

## Understanding the New Zealand Housing Market

by Keith Rankin, 18 February 2008

Helen Clark ([speech](#) 12 Feb) and many others see affordable housing as one of the big political issues of 2008. Unfortunately her thinking about the issue errs in two main respects: she sees the problem as one of a lack of supply of houses, and she equates "affordable housing" with "affordable property ownership". She has been lured into seeing an undersupplied market. The truth, [reported](#) in the *NZ Herald* the next day, is that the housing market is oversupplied; a "buyers' market".

Housing – meaning a place to live – is a basic necessity of life. It is a legitimate role of government to intervene where necessary to ensure that everyone can have a safe and healthy place to live. *The market in housing as a place to live is the rental market.*

Equity in residential property, however, is a financial asset; like shares and bonds. It is not a responsibility of government to make it possible for everyone to acquire risk-laden financial assets.

Further, the argument that there are social benefits in having a very high proportion of a country's residents living in homes that they own is often assumed but rarely examined. Indeed, living in new housing subdivisions may actually have substantial disadvantages (refer "Dead-end streets" by Valerie Schuler in *The Aucklander*, February 6).

Can we realistically argue that communities in relatively new mortgage-belt suburbs such as Henderson Heights or Flatbush have stronger social cohesion than Mt Albert or Grey Lynn, where substantial numbers of rental homes are interspersed with owner-occupied dwellings?

The fundamentals of the housing market are simple. *The normal market-clearing price of a house and section is determined by its rental value.* For example, if landlords require a five percent return on their assets, then the capital value of the assets should be approximately 20 times their rental values.

If the supply of housing is relatively fixed (as we are told it is) then changes to the rental value of housing are determined mainly by changes in the demand for places to live. Changes in the demand for housing are determined by the rates of population growth and income growth. And by other demographic factors such as the rate of divorce and the propensity for adult children to leave home.

Rental values of housing in New Zealand have not increased much since 2003. Reduced immigration, increased emigration, and reduced numbers of New Zealanders in their 20s and early 30s (due to low birth rates from 1975 to 1987) all mean there has been relatively little growth in the demand for places to live in New Zealand since 2003. *There is no housing crisis. Rather, there is a crisis in New Zealand's financial markets.*

On the supply side of housing, the value of residential property as a financial asset is influenced by returns on other assets. Thus, if interest rates increase, the capital values of the housing stock fall, because landlords can now get much better returns on bonds

than on property. If landlords now require a ten percent return instead of a five percent return, then the fundamental market values of houses falls from 20 times the rental value to 10 times the rental value.

There is a housing investment crisis in that the fundamental market values of the housing stock have fallen sharply since 2004. Nevertheless, actual (as opposed to fundamental) selling prices continued to rise until 2007, in a process sometimes described as a "rational bubble". Hence we have a crisis today in that owners of real estate refuse to sell their properties unless the buyer pays a bubble price that is well above what the property is really worth. (There are still many buyers willing to pay such prices, but not nearly as many as in 2007.)

The housing market, like the labour market, is flexible upwards but sticky downwards. The residential property market is unable to quickly adjust to its equilibrium (ie fundamental) market values. Rather, there are low sales volumes as vendors hold out for unrealistic prices.

Under these disequilibrium conditions (ie conditions where the market does not clear) rental values will increase relatively slowly, as owners lease the properties they would like to sell, rather than leave them unoccupied.

In 2008, low income households should have less difficulty than usual finding somewhere to live. Under no social circumstances should government be subsidising families into home ownership at the bubble prices vendors continue to ask for.

In 2008-09, either the housing bubble will burst as vendors are forced to substantially reduce their prices, or economic growth or inflation will lead to a catch-up growth of rental values.

The latter (growth or inflation) scenario is typical of New Zealand's economic past. The former (burst-bubble) scenario is more likely this time, however. Further, the addition of new public housing to an already oversupplied housing market will add to the likelihood of a dramatic reduction of house prices.

The outlook for economic growth is very weak. An overstretched labour market, an overvalued exchange rate, and interest rates that deter business investment in labour-saving technology all conspire to keep New Zealand's economic growth rate below that of our trading partners.

The outlook for inflation is also weak. By law, the Reserve Bank is required to prefer a recession to a period of inflation. Recessions are counter-inflationary, so a Reserve Bank induced recession this year or next year is unlikely to provide inflationary conditions that could re-establish an alignment between actual and fundamental prices in the residential property market.

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Other references (all 13 Feb 2008):

*NZ Herald* [report](#) of PM's Statement to Parliament 2008

*NZ Herald* [editorial](#) repeating odd claim that "Fundamentally the problem is the undersupply of affordable homes". The problem is that current prices do not reflect fundamental market values.

Postscript (19 Feb 2008):

*NZ Herald* [publication](#) of version (written on 13 Feb 2008) of this article