# The “Affordability” of Unaffordable Homes

We all seem to agree. New Zealand home prices look extremely high. But if they are so grossly unaffordable then how come so many people are willing and able to buy them?

- Friday, September 30th 2016 by Craig Ebert BNZ Economist

Very low interest rates help square the circle. This is not to say that such things as record immigration, land supply, lagged construction response and high and rising building costs are not important factors for the eye-watering prices people are paying for property. They clearly are. However, to help explain the heights that house prices are now probing, nationally, the inflammatory role of very low interest rates needs to be appreciated as well.

## The Politics of It

Of course, few people involved in the housing market have any cause to argue against unusually low interest rates. Existing homeowners, and investors, obviously prefer the higher prices that low interest rates tend to bring, along with the low mortgage payments entailed. Banks depend on the strong sales turnover that low interest rates stoke. So too do mortgage brokers and real estate agents. Home buyers, meanwhile, like to be armed with the lowest mortgage rates possible. For these reasons (and a lot more) the government has scant incentive to ever suggest interest rates are “too low”. And so goes the time-honoured politics of it.

This also helps explain why the debate about high and rising house prices is looking everywhere but interest rates – for attention, and solutions. If only we could build more houses, or lower the immigration targets, or change the tax treatment of housing, or just outright ban foreign buyers…then houses would become affordable again. The list goes on, and on.

And this is after having already implemented a lot of policy that was presumed to help bring the market to heel. Like the removal of depreciation allowances on most real estate, the

implementation of LVR restrictions (starting October 2013), requiring tax-registration of non-resident buyers and “bright-lining” existing capital gains tax.

Meanwhile, as home prices soar the government is doing more and more to support local first-home buyers through various means and schemes. Such as allowing people to cash in their Kiwisaver retirement funds for the specific purpose of “investing” in housing (a supposedly unproductive asset we are over-investing in, but which we have not nearly enough of). There are also the HomeStart grants and LVR exemptions for people on low to middle incomes. These policies, while well meaning, ultimately keep feeding the beast of house price inflation.

# The Power of Low Interest Rates – Pushing the Envelope

While many big forces are colliding in the NZ housing market, what tends to get downplayed in the debate, we find, is the basic role of interest rates.

To illustrate the power of low rates, we can imagine what people could “afford” to pay for a house, as a maximum, given a range of weekly accommodation budgets and mortgage rates. Along with this, assume people have, say, a 20% deposit and take out an interest-only loan. Sure, this is an over-simplification (even inconceivable for many first home buyers without recourse to flush parents, the HomeStart scheme or non-bank lending institutions who are outside the LVR remit). But the results of our simple matrix illuminate the broad points we want to make. It’s not about how much everyone can pay, and borrow, for a house. It’s about what someone can “afford” to pay, providing they meet certain thresholds.

And the main point is that the “affordability” of homes increases exponentially as interest rates become lower and lower. Each one percent fall in mortgage rates gives a greater and greater bang for buck. For example, if mortgage rates fall from 9% to 8% then affordability rises 12.5%. But a drop from 5%, to 4%, causes a rise in house “purchasing power” of 25%, in our simple example.

Consider the example of a 5% mortgage rate coupled with a $600 per week accommodation allowance (which might otherwise be put to renting). With this, one can “afford” to bid up to $780,000 for a house. But that maximum bid limit drops to about $557,000 if the mortgage rate goes up to 7% (arguably what New Zealanders had become accustomed to, on average, pre GFC). That’s a purchasing power correction of almost 30%, for what would appear to be a moderate rise in mortgage rates, of 2 per cent.

To be sure, no one normally has to bid to the maximum that their mortgage servicing affords. However, this envelope comes into play when the market is hot, as it has become (for a host of reasons). Lowering interest rates increases the upper bid limit (exponentially), just as increasing interest rates brings it down. It’s not rocket science. Indeed, it’s essentially what simple mortgage calculators go about showing.

# Sense and Sensitivity

Sensitivity to interest rate changes, when they are already quite low, is something to think about not just for house prices but asset prices more generally, and globally. At least New Zealand's starting point on interest rates isn't as low as it has become in large tracts of the world economy. The Reserve Bank has resisted this greater temptation.

But think about countries (and markets) whose "discount rates" might need to effectively double, treble, quadruple, just to get back to the "new normal" levels (which everyone agrees are lower than they used to be). And, by the very fact "new normal" assumes lower economic speed limits than before, it might take relatively less GDP growth to have inflation resurfacing, as a trigger for rates starting to go back up. Of course, this process could end up being very stop-start, depending on how much sensitivity is, in fact, revealed.

# A Fundamental Force

Of course, we've heard it said that the interest rate argument fails to explain New Zealand's house price inflation, in that it has had a regional pecking order to it. If the common problem was low interest rates then it should have affected all markets about the same, so the story goes.

However, this overlooks a few things. First is the fact that regional housing markets have had differing real pressures bearing upon them. Auckland, for instance, has experienced stronger population growth and arguably a greater lack of building in proportion to this. This is valid reason for house prices there to have gone up (to some extent). At the other end of the spectrum some smaller NZ cities and towns have struggled economically, including via structural stagnation/loss of population. This would normally have entailed falling-to-low house prices (as part of a relative price shift).

The stimulus of lower interest rates can thus be thought of as inflaming house price inflation in areas of genuine pressure, while obviating house price falls in areas where economic fundamentals have otherwise demanded it. This doesn't mean interest rates haven't provided a widespread force.

For good or bad, New Zealand didn't have a major house price reset as a result of its 2008/09 recession and GFC, of the sort most other major economies did. The 575 basis points reduction in the Official Cash Rate (OCR) during that time played no small role in this.

In any case, what we're seeing now is house price inflation picking up right across the country (while Auckland prices keep setting the new high-water mark). Anyone doubting the role of low interest rates in this is clearly not listening to what real estate agents are saying. And to think interest rates are not a significant driver of the housing market would be to assume a shift back up in mortgage rates of, say 2%, would not have much effect. We suggest that such a move would send a significant chill through the housing market.

# Investors – Who Can Blame Them?

What about the role of investors in the house price pressure? This group has obviously copped a lot of flak, as supposed central protagonists – even demonized by some. They have

undoubtedly attracted the attention of the Reserve Bank, which has imposed the greatest credit controls on this group of buyers.

However, one could argue that many investors have simply been behaving in a rational manner, rather than a speculative one. They have certainly done well not to believe the Reserve Bank's regular forecasts of soon-falling house price inflation. [Will we see the RBNZ conduct a forecast accuracy exercise on its house price forecasts, the way it has done for other key macro-economic variables?]

In this regard, it's worth noting that between its June and August Monetary Policy Statements the RBNZ yet again pushed out its foreseen house price inflation moderation.

This means for a 25% increase in prices over the next few years now, rather than 15%. With this, along with the Reserve Bank's maintained rhetoric about further interest rate cuts, can we blame anyone for wanting to put funds into the housing market? In this respect, the Bank's forward guidance has worked only too well – sustaining quite strong inflation expectations in the general populace, regarding house prices.

This process is reinforced by the fact that collapsed deposit rates, partly on the back of low OCR settings, are forcing people to look at alternative places to park their money. "Investors" are no different in this regard. Sure, rental yields on residential property have been bid low. But then this has not been wildly out of step with the relentless downward path of market interest rates.

In the end, investors will be dealing with similarly low interest rates that other home buyers are basing their purchases on.

# Central Bank Responsibility

To be fair, the Reserve Bank of New Zealand has increasingly admitted the role that low interest rates are playing in the housing market inflation. However, when push has come to shove, the Bank has also tended to downplay the relative importance of this – viewing house prices as principally a supply-side issue, out of its orbit of control. The big fish, when it comes to inflation, is seen by the RBNZ to be the Consumers Price Index.

To be sure, the NZ housing market has had all manner of major forces bearing upon it – some more difficult to foresee than others. Few predicted the relatively sudden surge in net immigration to all-time highs, for example. Nonetheless, the reality is that the Reserve Bank has to work with whatever may have a material bearing on inflation and/or financial stability, however helpful or unhelpful those factors might be.

Recall the loosening of the fiscal purse strings over the final term of the Labour-led government (2005-08). Or the frequent disappointment on productivity performance, which affects the economy's underlying "speed limit"? There's even the weather, which the RBNZ accepts, and positions for. Presently, there are a number of significant global forces that the Bank is taking as given. A major demand-supply imbalance in the local housing market also needs to be treated as macro-economically important.

We don't mean from this that the NZ central bank should be leaning against this latest asset price inflation. Ultimately, the cash rate is a blunt tool, which, yes, can sometimes put upward pressure on the currency and has a global context to work within. No-one is arguing for a stiff cash rate, even a more neutral-looking one. What we are doing, however, is questioning the amount of fuel the Bank is pouring on the housing market fire, with its policy choice of exceptionally low interest rates.

Perhaps an overcooking in asset prices is the rat we have had to swallow in order to support the broader economy and its CPI pulse. If so it seems like an awfully big rat (of the type that ultimately proved the undoing of the global economy and financial system…and long has been the indigestion).

But then who's to say less-low rates would have meant for a weaker path of NZ GDP and CPI path? Of course, this thought is anathema to those who see the OCR as an all-powerful joy stick. Those, also, who have probably been quick to blame the Reserve Bank's rate hikes of 2014 for slowing NZ GDP and CPI. Never mind the role of collapsing dairy and oil prices in these outcomes, as an example, or the many other things that have affected growth and inflation along the way.

Central banks certainly appear to think that what they do is crucial for macro-economic outcomes (even when we're often arguing over 25 basis points at a time). However, when it comes to assessing cash rate "stimulus" then we need to control for the myriad other things having an influence. This includes the natural passing of. Many economies and markets have a habit of getting back on their feet in spite of, not because of, what the policymakers do.

# A Bit Rich

What seems reasonably clear, however, is that low interest rates have been affecting asset prices, via quite traditional channels. Indeed, if you had asked someone ten years ago what you'd get if the NZ economy was in reasonable shape and mortgage rates were dropped to about 4%, we're pretty sure the answer would be house prices going nuts. There is nothing new in this.

It also bears mentioning that central banks have so desired the strength in asset prices we're witnessing, as a deliberate transmission mechanism of their super-easy policy measures. So it would be disingenuous for any central bank to then turn around and dissociate itself from the resultant richness in asset prices. "It's not us it is immigrants, and the local councils, and the tax rules, and foreigners…"

In truth, central banks, globally, are going out of their way to engender very low and relatively flat interest rate curves. Granted, some of this shape echoes slow economic growth and low inflation – and expectations that this will persist. However, there is also a lot of distortion being imparted by central banks.

The Vice-Chair of the Federal Reserve, Stanley Fischer, for instance, has indicated that the Fed's much-expanded balance sheet has depressed long-term US interest rates by as much as 100 basis points. Other studies have estimated additional depressing effects on US

interest rates from the monetary policy measures being pursued by the likes of the Bank of Japan, the ECB and the Bank of England.

Only after we can abstract from all these extraordinary policy measures of central banks, could we begin to get a sense of underlying (call them "natural") interest rates. Only then could we truly relate the "new normal" interest rate concepts back to growth and inflation, not to mention the extent of global savings glut we're supposed to have these days. Until then, however, it will remain a muddied debate. It will certainly be a long time before the major central banks return their balance sheets to anything like their pre-GFC proportions.

# Housing Affordability – Let's Be Honest

Let's imagine, however, that NZ homes do become "more affordable". What does this really mean? Does it imply, for example, that Auckland's house prices will reverse the near-70% they have risen since 2012? This is essentially what's suggested by economic fundamentals – such as incomes, rents, even construction costs – if historical trends and metrics are to be respected (not that we can see any immediate trigger for such a correction). But how would a drop of that size even begin to be stomached by everyone concerned?

The local banking system would be robust, according to RBNZ stress tests, even to a severe house price correction. This fortitude is being aided by the equity buffers inherent to the Reserve Bank's LVR policy. However, this is not to say that homeowners' equity would be invulnerable. The LVR policy might just mean a chunkier amount of equity to lose, for latecomers to the house price party. This could, in effect, be their retirement (Kiwisaver) funds, or parents' money, going down the dunny.

This is especially so, if a house price correction feeds back into the real economy, hitting construction in particular and jobs more generally (as typically becomes the process). It would be a deflationary force in more ways than one, in other words – one that the RBNZ can and should genuinely worry about.

All that we have really seen to date, however, is that the moment someone suggests house prices should best come back a bit, especially in Auckland, it becomes a political football. The default position appears to be that so long as house price inflation slows, even goes flat, then we can grow into these over-sized house prices. Practically, however, this means scant change in the affordability of home prices as we know it, for a very long time. This is not opinion so much as schoolboy mathematics.

But the problem with NZ house prices is not even a prospective one. The real issue is the heights to which they are already ascending. It stands out like the proverbial, as much as mortgage rates do to the downside – amid an economy that is otherwise looking normal. So even if some of the broader demand forces in the housing market abate, and supply factors respond, people will still be able to "afford" to pay very high prices for homes while interest rates stay this low. However, to the extent that interest rates go back up…