Home Truths.

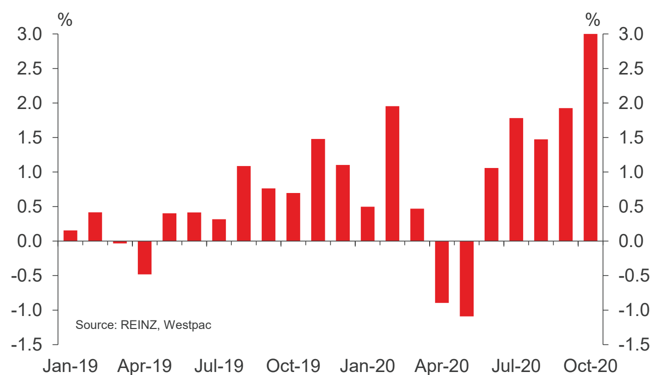
4 December 2020

The rise and rise of New Zealand house prices.

The New Zealand housing market is currently red-hot. The REINZ House Price Index, seasonally adjusted by Westpac, showed a price increase of 3% in October, the biggest monthly increase since 1996. All of the usual indicator dials are now redlining, indicating ongoing rapid house price inflation for at least the coming few months. Market turnover is the highest it has been since 2007. The average number of days taken to sell has dropped rapidly and is the lowest it has been since 2016. And stock available on a key real estate website has dropped sharply and is at an all-time low.

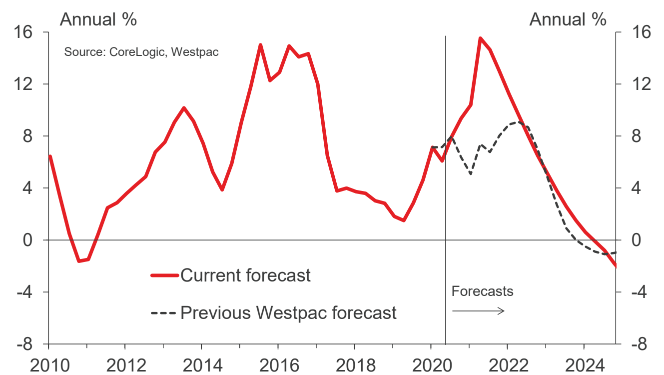
We think the current episode of house price inflation has a way to run yet. We are forecasting a peak of 16% annual house price inflation in June 2021, and a full-year increase over 2021 of 12.2%. House prices are being driven higher by low interest rates, and interest rates are set to stay low or fall further over the coming year. Meanwhile, other factors such as net migration and the economy are going to improve. So our models point to ongoing rapid house price increases.

Monthly seasonally adjusted change in House Price Index



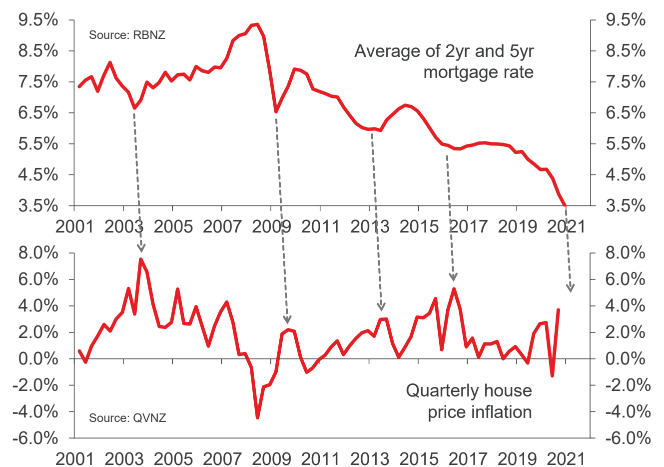
This episode of increasing house prices should not be considered mysterious or unanticipated. Home Truths first predicted that a sharp reduction in mortgage rates would cause a big lift in house prices in June 2019. By February 2020 house prices were indeed rising rapidly. When Covid-19 struck, Home Truths thought that the resulting economic disruption would cause a short, sharp 7% decline in house prices, followed by a return to rapidly rising prices due to low interest rates. In reality the economic disruption proved less severe and house prices actually fell only 2%. By August it was clear that the Covid impact had passed and house prices were once again rising in line with the fundamentals. At that time, Home Truths returned to forecasting an extended period of rapidly increasing house prices.

Westpac house price forecasts



The driver of the current increase in house prices is low interest rates. Physical factors like net migration and housing supply cannot be the driver right now - net migration has been zero since April, and the construction sector is booming.

Interest rates and house prices

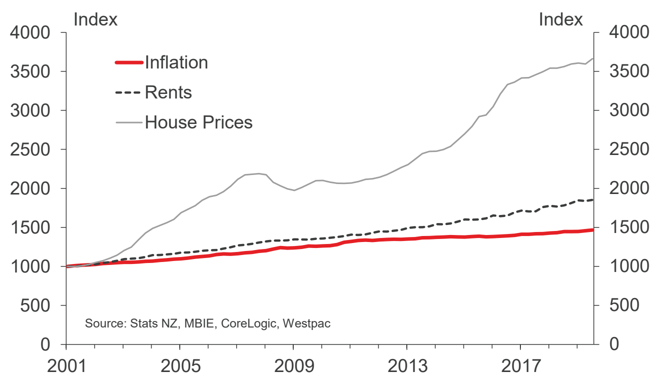


Home Truths has long argued that interest rates have played a more prominent role than physical supply/demand in driving house prices up over the past twenty years. Of course, physical shortages can matter. When they do, we observe both rents and house prices changing, because physical

shortages affect the price of all housing tenure types. For example, after the Christchurch earthquakes both house prices and rents rose in that city, and both subsequently cooled when supply came back on stream. In another example, in the late-2010s a big increase in the rate of population growth across the lower North Island and Otago drove both rents and prices up faster in those regions than in other parts of New Zealand.

But over the whole of the past twenty years, and across the whole of New Zealand, physical supply/demand factors have played only a supporting role. Over twenty years, rents have risen 29% faster than inflation. But real house prices have risen 158%. Physical shortages cannot explain why the price-to-rent ratio has doubled, or why property investors are now willing to pay 30-40 years' worth of rent to secure an investment property, whereas they used to pay only 15-20. Falling interest rates do explain the observed blowout in price-to-rent ratios – people are now willing to accept lower yields when they invest in anything from shares to property (and when interest rates fall, owner occupiers find that the rent-or-buy decision favours buying).

Inflation, rents and house prices, 2001 to today



Taxation also matters for house prices, and the Government's proposal to increase the top tax rate to 39% could subtly exacerbate the increase in house prices next year. The tax advantage of property ownership is proportional to the gap between the rate of income tax and the rate of capital gains tax (which is currently zero in most cases). Making the gap between income tax and capital gains tax even wider will tend to drive people even more towards investing in assets that yield capital gain rather than income – such as houses.

In 2007 we estimated that the introduction of a top tax rate at 39% in 2000 caused 17 percentage points of the house price inflation that occurred that decade. But the impact of next year's proposed tax hike could be much smaller, because the proposed top rate will apply to only 2% of earners. Also, tighter tax rules have made it harder to arrange the paper "losses" on rental properties that in the past allowed so many high earners to reduce their taxable income while increasing their tax-free capital gain.

If interest rates are the driver, then what do we do?

If falling interest rates are the main driver of rising house prices, it does get difficult to envisage what can be done about it. As we explained in our note earlier this week, simply asking the RBNZ to lift interest rates before the economy is ready is not an option – that could lead to disastrous deflation.[1]

That said, in our view interest rates will rise in time. We are forecasting significant increases in fixed mortgage rates from early-2022 onwards. If that is correct, then rising mortgage rates will eventually cool the market. In fact, we expect mortgage rates will rise high enough to cause a period of declining house prices around the middle of the decade.

Outside the influence of interest rate fluctuations, a range of options have been mooted for cooling the housing market. Our thoughts on each are below.

We have long favoured tax change. In 2018 we estimated that introducing a 10% capital gains tax would reduce house prices by 10.9%. A 1% land tax would have a similar effect. This could take years to play out as a slower-than-otherwise rate of house price increase, rather than as a sharp decline. But it would only be a one-off change in the *level* of house prices. A new tax system would not confer permanent immunity from future *changes* in house prices resulting from changing fundamentals like interest rates.

Allowing more urban intensification would make it easier for Kiwis to buy their own slice of paradise, but only because each slice would be smaller. It would make home ownership more affordable because smaller houses would be on offer. But it would not necessarily have much effect on house price indexes, which measure the price of houses on a like-for-like basis.

Restrictions on mortgage borrowing will have only a small effect on house prices in the long run, because people with sufficient savings to meet the deposit thresholds will buy the houses for what they are worth. (These restrictions are designed to keep the banking system safe, and they do that well).

Reducing construction costs is probably good for economic productivity, but won't necessarily do much to change house prices. For a start, rising construction costs have played only a small role in pushing house prices up – most of the price increase has actually been in the land, not in the cost of putting a house onto the land. Furthermore, in places where the supply of land is severely constrained, making it cheaper to build would simply increase the value of land, rather than making any difference to the price of a house-plus-land package. That said, reducing construction costs could be effective in places where land supply is less constrained, such as in smaller towns.

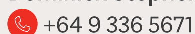
Increasing land supply would reduce house prices, if it could be achieved. However, increasing the supply of land *in places*

1 Read article here.

where people want to live and can earn a living is much easier said than done. For example, releasing more land on the periphery of a big city won't have much effect if the resulting commute is unpalatable – many people would rather pay up to live closer to their place of work. **Better transport networks and infrastructure** would make land-release on city fringes more effective, but that would take a long time to achieve.

A rent-to-buy scheme or another form of **help to muster a deposit** could help. The cost of servicing a mortgage is currently quite low by historical standards, because low interest rates more than compensate for high house prices. The housing "affordability" problem is really that saving for a deposit on a first home is now a Herculean task. Schemes such as rent-to-buy directly tackle this problem. Such schemes would probably push house prices up by increasing demand, worsening affordability for people not eligible for the scheme. But in our assessment the price impact would be relatively small and short-term rather than permanent.

Finally, a great way of easing the social angst associated with the difficulty of achieving home ownership is to **make renting a more attractive option.** For example, New Zealand tenants currently endure very poor security of tenure compared to countries where renting is more common.

Dominick Stephens, Chief Economist

+64 9 336 5671

Contact the Westpac economics team.

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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