 5% of GDP in such a boom, falls to close to zero – and stays there until the glut clears. Banks go into survival mode, lending only to the very best credits and calling in loans where possible. It's easy to see the linkages between the property price bust and the recession that follows.

Australia has had the residential property price rises, but not the over construction. Prices have risen strongly on the back of more generous, but still responsible, lending practices. That's not an oxymoron. Lower interest rates mean the same borrower can service a higher loan and banks are very happy to oblige. When every buyer has more to spend and is chasing an item that is in undersupply, what happens? Prices rise – and by a lot. However, if banks aren't simultaneously increasing loans to developers, we don't get oversupply, we don't get bad debts to the banks, we don't get a housing crash and we don't get a recession.

farrelly's thinks residential property prices are too high on both sides of the Tasman. But, without massive oversupply or sharply rising interest rates, price corrections happen slowly. As an example, between 1987 and 1989, Sydney residential property prices rose by over 100%. When a recession came – brought on by interest rates rising to 20% – prices fell around 15% and then went sideways for five years. It was nasty, but it took 20% interest rates to make it happen.

Over the next few years, we cannot see interest rates going back to 20% – or even 4% for that matter. It is residential property oversupply that we have to worry about. There are some small signs of trouble. Construction of units has risen strongly in Australia over the past few years, resolving some of the chronic undersupply of housing. Current levels aren't sustainable but the increases are much less than seen in the US and activity is already slowing, reducing the risk of oversupply. This puts a brake on growth, but is not enough to trigger a recession.

The Australian residential property market is stretched. But about to crash, triggering a recession? It's nuts and you can clearly see it's nuts.

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