The Commissioners
Inquiry into Housing Affordability
Productivity Commission
PO Box 8036
Wellington 6143
New Zealand

Dear Commissioners

COMMENTS ON DRAFT REPORT

The draft report that you and your staff have prepared is very disappointing. A reader of the draft could be forgiven for concluding that the Commission is either not aware of, or has chosen to ignore a large range of important material. On some fronts this amounts to a lack of reflection on the implications of the global financial crisis, on other fronts it shows a preference for highly questionable economic analysis.

There is no sense in the document that policymakers and markets may have operated or be operating for the benefit of narrow private interests, rather than for the broader public interest. This is unacceptable.

As was the case with my initial submission, I do not propose to address a wide range of issues; the causes of unaffordable housing have been comprehensively canvassed over the last 5 years. If the Commission is not able to produce a top quality report, and genuine solutions on the basis of this excellent foundation, that will not be for want of good material.

I will simply comment on some of the fundamental shortcomings of the draft.

Firstly I would single out the claim on page 13 of the draft that "low interest rates" impact on housing affordability. This myth - beloved of some financial commentators and property industry touts - was debunked by The Economist in 2001. In "How cheap is your mortgage" it showed that no such benefit existed, in cases where the reduction in nominal interest rates reflected falling inflation [1]. The Governor of Reserve Bank of Australia – Bernie Fraser – reminded people in 1991 to look past the nominal interest rate in assessing financial matters and focus on the real interest rate. There is even a name for this analytical failure – the money illusion.

The average real interest rate for mortgages in New Zealand in the last decade has been 5% to 6%. When that is placed in a long-term context, it could not possibly constitute a benefit to home-buyers, because the long-run real interest rate on mortgage borrowing is 5%.

Secondly, the claim that strong credit growth increased the borrowing capacity of households (see also page 13) must be put in perspective. To the extent that there was strong credit growth, this change was not sustainable, and consequently could only be described as having a negligible effect on housing affordability. That credit growth was ultimately fuelled by the folly of Alan Greenspan, and the "Greenspan put" that drove USA financial markets into a frenzy of malfeasance that collapsed in 2008. A bubble is a bubble is a bubble, it is never an improvement.

Thirdly I would note that your examination of the issue of saving by intending homebuyers is simplistic; largely you treat the purchase of a house as debt-based process. To the extent that you recognise savings calculations such as those by “Roost”, the public need to understand that Roost’s assumptions have been too rosy. Modelling of the saving of a deposit is only realistic if it is done on conservative assumptions – just ask depositors of South Canterbury Finance.

The fact is that over the long term, the cost of housing as a multiple of salary has increased by a factor of two, or more. There is of course a counter-argument that neo-liberal economists use, which points to a much smaller change when house prices are expressed relative to household income. But this, in turn, assigns a negligible value to household leisure. Over the last two decades it is indisputable that at the household level, the ratio of economically active persons to total persons has risen strongly. Household income rose, therefore, not because money rained on NZ, or productivity took off, but because labour force participation rose, and leisure fell.

Finally it is necessary to tackle the false impression that could be created for readers by Figure 2.1 on page 10. This appears to show that NZ house prices, both real and nominal, have experienced clear and enduring declines in the years between 2005 and 2010. This is extremely puzzling, for two reasons. The primary reason for doubt about this chart is that it is impossible to recreate the real house price decline using NZ CPI data and Quotable Value monthly Press Releases on house prices. These two data sets in combination show no meaningful and sustained real decline in the price for NZ houses in the period since 2005 when Figure 2.1 alleges it occurred. The other reason for concern is that even the nominal price series cannot be squared with Quotable Value Press Releases over the timeframe. The nominal series shows that the peak in nominal prices was 8 to 9% above the last data point in the series (2009). This implies that the nominal average NZ house price peaked, sometime in 2006, above $400,000. This is fanciful [2].

According to Quotable Value Press Releases the average NZ house price peaked in nominal terms in October 2007, slipped backwards until May 2009, and regained nominal 2007 levels by December 2009. It has remained there ever since, providing reassurance to all those who have sunk their own or others’ cash into real estate, that they have lost little, if any money.

In short, there is no good evidence in interest rates, in financial innovation, or in income growth that high house prices reflect consumer sovereignty. There is also no evidence of meaningful price falls. Yet your draft seeks to convince readers there is good evidence for all of the above.

It is essential that you confront less pleasant explanations of NZ’s house prices, including the market power and lending practices of the banks that operate in NZ. If you do not address their ability to shape housing industry outcomes, there is every reason to believe that the average NZ house price will be above $450,000 by 2014 and will continue to grow faster than inflation.

Yours sincerely

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[1] http://www.economist.com/node/550594
[2] It should be noted that Figure 2.1 would also have the reader believe that the average NZ house in 2009 cost in nominal terms roughly what it cost in 2005. No evidence supports this.