Macro
New Zealand Economics

New Zealand Digest

House price boom a worry for authorities

- **New Zealand's housing market is picking up strongly, supported by low rates, rising migration and weak supply**
- **Loan to valuation restrictions are being considered by the RBNZ, though we expect their effect would be small**
- **To deal with inflation risks from a rising housing market the RBNZ may need to consider lifting rates soon**

On track for double-digit house price growth

New Zealand's established housing market is booming. A combination of low policy rates and supply-side constraints in Auckland and Canterbury has supported a rapid rise in housing prices and a solid pick-up in turnover. Inward migration is also beginning to pick up more broadly in New Zealand, which should further support the market and could more than offset the impact of a recent rise in fixed mortgage rates.

Double-digit house price growth is looking likely this year for the first time in over five years. Our modelling – which follows RBNZ internal methods – suggests house prices could rise by over 10% this year and we are forecasting growth of 9% in 2014.

Overheating in the housing market is very much a concern for the RBNZ at the moment, both in terms of its implications for financial stability and for generalised inflation. Public consultation on the possible usage of 'macro-prudential tools' by the RBNZ has been on-going in recent months, with an announcement expected soon. If implemented, we expect the RBNZ would impose restrictions on loan-to-valuation ratios (LVR). While this could be a minor brake on the housing market, we don't expect a policy change like this to be a game changer, given that rising housing prices are largely being driven by fundamental factors: strong demand and weak supply. In our view, house price inflation is unlikely to moderate significantly until policy rates begin to rise.

The RBNZ has begun to note its concern about the wider inflationary consequences of the strong New Zealand housing market. This is a change in rhetoric, with previous commentary mostly focused on the financial stability risks. A stronger housing market is one reason the RBNZ may need to consider lifting rates later this year.

There has also been a notable shift toward fixed rate mortgages in recent months, which could have implications for monetary policy. More mortgages on fixed rates could reduce the effectiveness of policy rate changes, another factor encouraging an earlier RBNZ hike.

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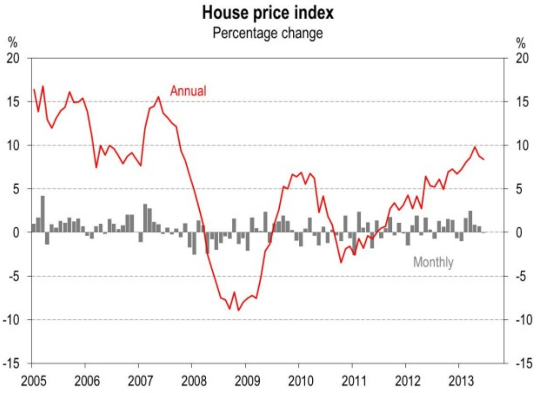
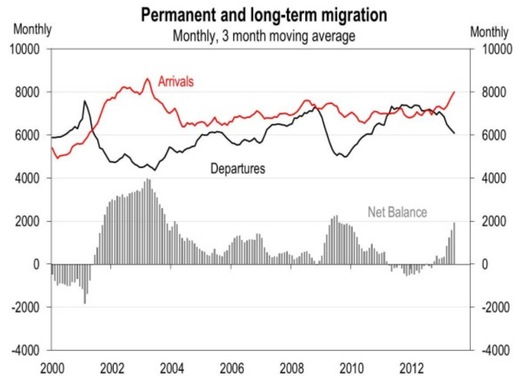
1. New Zealand's housing market continues to strengthen



Source: REINZ

2. A lift in inward migration to provide a further boost



Source: Statistics New Zealand

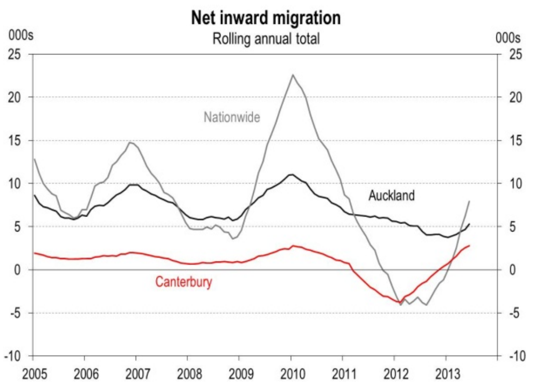
Fundamental demand and supply factors drive house prices

The New Zealand housing market has continued to pick up strongly in recent months, with annual house price inflation currently sitting at 8.4% (Chart 1). There have been a number of key drivers of housing market strength over the past year.

Firstly, inflation in the Canterbury market has been strong, with annual house price inflation in the region currently sitting around 11%. Damage to the housing stock during the Canterbury earthquakes and the subsequent strong lift in migration to help with the rebuild have seen the market come under pressure (Chart 2). These pressures will only gradually ease, as the building of new dwellings progresses (a process which is forecast to take the rest of this decade) and labour flows in the region begin to moderate.

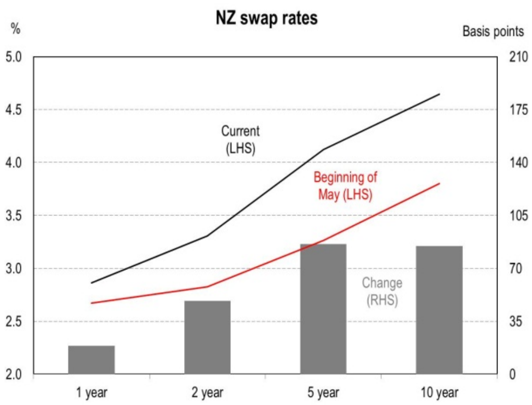
The Auckland region has been the second key driver of strength in the market, with annual house price inflation of 20% Auckland. Supply constraints are a part of the story. Estimates suggest there is a current shortfall of 20,000-30,000 houses, with a further 13,000 a year required to meet demand growth. With annual consents sitting around 5,300 per year, these pressures are unlikely to moderate anytime soon. The demand side has also been strong. Low interest rates are supporting demand, with floating mortgage rates sitting around their lowest levels since the 1960s.

3. Migration inflows becoming more broad-based



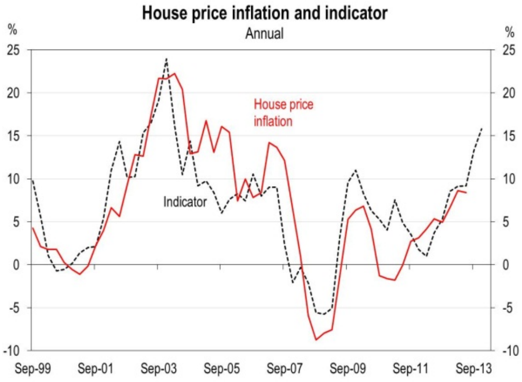
Source: Statistics New Zealand

4. Wholesale interest rates have risen in New Zealand



Source: Bloomberg

5. Conditions remain in place for further house price inflation



Source: Statistics New Zealand, RBNZ, Bloomberg, REINZ, HSBC

6. RBNZ concerned over growing financial stability risks

Source: Statistics New Zealand, Thomson Reuters Datastream

Demand is also expected to be supported by rising inward migration. Up until recently, New Zealand's rise in inward migration had been driven by arrivals into Canterbury. However, more generalised migration inflows are beginning to rise, particularly in Auckland, which should provide a further demand boost in the Auckland market (Chart 3).

Offsetting this, to some degree, we have also seen some tightening in financial conditions in New Zealand in recent months. A rise in global bond yields on the back of the prospects of a slowing in bond purchases from the US Federal Reserve, along with a stronger domestic outlook in New Zealand, have seen wholesale interest rates rise between 20-85 basis points since May (Chart 4). Following on from this, domestic banks have raised fixed mortgage rates from their lows.

To assess the impact of these competing forces, we estimate a model that is used internally at the RBNZ to assess where housing prices are headed (see Drought and McDonald (2011)). This model uses five-year mortgage rates and migration data to forecast housing price pressure. Over history, a combination of five-year mortgage rates and migration flows has been a good indicator of house price inflation. Updating this model for the recent lift in mortgage rates and the rise in inward migration, stronger migration wins out, with the model suggesting further strength in the housing market is likely (Chart 5).

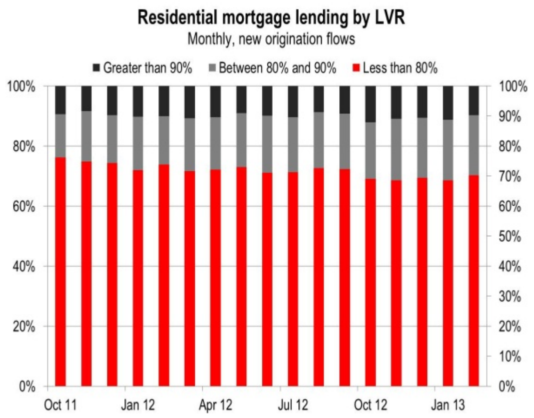
LVR restrictions not expected to be a game changer

With fundamental factors driving the trends in the housing market, we expect that it could be quite challenging to slow the housing market using so-called 'macro-prudential tools', as the RBNZ is potentially considering.

To address their concerns, the RBNZ has highlighted in recent commentary its intentions to cool the housing market's rapid rise. While overall credit growth in the economy is modest, the RBNZ is concerned about growing risks in housing lending, with housing turnover elevated, the level of mortgage approvals having reached 2006 highs (Chart 6), and a move towards greater high LVR lending.

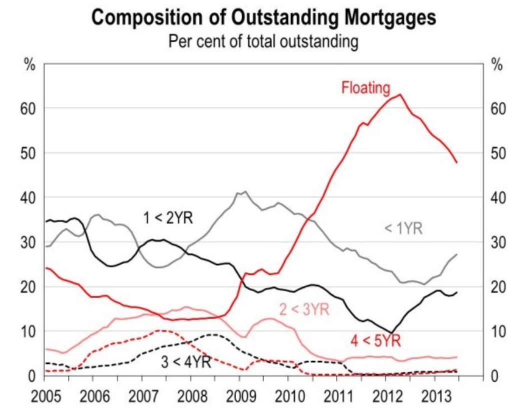
Given this, LVR restrictions could be the Bank's macro-prudential tool of choice. Media reports (source: *www.interest.co.nz)* have suggested this could take the form of 'speed limits', constraining lending in the 80%+ LVR category to around 12% of total new lending. The potential impacts of quantity restrictions

7. Around 30% of new lending is taking place with high LVRs



Source: RBNZ

8. A shift to fixed rates may blunt policy effectiveness



Source: RBNZ

like this are difficult to gauge. According to the latest statistics, around 30% of new lending was occurring in the 80%+ LVR category (Chart 7). As such, a policy that restricted new lending in this category to 10% (assuming banks built in a buffer over the mandated maximum) could see a substantial decline in loan growth.

However, some of those restricted from borrowing under the new policy could find ways around the restrictions. Potential homebuyers could top up their required deposit with unsecured personal loans, with money from friends and family or from outside of the regulated banking sector. In addition, more lightly geared buyers could take the place of some of those restricted from the market, if price pressures ease.

One way to assess the potential impact on the housing market is to assume all potential homebuyers restricted by the new policy borrow in the unsecured market to top-up their deposits. With unsecured rates currently around 1000 basis points higher than average advertised mortgage rates, this would add around 100 basis points to the average borrowing rate paid by these restricted buyers (an extra 1000 basis points for 10% of the loan). Given they would make up around 20% of the market, this would raise the average rate paid by all new borrowers by around 20 basis points.

So, using this simple, back-of-the-envelope method, the proposed LVR restrictions can be thought of as equivalent to a little less than a 25 basis point hike in the overnight cash rate. In the housing market model above, a 20 basis point increase in rates would take around 1 percentage point of annual house price inflation. So our modelling suggests that LVR restrictions of this degree may have only a small impact on the market. This would suggest that the recent rise in migration would more than offset the impact of the LVR restrictions that are being proposed.

Factors remain in place for continued strength in the market

On-net, the factors remain in place for continued housing market strength. In our view, house price inflation is expected to average 11% during 2013 and 9% during 2014 – cooling somewhat in 2014 on the back of expected rate hikes by the RBNZ.

So the question remains, what are the implications for monetary policy? We see stronger house price inflation than the RBNZ is currently assuming (RBNZ forecasts are for 9% in 2013 and 2014). As such, we see a greater boost to housing-related inflation pressures (for example, rents and housing construction costs) and to the consumer sector. A stronger housing market is one reason the RBNZ may need to consider increasing rates sooner, rather than later.

At the same time, the transmission of monetary policy may be becoming less effective due to the shift towards mortgage rate fixing. Recent months have seen a notable shift in new borrowing away from floating rates and towards fixed rates (Chart 8). Floating rate mortgages now account for around 48% of total loans, down from 63% in April 2012. With a greater proportion of borrowers on fixed rates, this decreases the efficacy of the RBNZ's policy rate, and may be another factor encouraging an earlier move in the overnight cash rate.

Bottom line

New Zealand's established housing market is booming, reflecting low borrowing rates, supply-side constraints and the recent increase in inward migration.

The implementation of LVR limits could take some froth out of the market, but the impact is expected to be small and, in our view, more than offset by the effect of the recent rise in migration.

The RBNZ has noted growing concerns over the inflationary consequences of a strong housing market, one factor that may see them need to lift rates this year, ahead of the current market pricing for a Q1 2014 hike.

References

Drought, Sarah and McDonald, Chris (2011), "Forecasting house price inflation – a model combination approach", *Reserve Bank of New Zealand Discussion Paper DP2011/08*

HSBC

1. HSBC forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2012	2013	2014	Q113	Q213e	Q313e	Q413e	Q114e	Q214e	Q314e
%*										
AUSTRALIA										
GDP	3.6	2.5	2.8	2.5	2.6	2.5	2.7	2.9	2.9	2.8
Consumption	3.3	2.2	2.9	2.0	1.9	2.3	2.6	2.8	2.9	3.0
Govt consumption	3.1	0.6	2.1	0.5	-0.5	0.8	1.8	1.8	2.1	2.2
Investment	8.7	-0.3	3.0	0.9	1.5	0.6	-2.9	3.8	3.7	2.6
- Dwelling	-3.8	5.0	9.4	2.7	5.6	5.6	6.1	8.7	10.2	10.3
- Business	16.5	-0.2	-0.6	2.3	1.4	-1.6	-2.5	1.6	0.1	-1.8
- Public	0.7	-4.3	9.8	-5.8	-2.0	4.2	-11.9	7.2	10.4	11.5
Final domestic demand	4.7	1.2	2.8	1.1	0.6	1.3	1.9	2.9	3.0	2.7
Domestic demand	4.7	0.7	2.8	0.3	0.4	0.6	1.6	3.0	3.0	2.7
Exports	6.0	7.6	6.6	8.1	8.0	8.4	6.1	6.5	6.1	6.7
Imports	6.4	-0.3	7.0	-3.2	-1.3	1.0	2.2	7.4	7.0	6.8
GDP (% quarter sa)	--	--	--	0.6	0.7	0.7	0.7	0.8	0.7	0.6
CPI**	1.8	2.4	3.0	2.5	2.5	1.8	2.6	2.9	3.1	3.1
Trimmed mean**	2.3	2.3	2.8	2.2	2.2	2.3	2.3	2.6	2.8	2.8
Unemployment rate	5.2	5.6	5.4	5.5	5.6	5.6	5.6	5.5	5.4	5.3
Labour price index	3.6	3.2	3.5	3.2	3.0	3.1	3.2	3.3	3.4	3.5
Current A/C (%GDP)	-3.9	-2.4	-2.5	-2.2	-2.4	-2.5	-2.4	-2.4	-2.4	-2.6
Terms of trade	-10.4	-2.9	-0.9	-6.2	-6.1	-0.8	2.1	-0.4	0.0	-1.0
Budget balance (%GDP)	-3.0	-1.5	-1.0	--	--	--	--	--		
Capital city house prices	-0.7	4.9	5.9	2.6	4.2	6.7	6.2	7.3	6.2	5.2
Private sector credit	3.8	3.8	6.6	3.2	3.2	3.9	4.9	6.1	6.8	6.8
USD/AUD (end period)	1.04	0.90	0.86	1.04	0.96	0.94	0.90	0.89	0.88	0.87
90 day bank bill rate	3.19	2.80	3.30	3.30	3.05	2.80	2.80	2.80	2.80	3.05
Cash rate (end period)	3.00	2.50	3.00	3.00	2.75	2.50	2.50	2.50	2.50	2.75
%*										
NEW ZEALAND										
GDP	2.7	3.0	2.8	2.4	2.8	3.6	3.0	3.4	3.1	2.6
Consumption	2.4	2.9	2.1	2.4	3.0	3.6	2.7	2.7	2.2	1.8
Govt consumption	0.6	0.2	1.2	0.6	-0.2	-0.2	0.7	1.2	1.2	1.2
Investment	6.5	6.3	7.3	4.2	3.5	9.2	8.5	9.4	7.7	6.2
Final domestic demand	2.9	3.2	3.1	2.4	2.5	4.2	3.6	3.9	3.3	2.7
Domestic demand	3.2	3.4	3.1	2.0	2.9	3.9	4.7	3.9	3.2	2.7
Exports	2.1	6.5	5.5	7.0	8.3	5.1	5.7	5.0	6.0	5.9
Imports	1.9	4.5	6.1	0.6	5.4	4.9	7.3	6.5	6.1	5.9
GDP (% quarter sa)				0.3	0.7	1.0	1.0	0.6	0.5	0.5
CPI	1.1	1.4	2.4	0.9	0.7	1.4	2.5	2.6	2.9	2.4
Unemployment rate	6.9	6.1	5.5	6.2	6.2	6.0	5.9	5.7	5.6	5.5
Labour price index	1.9	2.2	3.1	1.7	2.0	2.3	2.6	3.0	3.1	3.1
House price index	4.7	10.6	9.4	7.1	8.4	12.3	14.1	14.0	12.3	7.4
Current A/C (%GDP)	-5.0	-3.6	-2.5	-3.3	-3.7	-4.1	-3.4	-2.7	-2.7	-2.3
Cash rate (end period)	2.50	2.75	3.50	2.50	2.50	2.50	2.75	3.00	3.25	3.25

Source: ABS; HSBC estimates; RBA *unless otherwise specified **includes the effect of the carbon tax from Q312

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