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Contagion in the New Zealand housing market

By Peter C. B. Phillips, Ryan Greenaway-McGrevy
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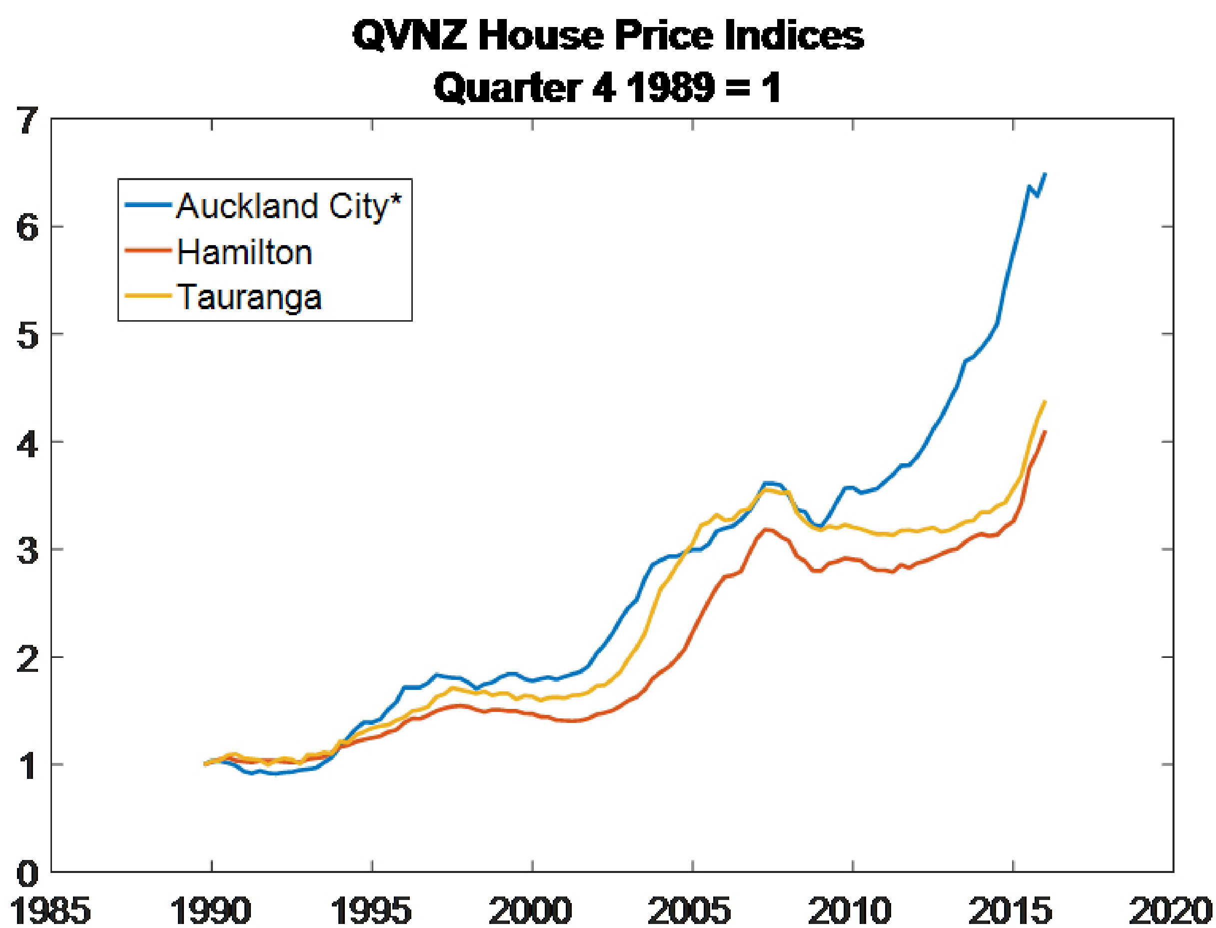
Auckland's housing bubble has spread to Tauranga and Hamilton: it's time to act

Auckland region's housing bubble is still growing, and has spread to Hamilton and Tauranga, but not to the other metropolitan centres. Photo / Getty Images

Not so long ago, the conventional wisdom was that you could spot a housing bubble only after it burst. But new econometric tools allow us to identify a bubble when it's expanding.

And there's a growing consensus that we must try. In 2014, no less than the soon-to-be US Federal Reserve Chair testified "it is important for the Fed, as hard as it is, to attempt to detect asset bubbles when they are forming".

We applied those new tools to New Zealand data from the 2016 first quarter.
What we found confirms the auction room buzz: Auckland region's housing bubble is still growing, and has spread to Hamilton and Tauranga, but not to the other metropolitan centres.



*Former Auckland City Council District

This is all despite the Reserve Bank's cooling measure last year that increased the loan-to-value ratio (LTV) for property investors, meaning they now have to stump up a 30 percent deposit. It's also despite recent Government legislation requiring overseas real estate buyers to register with the IRD.

Our latest analysis updated our previous published research, which told a story of two bubbles. First, a broad-based real estate market bubble relative to rent and income emerged in the main metropolitan centres around 2003-2004, and then collapsed in 2008 with the financial crisis. Second, a new bubble formed in the broader Auckland region in 2013 but had not spread to other regions by the end of 2014.

The excesses of the Auckland housing market, including the bidding war mania for run-down properties, continue to fascinate and appall. A Bloomberg report late last year confirmed that London real estate prices relative to income have nothing on the mushrooming Auckland statistics.

David Hisco, CEO of ANZ New Zealand, warned recently of the potentially messy consequences of the over-cooked Auckland housing market and the stubbornly strong NZ dollar. His suggested remedies are to raise the LTV ratio from 40 percent to 60 percent for investors, weaken the NZ dollar, voluntarily tighten bank loan criteria, review immigration, and build infrastructure.

All sensible policies that will affect demand and supply sides of the market. More measures may be needed. The Auckland market is now part of a circle of cities exposed to international price drivers, a complicating factor that makes international rather than domestic economic fundamentals relevant.

Overseas buyers are unaffected by domestic LTV ratio restrictions. High-end property purchases by overseas investors inject new money that feeds inflated prices, impacts spill-over purchases, and multiplies through the property market, raising price expectations in each round. Economists call this "riding the bubble".

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Last year, financial commentators warned of a looming housing market correction of up to 25 per cent. The latest chorus of warnings, including one from former RBNZ governor Don Brash and another by senior Motu Research analyst Arthur Grimes, have given explicit targets of a 40-60 per cent correction needed to bring prices in line with income fundamentals.

These targets are understandably based on domestic fundamentals, rather than background international fundamentals that are now relevant in Auckland, just as they are in Sydney, Vancouver, New York, London and other desirable cities.

Housing market corrections depend on many unpredictables, including unanticipated interventions by central banks and governments, as well as domestic and external shocks, and natural disasters.

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We know the three-year bubble in the Auckland market has proved resistant to policy interventions. We know new-money market drivers and supply constraints continue to sustain the bubble. And we know Auckland market exuberance has infected Hamilton and Tauranga.

The signals are clear. Concerted efforts by the monetary authority on bank loans, government legislation to control international new-money drivers, and Council regulatory intervention to stimulate supply are all needed to arrest the wild caravan of real estate exuberance.

The Independent Hearings Panel on the Auckland Unitary Plan has exceeded expectations in its zoning recommendations for Auckland to go "up and out". If implemented, these changes now sitting before Council are a first step towards relaxing the supply side of the Auckland market.

If the authorities fail to act to soften the market, history suggests that unanticipated future shocks will likely do so and in more dramatic measure. As Yellen's testimony put it, the authorities have a responsibility to inform themselves and to act, hard though that may be.

Peter C. B. Phillips is Sterling Professor of Economics, Yale University, and Distinguished Professor, University of Auckland.

Ryan Greenaway-McGrevy is Senior Lecturer in Economics, University of Auckland.

• See full anaylisis here

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