Should We Panic About Falling House Prices?

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> Household wealth is falling and Australians are saving again after the credit binge. Inflationary smoke and mirrors make it look alarming but it's not all bad news, writes Ian McAuley.

If your bedtime reading last Wednesday night was the latest six-monthly Reserve Bank Financial Stability Review you will already be well-briefed on what's happening with household savings. However, if you read about it the following morning in The Australian then read on, because The Oz gave a gloomy and partisan view of what most economists would consider to be good news.

Their lead article on the Review started: "One of the biggest falls in household wealth on record is undermining confidence and contributing to Labor's difficulty persuading voters of its economic credentials."

The Reserve Bank did indeed find that the market value of people's houses has fallen by about 4 per cent over 2011, accounting for most of the fall in household wealth. People's financial assets, on the other hand, have stood up remarkably well.

Does this fall in wealth really matter?

Over this century so far, there has been a remarkable growth in house values, and only over the last year or so has there been even a modest reversal. In most capitals, between 2002 and 2011, prices of established houses more than doubled while consumer prices rose by only 30 per cent. Sydney was the only exception, for by 2002 it had enjoyed a head start with the Olympic boom. A modest fall from a high base is hardly surprising.

Some of this growth may reflect improvements as people have modernised their kitchens, for example, but most is explained by price inflation. That is, inflation of house prices (mainly the land component) which is quite apart from and much higher than normal CPI inflation.

We are easily fooled by inflation. I recall the night of John Howard's 2004 election victory when a roving TV reporter, interviewing random voters, picked up a young man who said "Of course I voted for Howard: three years ago my house was worth only $300,000; now it's worth $500,000. I'm $200,000 wealthier thanks to the Government."

That didn't really make sense. If he were to sell his house and buy another, he would find that it too had inflated in market value. Only if he were to emigrate or live in a tent would he be able to realise that $200,000.

Did his house appreciate in real value? I don't know, but I can make a fair guess from personal experience. Over that same three year period the market value of my house would have risen, but its quality certainly didn't improve — it was accumulating the wear of children in their teens and early 20s. That's surely our common experience.

Many Australians didn't appreciate that the rising market value of their houses was no more than an inflationary illusion. Spurred on by banks wanting to expand their loan portfolio (showing as assets on their balance sheets) plenty went in for mortgage re-draw loans and similar credit extensions. Many others took advantage of generous provisions for investment in housing — provisions which essentially allow investors to double-count depreciation as a tax deduction. This taxpayer-subsidised speculative boom did little to increase housing supply, but it certainly contributed to demand and therefore to housing price inflation.

Most economists would welcome the end of an inflationary boom. Yet many people were carried away by the illusion of inflating house prices in the same way perhaps as Zimbabweans were in the early stages of their hyper-inflation before they realised that their billion dollar banknotes were close to worthless.

Now we are living more soberly. Credit card debt is no longer growing. The proportion of mortgagees who are actually ahead on their mortgage re-payments is growing. Household saving is up — it dipped into negative territory 10 years ago, but has been on an upward trend since then. Those who claim that our increased saving is a reaction to the 2008 crisis, or to a lack of confidence in the current Government, would do well to check their claims against the evidence.

Such behaviour is not characteristic of people suffering financial stress. It may reflect a degree of anxiety, but not stress. If people were badly stressed we would be expecting to find all the opposite trends. There is nothing dysfunctional about a degree of financial anxiety; it's less risky than blind optimism. Another word for financial anxiety is "prudence".

The good news about falling house prices is affordability. Provided those falls are slow, they should not result in significant stress among existing mortgagees. The Reserve Bank notes that Australia has very little mortgage stress. Housing loan arrears are up on recent levels but are no higher than they were in the mid 1990s. The only finding of concern is a relative concentration of mortgage stress in the urban areas surrounding Brisbane.

This may be a harbinger of more general problems in our rapidly developing urban fringes but it's a problem mainly about urban planning, rather than a general macroeconomic problem.

The other good news is that we are saving more, and that a greater proportion of our wealth is in financial assets. This means we can enjoy more financial independence. We can shop around more, seeking suppliers who give the lowest prices rather than the most permissive access to finance. More people can buy cars for cash rather than with bank loans. We can reduce our dependence on insurance, buying lower-cost policies with higher deductibles, because we can afford some level of self-insurance. If we have a few dollars in the bank and aren't maxed out on our credit card, we can feel a little more confident about leaving a poor employer and taking time to find a better job.

It's good news for consumers, but not such good news for the finance sector and real-estate agents. Retailers may have to wait a little longer before we replace our sofas and washing machines, and may even have to compete on the basis of price and quality rather than on the basis of availability of credit — a rude return to the discipline of a competitive market.

And, I suspect that the man who felt so wealthy when the market value of his house rose so strongly during Howard's term will now be blaming the Gillard Government for his feeling of poverty. That may be real poverty if he had been unwise enough to overcommit himself by borrowing against that $200,000 he never had.