24 March 2021

Government on Housing Market War Footing

- **Government stakes political credibility on slowing house price inflation**
- **First salvo is fired, it will do what it takes**
- **House price inflation will moderate**
- **RBNZ prudential policy may pick up the baton**
- **Monetary policy response far from clear**

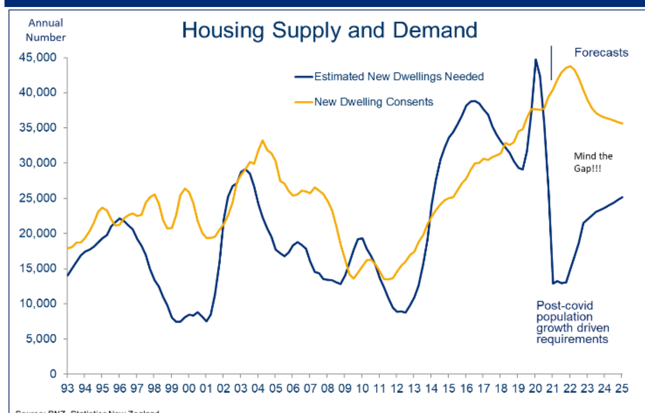
The New Zealand government is dead set on curtailing soaring house prices. It has been saying so for some time now and prices have just kept soaring. So, it should come as no surprise that their patience has now been exhausted and a full attack on prices is now underway.

Whether or not the measures announced yesterday have the desired impact or not is neither here nor there. The fact of the matter is the government will do what it takes. If this set of policies fails then more will be introduced until such time that house price inflation abates (or even prices fall). The government is, in large part, staking its credibility on this and cannot be seen to fail.

House prices unsustainable

One can argue over the efficacy and suitability of the policy mix, as announced, but, in our opinion, there is no doubt current house price inflation is unwarranted and unsustainable. It has been driven by a combination of ultra low interest rates, relatively poor perceived returns on other asset classes, speculative fervour and the fear, of first home buyers, of missing out.

Excess demand dropping fast



In contrast, the fundamentals of true demand and supply have actually been going the "wrong way". Thanks to Covid, population growth has plummeted alongside the slump in net migration. The increase in demand for housing is thus way less than we had expected. Moreover, even when borders do reopen it is unlikely the shortfall in demand generated will be quickly reversed. But while true demand has been much less than anticipated the pace of housing construction has accelerated beyond expectations.

It is reasonable to assume that the housing market should behave similarly to other asset markets in that pricing reflects all known information. On that basis a shortage of houses means that prices will adjust upwards. But once they have adjusted to the shortage it should be priced and there is no need for prices to keep going up. In order for prices to move either the shortage needs to be increasing (so prices go up) or decreasing (so they go down). The changes to supply and demand over the last twelve months unequivocally suggest inflation pressures should have diminished.

In the period prior to the arrival of Covid-19, growth in new houses was not keeping up with population growth so an already stretched market was becoming more stretched. But over the last twelve months we have been building far more houses than are needed to cope with the population's expansion. Indeed, right here and now, we are probably building one new dwelling for every one person increase in population. This is clearly not sustainable.

Our forecasts suggest we will continue to build more houses than we need to cope with population growth for some time. Consequently, we will be chewing into that housing shortage rapidly even without the measures the government has just announced. Our forecast profile suggests that to reach some form of equilibrium either residential construction needs to be weaker than we expect or population growth much stronger. And the natural clearing mechanism for the market would be a drop in prices.

Excess demand means different things to different people

The concept of excess demand is thrown around with gay abandon but we think the term is often misused and misunderstood. In reality excess demand can mean one (or a combination) of three things:

- Excess demand by those looking for an income or capital gain from the housing market;

- Excess demand by those who can normally access housing market but currently can't;
- Excess demand for low cost housing.

It is really important to recognize that while there is crossover between the above, solutions to each are very different.

In terms of the recent policy announcements, attempts are being made to address each issue with differing policy instruments. The removal of interest rate deductibility and the extension of the Brightline test are a clear attempt to reduce demand for housing by "investors" while tilting the balance towards potential first home-owners. Additionally, the announcement of the $3.8 billion contestable fund for councils to provide infrastructure for new developments is a nod towards increased supply as is the fact that new builds are exempted from the new tax deductibility rules and have reduced Brightline requirements.

Whether or not these policies "succeed" is largely irrelevant for those who require social housing. These folk are simply so far away from being able to purchase a house that even a major correction in house prices would not sate their excess demand. The solutions for this market are for local and central government to decide how much housing they are able to provide to those who might never be able to purchase a house, and how much housing might be available for those with the potential to eventually own property. At the same time, decisions as to how to use the benefit system to its best advantage will need to be made. And probably of most importance is what economic settings are the best to reduce the number of folk that become high-need in the first place. Amongst these are policies to provide appropriate education and support, reduce the unemployment rate and create a strong growth economy. In the latest set of housing related announcements, the policy most directly impacting this group of people will be encouraging Kainga Ora to borrow an extra $2 billion in order to purchase land, one assumes for social housing purposes.

Housing policy announcement implications

In terms of yesterday's policy announcements, we are conscious that we do not want to be drawn into making point forecasts of outcomes that are wildly uncertain. We are more interested in direction of travel and the risks that abound.

There are, nonetheless, conclusions that can be drawn.

The government has now fully exposed its intention to do what it takes in terms of moderating house price inflation. It will almost certainly win in the end. We have been saying this for some time now, and will repeat our warning, that investing in houses is not a one way bet.

The government will not be happy unless house price growth falls below income growth so it is reasonable to assume house price inflation will fall to near zero, at best, in the not too distant future.

The risk is that no government, or central bank for that matter, has ever been able to fine tune an asset market so the balance of risk is that a decent correction in prices occurs. For all but new purchasers this matters little as it will simply reverse some of the exceptional capital gain we have seen over the recent past. The possibility of a substantial correction is multiplied if we are right with our potential oversupply diagnosis and if the recently announced measures have a substantial negative impact on sentiment. House prices would come under significant pressure if everyone headed for the exit at the same time.

Returns to investors fall. Many have been investing purely for the purposes of capital gain. That capital gain will now be reduced to the extent the Brightline test might apply and the net cost of providing accommodation will rise given the reduced deductibility of interest rate costs. All other things being equal, this will initially push up rents and/or reduce the supply of rental accommodation.

The jury is still out as to the longer-term impact on rents and supply. The initial negative impact of the above may be partially offset if there is increased supply generated by the effective relative support developers have been delivered. Moreover, if house prices are lower than they would otherwise be then rents could also be lower than would otherwise be the case.

If there is to be a supply response one has to question where the capacity to build will come from. The construction sector is reporting significant labour shortages already. It is difficult to see how the sector can expand rapidly at this juncture.

The lifting of price and income caps on first home products will have minimal impact.

The RBNZ's response

It will now be interesting to see how the Reserve Bank responds to these developments. Overlooked by many was a one liner in the Government's announcement that said: "The Reserve Bank will report back to the Government on the possible introduction of debt-to-income restrictions and restrictions on interest-only mortgages in May." We're not sure where this will land but keep an eye out for the RBNZ's May response. Indeed, May will be a very interesting month. The RBNZ's Financial Stability Review will be delivered on May 5. This is highly likely to concentrate on how the Reserve Bank is seeing the housing market. This will dovetail with its response to Government. And on May 20 is the next Budget. Don't be in the slightest bit surprised if there is more housing related policy announced at this time.

By and large, housing is a prudential policy issue for the Reserve Bank. If it thinks lending is getting out of control

and banks' balance sheets are at threat then it will implement policy, which would ultimately cool the market, in order to protect the financial system. It has already done so with the re-introduction of LVRs. More may yet be forthcoming. That said, the housing market policy announcements do have monetary policy implications.

What happens to the rents and the costs of construction feeds directly into the CPI. We think that in this respect inflation will probably be higher and, hence, heighten the possibility that the Reserve Bank might tighten monetary policy. However, house price inflation is a major driver of the Reserve Bank's private consumption forecasts. If house prices are lower than they otherwise would be, the RBNZ's models will produce lower GDP growth and lower pressure on capacity than previously and, hence, less need for tighter policy.

Financial markets seem to have focused on the latter by pricing in later rate hikes and a consequentially lower NZD. Balance of risk says this is the right thing to do but we still caution that the economy's inflationary pulse, both domestically and internationally, is growing and we still think the next move in rates will be up, potentially sooner and more aggressively than many believe. This won't help the housing market either.

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