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HOUSING: Fundamentals and interest rate perversity

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KEITH RANKIN CAPTION: New Zealand is facing an investment crisis not a housing crisis. FAIRFAX

The Reserve Bank has undermined the conventional wisdom that high interest rates cool the housing market.

THERE has been a lot of misinformation about what's been driving the New Zealand housing market since 2004. It's time to look at the fundamentals of that market, to see what putative causes of the extended bubble can be dismissed, and to see why equilibrium cannot be achieved under present conditions.

It is only since 2005 that the housing investment market has departed from historical precedent.

Normal experience, at least from the 1970s, is that over a period of seven to nine years, real estate values jump ahead of the wider economy for a few years of above average GDP growth, and then paused as the rest of the national economy caught up. The residential property boom of 2002-04 fitted that pattern. The "second-wind" property boom from 2005 does not.

House prices are determined simultaneously in three separate markets: accommodation (essentially a rented good), real estate (a financial asset, like equities, that appreciates as the economy grows) and mortgage finance.

For the basic fundamentals, we have to look to the first of these three markets, namely housing as a rented good. An owner-occupier is simultaneously both a tenant and a landlord, a fact that is fully recognised in our GDP data, which include a component for the rental value of owner-occupied housing. Owner-occupied housing includes a rental component in its price.

House prices should be determined essentially by rents, just as share prices are determined by dividends and bond prices are determined by interest rates. The fundamentals are (i) the demand for a roof over our heads and a piece of land to use for private recreation, and (ii) the supply of houses, apartments and land for subdivision.

The demand for places to live has been soft since 2003. Net migration fell sharply in 2004. For the three years 2001-2003, net migration was 147,000. For 2004-2006, it was 35,000. Further, New Zealand suffered a baby bust from 1975. Birth rates were lowest from 1976 to 1986. Thus, based on demographic fundamentals, new household formation is relatively slow at present.

A number of commentators have turned to supply-side arguments. Restrictions in the supply of new land for housing is said to be the cause of continued rapid increases in property prices. But what has changed? There have been no sudden changes to laws and by-laws that have restricted supply since 2004.

So we must acknowledge this is not a housing crisis. It's an investment crisis; a bubble in asset values, much like a sharemarket bubble. Rational expectations theory tells us that market mechanism itself closes unexploited profit opportunities. Underpriced assets will appreciate quickly, while overpriced assets will depreciate in real terms. This is clearly not happening, suggesting that there is a counter-force that prevents the real estate market from working as free financial markets are supposed to work.

That counter-force is fuelling demand for investment housing by fuelling expectations of capital gain in excess of interest rates. That force arises from an oversupplied mortgage market.

The economics textbook that I teach from gives the following example: "If mortgage rates rise from 5% to 10%, but the expected rate of increase in housing prices rises from 2% to 9%, are people more or less likely to buy houses?" The answer is obvious when put that way.

The problem clearly is the expected rate of increase of house prices is much higher than it would be in a healthy balanced economy. What drives those expectations?

Expectations of the immediate future are formed adaptively, from consistent experience over the previous five years or so. In 2004, expectations were the bubble had run its course and the housing investment market would slow, in line with housing fundamentals.

That rational expectation was not realised, because banks increased their mortgage lending relative to other forms of lending while also increasing lending overall.

Indeed, as New Zealand interest rates increased, banks had access to increased quantities of foreign savings seeking higher fixed-interest returns than were available in their countries of origin. We can hardly blame the banks. Why were the banks more keen to expand mortgage lending than other types of lending?

In the process of banks increasing their New Zealand assets and their foreign liabilities, the exchange rate became grossly overvalued. And, because the exchange rate has been so overvalued, the banks reduced their lending to the struggling tradeable goods and services sectors (especially the non-farm tradable sector which has less collateral than the farm sector). Less lending to one sector means more lending to another: investment housing.

It all boils down to New Zealand having interest rates (and expected interest rates) that are determined by the Reserve Bank.

The frustrating irony is that the very reason, we are told, the Reserve Bank keeps interest rates high is that high interest rates are supposed to cool the housing market. Yet high interest rates have not cooled the housing market.

Rather, as I have shown, high policy driven (as opposed to market driven) interest rates create the conditions that keep the banks flush with foreign money, and that discourage the banks from lending to anyone without collateral. What else are the banks to do, under these circumstances created by monetary policy, other than to feed the markets that give them the greatest possible returns?

The Reserve Bank, by keeping interest rates high and assuring investors interest rates will stay high, is fuelling rather than dowsing the investment housing fire.

How will it end? It will end when it becomes favourable for banks to re- orient their lending towards the foreign-exchange earning and foreign-exchange saving sectors. In other words, it will end when supported interest rates are allowed to fall to appropriate market levels, and when the exchange rate follows a similar downward path.

Of course, when that happens, many of those property investors who require immediate capital gains will have to put their properties on the market, leading to capital losses until housing prices more accurately reflect the rental value of housing.

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