Housing: some perspectives on how governments have messed things up

Speech to Nelson Property Investors' Association

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I was on holiday in the United States a few weeks ago, staying with friends in their prosperous mid-western city. Their city is a bit smaller than Nelson, and just a bit newer. It seemed like a really nice place to raise a family - if, to a New Zealand sensibility, a thousand or more kilometres too far from the sea. The population is growing, and the economy is doing well. The unemployment rate is reported as being 2.1 per cent at present, roughly twice the (rather low) unemployment rate of Nelson-Marlborough.

Making conversation , I asked our friends about neighbourhood house prices. They reckoned that houses like theirs might go for around $US175,000 -decent-sized section, five minutes walk from the local university and football ground, four bedrooms etc. Popular sentiment was that prices were getting a little high.

When I got home, I checked those numbers on line. They looked about right. House prices go for not much more than three times median household income. And they were a little high by US standards.

When I looked at rents in this small university city, I was a bit surprised - they seemed New Zealand like. But then I realised that, of course, Americans quote rents on a monthly basis rather than a weekly one. Good housing is affordable for ordinary people.

By contrast, houses are incredibly expensive in New Zealand - even here in Nelson, and much much more so in our largest city Auckland. Rents aren't so bad, but then few people start hoping to rent in the long term.

Of course, not all of the United States is like the small city my friends live in. We spent time in San Francisco on the way home. In the city of San Francisco - typically with very small sections – the median house price is now over US$1 million. But across vast swathes of the south and Midwest, house prices are pretty moderate - around, or sometimes below, three times median household income. And that isn't just about small towns or modest cities. The median house price in Atlanta last year was US$168000 - in a city of around five million people. Houston prices are about US$200000 - and this in a city whose population has been growing very rapidly for decades.

The focus of the New Zealand debate at present is, understandably, on Auckland. Median house prices in Auckland are now around $770000, and those in Invercargill are a touch over $200000. And they have large sections in Invercargill and increasingly often tiny ones in Auckland. But Auckland just illustrates more starkly the issues that face housing markets across New Zealand. (There are exceptions - I grew up in Kawerau, and the current median price there is about NZ$105.000).

People often talk of "market failure", but this is "government failure". I'm going to explain how the choices of successive governments have messed up the housing market. And the financial crises of the last decade that were associated with housing were also directly - in the US case - or indirectly the fault of governments, skewing incentives to lend in ways that set the system up to fail.

But I'll also argue that there is no obvious reason to think that New Zealand's mess will be resolved any time soon - or that the patching-over-the-symptoms interventions of the government and the Reserve Bank have been helpful (let alone well-grounded in analysis ,evidence, or the law). It might be more rhetorically satisfying to argue that some dramatic catharsis is coming. It could happen, but none of the things that predispose countries to sharp falls or housing-related financial crises are present here - or in Australia, the UK or Canada. If governments keep on with their interventions, house prices can stay unnecessarily high indefinitely. [Think of how NZ govts kept up the real prices of second hand cars, or TVs, or the products of other protected industries for decades.]

House prices - what has driven them?

House prices in Auckland are simply a social and political scandal. And they result from regulatory choices made (actively or passively) by successive central and local governments that make it hard to use land for building, hard to build, and nonetheless keep on using instruments of policy to actively drive up the population.

Of course, mine isn't the only story on offer. Before I take you through my stry in more detail, let's have a look at some of the alternative stories.

Some will tell you that it is all about a convergence in the prices of houses in places where so-called "global elites" like to live. Globalisation does tend to equalise prices of things that are freely tradables across borders. But as the explanation for New Zealand house prices - even Auckland ones - frankly, it is nonsense. Even if we flatter ourselves that Auckland is such a global city, the argument might apply to a few inner-city suburbs - our pallid versions of Mayfair or the Upper West Side. But median prices are about prices in middling suburbs. It is about comparisons between real prices in those suburbs now, and those 30 or 50 years ago. Those suburbs – places like Onehunga, Mt Wellington, and Mt Roskill - are the sorts of places where young families might have reasonably expected to be able to buy. Instead, Auckland - which simply is not that big or successful a city - now has among the higher house price to income ratios anywhere in the advanced world. Some of the others are well-known big cities - San Francisco, Sydney, London, and Vancouver, but others aren't: high on the list are Honolulu, Bournemouth. Tweed Heads.

How about the tax system? One often hears talk about the tax-advantaged nature of owning houses? Sometimes it is suggested that people like you – owners of residential rental services businesses - are riding high on tax concessions and subsidies.

There is a reasonably good argument that taxes on businesses and capital income are too high as it is - apart from anything else, business investment in New Zealand has long been weaker than was probably needed. But let's take the current system as it is for now.

Housing is somewhat tax-advantaged in almost every country (even in the US Midwest). Most importantly, there is no country where home owners are fully taxed on the economic benefits (imputed rental income) they derive from living in their own homes. If there are tax advantages to housing the single biggest advantage is to people - like me - living in their own homes without a mortgage. People probably live in bigger houses, further into old age, than they might with a different - perhaps theoretically superior - tax system. But there is no reason why this should boost house prices, if the market is working well.

The ability to offset rental operating losses against other income is often criticised. But as I'm sure you know, it is no different for housing than for any other small business operation. And house price booms never **start** with residential rental property oweners making operating losses.

If "ring-fencing" were introduced, it would change the market to some extent. In particular, probably fewer rental properties would be owned by small individual investors, and more by big corporates or investment funds. But it isn't clear why such a rule change would make society any better off. The introduction of the PIE system a few years ago already tilted the playing field a little towards institutional vehicles.

Many of the great and the good favour a capital gains tax, and the new "bright-line" test brings us a little closer to having one for some assets. I don't have time to discuss it at length now - we can pick it up in questions if you like . I reckon a pure CGT does no real good and little harm, but that real world and partial CGTs do no good and a considerable amount of harm. And there is no international evidence suggesting that CGTs in other countries have materially altered house price levels or cycles

As I'm sure you know, asset prices are not a sure thing. Commentators often suggest there are free lunches - certain capital gains - on the table and that it is highly unfair such gains aren't taxed. SO-called "free lunches" are rare, and typically arise as a result of regulatory interventions , which should be fixed (reversed) at source. You'll all be aware that real house prices in Nelson, for example, are lower today than they were eight years ago.

In practice, capital gains taxes also tend to work against individual ownership of assets (including rental properties). Real world CGTs work on a realisations-basis - the tax obligation crystallises only when the asset is sold. Big companies or investment funds are typically better able to count on holding an asset for a very long time than an individual might be - whose circumstances might change, or where a job loss or transfer might force a liquidation.

But there are one or two areas where the tax system does skew things inappropriately. The Productivity Commission has recently highlighted the attractions of getting local councils to shift back to land value rating - which encourages owners to use vacant land, rather than just sit on it. And you as rental property owners get to write off all the interest you pay against rental income, as if all interest is an operating expense. In fact, around 2 percentage points of any interest rate is just compensation for inflation. That isn't a cost to you (sure you have to write the cheque but it is offset by a trend rise in nominal house prices). You shouldn't be able to deduct all the interest - at least while we have a positive target inflation rate - and savers shouldn't be taxed on all their interest earnings. This should be fixed up, and could be resolved relatively easily. But even if it isn't resolved, it doesn't make much difference to the level of house prices now, is partly offset the unjustified abolition of depreciation deductions, and…more importantly…has been in place almost for ever. It mattered more when inflation rates and max marginal tax rates were higher. It can't help explain the way house prices have gone crazy in the last 30 years or so.

Not one of these tax factors support **ongoing** rises in house prices now. In fact in the last 20 years there have been no material changes to the tax system that would, even in theory, have systematically boosted house and land prices. There is no windfall to current purchasers or owners. Any of these distortions (if such they are) were, in principle, fully priced into house and land prices a long time ago. Everyone, consciously or not, has to take taxes into account in making major financial decisions, so I'm not suggesting that the details of the tax system don't matter at all. But they are very far from being a first order issue.

Gareth Morgan will tell us high house prices are all about bank capital rules. Yes, banks hold less capital against each dollar of housing loans than against most other loans. That is because lending secured on housing is generally much less risky than lending for other things. This has been true across many countries and many decades - including the US, and Ireland in the last decade. And New Zealand banks have higher risk weights on housing lending than their peers in most other advanced countries. For a dollar of housing lending in New Zealand, more capital is held than would be held on the same sort of loan made in Australia, Canada, Sweden, or the United Kingdom.

What about low interest rates as the explanation for high house prices? Remember (a) that interest rates are (extraordinarily) low for a reason (about overall demand at that level of interest rates, and (b) that despite low interest rates, real house prices in much of the country are now well below those in 2007. And in a well-functioning market interest rates should only affect land prices (for any length of time)- in a well-functioning market, one can always build new houses, and if anything lower interest rates slightly lowers the cost of building new houses.

What about non-resident foreign buyers? In well-functioning markets increased demand to buy houses - whatever the source - does not push up prices much, or for long. Even if there are a lot of non-resident Chinese purchasers at present, the Chinese foreign purchasers story has been around for only a year or two, and Auckland prices have been absurdly high for a long time. There might be a second-best case for some policy action on this front - but mostly only because of the other restrictions central and local governments keep in place. Bear in mind that what is going on - here and in other Western countries - is historically unusual: it isn't the sort of thing that "globalisation" just makes inevitable. It is the unusual consequence of having a large country emerging where people don't feel safe holding their money in their own country. It was never an issue when the UK or the US were rising to positions of economic leadership. Rich Brits or Americans never diversified their wealth by holding NZ or Australian houses.

Construction costs are often cited as a factor in the story of high New Zealand house prices. There may be something to this, although it doesn't look to be mostly - or directly - a government story. But there may be areas where policy could make a difference - removing remaining tariffs, by enabling the development of large scale subdivisions with more economies of scale, and perhaps reforming the liability laws that now make local council building inspections incredibly risk averse - rationally so from their financial perspective, but at great cost to the rest of us.

People also talk about difficult geography. Whether it is hills in Wellington or San Francisco, or harbours in Auckland, Stockholm, or New York, geography does make things a little more difficult than for cities on wide open plains. But mostly it is an excuse, or perhaps one might put it this way: difficult geography just makes it even more important that land use rules are kept to a minimum if housing is to be affordable. As it is there are plenty of places - even in NZ - where geography isn't difficult and house price to income ratios are still high by international standards.

So

- Tax has been a second-order issue
- Bank capital rules are a non-issue
- Low interest rates are a reflection of how weak the economy has been
- Geography is an excuse, not an explanation.

- And there may be some modest regulatory issues around construction costs and non-resident foreign buyers.

It can't be repeated too often that there is nothing inevitable about high house prices and high price to income ratios. We can see this both across regions and across time. Perfectly pleasant prosperous growing cities in large chunks of the United States have house prices right now under US$200000 (say $300K NZ). Good affordable houses are quite possible. And scholars have demonstrated that ,in the US, and Australia for example, in the days before tight land use restrictions, real urban house prices fluctuated, but with no particular trend. Real house prices in the US had been not much different in 1990 than they were in 1890. Perhaps even more striking is the famous series from Amsterdam's Herengracht – where there had been little systematic change in the prices of the same canal-side houses over several centuries.

Sometimes this puzzles people. After all, there is a finite supply of land, and more people. And, of course, today's house has many more modern conveniences etc than one from 200 years ago did. But remember just how little land our cities and towns cover. It is slowly getting better known that in New Zealand only 0.7% of the country is covered by towns and cities. There is no scarcity of land - unless governments make land artificially scarce. And, of course, each house doesn't use much land. In a free market, the best alternative use determines the value of land. Even if agricultural land trended up in value over time - which it probably won't - top quality dairy farm land peaked at around $50000 per hectare in last decade's boom. Even with nice wide streets and ample public spaces, a typical suburban house on say 700 sq m of land might require on perhaps 1500 sq m of land (ie less than $10000 of raw land). And, of course, over long periods of time productivity gains that enable us to have more stuff for the same real cost.

Houses should be what economists refer to as normal goods - as our incomes rise we typically prefer to consume "more house" - more land, more building, better-quality building, more built-in stuff. But there is no reason to expect the prices of a constant-quality house to rise over time - if anything it should fall..

It helps to keep this framework in the back of your mind - it is a check on the absurdity of so much of what we hear - that as we get richer we should live in smaller, or more tightly-packed together, houses, or that land itself is (meaningfully) scarce in countries like ours. Even in somewhere like the UK, land isn't scarce - its use is just excessively regulated (think of the giant town belt encircling London)

In a well-functioning market, increased demand for houses should be followed, quite quickly, by an increased supply of houses, with not much change in the price of those houses. If the increased demand came out of the blue, prices might increase temporarily - but that would be the signal to builders and developers to build, and buyers to purchase, new houses rather than existing ones. That is the way other markets work - increased demand prompts increased supply. Expected increases in demand prompt supply in anticipation. It is the way house market used to work, and still do in great swathes of the US.

But governments too often stop things working that way. .

What matters most in New Zealand is the interaction of just two things:

- the regulatory measures which have made housing, and urban land supply in particular, only sluggishly responsive to changes in demand, and
- the active choice to target high levels of inward (non-citizen) permanent and long-term migration.

"Supply restrictions" is the shorthand for a whole range of laws and policies, set by central and local government, which mean that when demand for housing increases, too much of the impact is seen in prices (especially land prices) rather than volumes. Mostly they are restrictions on land use, but it includes building restrictions as well and the rules on how the infrastructure associated with new subdivisions is put in place, who pays for it, and so on.

A nice note that the Productivity Commission put out with one of their housing reports reminded us how little "town planning" there was in New Zealand for a long time. People were more or less free to use their land as they saw fit. Here[1] is a Cabinet minister introducing to Parliament New Zealand's first piece of town planning legislation in 1926:

> Cities and towns in the Dominion at the present time have no schemes of town planning and the sooner the controlling authorities have the power and set to work and draft such schemes the better for themselves and the people generally.

For the Councils perhaps, but it isn't clear how "the people generally" have come to benefit.

In fact, it wasn't until the 1950s that "town planning" became a major consideration. Even then, in the post-war decades, people wanting Housing Corp loans - the way most young couples (including my parents) got into their first homes - had to use them to build a new house. The whole focus of policy was on home ownership, and homeownership meant construction. It was similar story in other countries - the UK and Australia for example[2]. Norman Kirk, who built his own house, was Mayor of Kaiapoi in the 1950s - one suspects the local borough council had a different attitude and perspective than most of those today.

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[1] http://www.justice.govt.nz/courts/environment-court/about-the-environment-court/History

[2] John Kay discusses the UK experience here http://www.ft.com/intl/cms/s/0/14cd1280-f25d-11e4-b914-00144feab7de.html#axzz3aSTV7oXE

That mix of policies and attitudes all broke down in the 1970s and 1980s. The government largely got out of housing finance, and when finance was provided it could be used for new or existing houses. The legislation changed repeatedly over the years, finally landing in the form of the Resource Management Act in 1991.

It seems strange now but key participants apparently regarded the RMA as being likely to result in **less** restrictive planning regimes. That belief would have been consistent with the general thrust of policy, again under both governments at the time – the liberalising days of Roger Douglas and Ruth Richardson.

Quite what the RMA - and associated powers in later acts, e.g., the Local Government Act and the Land Transport Management Act- actually meant for housing and urban land prices wasn't immediately apparent. The whole panoply of rules around site coverage ratios, protection of view shafts, rules giving effect to Council prejudices against "sprawl", and so on were all something of a mystery. Macroeconomists, in particular, struggled to come to terms with the idea that these microeconomic provisions might make so much difference.

Deliberately or otherwise the powers of local government officials and councillors grew, and their interests and preferences seemed to diverge from those of residents wanting affordable housing. In their new report last week, the Productivity Commission captured - but seemed to take for granted - the ideological dimension, writing that "many urban councils have a clear idea about how they want to develop in the future and how they intend to meet a growing population demand for housing. Many larger cities have chosen to pursue a compact urban form" Who, one might wonder, asked them to "decide" on these questions - why did anyone need to "decide" them? Shouldn't councils operate to facilitate the individual preferences of residents and property owners, and how they want to lose their own land? As I've been trying to stress, governments are to blame for our house prices, not the private sector.

But I don't think anyone - even Councils - now really doubts that supply constraints are an important part of the story. Councils will sometimes defend themselves, talking about how many years of land supply they aim to "release". But the signals from the market (land prices) are pretty clear - land that can be built on is much more (artificially) valuable than nearby land that can't be built on. . There are debates about "densification" vs "sprawl", but in this context "land supply" can encompass either - it is about the ability to use land efficiently.

Personally, I'm a bit sceptical about the push for densification: New Zealand isn't exactly short of land, historical evidence is that as cities get richer they tend to become less dense - think of the tenements the poor lived in in New York, London or Paris - not more. In any case the data suggest that by New World standards, Auckland is already a relatively dense city. I'm not suggesting that we should put obstacles in the way of greater density, but nor should we put obstacles in the way of the traditional preference of a detached house and a decent backyard. But the latter is what too many councils are doing - imposing their bureaucratic vision on what cities “should” look like.

Of course, if Councils and governments keep on making land artificially scarce, then we probably will see more densification - an apartment in a 20 storey apartment block does not use much land. We’ve seen something of this is Sydney (a large share of the new build is now in apartments). Our Reserve Bank keeps making speeches suggesting it is a “good thing”, but I suspect that in terms of citizens’ own preferences it will be a distinctly second-best outcome. Most people seem to prefer space, and room for the kids to play soccer and cricket. One doesn’t see too families living in high rise apartment blocks - council houses aside - in those US cities without many land use restrictions.

The Auckland Council rightly gets a lot of flak, as an obstacle to affordable housing. Auckland’s rules may be no worse than those of councils around the rest of New Zealand. But these things matter much more in Auckland because the population is growing quite rapidly. New building is needed, constantly. As a general proposition, land use restrictions are much less of a problem in places with flat or falling populations. I haven’t checked the Kawerau district plan, but I doubt it creates too many problems in holding up Kawerau house prices. Not much building is needed there.

Population pressures are the second half of the equation, explaining high New Zealand (and especially Auckland) house prices.

In years gone by we had first:

- rapid population growth and a focus of making building easy and encouraging home ownership - until the early 1970s
- gradually tightening planning restrictions but very weak population growth (from the mid 1970s to the late 1980s)

Both were consistent with reasonably affordable houses. But since the early 1990s we’ve had much tighter planning restrictions AND much more rapid population growth. We’ve had one of least favourable economic performances among rich countries in the last 25 years, but we’ve had among the fastest rates of population growth. One of the few countries to have had much faster population growth was Israel - and their economic performance has been about as disappointing as ours.

Of course, the issues come into particular focus in Auckland. What marks Auckland is not total population size (1.5m isn’t that big), or even size as a share of the whole population (plenty of places abroad have big cities that make up a larger share), but rather the sheer pace of growth of the population of Auckland. I did some work a while ago trying to look at population growth in the largest cities of each advanced country in the post-war era. Across all advanced economies, as far as I could tell, only Tel Aviv had grown at a faster rate than Auckland[3].

This is where, incidentally, I'm somewhat critical of the latest Productivity Commission report on land. It suggests that land use restrictions are holding back population growth in Auckland and, as a result, per capita growth in real income and productivity across the whole country. It is a plausible story in theory, but when Auckland has grown so rapidly over recent decades anyway, it is a little hard to think that the theory matters much in practice. Is Auckland really an artificially small share of the total population. I doubt it. High house prices mostly just make good secure housing a whole lot less affordable than they could or should be. Deeply unfair redistributions ensue, and we probably consume less' house' than we otherwise would, but if the controls don't help, they probably don't do that much damage to size of the economy either.

Various things influence population, and mostly they are things governments can't or shouldn't do much about. Natural increase - the number of children people have, and the improvements in life expectancy - are largely a matter of technology and private choice. They are what they are. Governments shouldn't be telling people how many kids to have. And governments can't do anything much, directly, about New Zealanders leaving the country or coming home again. But the immigration of non-New Zealanders is directly under government control.

For a long time it was very easy for lots of people to migrate to New Zealand (especially those from the UK). We tightened policy a lot in the early 1970s, and at around the same time the number of New Zealanders leaving for Australia increased sharply - as our economic performance started drifting further behind theirs. Trend population growth slowed sharply.

But then immigration policy was reoriented and opened up again in the late 80s and early 1990s. There was some sensible aspects to the changes (eg in principle, a skills focus), but one of the oddest was a rather strange notion that we should replace people that were leaving, as if the government knew better than people about the opportunities in New Zealand. There wasn't much public debate about substantially increasing migrant numbers (or even, as far as I can tell, a very active one within government circles). It just happened - the sharp increase in migrant numbers didn't need Parliament's direct approval and even today the target level of non-citizen migration is just set by the Minister of Immigration (currently 45000-50000 residence approvals per annum). As a result, New Zealand now has had among the very largest average rates of non-citizen inflows (net) anywhere in OECD.

New Zealand is in a fortunate position when it comes to immigration. It is all a matter of choice. We aren't bound by treaty to let people in - unlike, say, EU countries. We don't have porous borders -

[3] There are other cities that have had larger absolute increases in population, but pressures of growth (including those around utilising land) tend to be proportional rather than absolute.

like the US or some EU countries - resulting in a big flow of illegals. Instead, our government chooses how many non-New Zealanders we allow in each year[4]. And it does so knowing that the bulk of them will gravitate to Auckland.

That immigrants disproportionately come to Auckland isn't unusual - it is what we see around the world. Many of the people coming are used to bigger cities (whether from China, the UK, South Africa, India or the Philippines). Migrants might want the opportunities of a new country, but they always want connections to their own culture. Migration research shows that (quite sensibly) people congregate where people like them already are.

Whereas in the 1980s we had an average inflow of around 10000 non-citizens a year, we have had an average net inflow of non-citizens of 40000 per annum since 2000. Those are really big differences (750000 people over 25 years). In fact, the difference is so large that if we went back to 1980s non-citizen immigration levels, New Zealand's population would now be flat or falling. There is still a little bit of natural increase, but in most years a large trend outflow of New Zealanders.

Some of you might have heard of Shamubeel Eaqub's recent book, *Generation Rent*, where he argues that immigration policy is not particularly important to understanding house prices. He does an interesting exercise breaking down household formation over the last 50 years down between natural increase, change in average household size, and net migration. Net migration accounted for only 9 per cent new New Zealand households over that period. But that is, in many ways, quite misleading. Most of the outflow of New Zealanders was happening anyway .- But foreign citizens can come, and stay, only with the permission of the New Zealand government. All the inflow of non-citizens is a policy choice.

And when I looked at the data this way, I found that since 1961 non-citizen immigration accounted for 45 per cent of all household formation, since 1991 about 70 per cent, and between the last two censuses, <u>more than all</u> the new household formation was accounted for by non-citizen immigration. In other words, all (or almost all)[5] the pressure to build new houses results from the net migration of non-citizens - it is a direct policy choice. Governments squeezing people out of the housing market, again.

If large scale immigration was improving our economic fortunes, we might be less bothered about the implications for house prices. But in fact, there is no sign that the immigration is doing New Zealanders any good at all. That shouldn't be surprising. There is no real evidence anywhere that large scale immigration has ever boosted the economic fortunes - as distinct from the population size - of countries that are already relatively rich and sophisticated. High immigration may make

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[4] Australian immigration to New Zealand is unrestricted, but the numbers involved are small and quite stable.

[5] With lower house (and land) prices it is likely that we would have seen the average number of people per dwelling continue to drop.

some sense if your economy is doing very well - one can share the gains around. That is what happened in NZ or the US in the late 19th century. But the NZ economy has been struggling at least since the 1950s. We've just kept slowly drifting further behind other rich countries, even in the last 25 years. The outflow of NZers in response was sensible and rational - just like flows from rural states to big cities in the US, or from Taihape to Auckland, or Invercargill to Christchurch. .

The crazy bit was the government intervening to bring in lots of new people. Many of them are good and able people. And moving here probably benefits those who moved, but it has just made it harder for those of us who stayed behind to maintain top tier living standards. And, of course, in combination with the sort of crazy land use laws that blight so much of the Anglo world, it has given us such high house and land prices. The young and poor suffer yet again.

Fast population growth, of course, doesn't make house and land inflation inevitable.

Houston is the best-known example of the alternative approach, where housing and urban land supply are much more responsive to changes in demand. Since 1979, the population of the Houston metropolitan statistical area has more than doubled, from 3 million in 1979 to 6.5 million last year. Over that period, real house prices have fallen in Houston. By contrast, since 1979 Auckland's population has less than doubled, and Auckland house prices have much more than doubled.

With a much more responsiveness housing market, rapid government-led population growth wouldn't represent a problem for the housing market. It isn't in Houston. It isn't in Atlanta But it is here.

Implications

So we've had a mix of government policies that has given us some of the costliest houses - relative to income - in the world We've had a massive shift of wealth to those who already own houses and urban land, from those who do not - but want to. The young have had to borrow much more heavily than they should from the old.

But a lot of the discussion of housing seems to proceed along the lines of "what goes up must come down".

In fact, there is nothing inevitable about it at all. Markets distorted by governments can stay distorted for a long time. To think about the risks we need to think carefully about what caused prices to get to where they are. And since overseas comparisons are often brought to the table - as they should be – we need to think hard about which experiences shed what light on the specifics of New Zealand.

Graeme Wheeler lived in the United States through the house price boom and subsequent bust. I think he is (reasonably enough) determined that New Zealand should not experience anything quite that bad. That is a laudable ambition, but the US experience is only useful if we correctly understand what happened there. We don't want to repeat their mistakes, but we need to know what the US mistakes were. And we need to look seriously at the (many) countries that had house price booms that didn't end in nasty domestic financial crises or sustained falls in house prices. Nasty housing busts don't happen in a vacuum, or as an unlucky draw by a random number generator.

Of all the explanations for the US housing finance boom and bust, I've found former US Treasury official (and now think-tanker) Peter Wallinson's book *Hidden in Plain Sight* most convincing. To cut a long story short, Wallinson documents the huge deterioration in housing lending standards that took place over the 10 or so years prior to the crisis. Most of it appears to have been due to directions from Congress and the federal government, both to the "agencies" (Fannie Mae and Freddie Mac) and to banks more generally who needed to stay on the right side of their regulators. Not every lender was directly affected, but pressure on, and choices of the, agencies in particular (who played such a huge role in the hugely distorted US housing finance market), drove down lending standards across the entire market. The data are pretty compelling. In other words, the US housing finance, and house price, boom and bust was, to a very substantial degree, a failure of government.

Unsurprisingly, we saw nothing similar in New Zealand or in other OECD countries. The housing finance markets in NZ, or Australia, or the UK, are private markets where government, Parliament and the Reserve Bank have historically played no real role in trying to influence lending standards. Yes, banks lent a great deal to housing borrowers during the boom, and no doubt credit standards eased to some extent during that period, but the incentives (and, not unrelatedly, the results) were very different from those in the United States. Banks simply weren't under government pressure - well-intentioned no doubt – to make more and more riskier loans.

The Reserve Bank also often cites Ireland. But there has been no obvious effort to analyse what made Ireland different from, say, New Zealand, Australia, or the UK. In particular, the fact that Ireland had no monetary policy autonomy: they'd adopted the euro and so had German interest rates through a period when their economy needed something more like New Zealand interest rates. The whole economy went crazy for a few years - an irrational exuberance that carried over into the house market and - even more catastrophically - into a huge commercial property boom. Borrowers and lenders took on loans they'd never have considered in more normal times and, in time, the commercial property development boom broke the banking system..

We certainly wouldn't want to repeat the Irish (or Spanish) mistake, and I hope their example is adduced if, say, anyone proposes New Zealand adopting a common currency with the United States. But countries with floating exchange rates, banks with well-hedged balance sheets, and housing finance markets in which the government does not play a substantial role, just did not find themselves with serious housing credit crises in the post 2007 era. Not a single one did, even though in many of those countries the stock of credit had grown rapidly, and house prices had grown rapidly, and even though the post -2007 recession was the most severe in decades for most advanced countries. Common sense, borrower self-discipline, and lender restraint (and diversification) worked.

If I am right that the New Zealand house price issues result from the interaction of our planning regime and our immigration policy, then these are structural policy choices that systematically overprice houses, largely independently of the banking and financial system. And they are not ephemeral pressures - here today and gone tomorrow (even if prices ebb and flow a little with the economic cycle). The distortions in the housing market have been building for decades. I hope they are reversed one day, but there are no market pressures that will compel them to be reversed any time soon (any more than there are market pressures that will compel the reversal of planning restrictions in Sydney, London, or San Francisco). These distortions are not about making credit available too easily and too cheaply right across the economy (and that is the single big difference between NZ or Australia, and say the Irish, US or Spanish situations). The structural policy distortions are simply about making houses less affordable - in the same way import licensing for decades made cars less affordable. The Reserve Bank has no better information than you, I, or the young buyers in Auckland do, on whether and when those policy distortions will ever be reversed. But these are not points that you hear brought out in the Governor's speeches, or in research or background papers from the Reserve Bank (few as they are). Instead, we are treated to lofty observations that New Zealand is one of the few OECD countries not to have had a substantial sustained fall in house prices in the last 45 years (which is not even really true, given the sharp fall in real prices in the late 1970s). Or a sense from the Deputy Governor that "something should be done" about the tax system, which turned out (when I OIA'ed it) to have been based on no analysis at all. Or scare stories about the US economy post-2008, without any systematic effort to explain how much of the US experience is down to financial crisis effects, and how to reconcile that story with the hard data which shows that the NZ and US economies have performed almost identically since 2007. Even the Treasury - no fan of market solutions these days - is sceptical of the Bank's analysis and arguments.

The Reserve Bank has been pretty poor in the way it has drawn lessons from the international experience. But it has also been weak in how it has

- engaged with the New Zealand experience of 2005 to 2010, and the lessons from that experience.
- lined up its LVR policies with the results of its own recent New Zealand stress tests.

Take the pre-crisis period first. In the 2000s, New Zealand bank lending rose very rapidly - at around 15 per cent for several years. Rapid bank lending growth (well in excess of rates of nominal GDP growth) has often been a precursor to financial crises. No financial crises that I'm aware of have arisen without strong recent growth in credit, but most countries that have experienced rapid growth in credit have not experienced a financial crisis.

And so in 2007 there was some reason to be a little anxious in New Zealand. Credit had been rising rapidly, across all components of bank lending books, and well ahead of rates of growth of nominal GDP. And asset prices had been rising rapidly for years - houses, farms, and commercial property. And the economy had also been booming for some years - rapid income growth, and very low unemployment. Interest rates had to be raised again and again - and arguably monetary policy has been too loose for too long.

And yet through the 2008/09 crisis the Bank and Treasury swore to the soundness of the banking system assets. And they were right to do so. The banks came through unscathed - there were modest increases in loan losses, but nothing more.

By contrast to the situation in 2007, consider the situation now:

- Credit to GDP (whether household or total) is still below levels reached in 2007
- Real asset prices, in most of the country, are well below levels in 2007(not just for houses)
- Unemployment is still quite high
- Wage growth has been subdued
- Housing turnover, relative to population, remains well below levels in the previous boom.
- Bank capital ratios are materially higher than they were then, as are risk weights on housing loans.
- There is none of the generalised optimism - exuberance in some quarters - that characterised the boom times of the 2000s.

There is almost nothing there that should give serious New Zealand bank supervisors great reason for concern. Of course, supervisors are paid to worry and to be vigilant, but we should need more than perennial worry to justify the sorts of new intrusions on our ability to leverage what is, for most of us, our largest asset. Crisis risks don't arise from 10 year old debt, but from new debt. It is difficult to take very seriously suggestions that the level of risk is greater than it was in 2007, and yet the banking system came through the post-2007 recession unscathed, even though the buffers were smaller then. Again, the Bank has never been willing to explain why this is not a reasonable argument now against the sorts of heavy-handed interventions it has been adopting.

The Bank has not really engaged openly with the results of its own stress tests. "Stress tests" are exercises in which supervisors provide banks with a severely adverse economic scenario and ask banks to estimate what such a shock would do to their loan losses and capital. The process involves several iterations, and interactions between regulators and banks. As compared to using risk-weighted capital ratios (which also look very solid, but which are much less transparent, to supervisors and to outsiders) it is as good as it gets (albeit not perfect) in checking out the resilience of a banking system.

How severe was the stress test? Well, the Bank assumed that house prices fell by 40 per cent nationwide, and 50 per cent in Auckland, and that the unemployment rate rose to 13 per cent. The biggest nationwide house price fall seen anywhere in modern times is around 50 per cent (and in much of New Zealand, real prices have been falling for some years already). As for the unemployment rate, New Zealand's has not got to 13 per cent since the Great Depression, and the scenario involved a larger increase in the unemployment rate than has been seen in any floating exchange rate country in the post-war era. Stress tests should be tough - but these ones were, and the banks came through unscathed. Perhaps the results are a bit too good to be true, but the Bank has never claimed that it thinks so.

One reason why the good stress test results should not be unduly surprising is the results of international work looking at what banks lose money on in financial crises. You won't hear it from the Governor, but in a quite recent issue of the *Bulletin* the authors reminded us the banks very rarely fail from vanilla housing loans. It is typically commercial property, and particularly property development loans, that bring down banks. Thus it was in New Zealand in the late 1980s, in the Nordic crises of the late 1980s and early 1990s, and in Ireland most recently. Thus, in fact, it was for the New Zealand finance company sector. The Nordic case is an interesting one. House prices in Finland, for example, fell by 50 per cent quite quickly in the early 1990s and there were significant loan losses on the residential mortgage books, but those losses were nowhere enough to threaten the health of well-capitalised banks operating nationwide.

This brings us back to the current New Zealand situation. Overall credit growth is still pretty modest – picking up a little at present, but that appears to be driven by rising prices themselves, rather than the other way round - as is lending for property development purposes. Commercial property prices are rising, but are not exuberant, and the level of development activity, outside Christchurch is not extraordinary (contrast the cranes on Manners St or the Terrace in late 1980s). Private sector banks simply do not fail in these circumstances; with the sort of loans (nature of exposure, age of exposure) they have on the books now. The Governor may not like Auckland house prices - his predecessor was uncomfortable with them eight years ago - but they pose no realistic or credible threat to the soundness of the financial system.

But in the most recent new restriction that comes into effect later this week, the Bank has concluded that New Zealand banks are so badly run, and New Zealand borrowers apparently so reckless, that not a (practical) cent, in huge balance sheets, can be lent safely to rental service providers in Auckland on LVRs in excess of 70 per cent. Where, we might ask, is the evidence that such lending is so unsafe, such a threat to the soundness of the system, that the coercive powers of the state should be exercised to ban it altogether?

And that is the statutory test when it comes to imposing controls. By contrast, the Reserve Bank's control do pose an increasing threat to the efficiency of the financial system – the latest Sunday Star Times gave some coverage to non-deposit-taking lenders are gearing up their business models to cope with increased demand from Auckland landlords. The damage being done only increases as the controls are in place for longer, or become more sector-specific: banks are allowed to lend only to the extent that bureaucrats say they can.

I've already suggested that the Reserve Bank has not done a good job of applying the lessons of other countries, and our own past experience. But what about the specifics of the current New Zealand situation?

Well, the share of lending to investment property buyers certainly increased in the 18 months or so leading up to the announcement of the investor finance restrictions. But that share had not risen to unusually high levels, and such increases are what one would expect when the initial LVR controls were put in place, since they were generally expected to fall most heavily on first home buyers (people who have always typically taken an 80 or 90 per cent loan to get into their first house). An increased share of loans going to investors might also be what would expect when there is an upsurge of immigration, including those on student visas - another trend championed by the government. Increased migration, and especially shorter-term migration means increased demand for the rental services provided by investment property owners. Someone has to provide that service.

And in addition to all this, the Reserve Bank has so far presented not a shred of evidence that bank lending standards around investment properties had deteriorated markedly, that capital requirements to cover the risks are inadequate, or that its own judgements and biases - or its implicit view of where nominal prices will be in say five or ten years' time - were more likely to be accurate than those of the borrowers, lenders (and market funders), who have their own funds at stake..

What is going on now simply does not seem like banking regulation focused on the soundness and efficiency of the financial system, but rather direct discretionary intervention and regulation of the type we thought we had got rid of in the 1980s. And it is not supported by the level of rigorous analysis that we should have hoped for from a powerful autonomous agency. As much as anything, it seems driven by a visceral distaste for people like you.

Perhaps as disconcertingly there has been no discussion of the implications if they were wrong in their view. We all know - and they know - that forecasting is a mug's game, never more so than with asset prices. The Reserve Bank has said that if they could rerun history, they would have put such controls on back in 2005 or 2006. But if so, how many lives and business plans would have been disrupted for a correction that, eight years on, has still not come? Even if there had been some slight gain in system soundness - itself arguable - how should we trade off the efficiency costs and the uneven distributional effects? A first home buyer squeezed out in 2006 might finally have been able to afford her house, with a higher deposit, in 2008, but only at a much higher price. Or someone just planning to get started in the business of providing rental property services in Auckland finds his or her plans disrupted because a single official in Wellington concludes that no bank can legally make such loans. Or the person from a family without substantial financial resources is squeezed out now in favour of one whose family can provide supplementary loans to get around the effects of the LVR limits. How is this an efficient financial system, let alone a fair one?

And even if, temporarily, the Bank's controls do hold down prices, won't that only mute the price signals that encourage people to overcome the panoply of rules and restrictions and bring new property to market?

So where to from here?

In some ways the planning restrictions and controls of the last few decades, at a time when the population has grown rapidly, have been a bit of a gift to the private residential rental services providers - certainly, the private rental market is now much larger than it would have been in the absence of the controls, and if real house prices had stayed at something around the level we see in much of the south and midwest in the United States. I'm not suggesting that - outside Auckland - it has been enormously profitable, and especially not to anyone who got into the business in the last decade - but there have been opportunities which otherwise wouldn't have existed. We'll always need a significant private rental market - for the young and the very poor, and those taking a job somewhere just for a few years - but it probably should be smaller than it is. The declining home ownership rate is a symptom of what has gone wrong with policy. I'm a bit sceptical of the arguments that there are overarching social benefits from increased home ownership, but there are certainly private benefits - it is what most people want for themselves and their kids. And yet home ownership has become increasingly difficult for all too many people, especially (but not exclusively) in Auckland. And those who do finally get on the ladder, now have to take on so much debt that they - although probably not the banking system or the whole economy – are vulnerable if things go wrong. I recall have negative equity on my first house for a few years - but I was single, and the mortgage was less than twice my income. I worry about people getting into the market now. And the problems are the fault of our governments.

Unfortunately, I'm not aware of any Anglo countries, states or cities that have effectively unwound the panoply of controls that have made housing increasingly unaffordable. I'd like to think there were such examples, but I've kept posing the question on my blog, and I've not had any responses. Prices in London, Sydney or San Francisco don't stay sky high because they are rich global cities, beloved of a handful of billionaires. They stay high (fluctuating with the cycle, but never settling back to Houston or Atlanta levels) because central and local governments make it hard to build - whether up or out. It is no different in rather less glamourous places - whether Auckland, or (no doubt) Honolulu or Bournemouth or Darwin. Things could be reformed - much of the US shows us better outcomes - but I'm not that optimistic they will. No one seems willing to force councils out of the planning business, no one seems willing to allow people to build houses pretty much wherever they like, and so on. It took 50 years or more to get rid of import licensing, that messed up so many markets in NZ for so long. It is difficult to be optimistic of anything much faster in respect of urban planning.

Governments messed up the housing market in the first place. Now they are messing up even more things - now the tax system, and our previously efficient financial system - trying somehow to paper over the consequences of the problems they themselves introduced and now maintain

Which brings me back to immigration policy. If we went back to the sorts of rates of inward migration New Zealand had in the 1980s - which weren't unusually high or low by international standards - we'd now have a flat or slightly falling population (like many of the better-performing European countries). If so most of the pressure on house prices - especially in what are now growing cities - would dissipate overnight. Yes, we'd still have a bunch of crazy planning laws - and over-mighty councils, and complacent governments - but they would be doing much less damage, and creating far fewer risks. Many people don't like this option - they keep arguing "but shouldn't we just free up housing supply?" Which is fine but there is no sign of it happening here, or of it happening abroad. How many more generations will we force into huge debts to get into a house, or squeeze them out of home ownership altogether? Or "force" both parents back to work soon after childbirth, as the only way to keep on servicing a mortgage.

As it is, there is no sign that our high rates of immigration - not the NZers but the policy controlled bit - is doing us any good at all, even setting the house price issue to one side. Much lower population growth would lower our interest rates, markedly lower our exchange rate, and provide a much better foundation for sustained growth in productivity and per capita incomes. And - not to put too fine a point on it - places like Nelson, or Hawke's Bay, Southland, or Gisborne would be much better positioned; we'd be growing export industries, not seeing disproportionate shares of economic resources tied up in building the roads, houses, factories, schools, shops, that a rapidly growing Auckland population needs, not to lift per capita incomes, but just keep things where they were.