6 July 2015

Stability Demands Housing Supply

- NZ housing market under-supplied
- And over-valued
- A toxic mix
- RBNZ and Treasury argue the antidote
- No change any time soon

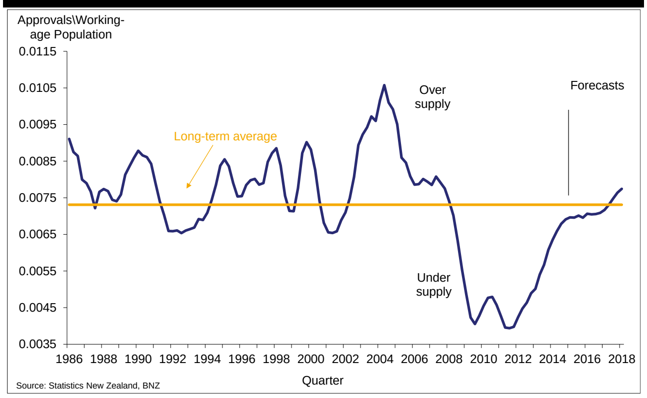
Much has and will be said about the state of the New Zealand housing market. The crux of the matter is: are there enough houses for New Zealand residents to find a place to live at a price that doesn't result in the crowding out of expenditure on the other necessities of life? The debate that rages, however, is more to do with price than volume. The owners of housing assets are ecstatic (though not openly so) that their asset base keeps growing while those without ownership bemoan their inability to enter the market.

There are multiple reasons why the housing market is behaving in the way it is but the economic fundamentals couldn't be more simplistic in explaining international, national and regional housing developments.

At its most basic (in a New Zealand context) there are too many people chasing too few homes. Supply and demand as a driver of pricing behaviour does work! Until such time as there is less demand (either people accept living in more crowded households or New Zealand's population declines) or enough houses are built to meet current demographic needs then there will remain upward pressure on the prices of the housing stock.

At this stage excess demand rules! We are not going to enter the debate as to exactly how many houses are needed, and where, but a back-of-the-envelope look at how many houses have been built over the last few years indicates simply not enough.

Dwelling Approvals



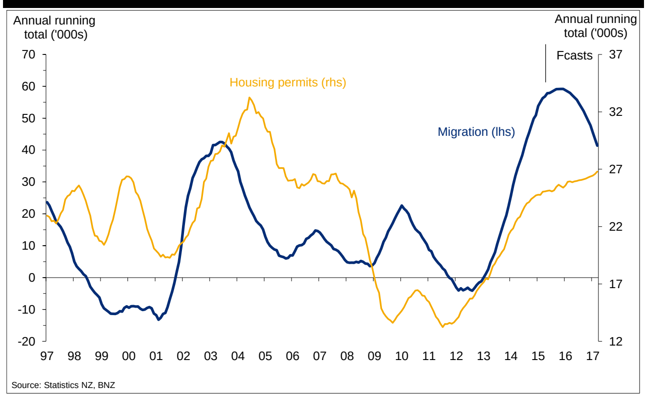
Net Immigration

We concede that if you map this evidence against measured house price inflation you get the counter-intuitive picture that over supply is correlated with rising prices. We would, however, interpret this as meaning you need rising prices to encourage the increased supply of housing that is necessary.

Migration will always be the swing factor in population growth. A developed country's natural rate of population growth, varies little from year to year so it's the cross border flow that matters and which has a significant bearing on the demand for (and, in turn, supply of) housing. Net migration inflows look set to peak at an annual rate of around 60,000 people a year. With a population of only 4.6 million this degree of inflow represents a 1.3% increase in total population.

The last time net migration peaked at anywhere near these levels (over 42,000 in 2003) housing permits consequently rose to a peak of around 33,000 on an

Building Authorisations



annual basis. At the moment we are building only 25,000 houses. This is just barely enough to cover the net migration inflows let alone the additional needs from natural population growth, past under build, the Christchurch earthquake and natural degradation in the housing stock.

This being the case, it is very difficult to see a sufficient supply response any time soon that will contain house price inflation in a meaningful fashion.

Of course there are calls for the Government to take action to moderate the migration flows but, when a significant driver of the net flows is people who are already New Zealanders either deciding not to leave or coming home from offshore, policy measures may not be particularly effective.

The differential in regional house price inflation correlates relatively well with the demographic story. It should be no surprise that Auckland house prices are rising faster than anywhere else in the economy because that's where the population is growing fastest and employment has grown aggressively.

Similarly, areas such as Otago (especially Queenstown) where employment and wealth growth have been in the ascendency have witnessed stronger house price growth whereas slow burners like Gisborne, Wellington and Manawatu have seen property prices struggle to move higher.

What's happened and will happen in Christchurch will be a very interesting case study as to what happens when a supply response satiates demand. In the immediate aftermath of the Christchurch earthquakes (and for some time thereafter) both rents and house prices moved steadily higher.

However, while the good folk in Christchurch may be disappointed about the pace of the rebuild, there has categorically been a lot of it. Indeed, so much so that the prospect of a future oversupply now looms. At this stage, the possible oversupply of land is more immediate but in time, given the land availability, it looks likely that demand for housing will be met. This is already being reflected in house price inflation which has fallen to zero from a peak of around 19% in late 2013. The possibility of house prices actually falling is now very real.

There is nothing weird and wonderful about this process which is a clear signal to all and sundry that there is no reason why house prices should just keep going up of their own accord.

In the last major housing uplift, 2003-2007, credit growth appeared to play a significant role in the process as speculative fervour added to the pressures on the sector from migration. Equity withdrawal was all the rage then too. This time around we had concluded that the cycle was a lot less sinister as credit growth had remained very

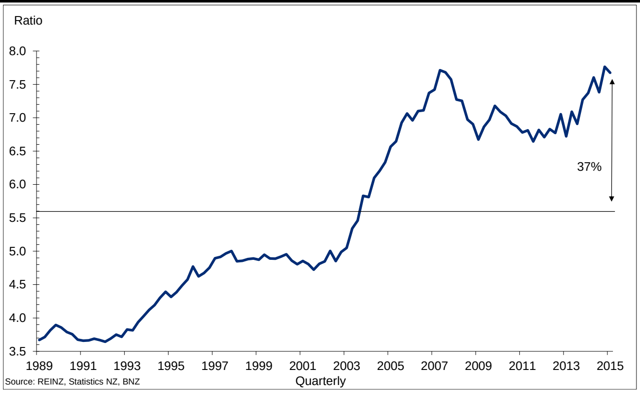
REINZ House Price Index - Christchurch

constrained and there was no sign of equity withdrawal. However, the worm may be turning. After a period of very low credit growth from mid-2008 to mid-2012 there was a step change higher to around 5.0% annual rates of growth in lending to households. While higher than the trough credit growth still didn't look particularly exciting. But the hike reported for May is very interesting. If this is a sign of things to come, credit growth could soon be back at double-digit annualised rates. If this becomes the norm then upward pressure on house prices will be heightened alongside financial stability concerns. Lowering interest rates does nothing but exacerbate this process.

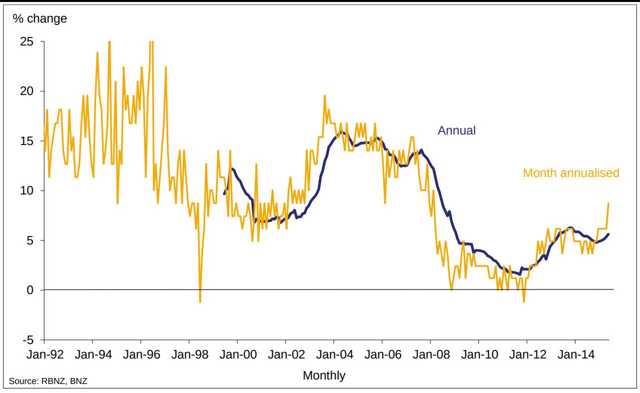
While there are some clearly unique things at play in New Zealand at the moment, it is worth noting that rising house prices are not just a New Zealand phenomenon. Neither is high house price inflation in major centres. With this in mind, it is important that policy makers differentiate between the things they may have some control over and those that are simply imposed.

The main reason house prices are running globally is because monetary conditions are extremely stimulatory. While such settings may not have created the goods price inflation one might have anticipated, inflation in asset prices is clear to see. With Quantitative Easing alive and well there is an excess supply of cash floating around the world looking for a home. Accordingly, asset prices of all descriptions have been rising strongly whether that be

House Prices/Average Earnings



Household Borrowing



property, equities, bond prices, art or stamp collections. Exacerbating this process has been ultra-low interest rates and the transfer of capital from places such as Eastern Europe, Russia and China. One also can't but wonder whether the real estate market has the same ability to monitor money laundering activity as financial markets, more generally, are now required to do.

Whatever the actual impact of the combination of the above, it is important to recognize that these forces are in existence and little can be done to moderate the impacts that are largely being driven from offshore.

There are two fundamental economy-wide concerns when house price inflation becomes too lofty and house prices become overvalued:

- Will folk withdraw equity from the housing market and use this to increase consumption in a manner that creates excess demand and worrying levels of domestic price pressure? This being so interest rates would need to rise to contain both demand and price pressures. This is a monetary policy issue.

- The other issue is the concern that house prices are becoming so extended that there becomes potential for a major future house price correction which undermines not only economic activity but, more importantly, puts bank balance sheets at risk given the extent of their exposure to the housing market. In a worst case scenario this could result in the sort of economic disaster that has afflicted parts of Europe over the last few years. This is a macro prudential issue.

The problem that the Reserve Bank currently faces is that the current state of the housing market demands higher interest rates from both a monetary and prudential perspective. But higher interest rates, through their impact on the currency, might generate deflation and defeat the RBNZ in its bid to get annual CPI inflation to 2.0%.

This being so, the RBNZ seems to have thrown in the towel on monetary policy as a means to contain house prices instead focusing on a cornucopia of macro prudential meddling to meet its objectives.

So far we have had (or soon will have):

- Increased capital requirements for lending to the agriculture sector;

- Increased capital requirements for high loan to value ratio loans and loans to investors;

- The implementation of loan to value ratio restrictions;

- Regional restrictions by way of a variation of the LVR restrictions depending on whether you are in Auckland or not and the requirement for residential property investors in the Auckland Council area using local bank loans to have a deposit of at least 30%.

In addition, the RBNZ has stated that it will continue to look for further macro prudential tools to meet its objectives. In this space keep an eye out for loan-to-income controls.

It all feels a bit piecemeal and desperate to us and even the RBNZ's own analysis suggests these changes will have only a modest impact and at indeterminate cost. And if we are right in our conclusion that supply is the real issue then much of the above may be barking up the wrong tree. Interestingly, in this regard, the Treasury boffins across the road seem unusually critical of the RBNZ's actions. Indeed there appears to be some patch protection and stone throwing from both sides of the Terrace with the RBNZ telling the Government it needs to get its act together on supply-impacting policy while Treasury tells the RBNZ to stick to its knitting and leave regulatory shifts to the Government. Meanwhile, the Finance Minister snipes from the sidelines about Governor Wheeler's failure to meet his inflation objectives. It's all a bit comic and unseemly really.

Of course the Government is pitching in by making alterations to the RMA to fast-track housing development, freeing up Government land for development and generally doing a lot of hand waving. In addition it has vowed to impose capital gains on residential properties bought and sold within two years regardless of whether the owner intended to make a profit or not and, in a bid to better capture information on foreign buyer activity, has stated that offshore purchasers will be required to provide a New Zealand IRD number.

Of course, all this activity is based on the fundamental premise that property is overvalued – particularly in Auckland. This conclusion is reached by looking at such things as the level of rental return, value relative to trend and price-to-income ratios. On these bases the conclusion of overvaluation is sound. What is less sound is the explanation as to why prices should, or indeed could, fall any time soon given the excess demand that persists.

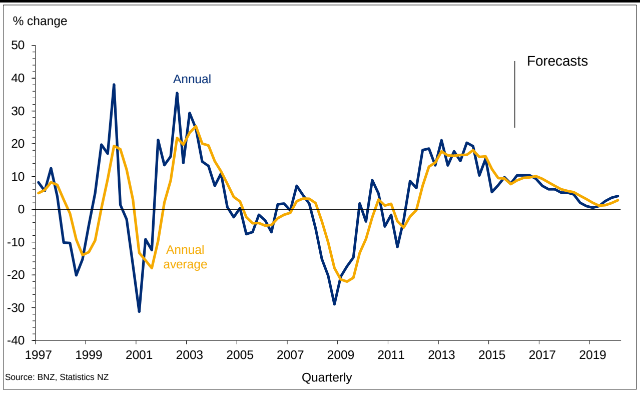
Moreover, it may be a case of be careful what you wish for. There is always the risk that policy makers eventually create the very price correction that they are seeking to avoid.

One thing's for sure. The debate around the sector has some way to run. And we think the concerns that currently abound will get worse before they get better.

There certainly seems very little chance of Auckland's demands being met any time soon. Accordingly, we think house prices nationally could keep inflating at around 5 to 7% per annum over the next three years. With prices holding up, population growth remaining elevated and employment prospects for most New Zealanders remaining positive, we expect further growth in construction, averaging around 6.5% per annum over the next three years. This is substantially less than the almost 14% per annum estimated for the four years ended December 2015 thanks largely to the substantial slowing in growth in Canterbury and a generally softening GDP profile.

The good news in all this is that an earth shattering correction in economic activity brought about by a slumping residential property market looks highly unlikely in the foreseeable future. The bad news is that the longer this is so the greater the chance that it may well happen one day further down the track.

Residential Construction



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