If New Zealand needs macro-prudential polices to control house prices, why doesn't Australia need them?

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Introduction

In much of the lead-up to the Global Financial Crisis (GFC), through the 2000s, there were comments by regulators and others about potential asset price bubbles. Were these occurring, did they matter, and was there anything that the authorities could or should be doing about them? Could markets prices assets inefficiently, or was any apparent mispricing just a temporary effect, which would be remedied by the prices of the relevant class of assets returning to some fundamental value? Some countries saw this as more of an issue than others: in the USA in particular there was a reluctance to intervene, with a case against intervention set out by Bernanke (2002).

Once United States house prices peaked in 2006, and as the symptoms of the GFC became more evident during 2007 and 2008, the authorities in many affected countries began to accept that there had been problems, and that the subsequent reductions in residential property prices (and in the prices of some other classes of assets) were a salutary outcome. Lower prices for residential property would counter some of the previous froth, and allow assets prices and economies to return to more stable levels.

There was a further set of lessons learned in from the crisis. If asset prices got out of line and there was a subsequent bust, problems could develop for the financial sector, particularly where the potentially inflated assets had been financed with debt. When asset prices fell, financial institution solvency could be seriously undermined, leading to systemic difficulties for the banking sector.

These lessons coincided with wider academic discussion of systemic risk in banking, and attempts to set this within a more rigorous framework. It was noted that the traditional microprudential capital requirements that had been put in place under the aegis of the 1988 capital accord (Basel I), and refined under Basel II, were only directed at the risks that banks were exposed to from their own asset portfolios. They took no account of the risks arising from the failure of other banks, or from difficulties across the financial system as a whole (Acharya, 2009). No account was taken of systemic risk, with the risks of the system as a whole likely to be more than a simple aggregation of the risks faced by individual firms. Macroprudential policies should thus be directed at trying to forestall the emergence of systemic banking crises, an obvious cause of which would be something such as the bursting of a bubble, in some asset class such as housing, which is rendered particularly risky because of its being financed by debt. If a bubble were to burst, the banks as providers of debt could be exposed to significant risk, which might be aggravated by high levels of borrowing relative to the value of the underlying assets.

There were a number of potential solutions to this, some of which were codified under Basel III, and some of which were classified under the heading of macroprudential policy. The debate clarified the role of macroprudential policy, and also meant that there was a legitimate interest in trying to control the emergence of asset price bubbles, the bursting of which made such a contribution to systemic crises. Those who had argued that asset prices could be a problem were vindicated.

As it turned out, some countries had already had periods of concern about asset price increases, and had already implemented macroprudential policies. An extensive list of tools had been proposed, and many of these applied, although, as Crowe et al (2013) have noted, not all of these were especially successful, and there were difficulties in measuring their effectiveness. The range of potential policy tools identified by Crowe et al to constrain real estate booms included monetary policy; fiscal tools such as changing the tax treatment of home ownership (and mortgage interest), transaction taxes and property taxes; and specific macroprudential tools such as higher capital requirements on either a sector-specific or general basis, dynamic provisioning and loan-to-value and debt-to-income restrictions. Other potential macroprudential policy tools identified, and sometimes used internationally have included include levies on foreign bank funding, so as to increase the costs of offshore borrowing that might be used to fund increased housing lending, and increases to required liquidity levels.

The rest of this paper provides some background to and an outline of the adoption of macroprudential policies in New Zealand, and then summarises and looks briefly at what some of the issues might be for Australia, where, no such macroprudential measures have so far been adopted.

The New Zealand experience

In the early to mid 2000s, New Zealand saw very strong house prices increases, associated with strong growth in housing credit, which is mainly provided by the banking sector. This engendered some official concern, which was reflected in an inquiry set up in late 2005 to investigate issues around the growth in house prices and potential policy actions that might be adopted to limit house price growth. No particular action was taken to make any changes, however, and the inquiry was not obviously linked to the working group within the Reserve Bank of New Zealand (RBNZ) which was targeted at macroprudential policy, and which had been established some years earlier.

House price growth came to something of a stop with the onset of the GFC, with New Zealand house prices peaking in the fourth quarter of 2007. Fortunately for the banking sector, the decline in prices was not too severe. Although there was some increase in non-performing loans in their housing loan portfolios, the house price declines and economic downturn associated with the GFC did not lead to major problems for any of the banks. It is possible that the steep decline in interest rates in response to the GFC mitigated the pressures that might otherwise have been applied to the banks.

New Zealand house prices reached a low in the first quarter of 2009, 9.7% below the peak. Since that time prices have gradually increased again, with the previous peak overtaken during the third quarter of 2012. Since then, house price growth has accelerated, with annualised growth consistently exceeding 5%. When this was viewed alongside concerns about relatively high levels of New Zealand household indebtedness relative to disposable incomes, house prices as a multiple of incomes, and a continuation of relatively low interest rates, the newly appointed (late 2012) RBNZ Governor became concerned. This is understood to have reflected his having been in the United States (US) during the period of housing market difficulties there, and he began to push for powers to take action in New Zealand, so as to limit the scope for future problems of the type that had been observed in the US. With the New Zealand economy showing excess capacity in areas other than housing construction, and with the level of New Zealand's Trade Weighted Index already high, there was not a lot of enthusiasm to start tightening monetary policy by raising interest rates. The potential solution was seen in macroprudential policies, which might be able to slow growth in house prices without the exchange rate effects that could follow from increasing interest rates.

Concerns about excessive house price growth were also supported by a revisiting of the history of the period from 2002 to 2007 in particular, where, with the benefit of hindsight, the RBNZ now perceives house price growth as having been too rapid. They have therefore suggested that it would have been better if they had intervened more assiduously at that stage, rather than relying just on monetary policy to restrain asset price growth.[1] A paper by Shi et al (2014, forthcoming) suggests that there might have been a housing price bubble in around 2002, but also finds that monetary policy was singularly ineffective at constraining growth in house prices during the period when they were rising most strongly, with real interest rates and real house prices being positively correlated with each other. This finding would also support the adoption of macroprudential policies in the face of strongly rising house prices. From an international perspective, Crowe et al (2013) have also noted

[1] See, for example, Hunt (2013).

that interest rate increases are not necessarily particularly effective at constraining real estate price booms.

When the RBNZ consulted on macroprudential policy instruments in 2013, four approaches were considered. These were counter-cyclical capital buffers (part of Basel III), adjustments to the minimum core funding ratio (related to the liquidity rules under Basel III), sectoral capital requirements, and restrictions on high loan-to-value residential mortgage lending. They also foreshadowed the possibility of debt servicing restrictions, although they indicated that these were not likely to be adopted in the short term (RBNZ, March 2013). They also flagged potential concerns about farm lending, which represents more than 15% of total credit. There have been substantial increases in farm land prices since 2001, financed to a significant extent by increased levels of debt.

The primary instrument adopted was on loan to value ratios (LVRs), with banks being required to limit new residential mortgage lending at LVRs over 80% to no more than 10% of the dollar value of their new housing lending flows, with effect from 30 September 2013. Such restrictions would mean that, if there was a house price bust, banks should not lose as much on their housing loan portfolios as they would in the absence of such restrictions.[2] Less prominently, but potentially more important in terms of constraining bank lending, the RBNZ also mandated higher capital requirements for the internal models banks (the Australian big four) for high LVR loans, also effective from 30 September 2013.[3]

An issue overlooked as part of the consultation process was the conditions under which the RBNZ should be implementing macroprudential policy instruments. Concern had been expressed about house prices, although it was also noted that a major factor in increasing house prices, particularly in Auckland and Christchurch (which is where the strongest house price growth has occurred), has been shortages of supply, with generally very limited house price growth in the rest of the country. In terms of historic averages, neither house price growth nor housing credit growth were exceptionally high. From the beginning of 1981 to the end of 2013, the average annualised rate of house price growth in New Zealand has been 8.5%: this has been exceeded since the June quarter 2013, but not by very much (the highest figure has been 10.2% for the September 2103 quarter). On the other hand, if one looks at the last 20 years, since the beginning of 1994, the average annualised

[2] Spencer (2013) highlights the impact of high LVR lending on accentuating losses in housing lending in both the US and Ireland.

[3] The RBNZ had previously mandated higher sectoral capital requirements for lending to the agricultural sector. See Harrison & Hoskin (2011).

growth rate in prices has been 6.8%, which might cause current figures to be viewed with more concern, although rates of price increase remain much lower than were observed in the 2002 to 2007period. Between June 1999 to April 2014, the average annualised rate of growth in housing lending was 8.6%, whereas the highest rate observed since the beginning of 2009 has been 6.0% in the year to October 2013. This provides no evidence that banks have been profligate in their lending, or that this has contributed to excessive house price growth.

The absence of any criteria for when macroprudential intervention might be justified means that we do not know when the housing and housing finance markets might be deemed to have slowed sufficiently to allow the macroprudential policy instruments to be withdrawn. There are suggestions that the restrictions might be eased later in 2014, but it is not clear that the problems the RBNZ perceived as warranting intervention will really have changed to any significant extent.

An obvious downside of the adoption of the LVR rules has been for first home buyers, who are in general more likely to borrow at high LVRs. This is likely to mean that the duration of the restrictions will have to be limited, and these problems have not been addressed by the adjustments made to the policy since it has come into effect, such as granting exemptions for new construction. In fact, RBNZ reporting on the effects of the policy (in data table C30) shows that bank lending at high LVRs, at least on a system-wide basis, has consistently fallen well short of the 10% limit.[4] Because of this, however, it is likely that if and when the restrictions are eased, there will be a surge of activity by first home buyers, which will be likely to push up prices, particularly in Auckland.

Some attempt has been made by the RBNZ to quantify the effects of the LVR policies on house prices and lending for housing. Prior to any effects being able to be measured, Bloor and McDonald (2013) found that the restrictions would be likely to reduce credit growth by 1 to 3 percentage points, and house price growth by between 1 and 4 percentage points, compared to what would have happened without the restrictions, reflecting a reduction in numbers of properties sold. The analysis is very much on an "other things being equal" basis, however, and it is not clear that the authors accounted for steadily increasing interest rates, with the official cash rate having increased by 0.75% between the introduction of the policy and the end of June 2014 (although only since March 2014, and thus unlikely to have had any significant impact before June). On the other hand, we have seen some reductions in the growth rates in both house prices and home lending, which might be argued as

[4] Apart from October 2013, which was a transitional month as the policy came into effect, the highest net proportion of over 80% LVR loans was in November 2013, at 5.7% (relative to the 10% cap). May 2014 has been the only other month in which such lending has exceeded 5%.

supporting the Bloor & McDonald (2013) analysis. In an initial analysis published in May 2014 (Price 2014), a significant reduction in property sales numbers was reported, with prices 3.3% below where they would have been otherwise, although considerable caution is placed around these estimates.

To summarise the New Zealand situation, one might note that there is limited evidence as to the severity of the problem that macroprudential policy in New Zealand is designed to address, and as to its effectiveness. One question we need to ask about Australia, then, is whether the Australian situation provides a weaker or stronger argument in favour of macroprudential intervention, while another would be to ask, if intervention were to be justified, how this might be undertaken.

The contrast with Australia: where to from here?

As in the New Zealand case, a number of questions are being asked about the Australian housing market, and whether it might lead to problems of various types. In both countries we see concerns over house prices relative to incomes (and thus housing affordability), about aggregate levels of home ownership, and about the availability of housing credit. The question is also being asked as to whether house price growth rates are excessive, and whether there might be a price bubble which might lead to a subsequent bust. This author does not set out to be an expert on the Australian market, but there are questions to be explored nonetheless.

Let us look at house prices multiples relative to incomes, as discussed by Fox and Finlay (2012). Their Graph 5 shows an increasing trend in both countries, yet this author knows that the sort of house he might have bought 30 years ago is not the same as the sort of house he would buy now. Quality and fittings would be much improved, and the overall quality of the house would be greatly superior. Going back to mantra such as that the price of a house should be no more than three times a median income (a guideline allegedly adopted in New Zealand in the 1930s) would be for houses which are of much inferior quality to what people now expect (and often also, what they are able to build profitably). Moreover, in both New Zealand and Australia there are significant regional differences in house prices, and in price to income multiples, which mean that caution should be exercised in using such a measure as a guide to policy on matters other than regional housing supply. In addition, people who own homes are not generally keen to see house prices falling, as it impairs their wealth, while the relative costs of home ownership have fallen significantly with interest rates now being much lower compared with, for example, the late 1980s.

For all this, we have been seeing more than one speech per month by RBA officials raising questions about house price rises, bubbles and the possibility of a bust. Analysts and commentators are inclined to argue that there is no problem, with an example of this being in recent work by Moodys: see, for example, Levine & Gibson (2014). A review of recent statistics shows that growth in housing lending has been quite moderate by historic standards. House price growth has been a little faster: for the 8 capital cities, growth in the year to March 2014 was 10.9%, compared to an average annual increase over the previous 27 years of 7.3%.

The lesson from this is that, although the authorities in New Zealand have taken action and those in Australia have not, there may not be any great difference in the circumstances applying in the two countries, in terms of the potential occurrence of housing bubbles and the consequent possibility of a bust. Is it just that it is easier for the single regulator in New Zealand to take action, in contrast to the Australian situation where more than one regulator is involved?[5] Is the New Zealand reaction excessive, in contrast with a considered analysis by the Australian authorities that no action is necessary, or is it the case that the New Zealand authorities have taken a correct position, and that the authorities in Australia are storing up problems by failing to take action to mitigate house price rises? Both countries have specific regional issues around house prices, which would often indicate challenges around housing supply, rather than necessarily being indicative of price bubbles.

Another lesson can be learned from the Bank of England, and in the UK we have seen clear guidelines being given in advance as to what might comprise excessive growth in house prices, which would justify intervention. Perhaps this is a lesson that the authorities in both New Zealand and Australia could learn?

[5] For more discussion on the Australian regulatory context see Littrell (2013).

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