

Should the government be concerned about house prices? If
so, why?

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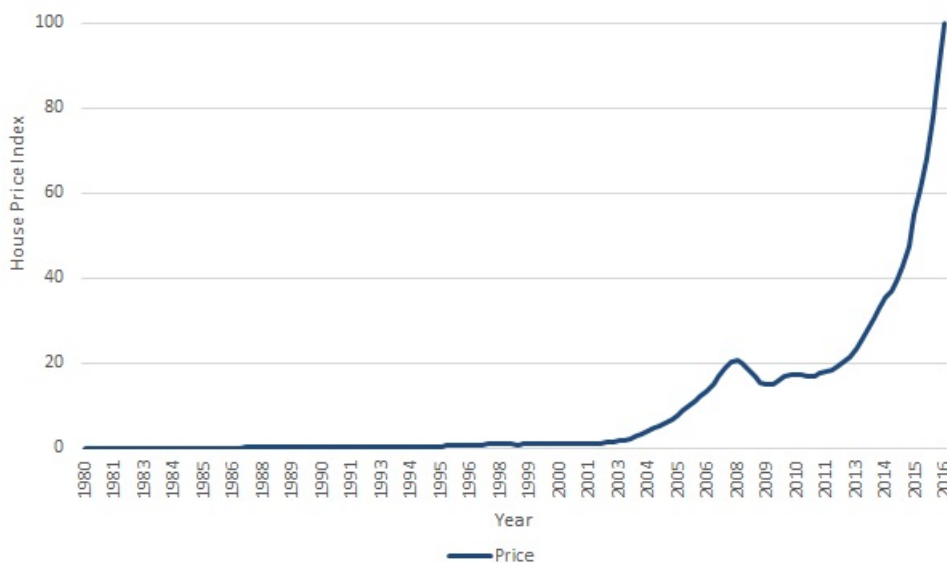
Introduction

The New Zealand government seeks to improve the living standards of all New Zealanders. To that end, the government regularly considers intervening in different markets where, in the absence of government intervention, activities performed by private sector actors will lead to sub-optimal economic outcomes. One such market is the housing sector. The government should be concerned about house prices in New Zealand if and only if there exists a socially optimal housing price path, the market outcome in the absence of government intervention diverges from the optimal housing price path, and a set of feasible, implementable, and politically salient policy options to regulate house prices exist. Given the negative social impact of insufficient affordable housing and the potential social and economic costs associated with excessive house price volatility, there is a strong economic justification for the government to be concerned about house prices and for the government to implement policies accordingly.

Housing affordability and the sustainability of house price growth are two major challenges facing the New Zealand economy. New Zealand house prices have experienced significant growth in recent years. A reduction in housing affordability, in particular a reduction in access to low cost housing, presents a unique threat to social cohesion and equity in New Zealand. Thus, implementing policies to encourage the construction and availability of affordable housing will assist local and central governments achieve their respective policy objectives. Additionally, unsustainable house price appreciation and speculation in the housing sector present credible threats to the stability of the New Zealand financial sector. Implementing policies to reduce the likelihood and severity of economic downturns brought about by a rapid decline in house prices is also consistent with the policy objectives of the New Zealand government. Thus, by implementing appropriate measures to stabilise house price growth and increase access to affordable housing, the New Zealand government will enhance the living standards of all New Zealanders.

Recent house price movements

Median house prices have risen substantially in New Zealand over the last three decades. In particular, average house prices have increased by a factor of five since 2007 (see figure 1). This rapid appreciation of house prices has presented the New Zealand economy with significant social and economic challenges.

Figure 1: House prices in New Zealand

Source: Reserve Bank of New Zealand

The impact of house prices on equity and social cohesion

Shelter is a basic human need. Adequate access to housing is necessary for individual health, community integration, and family stability, which are, in turn, key determinants of labour market dynamics and productivity (The New Zealand Productivity Commission, 2011). Consequently, inadequate access to affordable housing is a barrier to home ownership and limits the rental opportunities of low income families, thus threatening the cohesion and equity of the New Zealand society. Improvements in zoning and planning processes (Parker, 2015) combined with better targeted infrastructure spending (Nunns, 2017) will help to facilitate the construction of more affordable housing. Vacancy taxes will incentive property owners to rent out houses, increasing access to affordable housing (Bourke, 2016). An increase in the supply of affordable housing will promote equity and cohesion within the New Zealand community.

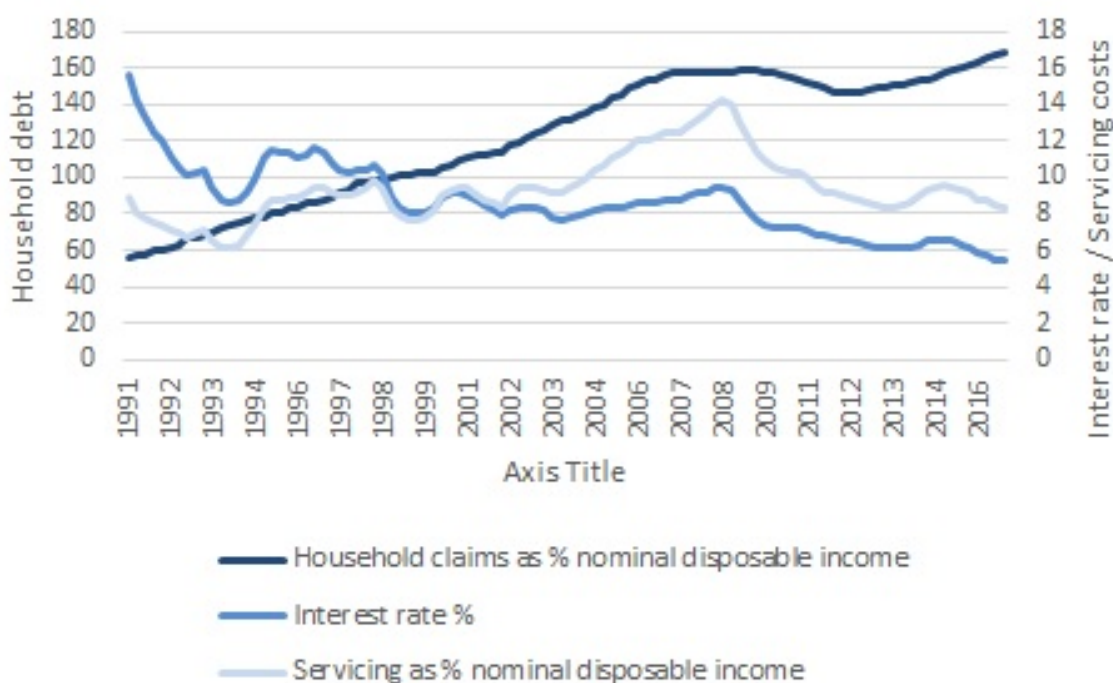
The sustainability of rapid house price appreciation

Rapid growth in house prices may not be sustainable over the medium term. Should house prices decline rapidly, the number of New Zealanders with negative equity and the number of New Zealanders facing house cost stress will increase substantially. This will impose costs on New Zealand financial institutions and the economy as a whole. Thus, implementing policies that will improve the stability of house prices will limit the exposure of the New Zealand economy to housing crises.

Asset prices tend to exhibit pro-cyclical characteristics. Asset prices during periods of economic expansion tend to appreciate due to positive wealth effects (see the good news case in Blanchard (1981)). As asset prices increase, this encourages speculative investment in assets, further driving asset price appreciation. As debt levels increase, the exposure of asset holders to adverse movements in asset prices increases. House price movements in New Zealand have exhibited this 'bubbly' behaviour. Should asset prices decline rapidly in a short period of time (i.e. should a Minsky moment take place) this may reduce economic growth through negative wealth effects.

A substantial increase in household debt has coincided with a rapid rise in house prices over the last two decades in New Zealand. Household debt as a percentage of nominal disposable income is now in excess of 160% (see figure 2). Household debt has increased for a variety of reasons. In particular, historically low interest rates, an increase in the availability of housing finance, and strong demand for debt from investors have been significant drivers of increased household debt in developed economies (Davies, 2009). Recently, rapid house price appreciation has been a significant driver in increases in household debt. This has exposed the New Zealand economy to significant economic risks.

Figure 2: Household debt in New Zealand ¹



Source: Reserve Bank of New Zealand

¹Nominal disposable income is income earned after tax from regular and recurring sources only

In the event the New Zealand economy experiences an adverse exogenous shock, house prices may depreciate rapidly. House prices have commonly experienced sharp corrections in numerous economies in recent decades (Glaeser and Nathanson, 2014). A rapid expansion in the supply of mortgages followed by a crash in house prices was a significant driver of mortgage default rates during several housing crises throughout North America and Europe in recent years (Himmelberg, Mayer, and Sinai, 2008). A sharp increase in default rates may impose systematic financial risks onto the New Zealand economy as banks incur losses due to asset write-downs.

High levels of indebtedness have also increased New Zealand household exposure to interest rate shocks. Household servicing costs are at historical lows (see figure 2). This is primarily as a result of historically low interest rates (Reserve Bank of New Zealand, 2017). If inflationary pressures were to take hold in the near future, normalisation of monetary policy may result in a rapid increase in interest rates (Federal Reserve, 2017). Thus, high levels of household debt increases the vulnerability of the New Zealand economy to adverse shocks to economic growth, unemployment, and interest rates (The Treasury, 2016). Thus, the number of households experiencing mortgage and debt service stress may rise dramatically in the event of adverse economic conditions. Curtailing house price growth and mortgage credit expansion may limit the negative impact of interest rate normalisation.

Risk mitigation

House price volatility has the potential to impose substantial social and economic costs on society. However, a substantial number of policy tools to limit excessive house price growth and stabilise house prices exist. Of particular note, the government can implement financial regulations on banks and other lending institutions and can review the treatment of capital gains and negative gearing to stabilise house prices.

Governments, as the regulators of financial institutions, can implement a considerable number of macro-prudential policies and financial regulations. Through implementing instruments such as core funding ratio, capital, and loan-to-value ratio requirements, policy makers can improve the resilience of the New Zealand economy to credit, asset price and liquidity shocks (English and Wheeler, 2013). Limiting bank lending activities can allow the government to manage the risk of house price volatility.

Speculators seek to acquire returns from house price appreciation through capital gains. By limiting the returns from capital gains, a capital gains tax can reduce the prevalence of speculative behaviour within a real estate market (Jasper, 2004). In addition, changes to negative gearing can incentive investors to shift investments away from the owner-occupied housing sector towards other sectors of the economy (Cigdem, Ong, and Wood, 2016). Thus, changes to the treatment of capital gains and negative gearing can also reduce speculation in the housing sector, thus reducing house price volatility.

Conclusion

The government should be concerned about house prices. Rapid house price appreciation is a significant threat to the well-being and living standards of all New Zealanders. When house prices rise faster than incomes, the relative increase in housing costs may result in inequitable outcomes and reduced social cohesion. In addition, mortgage credit expansion accompanying house price appreciation increases the exposure of the New Zealand economy to adverse economic shocks. Thus, increasing the availability of affordable housing and limiting excessive house price growth through macro-prudential regulation and counter-speculation policies are consistent with the overall objectives of The Treasury. Active intervention in the housing sector to stabilise house prices is socially optimal and economically justified.

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