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Question:

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

Introduction

The New Zealand housing market is in turmoil. Rampant speculation, restrictive urban planning laws, and massive population increases in urban areas have caused real house prices to increase more than in any other OECD country over the past seven years (OECD, 2017). The likelihood of an average New Zealander acquiring property is rapidly declining. The most obvious and popular response would be government intervention, in order to curtail housing inflation and create more affordable housing options. Unfortunately, many possible policies and amendments have been rendered impractical or ineffective due to the current condition of the housing market.

This essay will outline the underlying causes of New Zealand's housing crisis, including demand and supply issues, and explain why these issues are not easily fixed. It will explain the effects high house prices have on the population, with respect to the living standards framework, and illustrate why the Government should be worried.

Demand side problems

Demand is presently influenced by a multitude of factors, including strong immigration and an ideal climate for speculative investment. Currently, housing demand is difficult to curb, as policies targeting its causes are likely to negatively affect other facets of the economy.

One significant driver of demand is rapid population growth, especially in urban areas. Auckland's population has increased by 18 percent in the past ten years, compared to 11 percent and 4 percent in Wellington and Christchurch respectively (Stats NZ, 2016). Immigration has been a substantial contributor to this increase, with net migration reaching a record 72,400 in the July 2017 year (Stats NZ, 2017). Almost half of these immigrants attempt to find residence within the Auckland region (Stats NZ, 2014), mainly due to the already established communities of their co-ethnics and the myriad of job opportunities available in Auckland. Natural population increase, due to a higher birth rate than death rate, is unlikely to boost demand for housing noticeably, as many families will either remain in the same home after their baby is born, or sell their house and buy a new one. Immigrants, on the other hand, are likely to buy or rent a house in New Zealand, while selling their house in their country of origin. Immigration increases demand for housing without increasing the supply of housing, hence creating excess demand which drives up the price. High levels of immigration into Auckland helps explain why property prices are rising faster there than elsewhere. Immigration driven demand is unlikely to abate unless further restrictions are placed upon migration levels. The problem with further restrictions is that immigration tends to boost economic growth, fill skill gaps, and increase taxation revenue. Therefore, the government must carefully consider the cost-benefit of policies intended to reduce immigration levels, as using these policies with the intention of curbing housing demand is likely to have negative consequences elsewhere.

The rise in the level of investment in the housing market seems counterintuitive, as house prices are extremely high relative to income yields from renting the property. However, the majority of investment is coming from speculators, who buy in anticipation of a price increase and then sell once the value of the house becomes inflated, rather than buying to generate income from the asset. New Zealand currently has a low interest rate and no capital gains tax. Consequently, borrowing is cheap, which creates an ideal environment for speculators; who can make a sizeable, low risk profit by purchasing property.

House prices are becoming far removed from their intrinsic value, which is creating a housing bubble, inflated by cheap credit and lax property ownership laws. Historically, the existence of an asset bubble has almost always resulted in a crash, and there is little evidence to assume this situation is any different.

Supply side problems

One would expect housing supply to increase due to the high prices, as property developers attempt to maximise profits. However, mitigating factors are preventing supply from increasing at a desirable rate.

A main worry for property developers is that the rapid increase in market prices indicates a peak and downturn in the near future. It is risky to undertake development opportunities, as it is possible the value of the house could fall significantly during the construction phase. This risk also affects banks, who cannot justify lending sizable sums to developers, due to the distinct possibility of a severe market downturn and therefore debtor default.

Restrictive urban planning laws, especially in Auckland, are another underlying cause of the house price crisis. Design requirements such as building height limits and environmental performance requirements are contributing to the supply shortfall. There is also a limited amount of land currently in development, partly due to a severe shortage of construction workers. As of 2013, there was a 29,000 construction worker deficit, which is estimated to rise to 41,000 by 2020 (MBIE, 2017). This is a worrying trend, as it shows that it will be practically impossible to increase the number of construction workers to the required level. Prioritising construction workers for Work Visas is a proposed solution, but an influx of migrants into regions with housing shortages will be counterintuitive as demand will be further heightened.

The densification of housing is another option being proposed as a viable solution, but the current level of infrastructure is insufficient to support this. Infrastructure provision is mainly the prerogative of local councils, who face financial constraints and weak incentives to invest in amenities (OECD, 2017). Alterations to infrastructure provision can take a long time to implement, so densification may be impractical in the near future, although it is a possible long term solution.

Consequences of high house prices in the context of the Living Standards Framework

Economic growth

The median house price in Auckland has reached ten times the median income (Parker, 2015). Consequently, many buyers are forced to take out large mortgages relative to their income. This has contributed to an increase in household debt from 58 percent to 168 percent of nominal disposable income between 1991 and 2017 (RBNZ, 2017). Excessive household debt results in less consumption and investment as households cut back on spending in order to reduce their debt level. In general, high debt cycles cause longer expansions but more severe recessions (OECD, 2012 as cited in RBNZ, 2017). This slows economic growth, hinders wage growth, and hence further reduces the ability of households to pay off debt.

Housing market crashes that are preceded by high levels of household debt have been associated with significantly larger falls in economic activity (IMF, 2012 as cited in RBNZ, 2017). When house prices inevitably do fall many homeowners and investors will be incentivised to sell property as they expect the value of their properties to decrease. As a result, increased market supply will further reduce the price level. Home owners will have decreased wealth as their properties realise a lower value. Consumer confidence and therefore the marginal propensity to consume will fall, resulting in slower economic growth. Decreased consumption and investment, causing the overall price level to fall, will be especially damning given the low inflation rate. Deflation is a distinct possibility, which is a severe detractor to economic growth. Given the already low official cash rate (OCR), it will be difficult for the Reserve Bank of New Zealand (RBNZ) to counteract this. Consequently, poor future economic performance is almost certain.

Managing risk

Currently, New Zealand, and in particular Auckland, has a housing bubble, due to artificially high house price inflation.

Higher interest rates may stem the readily available flow of capital for speculators, reducing demand side price pressure on the housing market. However, it is unlikely that the OCR will increase significantly in the near future, given that inflation has been lower than the 2 percent target midpoint in all but one of the last 23 quarters. Consequently, interest rates are likely to remain consistently low over the medium term. Low interest rates reduce the portion of disposable income saved by households and encourage borrowing, which augments already unsustainable household debt levels. Furthermore, housing becomes a more attractive investment in relation to saving, which increases the magnitude of speculative investment and further raises house prices.

If the OCR is increased, the ability of households to repay loans will be hindered. Given current levels of household debt, this could have severe repercussions, including the possibility of mortgagors defaulting. Low interest rates will continue the expansion of the housing market bubble, while high interest rates have the potential to burst the bubble. Evidently, the market is in a precarious position.

Equity

A consequence of increasing prices is that fewer houses are being traded. Current home owners are reluctant to sell, as they expect property values to appreciate over time. High prices also decrease quantity demanded, as houses become less affordable. Both of these factors have combined to reduce total sales, which were down 20 percent overall for the year ended August 2017 (REINZ, 2017).

Based on this data, it is clear that it is becoming more difficult to buy a house in New Zealand, which amplifies the problems of intergenerational wealth transfer, poverty cycles, and inequality. Home owners are seeing their wealth amplified while those renting or attempting to buy are seeing their purchasing power in the property market decreasing.

Regional inequality is also prevalent, as house price inflation in Auckland is significantly greater than in other regions. Consequently, those who own homes in Auckland benefit greatly due to increased wealth, while people in other regions are relatively worse off. Contrarily, those without property in Auckland are relatively worse off than those without property in other regions. This makes inter-urban and rural-urban migration to Auckland less feasible, which restricts people's ability to move to an urban centre with better job opportunities or a better standard of living.

Social Cohesion

Higher house prices make crowded houses more ubiquitous. Consequently, infectious diseases increase in prevalence, especially amongst children, who commonly suffer from rheumatic fever and skin infections. This issue disproportionately affects children living in socioeconomically deprived areas, making it difficult for them to maximise educational opportunities. Adults are also affected, decreasing their productivity and potentially making them less employable. As a result, overall living standards decrease.

The inability to buy a house also increases the likelihood of intergenerational poverty cycles. Without asset ownership, retired people have less ability to live off their savings. Therefore, they are more likely to rely on relatives to either house them or assist them financially, which is detrimental to the financial position of the relatives, and contributes to the crowded houses problem. This cycle is notoriously hard to break, and may contribute to the already high child poverty rates within New Zealand.

Sustainability

Home ownership is considered by many to be a vital component of the 'Kiwi Dream', as it is commonly dubbed. In the current housing climate however, many would consider owning a house quixotic. High house prices affect young people significantly, as they have recently entered the workforce and are therefore likely to be earning at a low wage rate relative to experienced workers. Therefore, future generations are less likely to be endowed with the financial security provided by

asset holdings. They will also not acquire the benefits that come with home ownership, such as the ability to build wealth and equity. This may encourage some to leave the country in search of employment elsewhere, resulting in another 'brain drain'.

Conclusion

The Government should be worried about house prices. The housing market is currently extremely volatile, which renders many policies risky and impractical to implement. Rising household debt levels, greater wealth inequality, and a lower standard of living are all consequences of the current state of the housing market. The long term outlook is bleak, due to the unsustainable nature of the housing bubble formed as a result of high migration levels, speculative investment, and restrictive urban planning laws. This bubble will eventually burst, leaving New Zealand in a perilous economic position and many citizens in serious financial trouble.

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