Myths about the Reserve Bank and property investment

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Introduction

Mr President, ladies and gentlemen,

I accepted your invitation to address this annual meeting with some trepidation. There has, as you know, been a degree of tension between the real estate industry and the Reserve Bank in recent years, and I wondered whether I should seek a guarantee of safe passage before venturing into your midst!

But, on reflection, I decided it was important that I did accept the invitation. Precisely because of the tension which has existed between us from time to time, I thought it was important to try to improve communications in both directions. Your industry is an important one, and it is therefore important that neither of us misunderstand the other.

So today I want to debunk some myths.

Myth 1: The Reserve Bank doesn't want New Zealanders to own their own homes

This myth has been repeated so often that many people believe it implicitly. I suspect its origin goes back to a speech I gave to a Rotary International regional conference in the late 'eighties, very shortly after I became Governor.

Illustrating how deeply-engrained inflationary expectations were at that time, I recalled that I had just moved to Wellington and was living in a rented apartment. A real estate agent had phoned to tell me about a property for sale which he thought would suit me ideally. It sounded very suitable, so I asked about the price. Just $300,000 I was told. Wait a minute, I replied, that is going to cost me roughly $45,000 a year in interest (mortgage rates were over 15 per cent at the time), plus the expense of rates, insurance and repairs, in total probably at least $50,000 a year, or about $1,000 per week. I suggested I could rent the same place for about $500 per week. Yes, came the answer, but the advantage of buying it is that you'll own it, and with house prices going up, you'll be better off. You can avoid wasting money on rent. But I've got a problem, I explained. I'll still be spending $1,000 a week in interest and other outgoings, and if house prices do *not* go up by at least $500 a week (the difference between the weekly cost of buying and the weekly cost of renting), I'm going to be seriously out of pocket. And if house prices *do* go up by $500 a week, I'm seriously out of a job! So I can't buy it.

The point of the story, of course, was that at that time New Zealanders thought that paying twice as much in interest (and other expenses) to own a house as it would have cost to rent the same house made residential property a good investment, because increases in house prices could be relied upon to make up the difference. This seemed to me to be a dangerous delusion, and I said so. I was not making a general case against home ownership. But ever since it has been accepted wisdom that I am opposed to home ownership, and favour renting.

So let me be quite unambiguous. I am not opposed to home ownership. I have owned my own home for all but about two years since I turned 26 years of age, and my wife and I own our own home now. There are a great many positive things, both personal and social, about the fact that most New Zealanders own their own homes.

Myth 2: The Reserve Bank is opposed to property investment

This is the myth which is sometimes trotted out when it is demonstrated that the first myth, that the Reserve Bank is opposed to New Zealanders owning their own homes, is shown to be false. But this one is equally false. It is quite clear that property investment has been extremely rewarding to a great many New Zealanders over several decades.

One of the reasons for that, as plenty of real estate agents never tire of pointing out, is that investment in property has certain distinct tax advantages over some other forms of investment. And I certainly do not need to explain to this audience the nature of those tax advantages. Whether property investment *should* enjoy such tax advantages is, of course, a different issue. It is not at all clear to me why, given an already-strong tendency for New Zealanders to invest in property, we should give special tax advantages to that form of investment, but the fact of the matter is that we currently do (at least compared to the tax situation facing those who invest in most managed funds).

So yes, I can see that property investment is a perfectly sensible component of an investment portfolio for many New Zealanders. For the sake of the record, I do not own any investment properties myself, with the exception of a small lifestyle block currently planted in kiwifruit, but my wife and I do own a small number of shares in four listed property companies.

Myth 3: The Reserve Bank doesn't think paying off the mortgage is really saving

I am not quite sure where this myth came from, but it may simply have been an extension of the myth that the Reserve Bank is in some way opposed to New Zealanders investing in their own homes. So let me again be quite clear. Paying off the mortgage is without question a form of saving, and there isn't an economist in the country who would disagree with that view. Moreover, it is a very sensible form of saving for those who have mortgages outstanding. With many mortgages charging interest of close to 10 per cent, paying off the mortgage is equivalent to earning a 14.9 per cent pre-tax rate of return for those facing a 33 per cent marginal tax rate, and a still attractive rate of 12.4 per cent for those facing the 19.5 per cent marginal tax rate. Not only are those rates of return very attractive in an absolute sense, they are particularly attractive in relation to the risk involved, which is nil. If anybody can find any other risk-free investment yielding almost 15 per cent per annum, let him (or her) step forward! [1]

So I would strongly encourage New Zealanders to use any available savings to reduce existing debts as a first priority, starting with the debts carrying the highest rates of interest and progressively paying off all other interest-bearing debts. And that applies whether the debt is a home mortgage or some other kind of debt.

In January this year, I gave a speech on New Zealand's large balance of payments deficit and noted that all balance of payments deficits reflect a situation where more investment is taking place than can be financed from the savings of locals. I noted that, although much recent investment in New Zealand has been in the form of plant and equipment, a great deal has been in the form of houses. I also noted that, since New Zealanders have not been saving sufficiently to finance all of the investment which has been taking place, this means that, in effect, we have been borrowing the savings of non-New Zealanders 'not to generate faster economic growth but simply to buy ourselves larger houses'. In large measure this has been done by banks borrowing overseas and (after swapping foreign currency liabilities for New Zealand dollar liabilities to eliminate the foreign exchange risk) passing these foreign funds on to New Zealand borrowers, often at fixed rates of interest.

There is nothing inherently wrong with borrowing from non-New Zealanders to invest in houses, or even with borrowing on the security of houses to finance other forms of spending, but it is important to recognise that, as with any other lender, those non-New Zealanders will eventually want to be paid interest on their loans, and almost certainly will want to get their principal back also.

So the Reserve Bank is certainly not opposed to investment in housing, and recognises that paying off a mortgage is a perfectly sensible form of saving (indeed, arguably the *most* sensible form of saving). But it was, and is, appropriate to draw attention to the fact that we are financing a significant part of our total investment from the savings of non-New

[1] Even at mortgage interest rates of 8.5 per cent, paying off the mortgage is equivalent to investing for a pre-tax risk-free return of 12.8 per cent for those on the 33 per cent tax rate, and of 10.6 per cent for those on the 19.5 per cent marginal tax rate.

Zealanders. It is in that sense that pointing out the connection between the balance of payments deficit and New Zealanders' savings performance is relevant.

Myth 4: The Reserve Bank is totally obsessed with the housing market, and tightened monetary policy in 1994 to punish Auckland house buyers

It is fundamental to the market economy that prices are free to move, and that means free to move both up and down. Prices provide crucial information to people, assisting them in deciding what to buy, what to sell, what skills to acquire, and so on. If all prices were fixed by government fiat, it would not be long before the market economy broke down completely. The Reserve Bank is committed to helping the market economy work effectively not by suppressing price movements but rather by ensuring that prices *on average* are stable, or in other words that money keeps its value as a unit of measurement. That way individual price movements truly reflect supply and demand, providing consumers and producers with the best possible information about what they should consume and produce.

It follows that we have no mandate to tighten monetary policy in response to an increase in the price of apartments in central Auckland. We have no mandate to tighten monetary policy in response to an increase in house prices in Auckland generally. Indeed, we have no mandate to tighten monetary policy in response to an increase in the price of houses throughout New Zealand.

But we do have a mandate to tighten monetary policy when it appears that general inflationary pressures are building up, and that as a consequence the rate of inflation will increase towards the top of the inflation target we have been given. In 1994, it seemed to us that we needed to tighten monetary policy to deal with increasing inflationary pressures, and monetary conditions were progressively tightened throughout 1994, 1995, and 1996. Despite that, inflation slightly exceeded our target throughout 1996.

And yes, inflation in the housing market was one important contributor to that inflationary pressure. Between the December quarter of 1989 and the December quarter of 1997, the price of the average New Zealand house went up by 57 per cent, or by some 6 per cent per annum for the eight year period. Over the five years to the end of 1997, the CPI excluding both interest rates and housing increased at an average of just 1.3 per cent annually, close to the middle of the 0 to 2 per cent target which we had for most of that time. By contrast, the CPI excluding interest rates but *including* housing increased on average by 2.0 per cent annually, with the housing parts of the index showing an average inflation rate of 5.8 per cent.

The price of sections increased particularly strongly over that period, by an average of 9.6 per cent per annum over the five years to the end of 1997, to the point where sections in several of our major cities are now very expensive in comparison to, for example, the price of sections in some major US cities.

But inflationary pressures were creeping up in sectors quite unrelated to housing as well, and in the June quarter of 1996, for example, more than half of all the 312 items in the CPI regimen increased in price by 0.5 per cent or more - or in other words at an annual rate of 2 per cent or more. And that was after more than two years of firm monetary policy. Clearly, even if housing prices had not been increasing, monetary policy would have needed to be firm.

It might be appropriate to mention in passing, if only because many in the rural community thought that the pain they were bearing through the then-high exchange rate was caused by the Reserve Bank's reacting to Auckland house prices, that the price of rural land has on average risen by rather more than the price of Auckland houses for much of the last ten years. From 1985 to 1995, the average rate of increase in the value of dairy farms (on a per hectare basis) was 15.6 per cent per annum, and the comparable figure for sheep and beef farms was 14.4 per cent per annum. By contrast, the average increase in the value of Auckland house prices over the same period was 10.3 per cent. Despite some reduction in farm land prices in the last year or so, farm land appears to remain substantially more expensive, per stock unit, than in Australia.

Of course, the price of farm land is not included in the CPI measure of inflation, which in New Zealand is the main focus of monetary policy. But no central bank with a concern about inflation (and almost all have) can afford to ignore strong increases in property prices, whether or not they feature in their target inflation index. In New Zealand, increases in residential property prices feed directly into the CPI, and thus affect people's perceptions of current inflation and therefore their behaviour. And even where increases in property prices do not feed directly into the CPI (as in the case of farm land, or commercial property), they are still indirectly relevant to monetary policy. Because they affect people's perceptions of their own wealth (and in some cases of course affect their actual wealth), increases in property prices affect spending behaviour and thus indirectly affect other prices as well. As Wayne Angell, a former Governor of the Federal Reserve Board in the United States, once remarked, if all property prices are going up, in other words if there are signs that people generally are moving out of money into real estate, there is a *prima facie* case that monetary policy is too easy (and vice versa).

So the Reserve Bank did not tighten policy in 1994 out of any desire to 'punish Auckland home buyers', or indeed to punish any other home buyers. But it is fair to note that the increase in house prices in the period from 1993 to 1997 was one important component of inflation during that period, and to note also that, even if property prices are not in the Reserve Bank's target inflation index, they are not totally irrelevant to the formulation of monetary policy.

Myth 5: Property investment is a low risk activity, and it is prudent to borrow heavily to undertake it

This is a view which is, I'm afraid, promoted by many people in the real estate industry. To avoid taking an example too close to home, let me recall something which happened to me when I visited Queensland a few years ago. A real estate agent tried to interest me in buying a house on the Gold Coast, and the story he told me sounded pretty attractive, with the prospect of making a very large amount of money in quite a short period of time. The essence of the deal was buying a house for about A$200,000, using as much borrowed money as possible, renting it out for about A$200 per week (or about A$10,000 a year), and making a small fortune on a very small equity investment on an assumed annual appreciation in the house value of about 10 per cent a year. He had no answer to my question about why the price should continue escalating at 10 per cent a year, when the initial yield was less than 5 per cent on the purchase price, and when general Australian inflation, and therefore presumably, over time, the likely inflation of the rental income stream, was likely to be well below 10 per cent per annum.

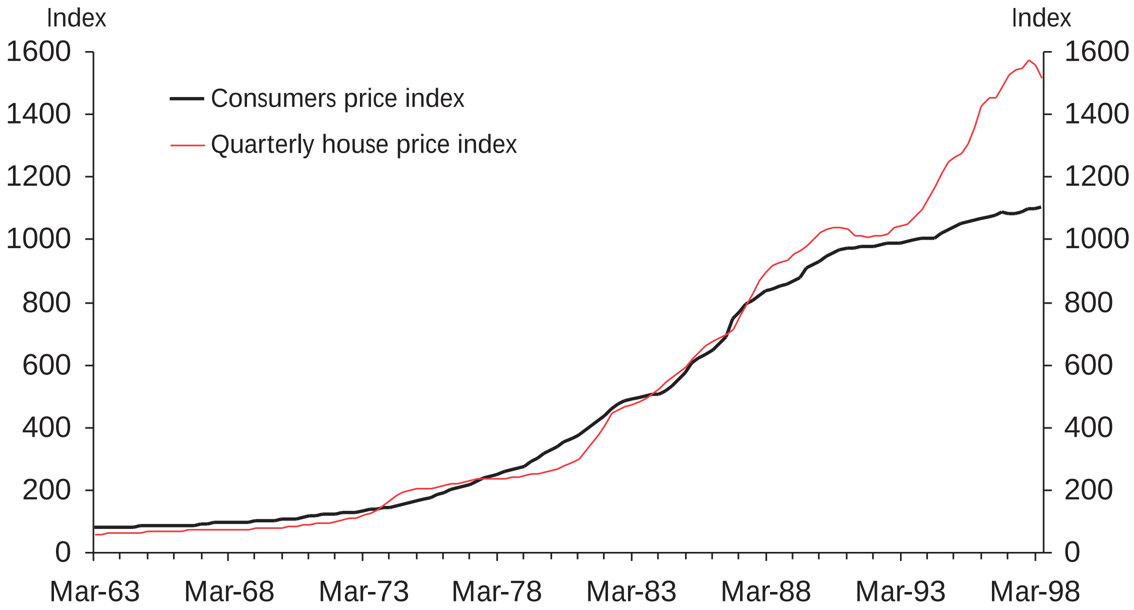
I fear that some New Zealand real estate agents may also be guilty of implying that, because house prices have increased by about 10 per cent a year since 1963, they are likely to continue doing so. Of course, since 1963 general inflation has averaged about 8 per cent a year, so that house prices have gone up by a mere 2 per cent a year faster than inflation over that 34 year period. [2]

But even that overstates the likely future inflation in house prices relative to general inflation. Much of the apparently faster inflation in house prices than in general inflation over that 34 year period is a result of the fact that, over the last few years, house prices have risen *much* faster than general inflation. Thus, between the December quarter of 1993 and the December quarter of 1997, house prices rose, on average, by over 9 per cent per annum, while general inflation averaged only about 2 per cent during that period. By contrast, over the full 20 years prior to 1993, house price inflation averaged 10.5 per cent per annum, while general inflation averaged 10.4 per cent. While playing with statistics, and using different time periods, might change the picture slightly, it seems hard to see why house prices should, *on average and over the longer term*, increase much more than other prices. (See figure 1.)

Moreover, the residential property market tends to be highly cyclical, in New Zealand as in many other countries. This means that, sometimes, house prices rise significantly faster

[2] Growth rates are between the December quarter of 1963 and the December quarter of 1997, and are based on movements in the Quarterly House Price Index, as published by Valuation New Zealand, and movements in the CPI, as produced by Statistics New Zealand.

Figure 1
House prices and headline CPI
Base: Dec 1993 = 100



than general inflation (as in the 1993 to 1997 period). But it also means that, sometimes, house prices rise significantly more slowly than general inflation (as in the early 'nineties and throughout the second half of the 'seventies). And if there is very little inflation, this is likely to mean that house prices will fall from time to time, or at very least go through prolonged periods of stability as other prices 'catch up'.

Some observers have suggested that house prices are likely to fall sharply this year, and some have suggested that they could well fall by as much as 40 per cent over the next few years (parallel to the fall in real house prices between 1975 and 1980). Others have drawn attention to the fact that, at present levels, house prices and average rentals are at historically very high levels in relation to the average wage. Still others have noted that the ratio of household sector debt to household disposable income is, at some 90 per cent, substantially above the level of around 55 per cent in the early 'nineties.

Time will tell, but I have to say that I myself do not expect average New Zealand house prices to fall dramatically, though of course the prices of some individual properties may do so. In our March *Economic Projections*, we assumed that on average house prices over the next year would rise very slowly in line with general inflation. In our May *Monetary Policy Statement*, we assumed that on average house prices would fall by about 2 per cent over 1998. Because we have our next *Monetary Policy Statement* due out in two days' time, I will not comment in detail on our present assumption, but I think I can say without breaching any confidences that we have not built into our projection the assumption that prices will fall by 40 per cent over the next six years!

My purpose today is not to preach doom and gloom. On the contrary, as indicated, we in the Reserve Bank believe that dramatic falls in average house prices are quite unlikely. Rather my purpose is simply to remind you that house prices are not, over the long term, likely to rise much faster than inflation. This implies that, if inflation stays around the middle of our inflation target, house prices on average are likely to rise by something like 2 per cent per annum over the longer term.

And that trend is a long-term average: actual prices will fluctuate around that trend, sometimes well above it but sometimes well below it. To me, this means that it is irresponsible to promote heavy concentration of highly-leveraged investment in residential property on the basis that it is a low risk investment class. New Zealanders already enjoy more housing per person than the citizens of almost any other country[3] and hold a substantially higher proportion of their gross assets in property than is true in most other developed countries. That made good sense in the years of high inflation. It certainly carries considerable risks in an era of very low inflation.

Myth 6: New Zealand interest rates have been far too high in inflation-adjusted terms

This is a very widespread view, and I am asked to explain New Zealand's apparently very high inflation-adjusted, or real, interest rates at almost every meeting I address. And on the face of it, New Zealand's interest rates *are* high compared to inflation. Our 90 day interest rates, for example, are currently about 5.2 per cent when adjusted by inflation as measured by the CPI excluding interest rates, compared with 4.9 per cent in the United Kingdom and 3.7 per cent in Australia. The difference was even greater a few weeks ago.

But it is often forgotten that interest rates are a price like any other price. An interest rate is the price which balances the willingness of people to *supply* their savings for others to borrow, with the willingness of others to *demand* those savings. If people are reluctant savers and enthusiastic borrowers, interest rates tend to be high. Conversely, if people are enthusiastic savers and reluctant borrowers, as in Japan today, interest rates tend to be low. The inflation rate is not directly relevant to the interest rate, except to the extent that it influences attitudes to borrowing and saving.

And one of our problems in recent years is that New Zealanders have been enthusiastic borrowers and reluctant savers because they have been thinking not of the Consumer Price Index in making their borrowing decisions but rather of the prospect for inflation in property prices. Property prices have been rising quite strongly, and people have been encouraged to believe that they would *continue* rising strongly. And if property prices can be relied on to rise by 10 per cent per annum more or less indefinitely, borrowing at 11.5 per cent looks like a very good deal, borrowing at 9 per cent looks like a steal, and being able to deduct the interest for tax purposes (as one can do when owning investment property) just makes it irresistible.

Indeed, it has seemed so irresistible that we New Zealanders have not been willing to provide sufficient savings of our own to meet the demand, and we have had to borrow increasingly large amounts from non-New Zealanders to fill the gap, as already mentioned. Non-New Zealanders have been willing to meet this demand, but only at interest rates which reflect the perceived currency risk.

If most New Zealanders had actually *perceived* real interest rates to be in some sense 'too high', we would have seen sluggish borrowing demand and a strong tendency to save in the form of long-term fixed interest deposits (to lock in the allegedly high real interest rates). What we have *actually* seen is very strong growth in borrowing by the household sector (average growth of 13 per cent per annum in lending by M3 institutions to the household sector between December 1993 and December 1997), and absolutely minimal investment by ordinary New Zealanders in any fixed interest security with a maturity longer than 12 months. In other words, New Zealanders have not *perceived* current interest rates as high in real terms. Our *words* say that interest rates are too high in real terms; our *actions* suggest that they have been too low.

Why have we still had such strong expectations of property price inflation, seven years after getting CPI inflation into the original 0 to 2 per cent inflation target? I think the answer to that question lies at the heart of our attitudes to saving, and at the heart of our preoccupation with property investment. And to me the answer is that every one of us, of adult age, has personally experienced, or knows somebody who has personally experienced, the power of property market inflation.

I often tell the story of my uncle, who owned an apple orchard in Motueka. As many New Zealanders now know, he sold his orchard when he retired in 1971 and, being a cautious man who wanted his retirement nest-egg to be completely safe, he used the proceeds of the sale to buy 18 year government stock at the then-yield of 5.4 per cent per

[3] Writing in *The New Zealand Population Review* in 1994, about a study which spanned the period 1951 to 1991, Philip Morrison noted that 'the amount of housing space per person is not only at an all-time high in New Zealand, but it exceeds virtually every other country in the world'.

annum. He reckoned without inflation. When that government stock matured in 1989, the $30,000 for which he had sold his orchard would have bought only one small car. In 1971, $30,000 would have bought him 11 similar cars. More than 90 per cent of his retirement nest-egg had been stolen from him by inflation.

Less frequently I tell the story of how my wife and I returned from some years overseas in 1971 (the same year that my uncle sold his orchard). We bought a house for $43,000 on the North Shore of Auckland, mainly with borrowed money. By the time my uncle's government stock matured in the late 'eighties, that house was worth more than $300,000 and, instead of owing the bank for 80 per cent of its value, we owned virtually all of it.

Lots of people have had one or other of those experiences over the last 20 or 30 years. And those experiences explain why we are determined to own property, preferably using lots of borrowed money, and why we are determined not to invest our savings in fixed interest securities. Until those attitudes change, as change they will, we can expect to pay interest rates which seem high when compared with the CPI. Indeed, in principle, interest rates need to be sufficiently high so that the benefits of investing in property, adjusted for the risk involved, look to be pretty similar to those of putting money on deposit in the bank.

What we can learn from all this is that public perceptions are powerful indeed. Recognising that fact, the Reserve Bank intends to release a publication aimed at the general public shortly, explaining the way in which low inflation requires a rethink of our approach to savings and investment. No, it certainly won't advise people never to buy a house, but it will say that if people think that inflation is going to deliver them never-ending capital gains through the ownership of real estate, and that therefore they should be in debt up to their eye-balls in order to own property, they are on a hiding to nothing.

Conclusion

So in summary:

- I am delighted that so many New Zealanders own their own homes.
- I am not at all opposed to property investment in principle.
- Paying off the mortgage is undoubtedly a form of saving, and for a great many people the most sensible form of saving.
- The Reserve Bank is certainly not obsessed with the housing market, and didn't set out to punish Auckland house buyers in 1994, but the Bank can't ignore developments in the housing market, any more than it can ignore developments in any other major part of the economy.
- Property investment is not a low risk activity in a low inflation environment, and urging people of limited means to borrow heavily to undertake it puts them at risk of serious loss in today's circumstances.
- New Zealand interest rates, far from being too high, have in recent years been too low to restrain our national passion for borrowing. But interest rates can be expected to decline somewhat as the belief in high levels of property price inflation gradually fades from the national consciousness. Indeed, there are some signs that this is already happening, and nobody is happier about that than I am.