Grant Spencer: Reserve Bank of New Zealand's perspective on housing

Speech by Mr Grant Spencer, Deputy Governor and Head of Financial Stability of the Reserve Bank of New Zealand, to Employers and Manufacturers Association, Auckland, 8 April 2013.

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The housing market is once again highly topical. When house prices move we get interested, and for good reason: the home is usually the single largest asset that a family owns; and a mortgage is often the single largest financial transaction undertaken by a household. The housing market is also a major driver of the macro-economy and of the financial sector. As such, housing market developments are very relevant for the Reserve Bank's two key policy objectives: price stability and financial stability.

Today I will discuss current developments in the New Zealand housing market, the risks that are emerging, and the policy responses that may be appropriate to address these risks.

The importance of housing

How important is housing to the typical New Zealand household? And how important is housing to New Zealand's economy and financial sector?

Table 1: Household assets and liabilities for Australia and New Zealand (as at December 2012)

	New Zealand		Australia	
	$bn	% of assets	$bn	% of assets
Financial assets	240	27	3317	44
Housing wealth	648	73	4199	56
Total assets	888		7517	
Financial liabilities	191	22	1682	22
Net worth	696		5834	

Note: Consumer durables are excluded from household assets. For New Zealand, net worth deducts student loans. The share of housing assets is somewhat overstated because the data excludes assets such as equity in unincorporated and unlisted businesses. See Briggs (2012) for more details on these excluded assets.[1]

Source: RBA, RBNZ calculations/estimates.

The most recent data on household balance sheets is shown in Table 1. Two observations are key: first, the value of housing is a large share of total household assets in New Zealand compared to Australia (and the United States) where financial assets play a much greater role in saving for retirement. Consequently, house price movements in New Zealand have a relatively large impact on household confidence and spending compared to many other developed countries where the state of the financial markets plays a larger role in driving consumer confidence and spending.

Second, debt is not evenly distributed across households. On average, gearing of New Zealand households is relatively low, with housing debt equal to around 27 percent of the value of the housing stock. And overall mortgage interest payments only account for around

[1] http://www.rbnz.govt.nz/research/bulletin/2012_2016/2012Dec75_4briggs.pdf

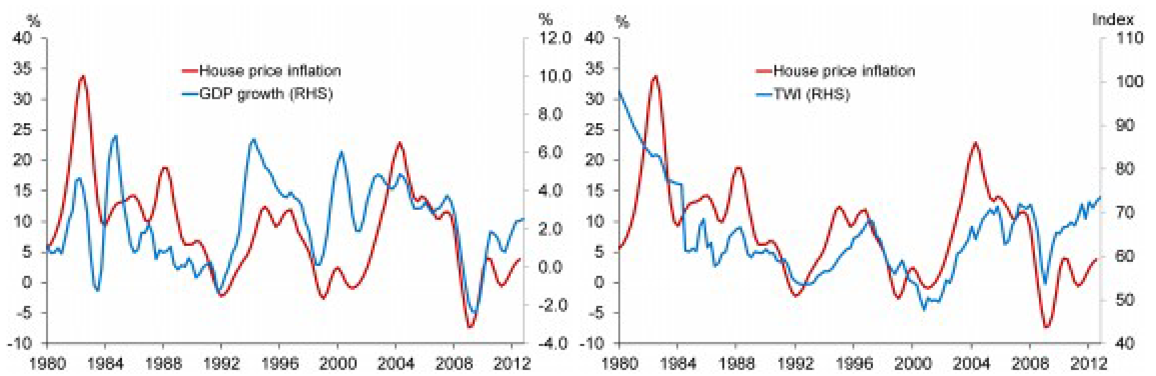
9 percent of total household disposable income in New Zealand. However, some households have very high levels of debt, and interest payments consume a large portion of their income. A first-home buyer borrowing 90 percent of the value of a house could have debt servicing costs of 35 percent of disposable income, even at today's low interest rates.

Add to this the fact that mortgage credit is by far the biggest asset class of the New Zealand banking system, making up just over half of total banking system lending, and it becomes clear that housing is a significant source of risk to both the household sector itself, and the New Zealand banking system.

Housing cycles in New Zealand can have important macroeconomic effects. Figure 1 shows long-term house price cycles against GDP growth and the exchange rate.

Housing has often been associated with real activity cycles, and is even more correlated with financial cycles, as represented by changes in credit demand and the exchange rate.

Figure 1: House price inflation, GDP growth and the exchange rate



Source: Property IQ, Statistics New Zealand, RBNZ.

Note: House price inflation and GDP growth are annual averages.

In the housing boom of 2003–07, for example, housing had a significant impact on the growth of aggregate demand and GDP through a number of channels: wealth and confidence effects where people felt richer, making them willing to spend and borrow more; direct effects on investment as higher house prices improved the return to residential construction; and financial accelerator effects where increased collateral values supported increased spending through credit expansion. The latter channel has created a strong link between house prices and the financial cycle. During the boom that link was accentuated with the emergence of widespread housing investment activity, bringing with it rapid credit growth, a high volume of offshore borrowing and upward pressure on the NZD exchange rate.

Consequently, housing can be highly relevant for the Reserve Bank's Monetary and Financial Stability policies.

Monetary policy responds to house price pressures when these are seen as a clear driver of inflationary pressure through stronger domestic demand. This can occur when wealth effects push consumption ahead of income growth and households borrow against housing capital gains. That process was prevalent in 2003–07 and a key reason why monetary policy leaned against the housing boom – with mortgage rates being pushed up to just under 11 percent by 2008. It is also why asset prices are explicitly mentioned in the new Policy Targets Agreement between the Governor and Minister of Finance, even though house prices do not enter the Consumer Price Index (CPI) directly.

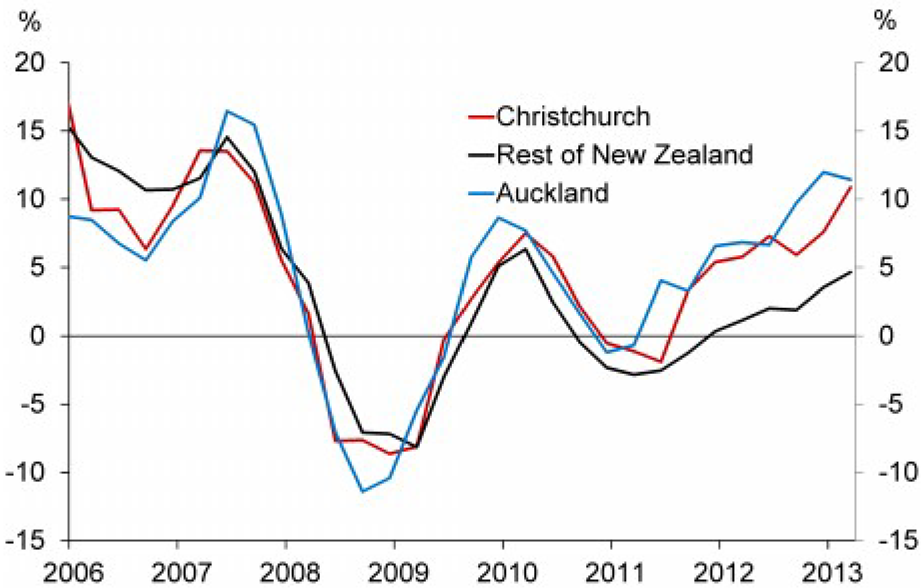
On the financial stability side of Reserve Bank policy, the dominance of residential property as the banking system's single largest sectoral exposure underpins the Reserve Bank's prudential focus on housing lending risk. We pay considerable attention to the housing risk models used to determine banks' capital requirements and have generally adopted a conservative approach, with higher risk weights relative to international norms. Consistent with this approach, we are currently reviewing the scale of housing risk weights in relation to loan-to-value ratios.

We are also focussing on the additional housing-related systemic risk that might arise from credit cycles in our new macro-prudential policy regime that is currently out for public consultation. While as yet untested in New Zealand, such policies are deployed in Canada, Switzerland, Sweden and Hong Kong, for example. Macro-prudential policies draw on existing prudential tools to limit financial system risk arising from excessive credit and asset price movements. Practically, this means that additional prudential requirements may be applied for a period during credit up-cycles and then removed during down-cycles. The tools operate directly to improve the resilience of bank balance sheets and indirectly to moderate the extremes of the credit cycle.

Sources of pressure in today's housing market

We are again facing a strong housing market with median house prices having risen by 8 percent over the past year. So far, the nature of the current market is different to the boom of 2003–07. As seen in Figure 2, the current house price pressures are concentrated in Auckland and Christchurch. House price inflation in the rest of the country is less pronounced, around 4 percent over the past 12 months, although there is considerable variation among districts.

Figure 2: House price inflation by region (annual percent change)



Source: REINZ, RBNZ estimates.

Supply constraints in Canterbury and Auckland and pent up demand from first-home buyers are important factors. There is an element of investor demand and of new foreign buyers entering the market in Auckland, but these factors – at least as yet – are not as influential as they were back in 2003–07.

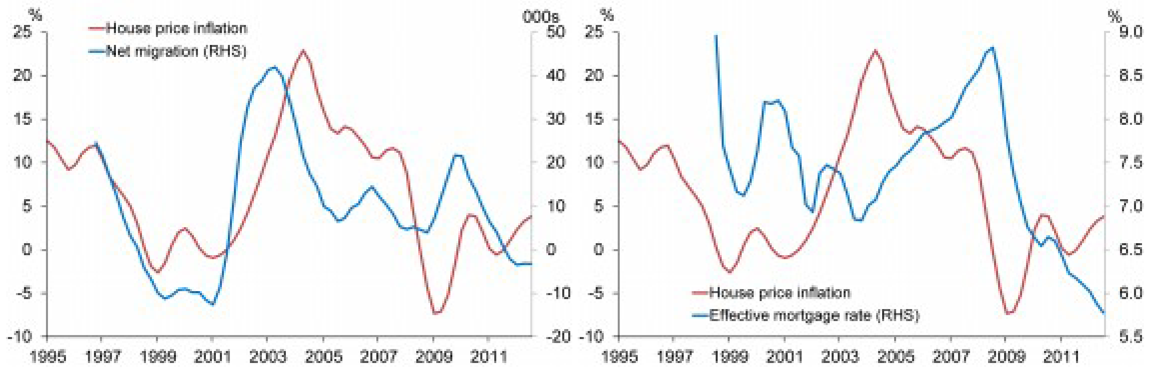
The relevance of housing supply constraints has been discussed in earlier Reserve Bank/Treasury reports and, most recently, in the Productivity Commission's report on housing affordability.[2] Contributing to the current national housing shortage has been the low level of residential construction activity in recent years. From 2007 to 2011, residential investment as a share of GDP fell by 2-and-a-half percentage points.

In Christchurch, the general shortage of accommodation is reflected in median house prices up 12 percent, rents up 16 percent, and the cost of building up 10 percent over the year to December 2012. These pressures are likely to persist for some time despite the insurance industry's plans to finance 10,000 new houses over the next three to four years.

In Auckland the situation is more complex – and more uncertain. The Auckland Council puts the current shortfall at around 20,000 to 30,000 homes, with an additional 13,000 per year needed going forward. However, the current rate of building is hardly making a dent in that, with residential building consents for new dwellings in Auckland currently running at just 4900 per annum. The Ministry of Business Innovation and Employment estimates that land ready for subdivision in Auckland has the capacity for 14,500 new homes. But, while zoning and utilities infrastructure may be complete for those subdivisions, only 2000 sites are ready to build on – with utilities actually connected and consents approved. These numbers reinforce the complexity of supply constraints noted by the Productivity Commission. It is not just a zoning or Metropolitan Urban Limit issue. The cost and the duration of subdivision development and house construction are also major constraints, particularly for the supply of "affordable" homes to first-home buyers.

On the demand side of the housing equation, the two key drivers historically have been migration flows and interest rates. Permanent and long-term migration inflows have not been exceptional in the post-global financial crisis (GFC) period, averaging 7000 per annum, compared to 18,000 per annum on average during the 2003–07 boom period (Figure 3). Internal migration to Auckland from Christchurch and other areas could be contributing to the Auckland housing shortage. However, while our data on internal migration flows is sketchy, this factor does not appear to be a strong driver of the current Auckland market.

Figure 3: House prices, net migration, and mortgage rates



Source: Property IQ, Statistics New Zealand, RBNZ.

The role of mortgage interest rates in current market pressures is much clearer. Current "best in market" rates are around 4.8–5.0 percent. These are down half a percent over the past year due to lower funding costs on international markets. They are the lowest mortgage rates on offer since the 1960s. While there are good reasons for this – low CPI inflation and very low international interest rates – the cost of credit is now only slightly above average

[2] http://www.rbnz.govt.nz/monpol/about/2452274.pdfhttp://www.productivity.govt.nz/sites/default/files/Final percent20Housing percent20Affordability percent20Report_0_0.pdf

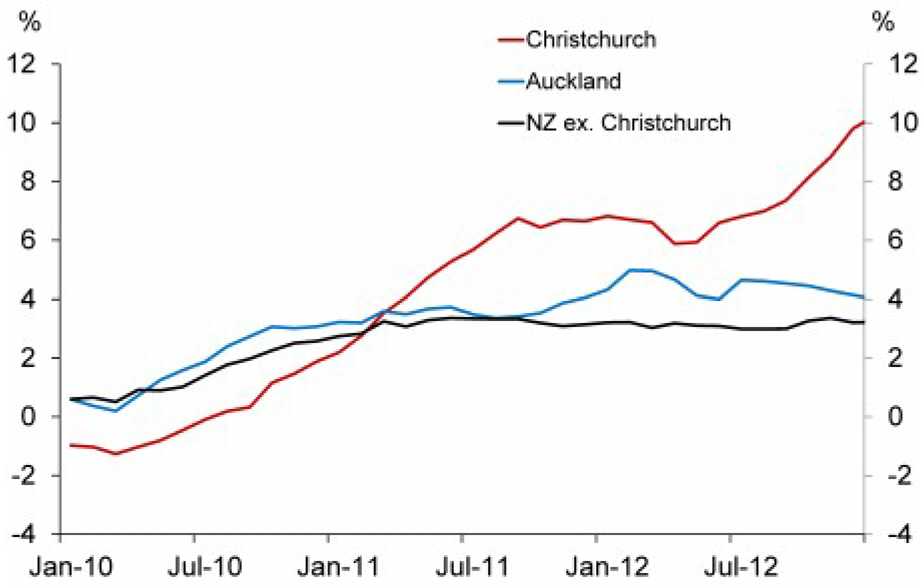
rental yields of 4.5 percent per year. Added to this, credit has become easier to obtain, with banks competing aggressively to gain or protect their mortgage market shares.

An increasing proportion of new mortgage lending is going out at high loan-to-value (LVR) ratios: now around 30 percent of new lending is at LVRs over 80 percent, compared to around 25 percent of lending in late 2011-early 2012. Annual growth in housing credit is just over 4 percent and has been running at higher rates over recent months.

Easy credit conditions, combined with the upward trend in house prices, are strengthening the incentive for renters to become first-home buyers and for existing owner-occupiers to upgrade. With new construction still at a slow pace, this excess housing demand increases house price pressures.

Movements in rents tend to support this interpretation. Compared to Christchurch, average rents in Auckland have been growing at a more moderate annual rate of 4 to 5 percent, although still somewhat stronger than for the rest of the country (Figure 4). This suggests that the physical housing shortage in Auckland is less acute than in Christchurch and that credit factors have been an important driver of escalating house prices in Auckland.

Figure 4: Inflation in rents by region
(annual average percent change)



Source: Department of Building and Housing

Reserve Bank policy perspective

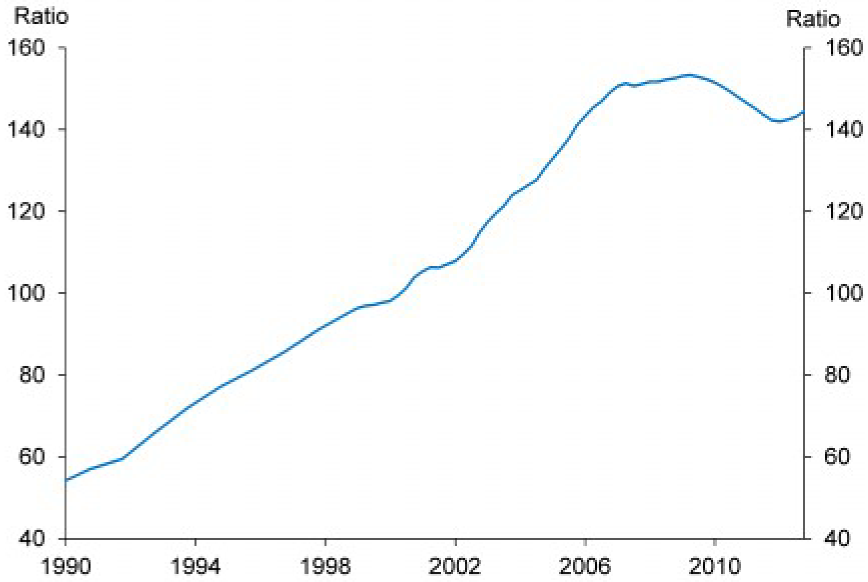
As mentioned earlier, the Reserve Bank views housing from a monetary policy perspective and from a financial stability perspective. Considering monetary policy first, the key question for us is whether the housing market buoyancy will lead to wider inflationary pressures. An important factor in this regard is whether we begin to see a reversal of the trend increase in the household savings rate that has occurred over recent years. This general deleveraging process, where many households have reduced debt and sold up investment properties, has moderated household demand in recent years and reduced the official interest rate settings needed to keep inflation pressures in check.

Our projections in the March *Monetary Policy Statement* suggest that household spending will generally pick up in line with stronger incomes. We assume that the boost to spending arising from perceived increases in housing wealth will not be pronounced and that housing market activity does not encourage a rise in speculative investment that could extend house price pressures to the rest of the country. So while new home owners will continue to take on new debt, we assume that existing home owners will continue to conserve or increase the equity in their properties, rather than seeking to "gear up" existing housing assets.

There is a risk of course that our assumptions turn out to be wrong: that the housing market continues to gather momentum and that households return to their pre-GFC ways of borrowing and spending in excess of incomes. The recent fourth quarter GDP numbers, which showed expenditure GDP growth of 1.4 percent and private consumption growth of 1.6 percent over the quarter, remind us that this alternative outlook for household behaviour is a real risk.

Turning to financial policy, we have been encouraged by the general improving trend in household (and business) balance sheets since the GFC. However, the improvement in household debt ratios has been gradual relative to the rapid escalation of debt during the pre-GFC boom (Figure 5)

Figure 5: Household debt to household disposable income



Source: RBNZ.

The chart shows a very recent uptick in household debt to household disposable income. If that uptick becomes a reversal of the recent downward trend, then household balance sheets will become increasingly stretched, making them vulnerable to future economic shocks, such as increases in interest rates or unemployment.

The trend in the banking system since the GFC has also been one of deleveraging and general risk reduction. Problem loans are reduced and stronger capital and liquidity buffers are in place. This trend has been a key theme of our *Financial Stability Reports* in recent years.

But if households become more stretched financially, then the banks' balance sheets will also become more risky. That is the prospect we now face as a result of debt levels rising faster than incomes and the increased proportion of high LVR lending that has been evident since early 2012.

We have concerns that the current escalation of house prices is increasing risk in the New Zealand financial system, by increasing both the probability and potential effect of a significant downward house price adjustment, that could result from a future economic or financial shock. Unlike many other countries, New Zealand did not experience a major house price correction during the GFC and the median house price is now 12 percent above its end-2007 level. This has left us with house prices that are already high relative to international norms. For example, in a recent international study of housing affordability, median New Zealand house prices (relative to disposable incomes) were the third highest amongst comparable countries.[3] The more that house prices continue to overshoot their long-run sustainable levels, the greater the prospect of an eventual significant downward correction. We have seen in those countries most affected by the GFC the significant damage that can result from sharp declines in house prices, both in terms of financial system losses and the economic stresses placed on borrowers. The impact of such an adjustment could be worsened by existing economic headwinds in the form of an overvalued exchange rate, drought affected agriculture and the government's significant fiscal consolidation.

We are not the only ones concerned. This view of increasing housing risk in the New Zealand financial system is shared by the International Monetary Fund in their recent "Article IV" assessment[4] and was voiced during the recent OECD mission to New Zealand. It is also shared by Moody's and Standard and Poor's in their most recent risk assessments of the New Zealand banking system.

What can be done to reduce the imbalances?

An important medium- to long-term policy response is to work on alleviating the housing supply constraints, particularly in Auckland. That means freeing up land for subdivisions and also reducing the time and cost barriers faced by developers. As recommended by the Productivity Commission, there is also a need to promote/facilitate productivity improvements in the building sector itself, in order to bring unit costs more into line with international norms. The Government is working on measures to address many of these supply constraints, but we know it could take many years to correct the supply/demand imbalances through supply measures alone.[5] For example, recent Motu research on a regional housing model for New Zealand concludes:

> *"The over-arching conclusion across all simulations is that housing markets are very slow to adjust to disequilibria, such that exogenous shocks have very long lasting effects on prices and the housing stock." (Grimes et al, 2013)*[6]

In the short-to medium-term, we want to ensure that the banking system is adequately capitalised for the risks associated with mortgage lending and also avoid demand pressures that could exacerbate a house price overshoot that is in no-one's best interest. A continued escalation of house prices would frustrate first-home buyers; it would risk drawing more investors into the market which would reinforce the price overshoot; it would likely reverse the recent improvement of household debt relative to income; and it would add a further layer of risk to the banking system.

From a Reserve Bank monetary policy perspective, if the house price and credit expansion begin to fuel excessive consumption spending and inflationary pressures, a monetary policy response would become more likely. The Reserve Bank's flat interest rate outlook in our recent *Monetary Policy Statement* would need to be revisited.

In the financial policy area we are currently consulting on a potential increase in bank capital requirements against high LVR lending. We also expect to soon have in place a macro-prudential policy framework that could be used to increase resilience in the banking system against a future housing downturn while having a moderating influence on credit expansion

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3 http://www.demographia.com/dhi.pdf

4 http://www.imf.org/external/np/ms/2013/031813b.htm

5 http://www.treasury.govt.nz/publications/informationreleases/housing/pdfs/ha-202689.pdf

6 http://motu-www.motu.org.nz/wpapers/13_02.pdf

to the housing sector.[7] Macro-prudential policy is primarily aimed at enhancing financial stability, but it may also contribute to achieving monetary policy objectives. It is not seen as a replacement for monetary policy and it is not expected to be as powerful a tool as monetary policy. Macro-prudential policy could nevertheless have a stabilising impact on credit supply decisions by the banks as well as credit demand decisions by households.

Conclusion

I have talked about the importance of housing to New Zealanders, certainly from an economic and financial perspective, and also from an emotional perspective. This often makes housing a major force behind economic and financial cycles, and a very relevant factor in the Reserve Bank's monetary and financial policy considerations.

Current housing market pressures are centred in Christchurch and Auckland where significant supply shortages are apparent, for quite different reasons. In Christchurch the imbalance is being addressed through a major four to six year rebuilding programme, funded largely by Government and the insurance sector.

In Auckland the housing imbalance is more complex and uncertain. There are clearly supply constraints and high costs of development that need to be worked on over the medium- to long-term. However, there are also escalating demand pressures in the Auckland market, particularly arising from low interest rates and an easier supply of credit. It is important that these pressures moderate in order to avoid a destabilising overshooting of house prices while additional supply is gradually brought on stream.

New Zealand needs to avoid another housing boom, which could potentially be more costly than the last, particularly at a time when the economy faces headwinds from an overvalued exchange rate, drought and a substantial programme of fiscal consolidation.

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7 http://www.rbnz.govt.nz/finstab/macro-prudential/5166933.pdf