



ECONOMICS & MARKETS RESEARCH AUSTRALIAN HOUSING UPDATE

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ARE AUSTRALIAN HOUSE PRICES OVERVALUED? PART 2 (DEBUNKING HOUSE PRICE TO INCOME MEAN REVERSION)

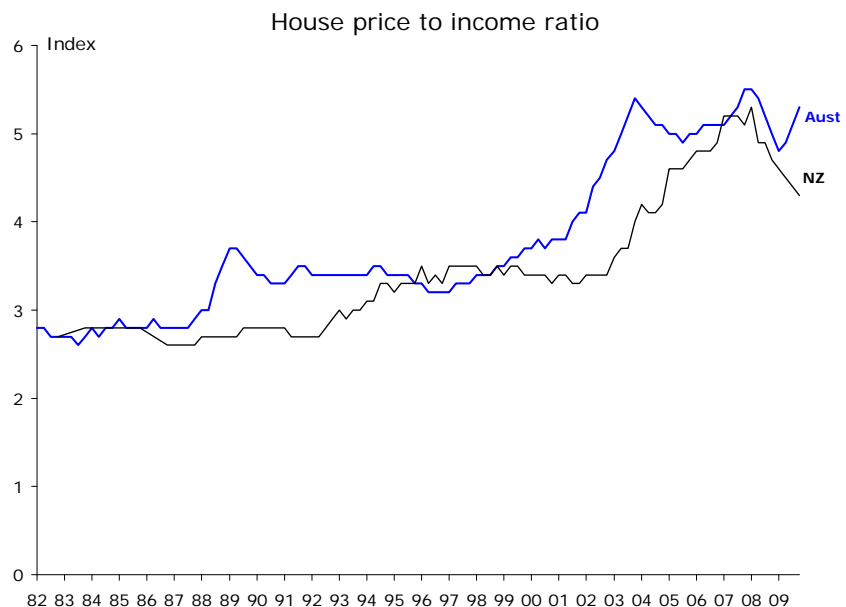
International comparisons of house price to income ratios have been widely used to suggest that Australian house prices are significantly overvalued. These analyses are not only dangerously simplistic but explicitly ignore a key component of the housing affordability equation – interest rates.

House price to income ratio: a flawed measure of affordability

Simple house price to income ratios have been widely used to suggest that Australian house prices are significantly overvalued. These arguments centre around the concept of 'mean reversion' i.e. elevated house price to income ratios *must revert* to their long term historical average for 'affordability' to be 'sustainable'.

However, as a measure of housing affordability, house price to income ratios are very misleading as they completely ignore *interest rates*. Ultimately, housing affordability comes down to debt *servicing* costs of which interest rates are a key driver. This not only means that house price to income ratios are fundamentally flawed as a measure of housing affordability but also makes intertemporal and cross border comparisons of these ratios next to meaningless.

House price to income ratios have risen...



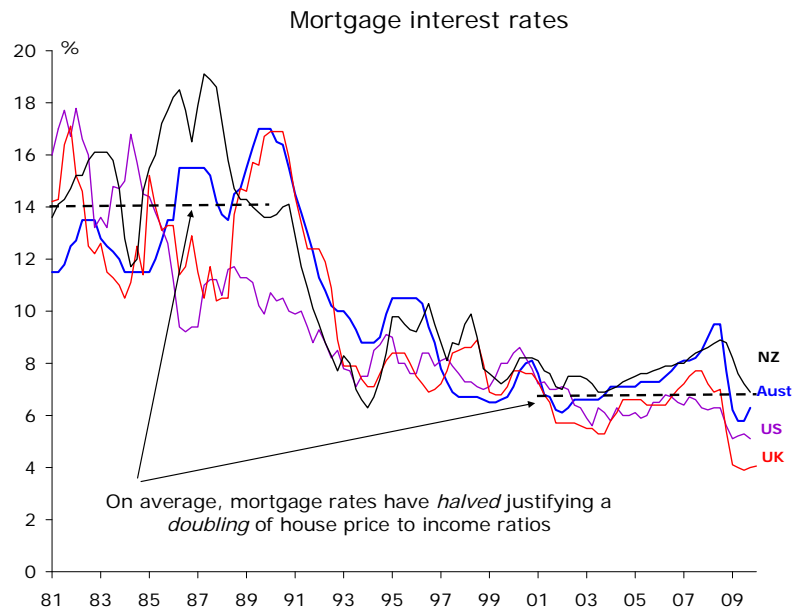
In Australia, the house price¹ to income ratio rose from an average of around 3 in the 1980s to an average around 5 since late 2003.

¹ Median capital city

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That is, the median house price in recent years represents 5 times the average household's annual disposable income compared to 3 times in the 1980s.

...due largely to a reduction in mortgage interest rates

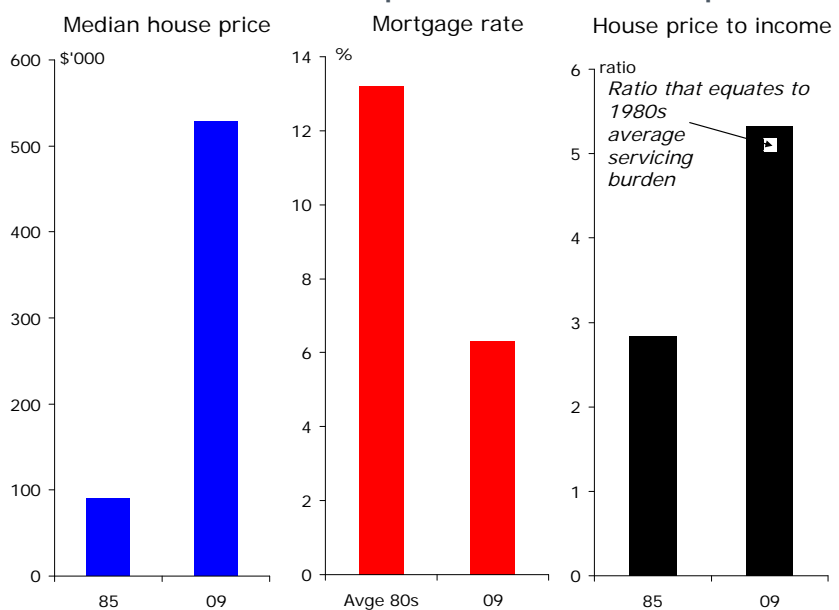


Sources: ABS, Datastream, ANZ Economics and Markets Research

However, the major *reason* for this has been a *structural* (read permanent) *reduction in interest rates*.

Mortgage interest rates in Australia in the 1980s averaged around 14%, however, since 2000 the average has been close to 7%. This reduction in mortgage interest rates has effectively been capitalised into house prices.

The rise in house price to income ratio explicable



Sources: ABS, RBA, ANZ Economics and Markets Research

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The halving of mortgage interest rates almost fully explains the measured rise in the house price to income ratio leaving the house price to income 'mean reversion' argument appearing myopic at best.

Housing affordability and the sustainability (or otherwise) of current house price levels are extremely complex issues and drawing conclusions from simplistic aggregate metrics such as house price to income ratios is very unwise.

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