Alan Bollard: Housing debt, inflation and the exchange rate

Speech notes by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, at an address to the Employers and Manufacturers Association (Northern) AGM, Wellington, 2 November 2005.

The graphs for this speech can be found on the Reserve Bank of New Zealand's website www.rbnz.govt.nz

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New Zealand has enjoyed very strong growth over the last decade. GDP growth has averaged 3.6 per cent over the last five years. But now it is starting to slow, causing some concern to businesses.

We have enjoyed strong growth

New Zealand is an open economy and over the cycle we rely on important contributions from the export sector. But at the moment we observe that despite reasonable terms of trade the impact of net exports is weak, while the domestic sector has continued to grow extremely strongly, driving imports strength.

Driven by very strong domestic spending

The inevitable upshot has been that the creditable positive trade balance we have enjoyed over the last decade and a half has now reversed. Based on last week's trade data, the trade balance has now fallen to a deficit of 2 per cent of GDP. This trade deficit has been a principal (but not the only) reason for the severe fall off in the current account balance (the balance of flows carried in the country and abroad.) Our current account deficit has now reached 8 per cent, the worst figure since 1986 and very marked by OECD standards.

Contributing to negative external balances

Another way of looking at this is to say that we are consuming and investing much more than we are saving. The Government has had a strong saving record over the last decade, and more recently the business sector has been saving too. But the household sector, which represents a large part of the economy, has been running down its savings in spectacular fashion. While we may contest the validity of some of the data, there is little doubt we are now dissaving at about 12 per cent, very low by OECD standards.

And very weak household savings

An important part of what is going on relates to housing. Over the last five years as capital has appeared cheaper and mortgages have become more accessible, the household sector has participated in a large housing boom, including: first time home buyers; others trading up; additions and alterations; second homes; investor houses; investor apartments; and rural property.

The outcome has been unsustainably high house price rises, exacerbated by a very tight labour market and growing non-residential construction. Several other OECD countries are going through a similar housing boom, but none of them have such a tight domestic economy and a poor savings record.

New Zealand households are also unusual in the dependence they have on property assets in their balance sheets. In fact many households hold essentially no other assets. The typical holding of financial assets and equities is very low by OECD standards. The danger of this is it means our love affair with housing leaves us very exposed to a property slump.

The housing boom has driven a lot of extra expenditure that typically accompanies new houses: fixtures and fittings, appliances, even cars. In addition, seeing their house value rise over the last five years, many people have felt richer and have spent more on unrelated items - entertainment, travel, etc. The very tight domestic economy largely reflects this.

Strong house price inflation

Such spending has been made easier by banks and other financial institutions lending freely on homes, encouraging people to put other debt on to their mortgage, and increasing mortgage levels to allow home-owners to consume part of the equity in their homes. This may be part of a longer term change in behaviour by baby boomers to consume more of their wealth during their lifetime. However, this is a difficult time for such adjustment in the business cycle.

The housing boom has meant good profits for many New Zealand companies supplying materials and building services. But it implies home-owners would rather invest in their country's homes rather than its businesses.

What has the Reserve Bank been doing about these growing imbalances and inflation pressures? We identified the issue several years ago and have increased the OCR eight times, the latest last week. Our intention has been to ensure mortgage rates rise so as to curb excess demand. In addition, we have spoken out frequently about the need for home-owners to show care in increasing their borrowings and to increase and diversify their savings.

These past interest rate hikes have slowed housing price growth. But it is still growing at around 14 per cent, driving unsustainable levels of consumer spending. The impact of higher rates on spending levels has been slower than in other periods because the effective mortgage rate has increased more gradually than the OCR. Global interest rates have been unusually low, reflecting loose monetary policies in a large part of the OECD, and supply of savings out of East Asia. Low global interest rates have kept longer-term rates in New Zealand lower than usual and necessitated more tightening in the OCR.

Mortgage rates on upward trend

In addition, late last year the banks in New Zealand started cutting margins as part of a mortgage war. The Australian-owned banks have enjoyed strong profits in New Zealand for some years. They are now seeking to keep up the returns by capturing more business through active marketing of fixed rate loans. This has kept the housing market much more buoyant, unlike in their home country Australia where floating rates predominate and the housing boom is over.

So far our focus has been on the overall effects on the New Zealand economy. But we also need to emphasise the position of certain households that are potentially at risk. About a third of households have mortgages, and one tenth of those are quite deeply in debt, already spending over half their disposable income on servicing their mortgage. These people are vulnerable to interest rates rising, property prices falling, or their employment positions becoming more fragile. Later in November we will be releasing our *Financial Stability Report*, which will comment on the housing sector in more detail.

This presents us all with a challenge.

Strong housing activity and other consumption in this tight economy is starting to drive inflation higher. In addition, pre-election fiscal promises and coalition undertakings could fuel the strong domestic economy further if they happen in the near future. And, the big oil price rise is already increasing headline CPI, while second-round effects could drive inflation further.

Oil price shocks

We are addressing these inflation pressures through higher interest rates. But at the same time this strong domestic demand is driving the current account deficit, which itself is partly exacerbated by the opportunities the relatively higher New Zealand interest rates offer overseas investors in the New Zealand dollar.

How do we intend to manage these issues?

Our primary concern is inflation. We are already seeing signs of domestic spending slowing. Last week we increased the OCR again and stated that we need to see more housing and consumer spending moderation before we will be comfortable that inflation pressures are contained. We will be helped in this by the pressures to increase mortgage rates already in the pipeline, by the tightening international bond rates, and by the increasing sensitivity of indebted households to monetary policy. We will be watching closely for signs of further slowing over coming months.

But we cannot reduce inflation and reduce external imbalances alone. There are other key players in this process, all with responsibilities.

Banks need to focus on their long-term interests, not just their one-year profit growth or market share target. In New Zealand, the banking sector is also responsible for the bulk of credit allocation. This task is an important determinant of New Zealand's long-term economic growth and hence banks' future profits, and must be considered carefully. The larger banks' shareholder interests, which are intrinsically linked to the health of the New Zealand economy, will not be achieved if they promote loans to people who cannot afford them.

Some of the comments that have come out of the property industry suggesting that activity can continue sustainably at this level have been self-serving and unhelpful to those that will be caught up and damaged by a property market correction. We look to the industry and the financial advisory profession to offer professional and realistic advice.

The more government can work to reduce fiscal pressures on the economy, the easier our job becomes.

History shows us that the exchange rate cycle is linked to the broad economic growth cycle. As tighter monetary policy eventually dampens domestic demand - the main source of strong growth in the New Zealand economy - the exchange rate will in time fall. A lower exchange rate is necessary to improve the current account balance by dampening consumption of imports and encouraging exports.

The high exchange rate dampens export earnings

As far as possible the Reserve Bank will not stand in the way of such exchange rate adjustment. Over the short-term, a fall in the exchange rate would push inflation temporarily higher through higher prices for imported goods. But monetary policy would be focusing on the medium-term inflation outlook.

Future track of interest rates

More generally, the correction of imbalances will be driven by the slowing in domestic demand, which will bring down inflation to the target zone by 2007. This, however, comes at the cost of slowing growth. But it is important to recognise that such an adjustment needs to happen - and the sooner it happens, the less costly it will be.

Inflation peaks at 4% then reduces

Finally, households need to remember that saving only through property is unwise, that house prices do not rise forever, and that they cannot rely on others to do their saving for them. If they do, then they can hardly complain when foreigners own a growing part of our capital stock and when they buy New Zealand dollars. We need to take responsibility for our own savings.

The high interest rates needed to encourage New Zealanders to save have had one difficult side-effect, and that is offering inducements to foreigners to buy New Zealand dollars to fund our consumption. This has been one reason why the New Zealand dollar has remained so high (although of course our high commodity prices are another reason). This is starting to cause considerable discomfort for some exporters.

We now see the exchange rate as exceptionally high, and in some respects this is unjustifiable; in time it will fall. The decline in the New Zealand dollar exchange rate will either be gradual, as domestic spending pressures ease off, or it will be more abrupt as global investors reassess New Zealand as an investment destination. Either way, those investors who think that the New Zealand dollar only goes up will be set up for disappointment.

The medium-term economic prospects for this country look good, but we have some short-term adjustment to go through first.