Interest Rates and New Zealand's Housing Bubble

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New Zealand has been going through a housing price bubble since 2002. The bubble may be about to end, ironically, because the Reserve Bank chose to not raise interest rates in the face of market expectations that it would.

John Calverley, in *The Investor's Guide to Economic Fundamentals* (p.76) says of the Japanese real estate mania of the late 1980s: "The drivers for this bubble were, as usual, optimism and liquidity". So let's apply this principle to New Zealand in the 2000s.

Firstly, optimism. For optimism, we can read "expectations". By 2002 the New Zealand economy was in full recovery mode, driven by, among other things, a low exchange rate, low interest rates by the standards of the previous decades, and an influx of migrants and students. With rising rents and the prospect of significant capital gains, expected returns to residential property increased substantially.

A bubble, born out of such optimism, continued because it was supported by liquidity. New Zealand banks in particular started to fall over themselves in the scramble to supply mortgage finance. And, as interest rates increased from 2004, the liquidity factor in housing strengthened rather than weakened. While optimism waned in much of published commentary, rational expectations were that future land prices would rise on account of the continued growth in the availability of mortgage credit.

At no point since 2004 would it have been rational to expect a downturn in housing prices, despite the price of an average house being about eight times the average annual wage before tax.

To understand this, we need to appreciate some subtleties about the workings of debt markets in open economies, as well as the economic theory of rational expectations (especially the "efficient markets" hypothesis which is the application of that theory to financial markets) which was the major development in macroeconomics in the late twentieth century.

In any economy, rising interest rates lead to reduced investment spending on capital goods. Under such interest rate conditions however, lending on residential property becomes relatively favoured over more risky business lending. So a general fall in the rate of lending growth may nevertheless be accompanied by a rise in liquidity in the residential property sector.

This is particularly likely if a bubble is already under way. If capital gains in residential property of ten percent per annum are being realised, a rise in interest rates to eight or nine percent will do little to deter borrowers in this sector. And, so long as borrowers continue to borrow and banks continue to increase their market shares in the favoured housing sector, the housing market will continue to realise capital gains and fuel expectations of further gains.

The process is limited in a closed self-sufficient economy, by the decline of non-housing investment, which soon enough generates a contraction in the business cycle. When incomes fall and unemployment rises, soon pessimism outweighs the continued growth of expenditure on housing. A correction in the housing market follows. Interest rates then fall and banks increasingly lend to other sectors.

In a fully open economy, the situation becomes more complex. Not only do we get overseas-based investors buying residential property in New Zealand, we also get increased flows of foreign savings entering our banking system, chasing high and rising interest rates. Further, by pushing up the exchange rate, lending to businesses that make exportable products becomes even less attractive, and mortgage lending becomes relatively more attractive.

So long as low-priced externally-sourced finance continues to be available (and profitable for the banks) the normal limits to the growth of liquidity in housing do not operate.

The determinant of liquidity in New Zealand's housing market is thus the interest rate margin between New Zealand and the next country, which for us is Australia. With an interest rate margin over Australia of say two percentage points, there are "unexploited profit opportunities". Australian banks profit by lending more to New Zealand banks, increasing mortgage liquidity in New Zealand while decreasing it in Australia.

Further, savings from "Japanese housewives" and "Belgian dentists" flow into New Zealand. A closer interest rate margin between New Zealand and Australia would see the bulk of that money going into Australia instead of New Zealand.

Normally unexploited profit opportunities in financial markets are closed as they are taken advantage of. However The Reserve Bank of New Zealand, by raising the Official Cash Rate through 2004 and 2005, has kept those opportunities open. Now, however, by not raising interest rates this October while an interest rate rise in Australia has been signalled for November, the signs are that the margin between the two countries' interest rates is finally set to fall. That can be expected to gradually shut off the overflow of mortgage liquidity that has driven New Zealand's housing bubble.

My analysis suggests that rising interest rates in New Zealand has been a cause of the inflation in asset-prices that Reserve Bank Governor Alan Bollard has been so concerned about. The solution, for us, is to bring New Zealand interest rates in line with Australia's. Further, reductions in interest rates would lead to increases in lending to businesses in the tradable sector, and to a reduction in the share of bank finance that goes into housing.

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