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Business | Opinion

Hot property market ... irrational or not?

Professor Peter Phillips and University of Auckland senior lecturer Ryan Greenaway-McGrevy analyse the housing roller-coaster.

FINANCIAL COMMENTATOR Brian Gaynor recently warned of a looming 10 to 25 per cent correction in New Zealand's buoyant residential property market.

Cognisant of the broader financial stability implications of any housing market collapse, the Reserve Bank commented that it had little domestic experience on mortgage default rates to draw upon in analysing the economic impact of a housing market collapse.

Looking instead at the roller coaster housing markets of Ireland and the United Kingdom, the Bank singled out the danger of a higher default risk among property investors than among owner-occupiers, hence its proposed regulatory separation of investors from owner-occupiers.

Is that measure going to be enough to assure financial stability in the event of a New Zealand housing market collapse? Would it have helped in the United States?

The US housing bubble collapse and resulting financial crisis tore up textbook thinking about property market diversification and sharpened central bank awareness of system-wide risks associated with property market exuberance, ballooning debt and complex financial derivatives.

It was predatory lending practices at teaser rates offered by financial institutions to ordinary owner-occupiers – not buy-to-let investors – that created the subprime mortgage industry. The consequences of the collapse of this industry could not have been avoided by regulatory measures that distinguished buy-to-let investors.

That history amply demonstrates how individual risktaking in the property market promoted by sustained low interest rates and loose lending practices in the financial industry aggregates into a wider peril for the real economy. Prudent regulatory controls may lessen those risks in advance

Bubbles: New money is driving up house values in Auckland.



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of any collapse but hardly address the roots of a property market bubble which, like any market abnormality, reside in supply and demand distortions.

The supply constraints here have manifold origins in New Zealand physical geography, zoning regulations, resource consent obstacles and council bureaucracies through to bottlenecks in skilled labour and the construction industry. Demand pressure originates in a growing population and associated demographics that inject 'new money' into the housing market from immigration, returning ex-patriates and foreign investment in desirable real estate.

Incoming 'new money' pressures and thirst for capital gain drive the demand side of the market, particularly in Auckland, waterfront, city, and desirable rural and island locations. These pressures overspill as contagion to regional markets with relocations, retirements, vacation home and multiple rental home purchases.



Regulatory controls that are used in some countries to inhibit the impact of 'new money' drivers on the general market (such as confining freehold purchases to citizens) would require government legislation and are beyond the purview of the Reserve Bank. But central banks can respond with market cooling measures when made aware of an emergent house price bubble. The key requirement for effective response is a reliable early warning alert system.

As Alan Greenspan put the question in his famous dinner speech of December 1996: "How do we know when irrational exuberance has unduly escalated asset values?"

Professor Peter Phillips

Answering this question is an active arena of econometric research. Recent techniques deliver real time detectors that assess evidence for irrational hotproperty bubbles against normal efficient market behaviour based on economic fundamentals.

When the techniques are applied to 1990s Nasdaq data, they show statistical evidence of a bubble some 15 months prior to Greenspan's speech, confirming that his concern had a hard quantitative basis and justifying policy intervention that in fact never occurred.

We applied the same econometric technology to monthly New Zealand property market data on house prices relative to rents in all the main centres over 1993-2014. The empirics show clear evidence of housing bubbles with many similarities and some differences among the centres:

A broad-based housing market bubble emerged in all centres over 2003-2004 and collapsed with the onset of the Great Recession in 2008;

The Auckland and Wellington markets led the other cities in both origination and collapse of this bubble;

A subsequent bubble has emerged in the broader Auckland region in 2013 and is still evident in the data;

There is no ongoing evidence of contagion from the latest Auckland bubble to the other centres.

The data (measured on the left axis) is exhibited in the graphic. The bubble detector test and 5% false detection threshold are shown for the Auckland region (measured on the right axis). When the test (the brown line) breaks above the threshold value (the black line), there is strong evidence of a market bubble. The test shows this to be the case for the Auckland region at present, as evidenced in the orange shaded areas of the Figure.

No one knows in advance the straw that might break the camel's back and lead to a housing market collapse, arresting the caravan of real estate momentum that has so amplified the wealth of propertied New Zealand households over the past two decades. But empirical confirmation of the ongoing housing bubble in Auckland supports the Reserve Bank's decision to implement regulatory controls to moderate default risk in the event of a severe correction or collapse.

Whether additional cooling measures are needed to avert serious consequences for the wider economy in the event of a New Zealand housing market collapse is a matter of debate.

That Auckland's hot property market is irrational in relation to rents is not.

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