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

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The Significance of Inflated House Prices on New Zealand Society and the Economy

Traditionally, most generations of New Zealanders have grown up expecting to own their own home, and to lay claim to their own tangible piece of our country. However, recently this 'national obsession' has come under threat, given the current state of New Zealand's real estate market, where house prices have reached a level fundamentally disparate relative to the financial benefits they provide, even in relation to other, more traditionally expensive international countries.

This essay will seek to demonstrate that the fundamental economic and social importance of housing means that inflated house prices undoubtedly should represent an area of concern for the government. In addition, it will outline several of the diverse and complex factors within the housing market which make it susceptible to price fluctuations, and consider the impact of these fluctuations on financial risk, economic growth, equity, social cohesion, and sustainability.

Financial risk

In New Zealand, the real estate market has become a major driver of growth across financial markets and the economy. As such, the most apparent and widely discussed impact of inflated house prices relates to the risk they pose to the financial stability of the economy.

While historically, the real estate market has been a relatively distinct and separate part of the national financial system, recent financial market developments mean it now plays a significant role within the global financial landscape.[1] Specifically, this has been driven by factors like a more globalised world economy, deregulation of financial markets, and especially securitisation, which has allowed for individual illiquid mortgages to become collectivised and thus more accessible as a purchasable investment asset within modern capital markets.

However, the role of subprime mortgages in causing the recent Global Financial Crisis (GFC), has served as a demonstration of the major perils resulting from the integrated nature of modern mortgage and capital markets.[2] In addition, the GFC provided a strong challenge to the concept that real estate represents a 'riskless' investment given that nominal real estate values infrequently experience substantial decreases, by proving that when such crises occur, they are incredibly costly.[3] Specifically, this has been evidenced through the bankruptcies, decreased output, increased unemployment and financial system harm that has occurred in many countries in the wake of the GFC.[4]

Given these significant consequences, the New Zealand government should be particularly concerned by the current state of the real estate market, with recent analysis by Goldman Sachs suggesting there is a 40 per cent probability of the New Zealand housing market falling in value by 5 percent or more over the next two years.[5] In addition, the IMF's most recent Global House Price Index, which measures international housing affordability suggests that the rate of increase in New Zealand's house price-to-income ratio since 2010 is the highest worldwide, with our house price-to-rent ratio increase also

[1] (Murphy, 2011)
[2] (Murphy, 2011)
[3] (Murphy, 2011)
[4] (Murphy, 2011).
[5] (NZ Herald, 2017).

being the third highest worldwide.[6] These findings represent major concerns as the more current house prices deviate from their fundamental long term values, the more likely and more damaging will be any market correction.

The RBNZ have also highlighted that any market correction would likely be exacerbated by current economic issues such as New Zealand's over-valued exchange rate.[7] In addition, the significant time taken for housing development plans to be approved and physically constructed, means the real estate supply response is far slower,[8] which alongside the lack of transparency and price information means real estate prices are more responsive to macroeconomic changes and subject to sustained variations from their intrinsic value[9]. This means that were any major correction to occur, it would be immensely difficult to contain.

New Zealand's relaxed current credit climate is another contributing factor to the threat of financial crisis. Specifically, in New Zealand, these relaxed credit conditions, given the historically low current Official Cash Rate of 1.75%, together with the perception that the housing market will continue to sustain its recent capital gain increases, have strengthened the incentives for prospective first-time buyers and speculative purchasers. The major issue here is that during such periods, the need for effective prudential oversight becomes paradoxically both more significant and more difficult to implement, given that while credit conditions remain conducive those taking out loans can comfortably afford to meet their repayment obligations. However, once market conditions change, generally through a rise in interest rates, then repayment obligations become less viable and the financial system begins to implode. Given this, it is worrying that New Zealand's current situation somewhat mirrors the situation in the US prior to the GFC, with low interest rates that are expected to gradually increase posing a major threat to more highly leveraged homeowners.

These considerations have been the motivation for more restrictive lending policies introduced by the Reserve Bank in 2013, such as restricting lending of LVRs above 80 percent to below ten percent of mortgage lending, which has since been further expanded to limiting the number of loans to speculators with less than 40 percent equity to five percent of all mortgages. Given these proactive actions by the Reserve Bank, there is clearly a genuine financial risk associated with New Zealand's current house prices, which serves as a major reason why the government should be concerned.

Economic growth

One major way house prices influence economic growth arises since real estate investments are often utilised as a source of collateral to fund other consumption and financial investment.[10] However, as considered above, a major consequence of this deleterious relationship is that any variability across real estate prices has a significant impact on the broader economy. These serious consequences have thus meant that New Zealand needs to consider the drawbacks of our current system, which relies heavily upon sustained increases in capital gains to drive economic activity[11].

Allowing the real estate market to have such an integral role in New Zealand's financial system has helped reduce economic resilience, by making both investment and consumption spending subject to real estate price fluctuations as opposed to economic conditions[12]. In addition, the wealth effects of

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[6] (IMF, 2017)
[7] (Skilling, 2015)
[8] (Eaqub, 2014)
[9] (Goodhart & Hofmann, 2007)
[10](Goodhart & Hofmann, 2007)
[11] (Murphy, 2011)
[12] (Eaqub, 2014)

rising house prices help spur unsustainable borrowing for short-term expenditure, the negative effects of which are only fully felt once house prices begin to decline. Evidence of the negative effects of this phenomenon can be seen through the post-GFC experiences in the U.S, Japan, Denmark, the U.K, and particularly Ireland, where retail sales declined by nearly 20% in 2009 because of pronounced consumption decreases by households with higher LVR mortgages.[13] This consumption downturn contributed to widespread defaults on business loans, with Ireland having more than 40% of SME loans in default by 2013.[14] Given this, it is a major concern that the current New Zealand real estate price inflation appears to be driving increases in national debt-to-income ratios, particularly in Auckland, where nearly 60 percent of mortgages are made to homeowners with debt-to-income ratios of greater than five[15].

In addition, periods of excessive house price inflation result in marginal funds being invested in real estate instead of other more viable business investments[16]. Thus, even if any housing price correction is relatively tame, this period of misdirected investment means that potentially profitable and economically stimulating investments may have been foregone.

National equity and social cohesion

New Zealand's inflated real estate market has also helped increase social inequity, particularly across generations, with this effect being particularly significant due to the concept of home ownership having become ingrained within the New Zealand psyche.

In many respects, this reverence can be attributed to historic actions by the New Zealand government, who during the early 20th century implemented several measures such as offering affordable sections to builders and creating a State Advances Financing Corporation to help promote the concept of home ownership[17]. However, such measures proved too successful, with concerns regarding the consequences of urban sprawl and other factors leading to the government scaling back its role during the 1970s and 1980s[18]. Consistent with these governmental actions, New Zealand's historical home ownership rates have been in decline since the 1990s, recently reaching their lowest levels since 1951[19]. This trend has been particularly pronounced since house prices began their rapid ascent in 2001, with property ownership rates for New Zealanders between the age of 30 and 39 years having decreased from 55% to 43% over this period.[20]

Some commentators have partially attributed this shift to changing social factors relating to an increased number of New Zealanders taking on debt to pursue tertiary studies, greater gender equality within the workplace, and a delay in the time taken to get married and begin starting a family[21]. However, the driving force behind the decrease is undoubtedly the intergenerational 'purchasing power' gap, which has arisen since a typical first home buyer in 1990 would have been

[13] (Reserve Bank of New Zealand, 2017)
[14] (Kelly & O'Toole, 2016)
[15] (Reserve Bank of New Zealand, 2017)

[16] (Eaqub, 2014)
[17] (Ferguson, 1994).
[18] (Ferguson, 1994)
[19] (Eaqub, 2014)
[20] (Eaqub, 2014)
[21] (Eaqub, 2014)

able to fully pay off a mortgage inside 30 years, but nowadays, it would take the average first home buyer in Auckland more than 50 years.[22]

Inflated house prices also help to reduce national equity by entrenching current social dynamics and preventing social mobility as the children of wealthier parents can reap the benefits of their parent's investment and purchase their own property in the future with their support. Such a situation is undoubtedly made far simpler through New Zealand's unique situation of not having a capital gains tax, a factor highlighted within the recent IMF Article IV evaluation of New Zealand's economic situation as being one way to discourage highly leveraged property investment.[23]

Financially, real estate investments also potentially allow individuals to substantially reduce accommodation costs later in life. Additionally, the wealth they provide serves as an easy mechanism for individuals to build retirement savings and provides a safety net in the event of personal financial difficulties.[24] Furthermore, real estate can also serve as collateral in loan agreements, allowing home-owners more favourable credit terms, and thus the potential to earn greater returns from other investments, further helping them build personal wealth. Property ownership also provides several non-financial benefits including home-owners having greater power over their domestic situation, which means they can personalise their home and live their life without fear of loss of tenure[25]. In addition, property ownership potentially helps individuals develop feelings of accomplishment and assurance given its venerated status within New Zealand society[26].

Thus, this disparity in opportunities available to home-owners and non-home-owners is likely to result in a significant social discord. Most notably, this could manifest itself through a collapse in social cohesion between elder generations who have been afforded greater opportunities and younger generations who have not, as well as across income brackets if the current inequality within the housing market continues.[27] In addition, as house price inflation tends to have a more pronounced effect in more urbanised, economically profitable areas, those denied the opportunity to live within those areas are likewise denied access to better quality jobs and schools. Similarly, house price inflation likely leads to a greater concentration of low-income groups within specific areas, which has a range of negative social implications.[28]

Sustainability

Overall, the current housing market system is highly unsustainable given that it rewards higher income earners, which is anathema to New Zealand's democracy founded on egalitarian principles. Having a situation where those already having established considerable wealth can easily build upon that wealth to further economic inequality, is clearly socially unsustainable over the long-term.

In addition, the current environment characterised by shortages creates an environment predicated on competition for scarce resources as opposed to collaboration, which has a hugely negative impact on social capital. Such an environment also impedes upon an economy's ability to create human capital, as it prevents individuals from achieving their full economic potential.

[22] (Eaqub, 2014)
[23] (IMF, 2017)
[24] (Yates & Bradbury, 2010)
[25] (Kelly, Hunter, Harrison, & Donegan, 2013)
[26] (Kelly, Hunter, Harrison, & Donegan, 2013)
[27] (Eaqub, 2014)
[28] (Ferguson, 1994)

Conclusion

Overall, the range and seriousness of consequences of government inaction that have been outlined within this essay clearly demonstrate that the government should be concerned about New Zealand's current house prices. With inflated house prices having a significant impact on financial risk, economic growth, national equity, social cohesion and sustainability, some form of government involvement within the real estate market is highly recommended to prevent further national economic and social issues in the future.

Word Count: 1997 Words (excluding footnotes)

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