Housing market slowdown to put the brakes on household debt

30 April 2018

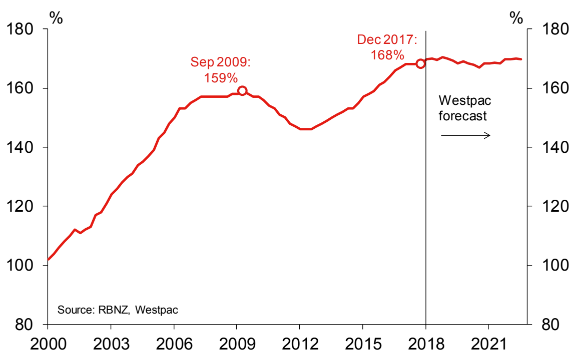
In recent years, the combination of low interest rates and the favourable tax treatment of housing saw house prices rising rapidly. These same conditions also saw household debt rising to record levels. Now, with the housing market cooler than it was in previous years, the creep upwards in household debt has slowed. And over the coming years, policies aimed at dampening housing market pressures will put a brake on further debt accumulation. These changes also signal a drag on household spending, and will have an important impact on the RBNZ's policy stance.

Household debt remains elevated

Household debt levels in New Zealand have risen by 35% since 2012. That's roughly double the increase in incomes over the same period. As a result, households are now carrying debt that is equivalent to 168% of their annual disposable income – a level that's well above the peak of 159% that we saw just prior to the financial crisis (figure 1).

As we've previously highlighted, the major contributor to the run up in household debt has been the low level of interest rates in recent years, and the related increases in house prices. With low interest rates generating low nominal returns on savings, investors have sought to diversify into housing and other assets. Combined with the favourable tax treatment of investment housing in New Zealand, this boosted the demand for housing assets and pushed house prices higher. Aspiring buyers

Figure 1: Household debt (% of disposable income)



have had to borrow more. In addition, as has historically been the case, strength in the housing market also saw homeowners spending some of the windfall they perceive when the value of their house rises. The net effect has been more borrowing and more spending, with the low cost of borrowing reinforcing both of these trends.

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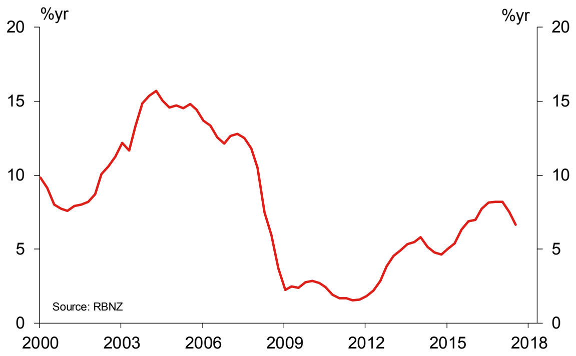
In recent years, this run up of household debt has raised concerns about the economy's longer-term financial stability. That includes concerns about the eventual drag on economic activity from increased debt servicing obligations, particularly if interest rates rise. In addition, higher debt levels mean that the economy is more vulnerable to unfavourable changes in economic or financial conditions, especially as such disruptions could be amplified through changes in the housing market. Such concerns are a key reason why the RBNZ introduced restrictions on high loan-to-value (LVR) lending in recent years.

However, while debt levels are at historically high levels, the past year has actually seen debt accumulation slowing (figure 2), and the ratio of household debt to income has been steady since the start of 2017. That follows the slowdown in house price inflation over the past year that came as a result of a tightening in lending restrictions by the RBNZ, as well as an increase in mortgage rates in early 2017.

Figure 2: Household financial liabilities



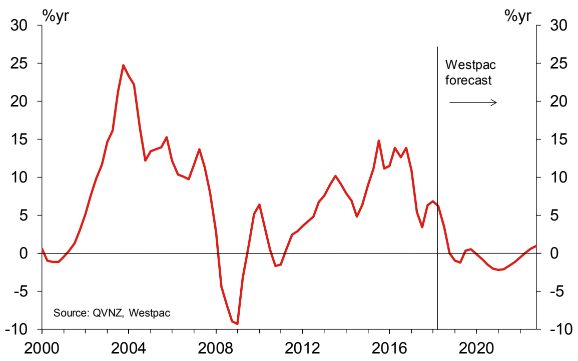
Changes in policy will put the brakes on both house price growth and debt accumulation...

In recent months, the housing market has firmed again as borrowing restrictions have been eased and mortgage rates have pushed down again. At the same time, mortgage borrowing has picked up a little. However, as we discussed in our recent *Home Truths* report[1], we expect this resurgence will be short lived. The Government plans to roll out a series of policies aimed at dampening housing market conditions. That includes policies affecting physical demand and supply, such as restrictions on foreign buyers, a tightening in migration settings, and efforts to increase the housing stock (such as the KiwiBuild program).

More important, however, are a range of policies that will affect the financial incentives associated with property investment. The Government has already extended the holding period for taxing capital gains on investment properties from two to five years (the so-called 'bright line' test). Over the coming years we also expect the ability to use losses on rental properties to offset other tax obligations (i.e. negative gearing) will be significantly curtailed. Finally, there is the possibility that the government will look at introducing a broad-based capital gains tax if elected to a second term in office.

This wide reaching suite of policies will significantly dampen the demand for housing , especially by investors. Consequently, we expect that the nationwide level of house prices will fall by a total of 2% over the next four years (figure 3).

Figure 3: House price inflation



The slowdown in the demand for housing will also put the brakes on debt accumulation, with debt to income levels expected to remain broadly stable over the next few years (as shown in figure 1). This will have important implications for the Reserve Bank's choice of policy settings, potentially allowing for a further loosing of LVR lending restrictions. A slowdown in the housing market will also be important for monetary policy and the level of the Official Cash Rate. As discussed below, the slowdown in the housing market will have a more general dampening impact on economic activity, removing any need for the RBNZ to hike the OCR in the near term.

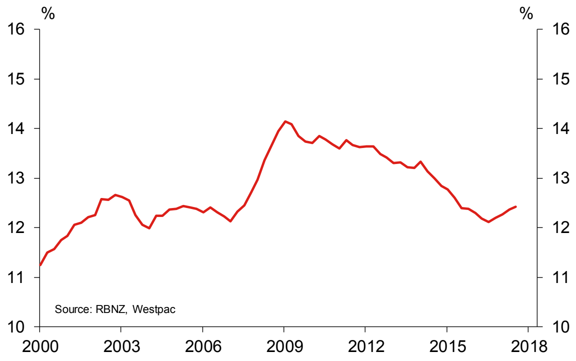
... which will dampen household spending

New Zealanders hold a significant proportion of their wealth in either investment or owner-occupied housing. As a result, we expect that the coming slowdown in the housing market will also see softness in household spending growth. This is likely to be reinforced by associated changes in the access to credit. The strong housing demand that encouraged the build-up of debt in recent years also pushed up house prices. That flattered household debt positions, with debt-to-asset ratios falling. However, the stalling in the housing market over the past year has seen debt-to asset positions rising modestly (figure 4). And with further housing market softness expected, such gauges of the economy's financial health could deteriorate further. In such circumstances, many borrowers could find their borrowing ability curtailed, while debt servicing requirements result in their disposable incomes being squeezed.

Policy changes also mean that the Government will be collecting more tax from rental properties over the coming years. This signals a further drag on households' disposable incomes and spending.

[1] Available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/NZ-Home-Truths-April-2018.pdf

Figure 4: Households' debt-to-asset levels

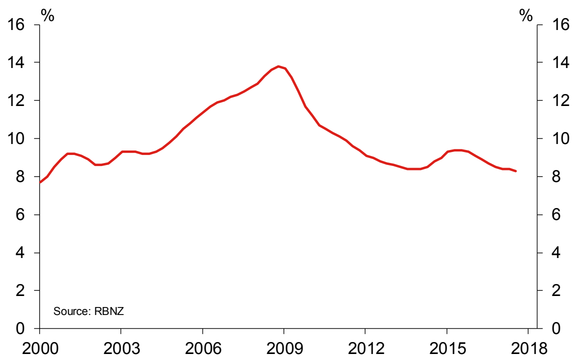


Note: This chart compares the level of households' financial and real assets to the level of their financial liabilities.

While there are risks, debt remains manageable

The run up in household debt in recent years and associated increases in financial vulnerabilities are important clouds on the horizon, but are unlikely to topple the economy. Despite the increase in debt levels, low interest rates mean that households' debt servicing costs remain modest: households currently spend an average of 8.3% of disposable incomes on debt servicing (well below the peak of 14% in 2009 – figure 5). On top of this, the labour market is in good health, and New Zealand hasn't had difficulties funding its current account deficit in recent years.

Figure 5: Debt servicing costs as a share of households' disposable incomes



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