Westpac

Institutional Bank

New Zealand debt and house prices climbing rapidly relative to other developed economies

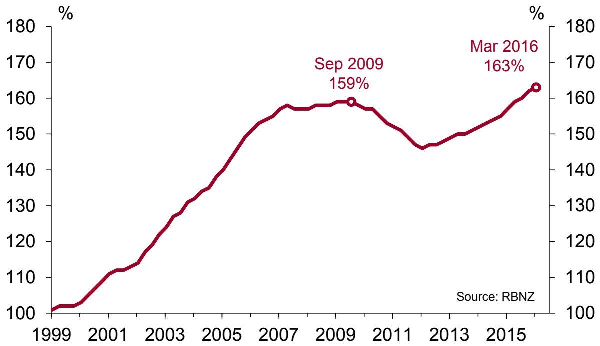
12 July 2016

- Household debt levels in New Zealand have continued to break records, with the build-up in debt closely related to the continued strong gains in house prices.
- Compared to other developed economies, household debt-to-GDP in New Zealand is at high levels and has been rising at a relatively fast pace.
- However, the build-up in New Zealand's household debt doesn't mean that the economy is about to topple over. Debt servicing costs remain low and most lending is secured against assets. In addition, lending practices have changed over time to limit the risk to the economy from highly leveraged borrowing.
- Increases in debt levels are still likely to provide a brake on longer-term growth and mean that we are more vulnerable to unfavourable changes in economic conditions.

What has been happening to New Zealanders' appetite for debt?

One of the key issues confronting the New Zealand economy is a build-up of debt in the household sector. Over 2015, household debt rose to levels higher than those reached prior to the financial crisis. And the latest figures from the Reserve Bank have shown this trend has continued in early 2016. Household debt is now at levels equivalent to 163% of annual household disposable income (figure 1).

Figure 1: Household debt as a share of disposable income (including investment properties)



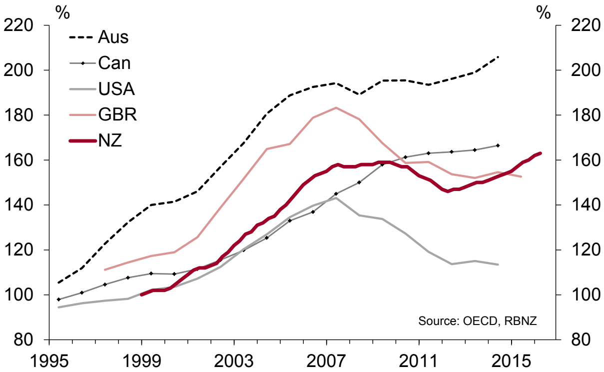
A key contributor to this trend has been historically low interest rates. Low interest rates have provided a powerful boost to asset prices, particularly for housing. And as has historically been the case, strength in the housing market has seen home owners spending some of the windfall they perceive when the value of their house rises, while aspiring buyers must borrow more. The net effect is an increase in both borrowing and spending.[1]

The above conditions have resulted in household credit growth rising to 8.1% in the year to May – its fastest pace since 2008, with much of this lending secured against non-owner occupied housing assets.

How do we compare?

New Zealand is not the only country where household debt-to-income levels have been climbing. Some of our trading partner economies, such Australia and Canada, have also seen debt rising to record levels (figure 2). However, trends in debt levels have varied across countries in recent years. For instance, in economies such as the US and UK (where debt levels also rose strongly in the lead up to the global financial crisis), household debt-to-income levels trended down following the financial crisis and have been stable in recent years. This is despite firming GDP growth and while interest rates have remained low.

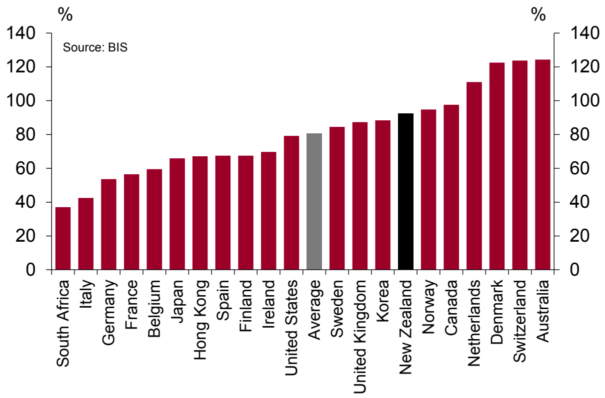
Figure 2: Household debt as a share of disposable income by country



Compared to other developed economies, household debt-to-GDP in New Zealand is relatively high (figure 3). However, due to differences in measurement, we need to be cautious when comparing the level of debt across economies. For instance, in Australia gross debt figures exclude funds held in mortgage offset accounts, exagerating estimates of indebtedness. It's also hard to determine what a sustainable level of debt is as this will be affected by a range of factors specific to a country, such the sophistication of the financial system and the treatment of leveraged investments.

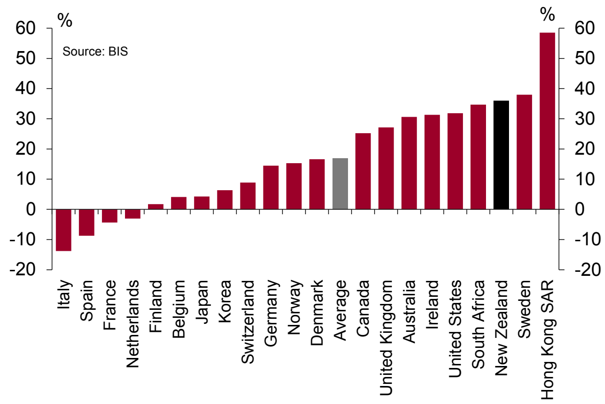
Nevertheless, trends in debt levels over time can alert us to the build-up of risk. And over the past five years, household debt-to-GDP in New Zealand has been rising at a relatively fast pace.

Figure 3: Household debt to GDP by country



The relatively large increase in New Zealand's household debt levels compared to many other developed economies is consistent with strong growth in our house prices (figure 4). Among the factors that have contributed to these trends in New Zealand are record low interest rates which have provided a substantial boost to housing demand, and housing supply that has not kept up with population growth – especially in Auckland. These conditions have made it very attractive for investors to purchase residential property using debt. Strong growth in house prices has also meant that owner-occupiers are borrowing more to purchase housing.

Figure 4: House price growth (2011 to 2015, selected countries)



Relative to changes in house prices, changes in debt levels here in New Zealand and elsewhere have been more moderate in recent years than we saw prior to the financial crisis. This relationship is illustrated in figures 5a and 5b. Since the financial crisis, lending policies have tightened globally. In part this is because of actions by regulators to improve the stability of the financial system. For instance, in New Zealand restrictions have been introduced to limit lending at very high loan-to-value levels. We've also seen many lenders independently tightening the access to credit to limit the risks associated with highly leveraged lending.

[1] The interaction between debt, interest rates and house prices is discussed in more depth in our earlier article, available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Household-debt-levels-now-higher-than-before-the-financial-crisis-April-2016.pdf

Figure 5a: Growth in house prices and household credit 2003 to 2008, selected economies

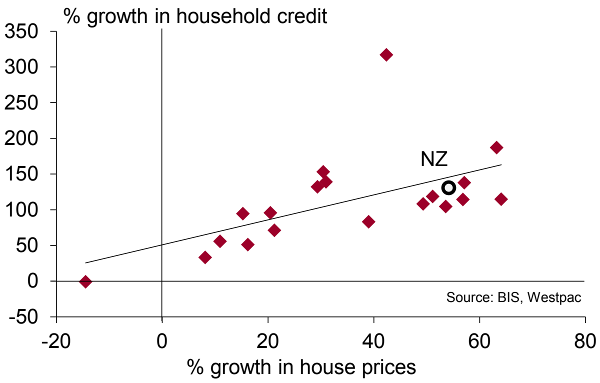
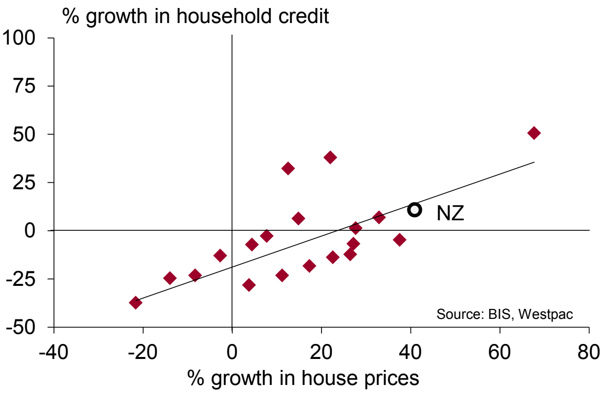


Figure 5b: Growth in house prices and household credit 2011 to 2015, selected economies

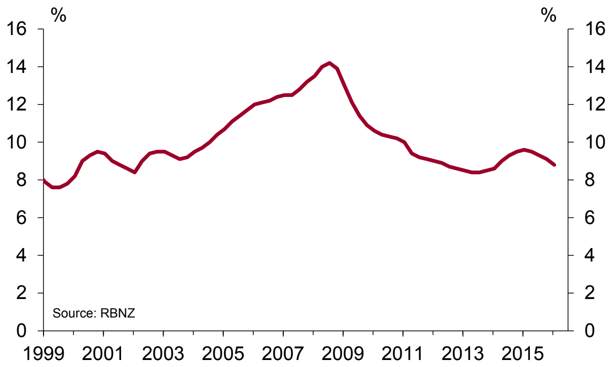


The debt build-up and the economic outlook

The build-up in New Zealand's household debt certainly doesn't mean that the economy is about to topple over. As noted above, lending practices have changed over time to limit the risk associated with highly leveraged borrowing. In addition, despite the increase in debt levels, very low interest rates mean that households' debt servicing costs remain modest. In the early part of 2016, the proportion of household incomes spent on debt serving dropped back to 8.8% (figure 6). On top of this, the current account deficit is only around 3% of GDP, and we don't expect that to change much over the year ahead.

A further notable feature of the increase in debt levels in recent years is that much of it has been secured against housing assets, including investment housing. Looking at households' debt levels compared to their assets, there has been a stark improvement in recent years. In fact, debt-to-asset ratios have dropped back to levels last seen in 2007.

Figure 6: Debt servicing costs as a share of households' disposable incomes



Some pick-up in debt levels is not a problem for an economy. Debt and credit play important roles in ensuring the economies run smoothly. And the increase in household debt on the back of low interest rates is actually a sign that monetary policy is operating as expected. The RBNZ has set interest rates at low levels to boost domestic activity, and this is helping to offset headwinds in externally focused parts of the economy. We expect that low interest rates and households' appetite for debt will continue to support economic activity for the next few years. Rate hikes won't be on the RBNZ's radar for some time yet.

Nevertheless, the build-up in household debt still raises important concerns for the longer-term economic outlook for two main reasons. First, increases in debt can't boost growth indefinitely. Households eventually need to repay debt, and larger increases now will require them to commit a great proportion of their income to debt servicing in the future.

Second, higher debt levels mean that the economy is more vulnerable to unfavourable changes in economic or financial conditions. And in this respect, there are some red flags on the economic horizon. In the near term, the increased uncertainty following the recent Brexit vote and the resulting nervousness in financial conditions have added to the downside risks for global economic growth. Further ahead, some of the key factors that are currently boosting economic growth will dissipate. In particular, the migration cycle has already started to turn, and through the latter part of the decade the Canterbury rebuild will begin to wind down. These conditions will dampen growth. And with higher debt levels, the slowdown in economic growth could be even more pronounced due to the impact on households' debt servicing abilities.

Satish Ranchhod
Senior economist

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

David Norman, Industry Economist +64 9 336 5656

Sarah Drought, Economist +64 9 336 5659

Any questions email: economics@westpac.co.nz

Disclaimer

Disclaimer continued

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

Investment Recommendations Disclosure

Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(ii) physical separation of various Business/Support Units;

(iii) Strict and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.