Grant Spencer: Trends in the New Zealand housing market

Speech by Mr Grant Spencer, Deputy Governor and Head of Financial Stability of the Reserve Bank of New Zealand, to the Property Council of New Zealand, Auckland, 15 October 2013.

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It is a pleasure to be here today at the Property Council of New Zealand to participate in your residential summit. Your speakers will have various perspectives on the New Zealand housing market. The Reserve Bank's perspective is a macro one. We see the housing market as an important driving force in the overall New Zealand economy. It is not just of relevance for the building industry and for people buying and selling houses. The housing market is also relevant for upstream manufacturers of building products, for the net worth of all existing home owners, for banks seeking to fund home purchases, and for exporters facing pressures on the exchange rate. As a central bank mandated with price stability and financial stability objectives, the housing market is a key factor influencing our policy decisions. Most recently, we introduced restrictions on mortgage lending with a high loan-to-value ratio (LVR), starting from the first of October.

The main purpose of the LVR restrictions is to reduce risk in the financial system by moderating the current excess demand pressures on house prices, which are particularly evident in Auckland. We agree with most commentators that the key underlying issue here is a chronic housing supply shortage, and I will come back to this topic. But the period of rapid price increases over the past two years has coincided with very low interest rates and easier bank credit. Banks have competed aggressively for mortgage business and this has contributed to a ramp up in housing demand, which has far exceeded the available supply.

If the growth in demand continues to exceed the growth in housing supply, house prices will become increasingly vulnerable to a sharp correction, which could be prompted, say, by a global financial shock. As seen in many developed countries in the global financial crisis (GFC), such a correction can come with significant financial and economic costs. Further, growing momentum in house price inflation would risk a return to the "borrow and spend"mentality of the last housing boom. The consequent growth in consumption would add to general inflation pressures and ultimately prompt stronger interest rate increases than would otherwise be necessary. In this way, a housing expansion can easily start to crowd out other economic activity including, in particular, export production through upward pressure on the New Zealand dollar exchange rate.

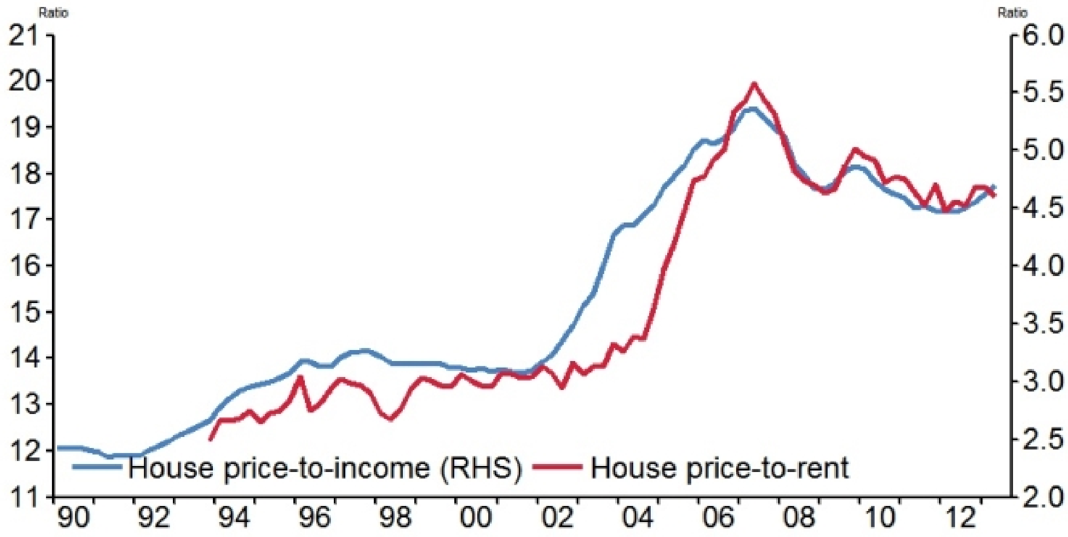
In my talk today I want to look specifically at the current supply and demand pressures in the New Zealand housing market, at how the imbalance might be alleviated in coming years, and the impact that the LVR restrictions are expected to have.

Housing market pressures are growing

Between 2000 and 2007 house prices in New Zealand more than doubled, and household indebtedness increased from 100 to 150 percent of household disposable income. When the cycle turned in 2007, house prices fell 10 percent – a relatively benign fall compared with some countries, such as the United States, Spain and Ireland, where house prices fell by 30 to 40 percent. This is a key reason why the New Zealand economy has performed relatively well amongst OECD countries through the post-GFC period.

But while New Zealand households' balance sheets fared relatively well in the downturn, the vulnerabilities built up during the 2000s housing boom have not unwound: house prices and household debt both remain elevated relative to international and historical norms. These imbalances leave New Zealand vulnerable to a fall in house prices at some point in the future. Such a fall, potentially triggered by an external financial shock, could cause real damage to New Zealand's financial system and broader economy. Figure 1 shows that house prices are high relative to household disposable incomes and rents, even though they have eased from their 2007 peak. On these sorts of measures, the OECD estimates that New Zealand house prices are 25 percent above their long-term averages.

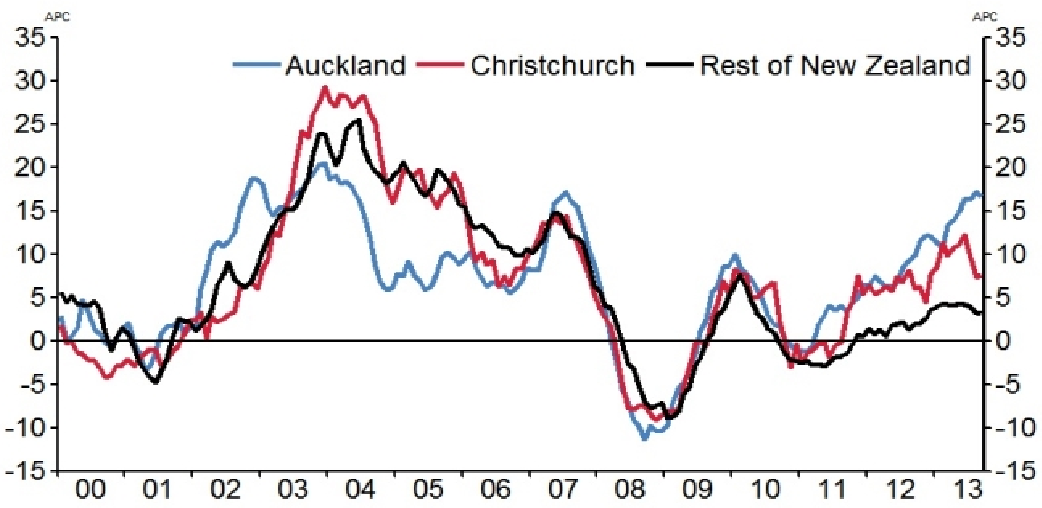
Figure 1: House prices relative to income and rents



Source: Quotable Value Ltd., RBNZ, Statistics New Zealand, Ministry of Business, Innovation and Employment.

From this high starting level, New Zealand house prices are now rising rapidly once more. Over the year to the September quarter, New Zealand house prices increased 9 percent. According to REINZ, house prices have increased particularly strongly in Auckland and Christchurch, with annual rates of 17 and 8 percent respectively (figure 2). House price inflation in the rest of New Zealand is running at around 3 percent. Some of the stronger regions include Nelson, New Plymouth and Queenstown. As a consequence of these rises, national house prices are now 11 percent higher than at the peak of the boom. Auckland prices are 26 percent above their previous peak.

Figure 2: House price inflation by region, three-month moving average



Source: REINZ.

While we are currently satisfied with the soundness of the financial system and the stability of general prices, the increasing stretch in house prices presents a risk to future financial stability and future general price stability. The stretch is being driven by supply constraints, combined with an expansion in credit-based demand.

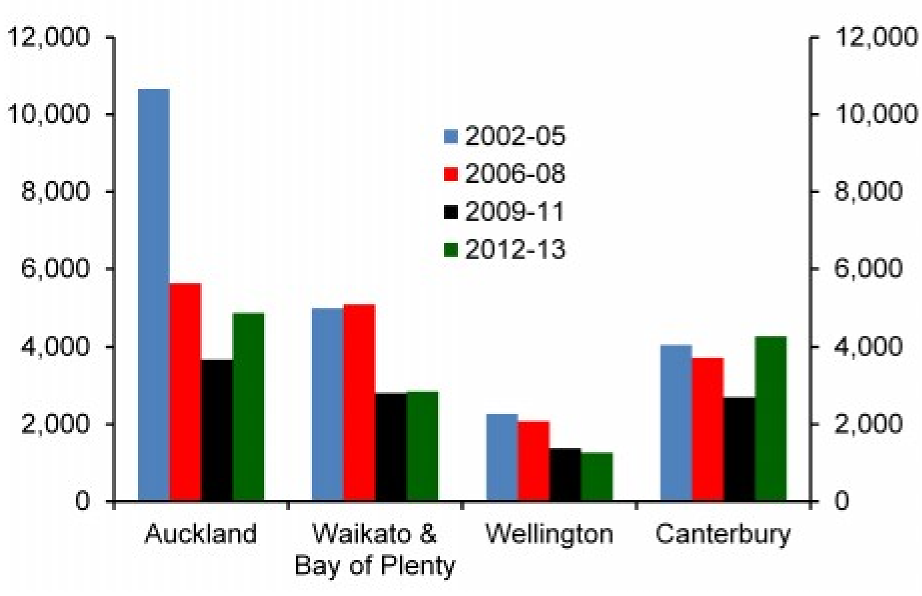
The housing supply shortage

In Christchurch, the supply of habitable homes was significantly reduced as a result of the Canterbury earthquakes in 2010/11. Both house prices and rents increased substantially as permanent residents sought to re-establish themselves and temporary residents moved in to work on the rebuild.

In Auckland, the picture is different. The housing shortage has emerged over a longer period, and is more evident in homes for sale than in rental properties, with house prices moving up well in excess of rents. This pattern is consistent with an increasing trend of existing renters seeking to become first home buyers. In the last June quarter, available listings of houses for sale in Auckland reached the lowest level ever recorded.

Looking back, the building of new homes in Auckland has been weak for many years. A significant number of new homes were built in Auckland between 2002 and 2005 when overseas immigration into New Zealand was strong. However, the rate of new building slowed dramatically in 2005, as immigration flows moderated, and has remained low since. In the rest of the country, construction of new dwellings remained elevated from 2002 right through until the 2008/09 recession, with many houses built outside of the main urban centres in regions such as Waikato and the Bay of Plenty (figure 3).

Figure 3: New dwelling consents in selected regions (annual average)

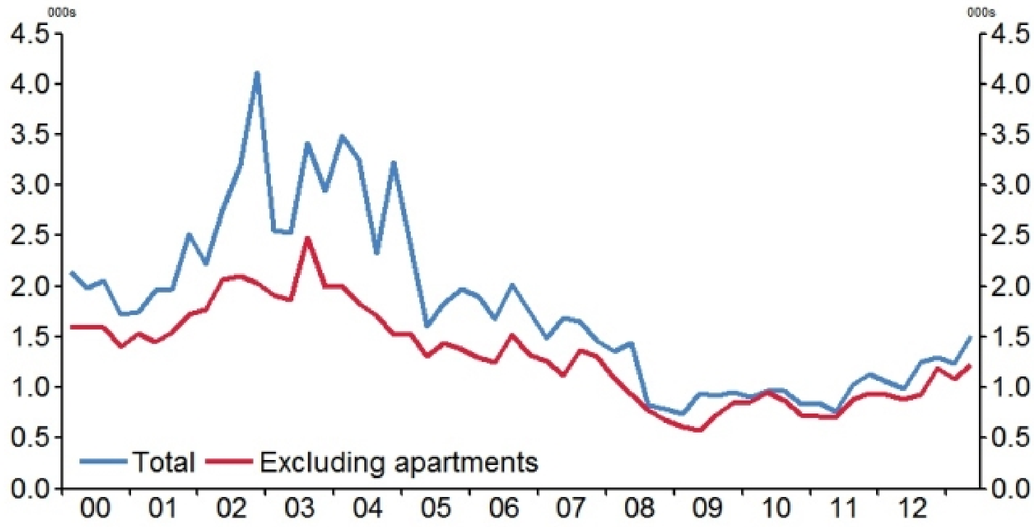


Source: Statistics New Zealand.

While many dwellings were built in Auckland between 1991 and 2005, research suggests that, relative to population growth, districts in Auckland have the lowest supply responsiveness in the country.[1] If we exclude apartments from the picture, the construction of new dwellings has been weak or declining since 2004 (figure 4).

[1] See Grimes & Aitken (2006).

Figure 4: New building consents in Auckland (quarterly)



Source: Statistics New Zealand.

Low rates of building have led to a gradually increasing shortage of homes in Auckland. This is reflected in a consistent upward trend in population-per-dwelling in Auckland since 2005.[2] Auckland Council estimates that there is a shortage of 20,000 to 30,000 homes in the region currently, and that 13,000 new dwellings will be needed each year to meet projected population growth over the next 30 years.

A significant limitation on new home building in Auckland appears to be a scarcity of available land. This has been an increasing problem as the Metropolitan Urban Limit (MUL) has become more binding. As the availability of land within the MUL has decreased, land prices have been bid up, which, in turn, has probably curbed housing supply. The Productivity Commission (2013) estimates that, in 2010, land just inside the MUL was worth nine times the value of land just outside the boundary – up from six times in 1998. This is a key reason why land costs now comprise 60 percent of the cost of building a new dwelling in Auckland, compared with 40 percent in the rest of the country. In its report on housing affordability, the Productivity Commission (2012) identified restrictive urban planning, and the time and costs associated with land development and construction, as additional factors constraining the building of new houses.

To help alleviate supply constraints, the Government, in agreement with the Auckland Council, has passed legislation to implement the Auckland Housing Accord. The accord seeks to free up enough land for 39,000 new homes in the next three years. To do this, the resource consent process will be sped up for housing developments within specified areas, consistent with the rules outlined in Auckland's Unitary Plan.[3]

Auckland Accord targets aim to make enough land available for 9000 new dwellings over the year to March 2014 – well above the current rate of 5600 new dwellings consented over the year to August. So far, the council has announced the release of enough land for 6000 homes under the accord. The accord targets are ambitious and it will take time for land

2 Many thanks to Westpac for providing regional population-per-dwelling data.

3 The Unitary Plan is regulatory document developed under the Resource Management Act, in accordance with the Council's vision for housing development in Auckland over the next 30 years.

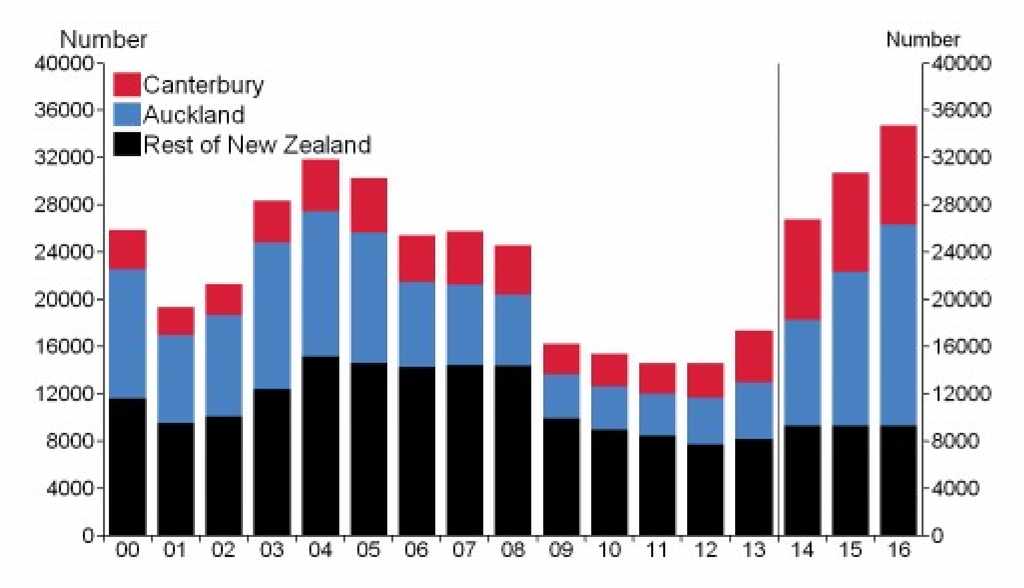
to be developed and houses built. Nonetheless, the accord is an important step forward in helping to alleviate the Auckland housing shortage.

Pressures on construction

As more new homes are built in Auckland, this will create construction jobs and contribute to economic growth. However, this new building will occur at the same time as the Canterbury rebuild is taking place, creating significant resource pressures in the national construction industry.

Figure 5 shows the amount of new dwellings that might be built over the coming three years if accord targets were fully met and 12,000 new homes were built in Canterbury over the same period. To achieve this, new dwelling construction would need to be 9 percent higher than at the height of the recent housing boom, even assuming no growth in home building through the rest of the country. At the same time, a significant amount of repair work, infrastructure and commercial construction will be taking place in Canterbury. In reality, we expect the targeted house building in Auckland and Christchurch to occur over a longer period than three years. How much longer will depend on the extent of improvements in approval processes and on the ability of the construction industry to expand its current capacity.

Figure 5: New dwellings consented in an unconstrained building scenario



Source: Statistics New Zealand, RBNZ calculations.

Note: This scenario assumes that Auckland Accord targets are met, 12,000 homes are built in Canterbury over the next three years, and that building through the rest of New Zealand continues at its current rate.

While phasing of this major home building programme will help to limit resource pressures, some wage and price pressures will inevitably result. The upward pressure on construction costs that we are currently seeing in Canterbury may well extend more broadly across the industry. On a moderate scale, this would help to attract resources into the construction industry and hence facilitate the building expansion. On an excessive scale, this would risk spilling over into general inflation and put upward pressure on interest rates and the exchange rate.

To avoid the potential problems associated with excessive house price and construction cost inflation, we will need a more responsive supply side that includes:

- A responsive and innovative building sector;
- An adequate supply of labour, some of which will need to be imported; and
- A responsive planning and consenting process.

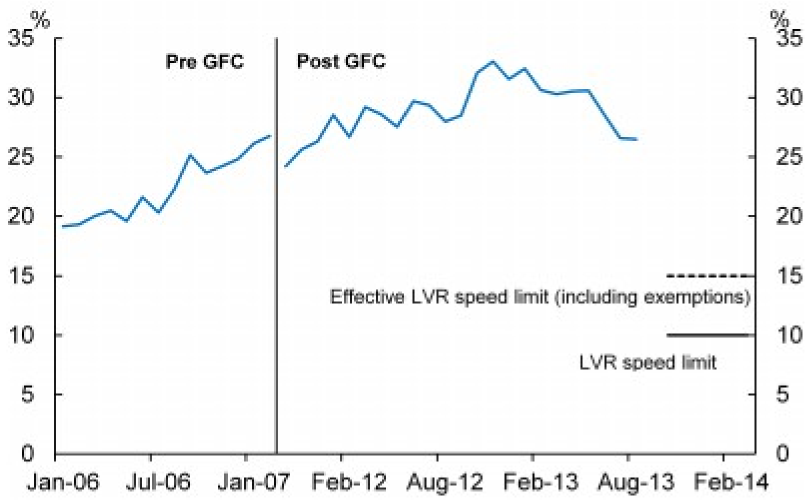
We will also need the demand side to be kept in check while the supply response takes place.

The demand side and credit

Clearly, the supply of houses is an important determinant of house prices– but it is only one side of the story. We have seen the shortage of homes in Auckland emerge due to low construction rates over many years. But house price inflation has accelerated only over the past two years, over the same period that credit conditions became easier and population growth picked up with stronger net inward migration. It is relevant that house price inflation in Auckland has not been matched by rental inflation, which is less affected by credit conditions.

Looking more closely at credit conditions, interest rates are currently very low by historical standards. Indeed, the sub-5 percent mortgage rates on offer earlier in the year were the lowest since the 1960s. Low interest rates increase the incentive for households to own rather than rent. Over the past 18 months, as housing demand picked up, housing credit has also been easier to obtain than previously, with banks competing aggressively to write mortgages. As a consequence, credit growth has risen, with outstanding housing credit rising 6 percent through the year to August. Lending to borrowers with high LVRs has grown twice as fast, causing the share of high LVR lending to rise (figure 6).

Figure 6: High-LVR loans as a share of new lending



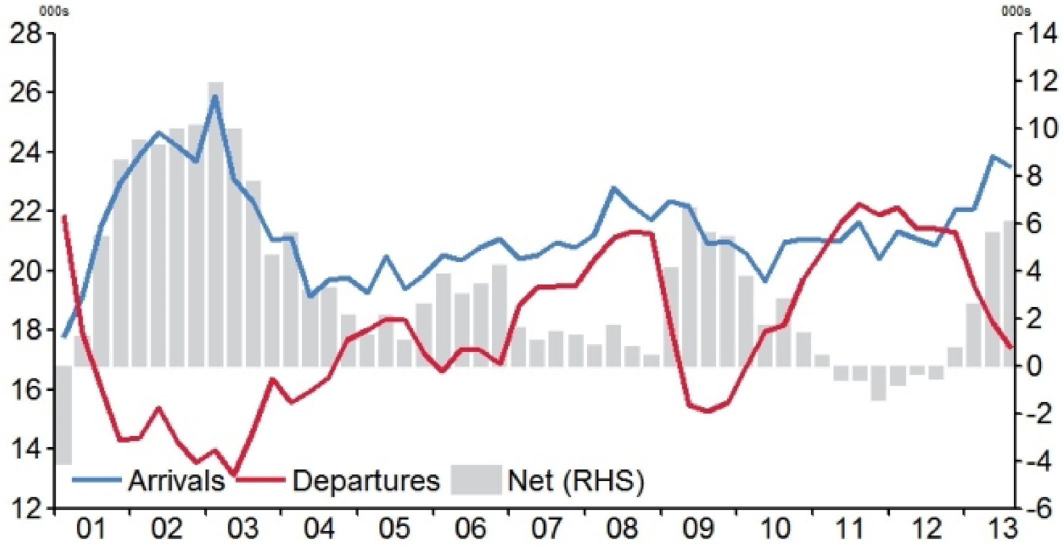
Source: RBNZ.

Households who borrow at high LVRs tend to be the most vulnerable to a fall in house prices. In the event that house prices fall, these borrowers are more likely to see the value of their house fall below the amount of debt they have outstanding – particularly if they have entered the market recently. This can lead to financial hardship, mortgage defaults and, potentially, stress across the broader financial system.

Apart from easy credit conditions, housing demand over the past year has been boosted by a growing net inflow of immigrants (figure 7). Net immigration to New Zealand has risen substantially over 2013 due to fewer departures of New Zealand citizens to Australia at the same time as inflows of returning citizens and non-New Zealand citizens from Europe, the

United Kingdom and Asia have continued to increase. Over the year to August 2013, a net 13,000 people moved to New Zealand with the intent of staying a year or longer – the highest annual inflow since early 2010. As more people enter the country, this increases the demand for housing, tending to put upward pressure on rents and house prices – particularly in Auckland, where immigration flows have been strongest.

Figure 7: Permanent and long-term immigration to New Zealand (quarterly)



Source: Statistics New Zealand.

The role of high-LVR lending restrictions

The LVR lending restrictions in operation from 1 October 2013 are primarily intended to reduce systemic risk by slowing house price inflation. They seek to reduce the risk that a subsequent price correction in an increasingly overvalued housing market could pose for the financial sector and broader economy. Given the relatively slow response of housing supply, it does not make sense to let credit-based housing demand get too far out in front. Further, to the extent that the LVR restrictions dampen overall demand in the economy, they could also reduce the extent of interest rate increases, and hence exchange rate pressure, that may be needed over the coming cycle. At this point, we estimate that the LVR restrictions are worth approximately 30bp of OCR adjustment. The LVR restrictions are also expected to reduce risk in the banks' balance sheets.

Estimating the impact of the LVR restrictions is complicated by the fact that this is a new tool and New Zealand appears to be unique in using a speed limit approach. Quantitative estimates of impact are necessarily approximate, with key uncertainties including the extent to which low-deposit borrowers find other sources of funds, and the extent to which lower credit growth feeds through to house sales and prices.

We estimate[4] that:

- Mortgage credit growth will be 1–3 percentage points lower over the first year.
- Home sales will be 3–8 percent lower over the first year
- House price inflation will be 1–4 percentage points lower over the first year.

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[4] See Bloor & McDonald (2013).

Beyond the first year, these effects will be reduced. Also, the impact of LVR restrictions will not be uniform across the country. Market segments with a higher proportion of high-LVR borrowers are likely to see larger effects, as will areas where house prices and borrower incomes exceed the criteria for Welcome Home Loans, which are exempt.

An important point to make here is that while house price inflation should be reduced by the LVR restrictions, New Zealand house price levels will remain high on most metrics, for example, relative to incomes and rents. In this sense it is hard to see how these restrictions will materially reduce the existing incentives to develop new residential property. Provided the "red tape" costs and delays are reduced, there will remain a strong price incentive to expand the housing stock, particularly in Auckland and Christchurch.

In due course, we expect housing supply to catch up with demand, and for demand to be further moderated as interest rates return to more normal levels over the next couple of years. As the imbalance between demand and supply is reduced, we will look to lift the LVR restrictions. The indicators we will assess in this regard include house price inflation, mortgage approvals, credit growth and house sales. We will be looking for clear signs that excess demand pressures have substantially reduced and that a removal of the restrictions will not result in a return of such pressures.

Conclusion

The underlying issue in the New Zealand housing market is a shortage of supply. In Christchurch there is a specific housing shortage as a result of the earthquake-damaged housing stock. In Auckland, the shortage has been growing over a much longer period, with weak or declining rates of house building since 2005. While the trend in people-per-dwelling in Auckland has been moving steadily upwards since 2005, demand for home-ownership has accelerated in more recent times due to the ready availability of cheap credit and a growing trend amongst renters to become first home buyers. The recent growth in net immigration is also adding to the excess demand situation.

Plans to increase the housing supply are well underway. Residential building consents are trending upwards in Christchurch and Auckland, and indeed in the rest of the country. The residential consent process has improved in Christchurch and efforts are being made to streamline planning and consents in Auckland via the Government/council accord and the Unitary Plan. However, meeting the combined three year targets of Christchurch and Auckland would require a major mobilisation of national construction resources. In all likelihood, the build will be stretched over a longer period.

Expanding housing demand through easy credit will do nothing to speed up the housing supply response. It simply adds to housing demand, pushes up house prices and makes housing less affordable. The Reserve Bank has introduced LVR restrictions on bank mortgage lending aimed at moderating house price inflation by reducing the effective demand for housing. This is intended to reduce the build-up of systematic risk in the New Zealand financial system. It will also potentially reduce the extent of interest rate increases, and hence exchange rate pressure, that may be needed in the coming cycle.

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