

The Chair
Cabinet Economic Growth and Infrastructure Committee

THE NEW ZEALAND HOUSING MARKET

Purpose

1. This paper provides you with an update on the New Zealand housing market, and potential regulatory actions to strengthen the capacity of banks to withstand a housing downturn, and mitigate excesses in the housing credit cycle.

Background

2. I have requested that the Governor of the Reserve Bank present the Reserve Bank's views on the New Zealand housing market to the Cabinet Economic Growth and Infrastructure Committee (EGI).
3. The Governor will be presenting to EGI on 8 May. As background to the Governor's presentation, the Reserve Bank has prepared the following comment. The presentation slides will be circulated to EGI alongside this paper.

Comment

The New Zealand Housing Market

4. The housing market is a major driver of the New Zealand economy and its financial sector. As such, housing market developments are very relevant for the Reserve Bank's two key policy objectives: price stability and financial stability.
5. The value of housing represents almost three quarters of total household assets in New Zealand – higher than other advanced economies where financial assets play a greater role in saving for retirement. Housing debt is around 27 per cent of the value of the housing stock, and mortgages make up just over half of total banking system lending. Consequently, housing is a significant source of risk to the household sector itself, and the New Zealand banking system.
6. In considering this risk, the Reserve Bank focusses on three broad dimensions. First, the inflation risks associated with rising construction costs, rents and other related expenditures, and the impact of wealth and confidence effects on borrowing and spending behaviour that can create inflation pressure. Second, how well the banks are capitalised in order to protect their balance sheets against a significant fall in house prices and how serious might the risk be for individual banks and the domestic financial system as a whole. Third, the potential impact of a significant fall in house prices on the New Zealand economy.

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7. We are again facing a strong housing market with the REINZ measure of house prices having risen by 8 per cent over the past year. The current house price pressures are concentrated in Auckland and Christchurch with house prices increasing by 16 per cent and 8 per cent respectively over the past 12 months. House price inflation in the rest of the country is less pronounced, around 4 per cent over the past 12 months, although there is considerable variation among districts.
8. The rise in house prices is mainly due to a combination of domestic supply shortages, pent up demand, and the lowest mortgage rates since the mid-1960s. In Christchurch, the general shortage of accommodation is reflected in the 8 per cent rise in house prices, with rents up 16 per cent and the cost of building up 10 per cent over the year to December 2012. These pressures are likely to persist for some time despite the insurance industry's plan to finance 10,000 new houses over the next 3-4 years.
9. In Auckland, the situation is more complex – and more uncertain. The Auckland Council puts the current shortfall at around 20,000-30,000 homes, with an additional 13,000 per year needed going forward. However, residential building consents for new dwellings in Auckland are currently running at 4,900 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 2,000 sites are ready to build on – with utilities actually connected and consents approved.
10. On the demand side of the housing equation, the two key drivers historically have been migration flows and interest rates. While data on internal migration flows is sketchy, this factor does not appear to be a strong driver of the current Auckland market. The role of mortgage interest rates in current market pressures is much clearer. Current “best in market rates” are around 5 per cent. These are down half a percent over the past year due to lower funding costs on international markets. 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 rental yields of 4.5 per cent per year. In addition, credit has become easier to obtain with banks competing aggressively to gain or protect their mortgage market shares.
11. An increasing proportion of new mortgage lending is going out at high loan-to-value (LVR) ratios. Around 30 per cent of new lending is at LVRs over 80 per cent, compared to around 25 per cent of lending in late 2011 to early 2012. Annual growth in housing credit is just over 4 per cent 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 at a slow pace, this excess housing demand increases house price pressures.
12. The Reserve Bank is concerned that the current escalation of house prices is increasing risk in the New Zealand financial system by increasing the likelihood and potential impact 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 global financial crisis and the median house price is now 12 per cent above its end 2007 level.

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13. House prices are already high relative to international norms. A recent international study of housing affordability suggested that median New Zealand house prices (relative to disposable incomes) were the third highest among comparable countries. 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 global financial crisis, the significant damage that can result from sharp declines in house prices in terms of lost output, bankruptcies, rising unemployment, and damage to the financial system. The impact of such an adjustment could be worsened by the existing headwinds facing the economy in the form of an over-valued exchange rate, drought, and the government's significant fiscal consolidation. Other commentators have expressed similar concerns - most notably the IMF in their recent Article IV assessment, the OECD during its recent mission to New Zealand, and the three major international credit rating agencies.
14. In order to help alleviate the housing supply constraints, the types of initiatives outlined by the Productivity Commission are important. These included freeing up land for subdivisions, reducing the time and cost barriers faced by developers, and promoting productivity improvements in the building sector itself. But it is likely to take time to correct the supply/demand imbalances through supply measures alone.
15. The Reserve Bank is in the process of introducing higher baseline bank capital requirements against high LVR housing lending. This is designed to further strengthen the capacity of banks to withstand a housing downturn, and encourage banks to review the riskiness of the loans they are writing. The measures will formally come into effect from 30 September 2013, but as it will apply to all of a bank's existing holdings of high LVR lending, banks will need to factor the additional capital requirements into their immediate lending decisions.
16. The Reserve Bank recently completed a round of public consultations on macro prudential instruments. These comprise measures such as adjustments to the core funding ratio, introduction of a counter cyclical capital buffer, adjustments to sectoral risk weights, and housing loan to value ratio restrictions. The Minister of Finance and the Governor of the Reserve Bank will shortly sign a Memorandum of Understanding on the use of these instruments. Macro prudential policy can have a stabilising impact on credit supply decisions by the banks as well as credit demand decisions by households. The Bank will shortly be following up with additional public consultation on operational details relating to the use of these instruments.

Consultation

17. There has been no consultation arising from this paper.

Financial implications

18. There are no direct financial implications arising from this paper.

Human Rights

19. There are no human rights implications arising from the paper.

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Legislative Implications

20. There are no legislative implications arising from the paper.

Regulatory Impact Analysis

21. There are no regulatory impact implications arising from the paper.

Gender Implications

22. There are no gender implications arising from this paper.

Disability Perspective

23. There are no disability implications arising from this paper.

Recommendations

24. I recommend that the Cabinet Economic and Growth Committee:

1. **note** the Reserve Bank's views on the drivers and key risks around the New Zealand housing market.
2. **note** that the Reserve Bank is currently consulting on tightening its prudential policy framework.
3. **note** that the Minister of Finance will sign a Memorandum of Understanding on Macro-prudential Policy with the Reserve Bank, and announce the framework in the Budget address.

Hon. Bill English
Minister of Finance

Date: