3 December 2007

Housing down, but inflation not out

Why the housing downturn will not end the interest rate cycle

- **The weak housing market will reduce inflation pressure via the wealth effect, but the RBNZ cannot relax yet.**
- **Rents are set to rise 6% p.a., creating a new source of inflation.**
- **The dairy boom alone will outweigh the housing market in its effect on spending and inflation.**

New Zealand's house price boom is over, killed off by high interest rates. Annual house price inflation is on target to hit zero before the middle of 2008. That will come as a shock to an economy that has experienced double-digit house price growth for five years running. Withdrawing equity from property to finance consumption, which has come to feel like a birthright, will become difficult or impossible. Some retailers will be hit hard, especially those selling big-ticket items in the cities. House building, which has already slowed, will slow further. A range of related industries, from furniture movers to banks, will feel the pinch. And with spectacular capital gains no longer on offer, landlords will not be content to sit on their paltry rental yields. Rents will rise.

It is clear that the housing downturn will cool the economy. Does that mean the Reserve Bank can relax? We think not. In this bulletin we survey the *inflation* consequences of the house price downturn. The current house price downturn is unusual because it is being driven by high interest rates rather than a weak economy. Things will play out differently. The strongest external economic conditions in three decades will generate inflation pressures to outweigh the moderating influence of the housing slowdown. High interest rates and strong wage growth will drive rents substantially higher, creating a new inflation bugbear for the Reserve Bank. We will begin by detailing our forecast for rents.

The outlook for rents

Rents make up 6.9% of the CPI, or 12.8% of non-tradables inflation. They have been subdued for years, rising at an average annual rate of just 2.2% over the past four years, and helping to keep overall inflation in check. We predict that rent inflation will accelerate rapidly to 6% per annum, and will stay that high for five years. Rents could generate quite a headache for the Reserve Bank, by adding 0.4 percentage points to the CPI each year. There are four main reasons we expect rents to rise.

1. **High interest rates will reduce supply and increase demand for rental housing.** With mortgage rates above 9%, rental yields at 4%, and little prospect of capital gain, the numbers just do not stack up for landlords. Over the next few years there will be fewer landlords keen to build new properties and expand the rental stock. Therefore the supply of rental housing will be lacklustre.

   At the same time, demand for rental property will rise. Consider the equation from the point of view of a tenant deciding whether to continue renting or buy. To rent costs around 4% of a house's value per annum, whereas a mortgage costs over 9%. Local authority rates and insurance are going up, but you don't pay those when you rent. And capital gains, a key benefit of ownership, look like being pretty low for some time. Home ownership is looking either less attractive or downright unaffordable to an increasing number of people. Fewer people buying means more people renting – an increase in demand for rental properties.

   Lacklustre supply and increasing demand is the classic combination for market forces to place upward pressure on rents. We estimate that rents need to rise by 34% to bring them back into line with current house prices – a process that could take five years.

2. **Wages will rise.** Market forces may suggest higher rents, but rent increases always depend on affordability. Currently affordability is good, suggesting rents do have room to rise. Rents are cheaper than normal as a proportion of the average wage. And the average wage itself is set to increase strongly – New Zealand's unemployment rate has dropped to 3.5%

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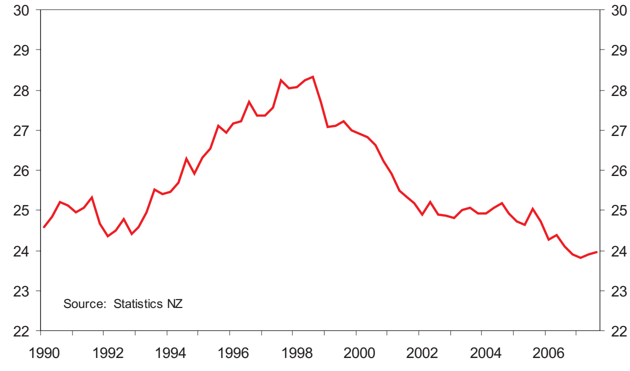
and the best is still to come. We are forecasting the average wage to increase by 5% per annum, and rents to increase by 6% per annum, meaning only a slight deterioration in average affordability.

Figure 1: Average rent as % of average wage

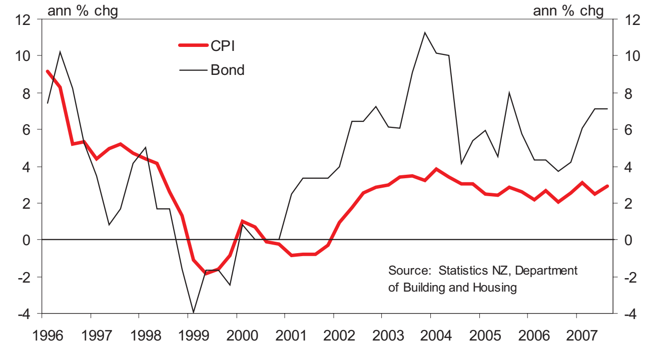


3. **Housing New Zealand rents will rise.** Housing New Zealand (HNZ) owns almost 17% of the rental accommodation in New Zealand. In the 1990s HNZ properties were let at market rentals, but since 2000 tenants have instead paid much lower Income Related Rent (IRR). The change in policy knocked 8.8% off the rents component of the CPI in March 2001, or 0.6% off the total CPI. As more tenants have moved onto IRR, a further 0.9% has been knocked off the rent component of CPI. IRR has helped the Reserve Bank out quite substantially over the years, but the effect is now past.

   In fact, HNZ is now boosting inflation, because HNZ rents are rising faster than private rents. HNZ rents rose 17.8% between June 2003 and June 2007, while private rents rose just 10.4% by our calculations. This presumably reflects an increase in the incomes of HNZ tenants, thanks to CPI-indexation of social welfare benefits, the very strong labour market, rapid increases in the minimum wage, the introduction of Working for Families, and the increased availability of part-time work. We expect these trends to continue. The lowest end of the income spectrum will lift even more in coming years, with a consequent further increase in Housing New Zealand rentals. This will have a small upward effect on rents as measured in the CPI.

4. **Median new rentals are already on the rise.** The Department of Building and Housing's bond lodgement data shows that the median *new* rental contract has been going up by around 6% per annum for a number of years now, and has recently accelerated. To some extent this simply reflects better quality rental properties coming onto the market (bond lodgements are not quality adjusted like the CPI). But the bond lodgement data could also be a harbinger of higher CPI rents in the near future. Rents tend to increase when new tenants move in. The new rentals data therefore reflects market changes instantly whereas the CPI, which measures the rent paid by the full spectrum of tenants, moves more slowly. New Zealand data is insufficient to accurately gauge the lag from bond data to CPI rents, but Westpac economists in Australia estimate that when their bond data goes up, Australian CPI rents follow between six months and two years later.[1]

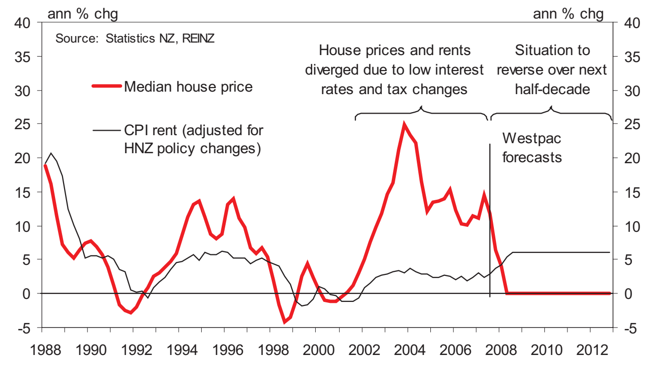
Figure 2: CPI rents versus median new rental from bond data



Rents and house prices to diverge

Our forecast for rising rents and stagnating house prices is unusual. Normally, house prices and rents move together, as both respond to macroeconomic conditions – for example, falling unemployment in the mid-1990s led to strong house price increases and rent increases. During the brief recession of 1998 both house prices and rents fell. But during the 2000s low interest rates and tax changes caused an explosion in property prices over and above what economic conditions would normally dictate. The same factors kept rents low – landlords were chasing tax relief and capital gain more than yield. For the latter part of the decade, we expect the situation to reverse. A long period of high interest rates will subdue property prices but boost rents.

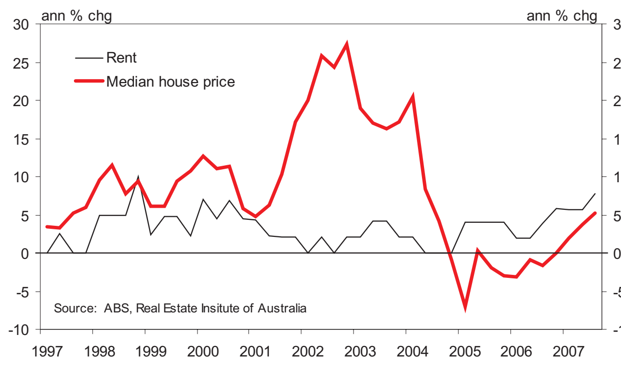
Figure 3: New Zealand rents and house prices



[1] http://www.westpac.com.au/manage/wrap.nsf/vPdfUrls/76B9C9E6855D75E2CA2573920013A4FA/$File/er20071113BullModellingRents.pdf?OpenElement

The Sydney housing market serves as an interesting precedent for our predictions. In the early 2000s, Sydney house prices boomed while rents were stagnant. But house prices fell in 2004 and stagnated for four years thereafter. The lack of capital gain, combined with higher interest rates and tax changes that made other investment vehicles more attractive than property, led to a shortage of new rental property being built. Rental inflation accelerated as a consequence.

Figure 4: Sydney house prices and rents



Construction cost inflation – easing, but only a little

Construction cost inflation is tightly tied to the housing cycle. Rising house prices incentivise the construction of new dwellings and allow people to finance renovations. The extra demand for builders tends to push construction prices up. The "purchase of new dwellings" sector accounts for 4.7% of the CPI, and has been a key cause of elevated non-tradables inflation over recent years. In past housing downturns, construction cost inflation has come off, and inflation pressure has eased.

In the current cycle, construction cost inflation has already eased from 9% p.a. to 6%. But despite the housing downturn, construction cost inflation now seems unlikely to slow much further. The non-residential construction industry will pick up substantially next year due to shortages of office space and planned infrastructure projects. Non-residential construction will suck up many skilled and unskilled workers from the ailing residential construction industry. The mining and construction boom in Western Australia and Queensland will attract other workers across the Tasman. So even as residential construction in New Zealand slows, the shortage of builders will continue. Furthermore, with the world economy the strongest it has been for decades, the cost of construction materials is rising dramatically. Construction cost inflation will remain stronger than in previous housing downturns.

The weak housing market and consumption

The main way that the housing market affects inflation is the "wealth effect." When house prices rise people feel wealthier and they spend more. This extra spending is called housing equity withdrawal, and it comes about in two main ways:

- **Active equity withdrawal** is where people extend the mortgage and spend the proceeds.
- **Passive equity withdrawal** occurs when retirees downsize in an inflated market, ending up with more to spend than they bargained on. Meanwhile, the buyer is more indebted. Although one person is doing the spending while another pays off the debt, the net effect for the economy is the same – more debt and more spending.

We estimate that over the past two years, $9b of equity has been withdrawn from the housing market. Over the next two years, we expect only $5b of equity to be withdrawn. That means there will be $4b less money available for consumption, equivalent to 2% of private consumption. Recent experience in the UK and Australia shows how consumer spending can react to housing market slowdowns – New Zealand consumption is thought to be even more sensitive to house prices.

Figure 5: Australian house prices and consumption

Figure 6: UK house prices and consumption

The reduction in housing equity withdrawal will be important. But it pales in comparison to the effect that the dairy boom will have on spending. We estimate that over the next two years, New Zealand dairy farmers will receive an unbudgeted cash windfall of $7.2b – almost double the housing market's effect! The government's coffers will swell with dairy cash, meaning either more government spending or bigger tax cuts for the whole of New Zealand. And dairy is just the vanguard – other food prices are likely to rise in the next couple of years, creating a whole new round of good fortune for New Zealand producers. The Reserve Bank itself is well aware that the food-commodity boom will vastly outweigh the slowing housing market. Consider the following quotes from the September *Monetary Policy Statement*:

"…even if the housing market does turn down sharply, inflation pressures persist elsewhere in the economy."

"We forecast continued robust [GDP] growth throughout the projection horizon, with the flow-on effects on aggregate activity of the stronger terms of trade and strong labour incomes expected to outweigh the negative effect of higher interest rates, tighter credit conditions, and a high New Zealand dollar."

Conclusion

Normally, stagnating house prices would signal an economic downturn, easing inflation pressure, and lower interest rates. But these are not normal times. Firstly, the slowdown is occurring at the same time as the strongest external conditions that the New Zealand economy has seen in three decades – an unprecedented combination. Getting on top of the housing market will not be sufficient to tame inflation this time. Housing will be disinflationary, but the effect will be swamped by other inflation pressures including the dairy boom, fiscal expansion, the tight labour market, and the strong economy in Australia. Interest rates are more likely to go up than down.

Secondly, with interest rates remaining high despite the housing slowdown, there will be an increase in demand and a decrease in supply for rental properties. Rents will rise, facilitated by an improving ability to pay. Higher rents will generate a new source of inflation pressure that the Reserve Bank must combat.

Overall, the housing slowdown will help, but it will not solve all of the Reserve Bank's inflation woes. Judging by recent communications, the Reserve Bank agrees. We expect the Reserve Bank to hike the OCR twice next year (unless the global credit market situation worsens substantially). We will be very surprised if the hikes are not foreshadowed in Thursday's *Monetary Policy Statement*.

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