October 1 looms as a vital day for both the Government and the Reserve Bank

Posted in Opinion July 20, 2015 - 04:54pm, David Hargreaves

Image sourced from Shutterstock.com

By David Hargreaves

Anybody that has cast half an eye over history will know that the "Phoney War" referred to the rather strange, waiting, eight month period between September 1939 (declaration of WWII) and May 1940 (invasion of France and Low Countries).

It was the pregnant and rather long pause that followed the announcement of affirmative action.

At the moment we are in our very own peacetime 'Phoney War' - this one stretching from May to October 1 as we wait for the announced (in May) 'pincer movement' of the **Government** and **Reserve Bank** to take effect against that unruly offspring of an Auckland house market.

And while October is unlikely to bring speeches from either the Prime Minister or the RBNZ Governor exhorting us to fight on the beaches, er, houses, both John Key and Graeme Wheeler will know that it is an important time for both of them and that the measures that have been announced better blinking well work.

The RBNZ has realised that it can no longer ignore the fact that **inflation has fallen well and truly out of the bottom** of its official 1%-3% target range and is light years distant from the RBNZ's own explicit goal of 2%. That's why we now have the odd sight of the RBNZ bringing its own tankers of petrol (also known as interest rate cuts) to the blazing house fires of Parnell, Herne Bay and rest, while also standing guard with the fire extinguisher (courtesy of a continued 10% high-LVR 'speed limit' and a new limit of no more than 70% borrowed financing for investment properties).

To me this is just plain weird and highlights the growing inherent conflict between the RBNZ's monetary policy role on the one hand and financial stability role on the other. **This needs looking at**.

It will work

But notwithstanding the stimulatory interest rate conditions that are coming (an Official Cash Rate cut to at least 3% this week is a given and the OCR can now confidently be expected to revert to historic lows of 2.5% by end of the year) I actually think the housing specific measures announced in May - most particularly the RBNZ's move on Auckland investors - will work. And I will stick my head on the block and forecast that we'll see a drop in the Auckland region's median house price of between 5-10% in the 12 months from October 2015 to October 2016. It is the first time I have personally specifically predicted Auckland house prices will fall.

Time will tell, but rather than being worried about whether the measures will dampen the market, I think the RBNZ particularly needs to be very careful that it doesn't precipitate the very thing it is seeking to avoid, namely a very sharp correction in Auckland prices and I think the central bank will need to be very vigilant on a month by month basis that it's not throttling the golden goose. I'm guessing that a 5-10% decline within a 12-month period, given the recent astronomical gains is certainly something the central bank - if not your average Auckland home owner - would be reasonably comfortable with.

It would be the pause that would let everybody catch breath.

Recent history would suggest that were are a very long way indeed from seeing Auckland house price rises even slow, let alone reverse.

But we are in that Phoney War period. While any new restrictive measure generally needs to have a phase-in period - just for pure logistic reasons - it is never ideal in my view. In this instance we've seen the back of the hand raised in May, but don't get the clip around the ear for three-and-a-half months. That's long enough for people to kind of half forget that the measures are actually coming. I genuinely think it is going to come as a rude shock to some people to find - as is now starting to happen with some pre-approvals - that the the 70% limit has slammed down.

Auckland's perceived shortage of houses has been well canvassed. Probably less well understood has been the demand side of the equation because we just haven't had enough information on that. And, please, no, let's not go down that over-worn path again.

We can see that investors have been increasingly significant in that Auckland market, driven no doubt by low interest rates that on the one hand make borrowing money cheap and on the other make for reasonably rubbish term deposit returns. So, buying property it is, then. **Figures produced by property information, analytics and services provider CoreLogic** suggest that investor interest in the Auckland market has surged to such an extent that investors now account for more than 40% of sales.

Clearly anything that has a dampening effect on the investors will have some dampening effect on the Auckland market. The **RBNZ's own figures**, which are nationwide ones, show that among investors very few of them fall into the high (above 80% of the property's value) loan-to-value ratio. BUT, nearly half of all the money borrowed by investors (over $1 billion worth in May) falls into the 70-80% LVR bracket.

The big question then is how many of these investors will be able to find a bigger deposit, or do some other regorganisation, that would get them down under 70%. Clearly at least some are going to drop out. Some may move their attention out of Auckland (there's some signs that might be happening already), with other regions now offering the advantage of cheaper prices - but also after October 1 easier access to finance.

I think this impact on the investors will alone be sufficient to start seriously dampening things down in Auckland.

The real wild card is the extent to which cash buyers - impervious of course to any credit-based restrictions - might continue to carry the market in our largest city. According to CoreLogic cash buyers make up about 20% of Auckland purchases - which is a lot. If the cash buyers keep coming then it is certainly possible these new measures could at least in part be blunted, and I happily concede, I could be wrong about falling prices.

I think the Government will do itself a lot of favours if it makes a clear signal sooner rather than later that it DOES intend to go ahead next year with plans for a withholding tax on offshore investors who sell properties. A very clear sign of a changing mood would have an impact on offshore interest.

Slowing economy

Another potential dampener on the property market is the slowing economy. While the property market currently appears to be operating in its own separate dimension, the gravitational pull of a slow-down will gradually have an impact. It must. Whereas two years ago dairy farmers, for example, were flush with sky-high global prices for their products, now the are looking at prices hitting 13-year lows and with the prospect of a second bad season in a row. This has direct and indirect impacts.

Indirectly there's a morale factor. Morale goes down, people are less encouraged to invest - and they might be less encouraged to buy houses.

Then there's the direct impact of actually less money in the economy. And, how many dairy farmers might have invested some of the strong returns of recent years in investment properties? I honestly wouldn't have a clue how many, but you would have to think at least some might have. Will they now need to sell those investments to raise cash?

The Phoney War has a little while to run yet. Unlike that other Phoney War this one's turning out to be a pretty noisy affair, one way or another.

Ironically it is when October comes that I think we'll see quiet descend. On the Auckland housing market. Then maybe we can all get some sleep.