5 August 2016

Housing in New Zealand

Housing markets are the same as any other goods or assets markets in that relative supply and demand will drive prices. Housing, however, is a little different in that the market shares some of the characteristics of a goods market and some of an asset market. Put simply, owner-occupiers purchase a house to "consume" what a house offers them in a similar way that we might purchase and use a car. But, in addition, there are also speculators and investors who are looking to buy a house either as a store of value or as a means to earn returns.

We, therefore, need to be very careful when talking about excess demand. When demand (designated as people needing a house to live in) genuinely exceeds supply (the number of houses available to live in) then house prices will rise and stay elevated until such time that the number of houses rises to match the physical needs of the population.

When houses are being bought and sold for speculative purposes then prices can more quickly adjust and do not necessarily reflect underlying supply and demand conditions.

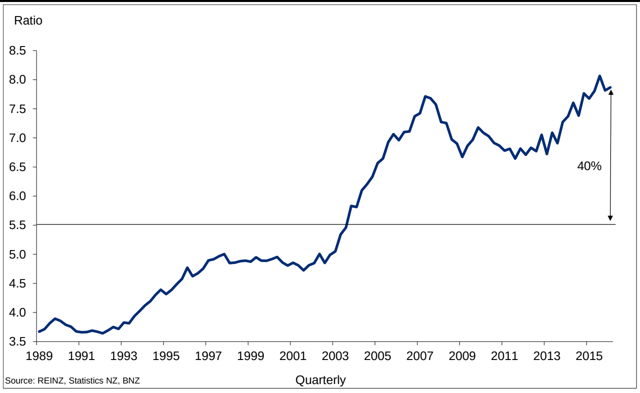
Currently, we are in a market whereby demand genuinely exceeds supply and is the fundamental driver of price movements. In addition, there is speculative froth on top of this as speculators also try to take advantage of rising prices.

As genuine demand is expected to exceed genuine supply for the foreseeable future further upward pressure on house prices can expected. Accordingly, while action can be relatively easily taken to address the speculative froth, a sustainable price adjustment will only occur if there is either a sufficient supply response or a drop in demand.

Be warned that when this inevitably occurs a significant drop in house prices can be anticipated. The likelihood of that occurring soon is low. But the longer house prices continue to grow in excess of incomes the greater the eventual correction will be.

It goes without saying that our starting assumption is that house prices are unequivocally over-valued and unsustainable. You reach the same conclusion using a variety of metrics including: price to trend; price to rents; price to incomes; price compared to offshore; housing affordability.

House Prices/Average Earnings



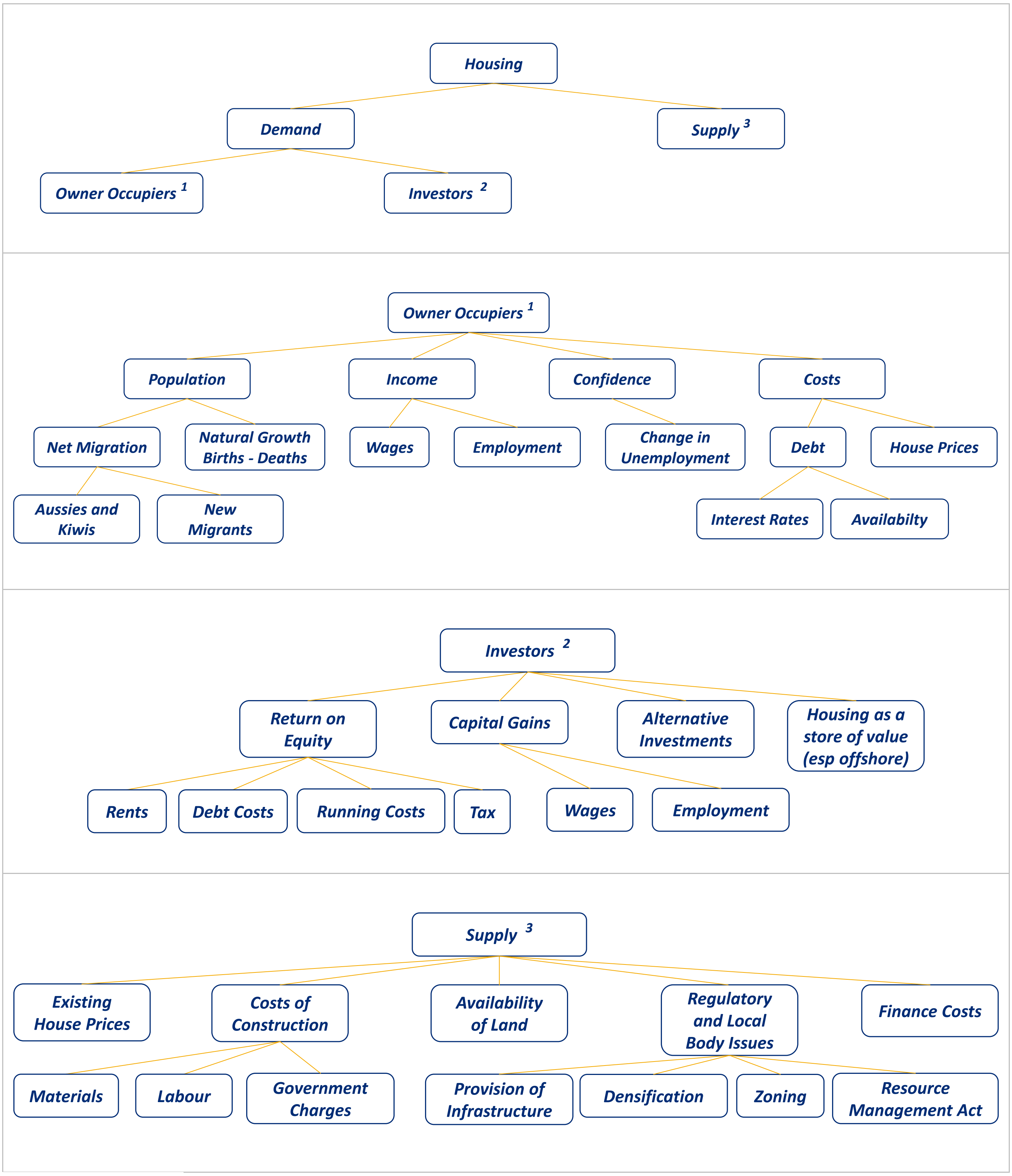
With all the above in mind, our biggest concerns about the state of the housing market is the superficiality of the discussion that is occurring. Too many people are pointing fingers and proposing quick fix solutions without acknowledging the complexity of the situation. Apparently, all we need to do is: ban migrants; raise taxes on property speculators; get the government to build lots of houses and all will be fixed. Simple. And, of course we'll do this without adversely affecting the price of the house that I have just bought (because that would be unfair) but, at the same time, make the price of housing for all the other folk who need one much cheaper. See the problem?

We do not intend to go over what has already been gone over a hundred times before. Instead we wish to (a) stress the complexity of the issue and (b) have a quick discussion of some of the issues that we think need some focus.

Rather than write at length about the complexities of the housing dilemma we have produced the flow charts overleaf to highlight just how many moving parts there are to the story. As you flick through these charts you will note that they are grossly overly-simplistic and having many missing elements. This only goes to show just how convoluted the process at work is. The other thing that becomes immediately apparent is how many of the components are beyond the control of central government and how many more again are completely outside the sphere of influence of the central bank.

Unless we write a book we can't possibly cover off all the issues that deserve to be covered off. For more detail

A Simple Housing Model?



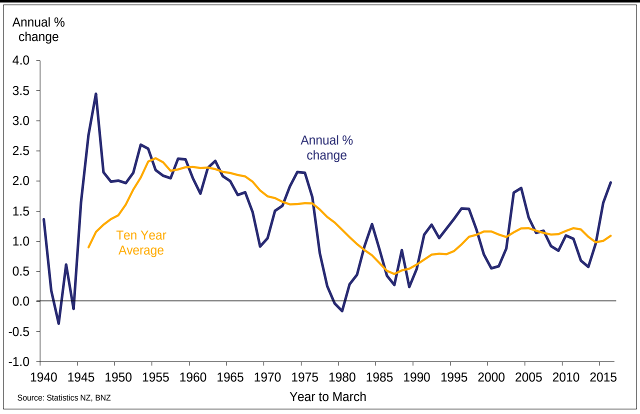
Source: BNZ

than we are willing to provide we would defer you to the numerous articles on the topic of housing produced by the Reserve Bank and the Productivity Commission. That said, we have chosen to highlight a number of key issues that we think deserve some specific mention. The list is not meant to be exhaustive. Nor is it in any order of importance. And in the spirit of keeping this note to a manageable size we have also bullet pointed the issues rather than fully scripting the arguments.

Population policy

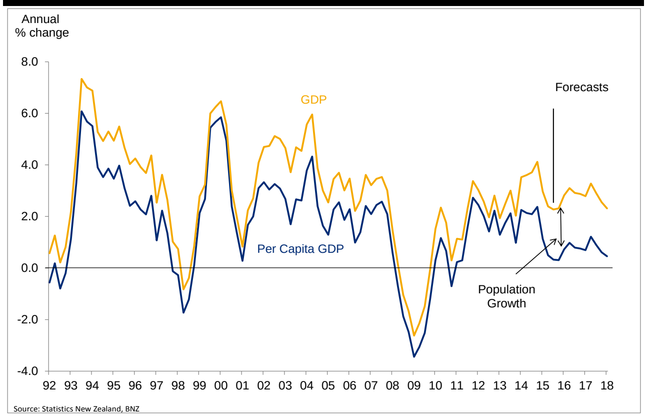
- New Zealand may need to address the idea of having a population/demographic policy. In this manner we could deflect the discussion from simply migration to a more general discussion on population size and composition.

Population Growth



- To start with, does New Zealand want GDP growth or per capita GDP growth?

GDP Growth

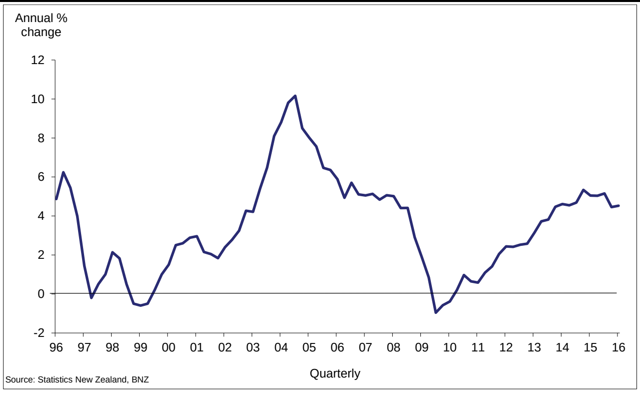


- Are the benefits of population growth more beneficial than the externalities that come with it – such as congestion, pollution and greater stress on our natural resources?
- Is there an optimal population size for New Zealand? And what is the optimal growth rate both in terms of quantum and timing?
- If we want to attempt to control net migration note that, we can't impose policy that impacts the net flows of Australians and New Zealanders and, yet, this is having a significant impact on total net flows at the moment.
- We may wish to address who we allow in as migrants and how many but:
  - If we impose too strict control on migration we may curb necessary labour supply. This could be counterproductive if that labour is coming to New Zealand to build houses or to provide skills that are lacking.
  - Reduction in education migrants could have a significant negative GDP impact on services exports.
  - We can't really restrict migrant flows by race for fear of accusation of racism or a trade backlash from those impacted.
- More generally, xenophobics should pause to ponder whether they themselves are of migrant stock? After all, all Anglo Saxon New Zealanders were migrants not that many generations ago.
- Arguments for and against migration would best be focused around "economic" and, potentially, "cultural" grounds.

RBNZ

- The RBNZ faces potentially conflicting outcomes as it tries to juggle policy addressing the dual objectives of financial stability and price stability. For example, the RBNZ's interpretation of the Policy Targets Agreement demands lower interest rates in a bid to raise CPI inflation while financial stability concerns probably demand higher rates.
- The RBNZ is actively targeting the investor market with its latest round of announcements. This is intended to take the froth off the top of the market and appears entirely appropriate. The RBNZ estimates that the recent measures will lower house sales by 5 to 15% and both house prices and mortgage credit by 2 to 5%.

Capital Goods Price Index – Residential Building



- The RBNZ is implementing current policy via quantity restriction of debt rather than price increases. Is there a better mechanism which might affect the cost of debt directly rather than simply restricting its supply?

- When interest rates eventually rise, the impact of the rate increase is likely to be greater than previous cycles because the level of household debt is now at record highs. This has significant implications for future monetary policy decisions and the vulnerability of the housing sector.

- There are three areas of macro prudential policy options that are being considered by the Bank: adjustments to Loan to Value Ratios (LVRs), Debt to Income ratios (DTIs), and macro-prudential buffers. LVR adjustments are already underway. Expect DTI ratios to be the next cab off the block. Note, though, that the aforementioned are all cyclical (not structural tools) and, most importantly, are designed with the purpose of financial stability in mind not to manage housing activity per se.

- The RBNZ does not have the tool kit to impact supply.

Government policy

- Government, both local and central, needs to do everything it can to reduce the costs of building and the obstacles to construction while, of course, maintaining building standards.

- Building more houses, directly, in and of itself may not necessarily be an appropriate solution in the current environment. If the industry has insufficient capacity to build then further government-led activity might only result in higher costs of construction and\or the crowding out of private sector investment. This may be sub-optimal.

- There is a very strong argument for a Capital Gains Tax but:
    - This is simply on equity grounds. There is no evidence that CGT's constrain housing markets over the longer term.
    - If a CGT is to be imposed for equity reasons it needs to be on every property. The electorate will simply not stomach this.

- Ongoing assessment as to how one might, generally, remove the tax advantage to investing in property should continue to be investigated.

- Many argue for property taxes. There are possibly strong equity grounds for doing so but little evidence that such taxes would curb current property market excesses.

The role of foreign money

- The role of foreign money will always be overstated thanks to the inherent xenophobia that exists in any resident population.

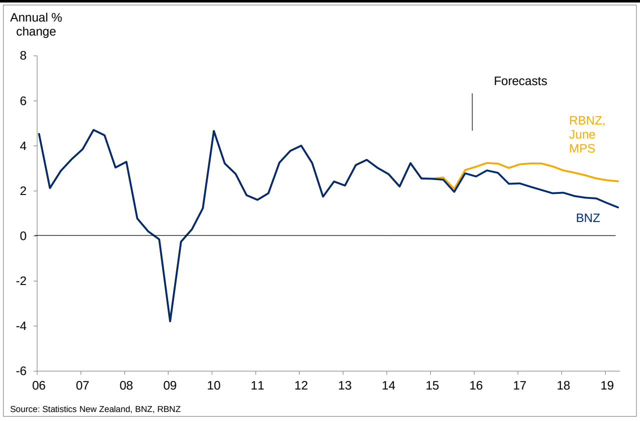
- Nonetheless, foreigners are often the marginal buyer and, hence, may set the marginal price. This becomes even more problematic as an issue if foreigners are just utilizing the housing market to store value.

- In the extreme there is always the danger that property investment is a means to launder money or, more generally, to get money out of a country to a "safer" place. Regulators will be watching this space very carefully.

Housing and CPI inflation

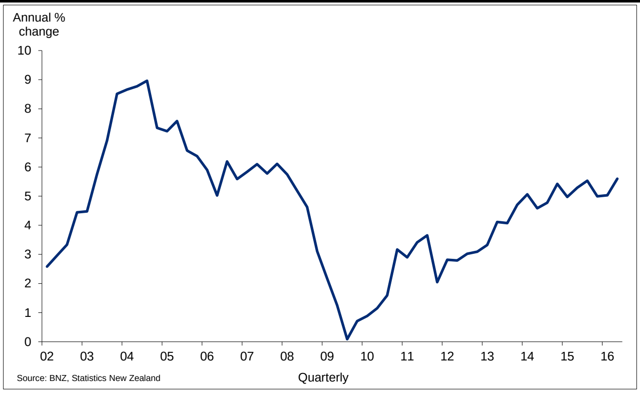
- The RBNZ has said that it is only worried about the housing market creating CPI inflation to the extent that a rampant housing market feeds through to increased private consumption and a tighter output gap. There is little evidence of this so far.

Private Consumption



- However, the other way that housing may create CPI inflation is via: rising construction costs – which are clearly evident; rents, which are edging higher; and the increased demand for durable goods to furnish new houses – which is also evident. This channel needs to be monitored closely as housing excesses may yet push CPI inflation up and, hence, be the eventual catalyst for higher interest rates.

CPI Construction Cost Inflation



- The RBNZ may need to place a bit more weight on the role of asset prices (namely housing) as it "flexibly" adheres to its PTA.

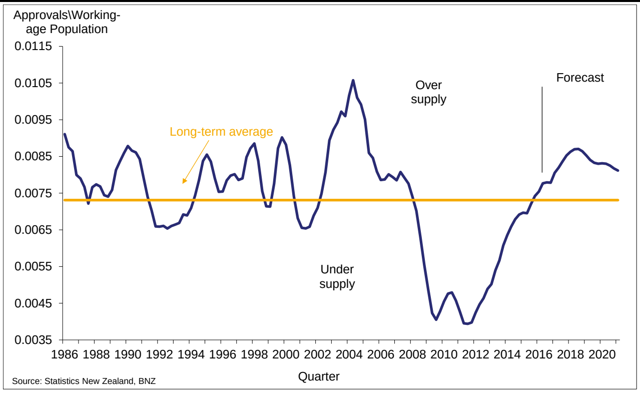
Accountability Issues

- Everyone talks about the need to improve the affordability of housing but no one really has any vested interest in doing so apart from, potentially, the central bank which, really, is only a bit player in the bigger picture.
- What are the chances of a Government being re-elected if it succeeds in returning house prices to more sustainable levels, which is probably about 40% below where prices are now?
- Which local councilors are keen to do the same?
- There are more families who own houses than those trying to enter the market. Do many of those who clamour for a solution to the housing problem really understand what it might mean for them personally? Who really wants their own house price to fall?

The Ultimate Solution

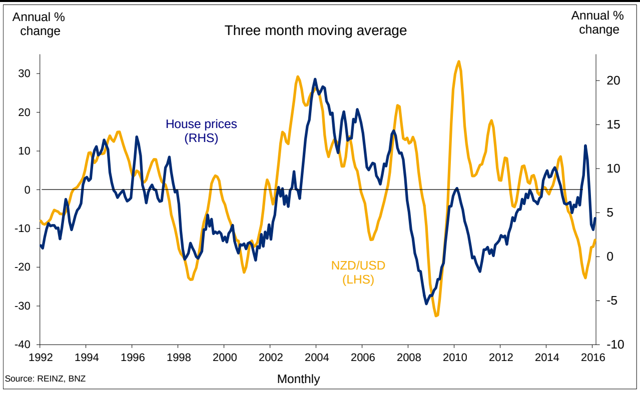
- Eventually supply will be sufficient to fill the shortfall and prices will respond.

Dwelling Approvals



- Offshore investors will get stung the most as the NZD tends to fall when the housing market is weakening hence offshore purchasers are faced with a double-whammy.

House Prices And The NZD



- Policy makers must be very careful that measures to curb demand do not adversely impact supply at the same time.
- Be warned, one day prices will fall. Falling prices also tend to be accompanied by economic downturns and rising unemployment rates. People need to be prepared for this possibility.

No Easy Fix

- The general populace needs to understand that there is no easy fix to our current housing market issues.
- The Reserve Bank can impact only a very small number of factors that drive the market.
- Even the Government has only modest control, at least theoretically, and much of that potential control is undermined by the fact that the electorate would rebel if many of the requisite policies were ever implemented.

stephen_toplis@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Kymberly Martin
Senior Market Strategist
+(64 4) 924 7654

Jason Wong
Currency Strategist
+(64 4) 924 7652

Main Offices

Wellington
60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
81 Riccarton Road
PO Box 1461
Christchurch 8022
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891