# The Balance of Payments and the Housing Market

Keith Rankin, 30 July 2015

On Morning Report on Friday (24 July), I heard the following exchange between Guyon Espiner and Finance Minister, Bill English.

Guyon Espiner: "So what's the good bit about allowing foreign buyers to buy [existing] houses in Auckland? What's the good bit?"

Bill English: "New Zealand traditionally has not had sufficient savings to fund all the investment that it does, ... we've traditionally always been open to foreign capital because in the long run it enables us to have more people and more jobs and more houses."

Bill English is arguing that all money coming into New Zealand for the purposes of securing an income stream or a capital gain enables actual investment (in new structures and equipment) to take place that otherwise would not have. Essentially, he says that New Zealanders have a longstanding aversion to saving, and therefore we need any kind of foreign money to come into New Zealand to compensate.

Mr English's view represents an 'over-consumptionist' interpretation of a country's balance of payments. Aggregate private demand is deemed so great that New Zealand perpetually has to incur foreign liabilities in order to maintain economic growth. And that somehow, any foreign liability that New Zealanders incur will eventually be reflected in the national accounts as 'investment'.

It's simply not so. New Zealand has the capacity to save; many New Zealanders certainly do save. But the price signals that New Zealanders face lead New Zealanders to spend considerable amounts on imports. For every year since 1973, New Zealand's Gross National Expenditure has exceeded New Zealand's Gross National Income.

This is what really happens. The world suffers from a global savings glut, and has done so for the last 25 years. So foreign savers, and the financial professionals who act for them, are constantly on the lookout for good financial returns. Year after year, New Zealand has ticked their boxes. New Zealand, open for business with all-comers, advertises itself through its comparatively high interest rates, its high credit ratings, and it's very low record of default to foreign creditors. So money that New Zealand does not need flows into the country, setting exchange rates that have been significantly higher than they would otherwise have been.

Two prices in particular have distorted the market: interest rates set by a bureaucrat rather than by market forces, and an exchange rate set by market forces though strongly influenced by the bureaucratically-set interest rate. (A third price has also distorted the exchange rate in recent years; the price of milk. That, too, has influenced the exchange rate, imposing systemic effects on the non-dairy tradable sector. The good news, for now, is that the non-dairy tradable sector is in full recovery mode, thanks in large part to the fall in the international milk price.)

The inflow of financial capital – such as foreign money used to buy existing houses – is equal, by definition, to the deficit on the current account of the balance of payments. (Likewise, in countries like Germany and Singapore, the outflow of financial capital is equal, by definition, to their current account surpluses.) New Zealand's perpetual current account deficit (our "traditional" overspending and undersaving) is a direct and immediate accounting consequence of these inflows of foreign money seeking a quick return.

How does it work? All money making a one-way trip into New Zealand causes the exchange rate to go up. The higher exchange rate makes traded goods (and services such as overseas holidays) cheaper. Following the basic laws of demand and supply, when traded goods and services become cheaper we buy more of them and sell fewer of them. The balance of trade and the current account fall. This fall in the current account achieves the monetary outflow that balances the speculative inflow, and an equilibrium is established with an overvalued exchange rate and perpetual current account deficits.

The cause of our balance of payments current account deficits is not because we will not save. It's because New Zealanders follow the basic economic principles of demand and supply when confronted with cheaper prices of traded goods and services. And those cheaper prices are caused by these unrequired one-way inflows of foreign money.

What can our policymakers do about it? First, allow the market to set interest rates, or at least aim to have interest rates that reflect the actual perception of risk that foreigners have of us. Thus, our Official Cash Rate should be as close to zero as is consistent with exchange rate stability. ('Exchange rate stability' means that the exchange rate should be determined only by fundamentals such as the terms of trade and comparative domestic inflation rates).

Non-distortionary interest rates may be enough, though other disincentives, such as taxes on land purchases, will help to quell excessive inflows of foreign money. But, if such price-and-tax based disincentives are not enough, or are not even tried, then we need to re-'invest' these unrequited monies 'offshore' (as they say).

But surely very low interest rates will just stimulate the housing market even more, and will reduce saving? Actually, no. Lower interest rates will encourage businesses to take on more debt for investment (as the economy needs them to do), and will encourage banks to lend to businesses more and to house-buyers less. We save income mainly when we have enough for present needs, and decide it's better to save the rest for the future. We may be suckers for seemingly good deals on deposit interest rates, but interest rates rarely have much effect on our save-versus-spend decisions. It's mainly rising exchange rates that induce increased household spending, not low interest rates.

People around the world save because they have enough, or because they are fearful of the future. There is a glut of unspent money worldwide, despite very low interest rates.

In recent months, the New Zealand exchange rate has come down quite a lot; 70 on the TWI compared to 80 in April, a fall of 12.5% from its recent highs. It suggests that less foreign money is being used to buy used houses now than in the summer and autumn. Yet house prices are still rising.

While Bill English is wrong to say that we need foreign speculators' money to offset low domestic savings, he may be right to suggest that foreign money is not (or is no longer) the principal driver of the Auckland housing market. It may turn out to be that resident kiwi landbankers are much more active than we had ever imagined. I note that "Matt Bowden's clifftop Torbay property" has been bought up by a well-known "local investor" who plans to landbank the property ('Party pill godfather Matt Bowden's $2m house sale'; New Zealand Herald, 29 July).

We should note that 'landbanking' appears to be a euphemism for leaving a property empty with the intention of future resale for capital gain. And we should note that former Reserve Bank economist Michael Reddell pondered on TVNZ's Q+A (26 July) that "houses are being left empty here". (See transcript on Scoop.) TVNZ's Simon Dallow failed to pick up on this comment, as he had failed on similar comments the week before. Our mainstream media is still largely silent on the real scandal; that houses are being bought for rental or investment, and that 'investment' may often be another euphemism for empty. (New Zealander residents and non-residents alike have a history of acquiring and holding real estate that precedes the 1840 Treaty of Waitangi.)

We don't want foreign money coming into the country unless it is an export receipt, another form of income such as interest earned overseas, a gift, or a genuine and worthwhile investment in something newly produced in New Zealand. And, we do not want anybody, resident or non-resident, buying houses that have had people living in them and subsequently leaving those houses empty.

That may be the real story about housing supply that Bill English should address. Houses left empty. My feeling is that there are now rather more empty houses in Auckland's desirable suburbs than the considerable number that were empty at the time of the census, more than two years ago. (Maybe not as bad, yet, as in Vancouver where the Radio NZ interviewee, a Vancouver resident of Chinese descent, noted with sorrow that the problem of ghost houses is almost becoming a problem of ghost suburbs; refer Checkpoint, 23 July 'Auckland housing unaffordability pales against Vancouver's'.)

We are in danger of following the experiences of Spain and Ireland where, before the global financial crisis, too many houses were started and many of those were never finished, caught up in the bankruptcies brought about by that crisis. The first rule of housing supply is to ensure that all of our presently occupyable houses are occupied.

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