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## RODNEY'S RAVINGS

Property tax changes mean few OCR hikes are needed

### EXECUTIVE SUMMARY

It was pleasing to see that at the same time as hiking the OCR 0.25% to 3% on 29 July, Governor Bollard stated that further increases would be less than previously expected. However, there is still a fundamental and glaring error in the RBNZ's assessment of economic growth prospects. To be kind to the RBNZ, all the 10 economic forecasters surveyed by NZIER in June are making the same mistake. In contradiction to how things actually work, they are predicting significant increases in interest rates and robust growth in residential building activity.

No surprisingly, a leading figure in the residential building industry – Richard Carver, Director of Jennian Homes – has taken the RBNZ and the economic forecasters to task over their residential building forecasts. And this is not a case of sour grapes. Our leading indicator analysis, which has a fantastic track record at picking the near-term outlook for residential building among other things, has identified the risk of an imminent and significant fall in the number of consents for new dwellings over the next two quarters.

There is more to the story than the economic forecasters having a topsy-turvy view of the relationship between interest rates and residential building activity, and them not understanding how people are responding to the housing affordability nightmare. The initial indications are that the changes in property tax introduced in the Budget will have the same impact on housing activity as a 1-1.5% increase in mortgage interest rates. If this proves to be the case it hugely undermines the need for the RBNZ to hike the OCR over the next 6-12 months. The key question seems to be not whether this will halt OCR hikes, but how quickly Governor Bollard will realise that the RBNZ's forecasts for residential building activity and economic growth are still way too optimistic.



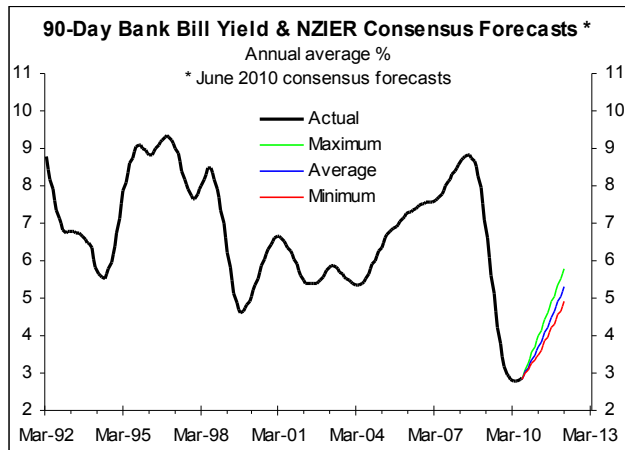
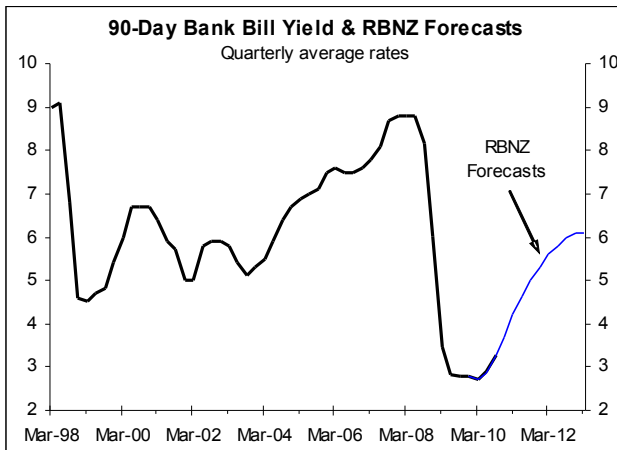
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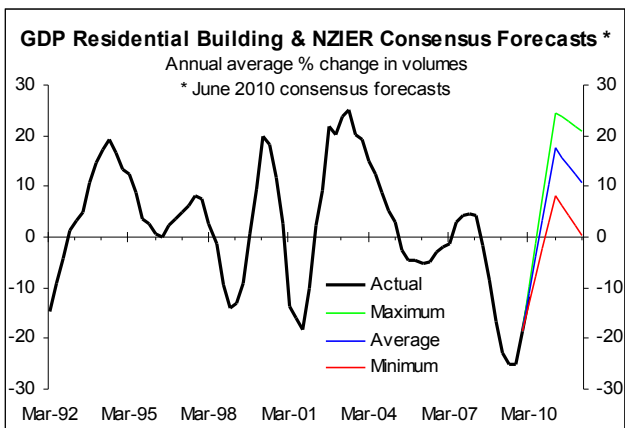
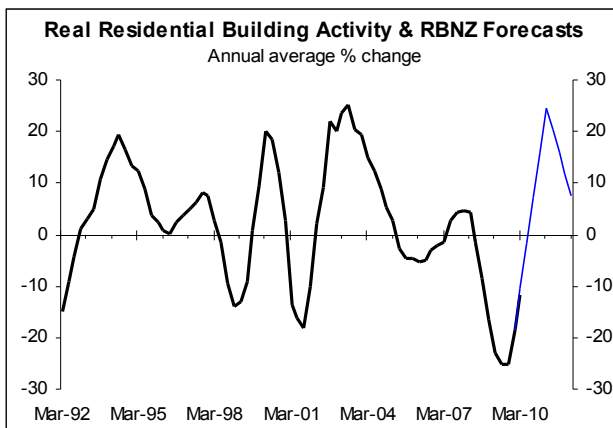
## Is NZ heading for a residential building boom or bust?

It was pleasing to see that at the same time as hiking the OCR 0.25% to 3% on 29 July, Governor Bollard stated that further increases would be less than previously expected: "The pace and extent of further OCR increases is likely to be more moderate than was projected in the June *Statement*" (Source: <http://www.rbnz.govt.nz/news/2010/4127034.html>). However, the governor also said: "some further removal of monetary policy stimulus is appropriate at this stage. Even after today's move, the level of the OCR is still very supportive of economic activity" (i.e. expect a series of further OCR hikes to come, just somewhat slower and less than the large increases the RBNZ predicted in June).

The RBNZ doesn't provide predictions for the OCR, but it predicts the 90-day bank bill yield, the benchmark short-term wholesale interest rate, but these predictions are akin to OCR forecasts. In June the RBNZ predicted aggressive increases in the 90-day bank bill yield over the next 2.5 year (blue line, left chart). The 10 economic forecasters surveyed by NZIER in June, including the bank economists, on average predicted similar increases in the 90-day bank bill yield as the RBNZ over the next two years (blue line, right chart). Even the most pessimistic of the 10 forecasters predicted large increases in the 90-day bank bill yield over the next two years (red line, right chart). All of these forecasters were singing roughly the same tune as the RBNZ in June.



The 10 forecasters surveyed by NZIER in June were also on average predicting a similar outlook for annual average growth in residential building activity in the 2010/11 and 2011/12 March years as the RBNZ (blue lines, charts below). According to the economic forecasters, residential building activity will grow somewhere between 8.3% and 24.6% in 2010/11 and somewhere between 0.3% and 20.8% in 2011/12, with average predictions for these two years of 17.5% and 10.6%, respectively. None of the 10 forecasters were predicting falling residential building activity over the next two years (red line, right chart).



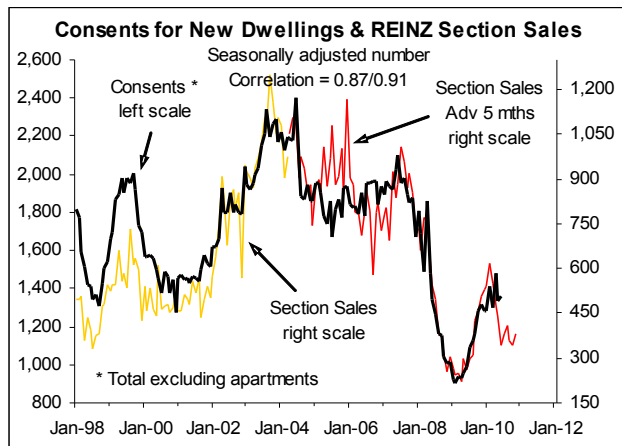
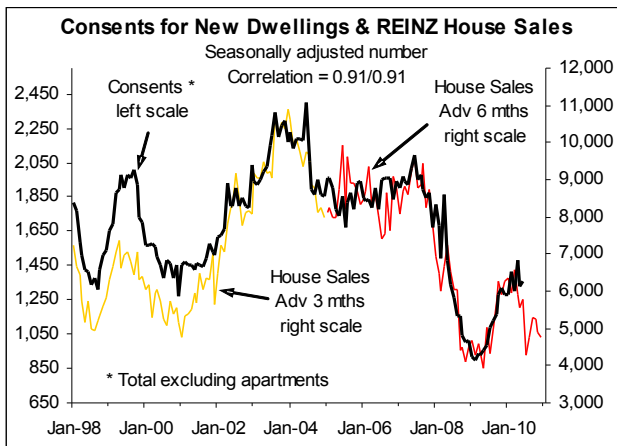
Anyone with any vague knowledge of what drives cycles in residential building activity should quickly see the blatant contradiction in the economists' interest rate and residential building forecasts. If interest rates were to increase anything like what the forecasters are predicting over the next couple of years residential



building activity will tumble. In our **Housing Prospects** reports we show the consistent inverse relationship between existing house sales and interest rates (see <http://www.sra.co.nz/housing.html> for info on these), while in our **Building Barometer** reports we show the equally consistent inverse relationship between interest rates and residential building consents (see <http://www.sra.co.nz/building.html> for info on these). The unique framework we have for predicting the near-term outlook for housing and residential building means our near-term predictions are second to none and even pretty reliable.

The economic forecasters have a long standing tradition to uphold, which is to get it wrong more often than they get it right. This makes them easy targets for criticism, but to predict large increases in interest rates at the same time as predicting robust growth in residential building activity is just plain dumb!!! And the charts below, that are regulars from our **Building Barometer** reports, show how dumb the economists' residential building predictions are likely to be.

The left chart shows the number of house sales reported by REINZ each month as a useful leading indicator of the number of consents for new dwellings (excluding apartments), with the red house sales line advanced or shifted to the right by six months reflecting the lead house sales have had over consents since the consenting process was altered in 2004/05. The right chart shows the number of REINZ section sales as an equally useful leading indicator of consents, with the red section sales line advanced by five months (i.e. providing a prediction for consents over the next five months). The tumble in house and section sales over the last couple of quarters point to the risk of significant downside in the number of consents for new dwellings over the next couple of quarters. These charts make a mockery of the economists' forecasts for residential building, which in turn makes a mockery of their interest rate forecasts.



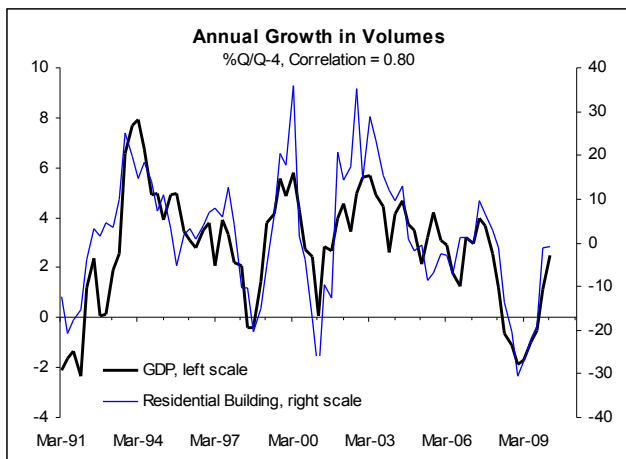
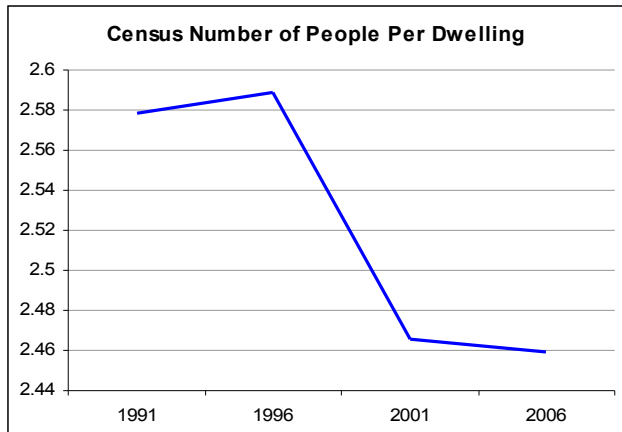
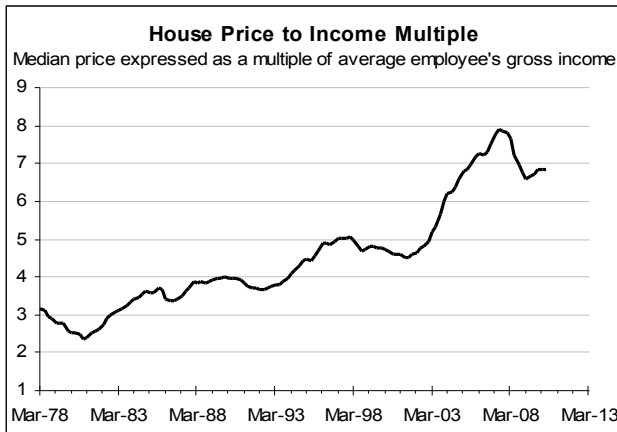
It should be no surprise that a prominent figure in the residential building industry – Richard Carver, Director of Jennian Homes – has spoken out publically about the situation. Some people will always be suspicious of the motives of business leaders, assuming they are driven purely by self-interest, which will be partly the case, but in this instance I believe Richard has been driven to making a public statement because he has well-founded, firsthand knowledge of how misplaced the RBNZ's predictions for residential building are. As he says in the media release: “new housing growth is stalling and maybe starting to fall away again”. “The Reserve Bank’s assumptions on housing growth are flawed”. “The indicators are no longer pointing to an upswing in residential construction, and consumers are still holding back.” “Slowing immigration and the grossly optimistic view on pent up new housing demand by many of New Zealand’s leading economists will prove the timing of these OCR increase assumptions to be flawed. The predicted housing shortage, at this stage, appears to be just a myth, as every departing Kiwi, mostly heading for Australia, will tell you, along with 20-plus-year-olds who are more than happy staying at home with their overburdened parents.” Source: <http://www.sra.co.nz/pdf/JennianMediaRelease.pdf>

So what is going on with the economists' residential building forecasts and why can they be so, so wrong! Having many, many years ago started my career as an economists working at the RBNZ, including having been involved in building a version of the RBNZ's forecasting model, I have seen first hand what really drives the central bank's economic forecasts. While the bank economists in general don't even have proper forecasting models and when it comes to predictions for the likes of interest rates and residential building have a tendency to “flock”.



When it comes to interest rate forecasts (and exchange rate forecasts) the economists almost without exception predict that they will revert back to around the historical average or mean. All they are doing is predicting that the 90-day bank bill yield will increase to around the historical average level. There is no science in this, just an assumption that things will return to “normal”. The same thing is driving the economists’ residential building predictions (i.e. on average they are predicting that the level of residential building activity returns to around an average level over the next two years). But we live in the aftermath of a speculative bubble in house and section prices that still hasn’t burst, associated with the housing bubble is stacks of debt, and we are still living in an environment in which the international financial crisis is having and will continue to have a major impact. In short, to assume that the level of housing activity and interest rates will return to “normal” or average levels is either naïve or dumb, but probably both.

As covered in the **Housing Prospects** reports, house prices remain extremely high compared to incomes (left chart). This is giving people the incentive to economise on housing (e.g. young people/couples stay at home longer or move back home; people take in boarders to help pay the rent/mortgage; people convert garages to living quarters; retired people hit by finance company failures move in together). In the 2006 Census there were 2.46 people per house on average. If the number of people per house increases to just 2.5 it means that roughly 26,400 less houses are needed. This is what is currently going on in NZ and is why, as Richard Carver says, “The predicted housing shortage, at this stage, appears to be just a myth”. It is just a myth even if some of the economic forecasters don’t realize it yet. People responding to a major incentive, like extremely expensive housing, is the sort of thing that economists are taught should happen when they study at university, but for some reason they are too willing to assume this sort of behaviour away in their desire to predict that things will return to “normal”.



The housing market isn't the be all and end all of economic growth. The story at the moment is about the economic recovery that started in the housing market and export sector filtering around the economy. This is the “broadening” of the economic recovery driven by the “economic multipliers” of text book economics we discuss in the **Interesting Times** reports (see the following for info on these - <http://www.sra.co.nz/interesting.html>). However, as the adjacent chart shows, cycles in residential building activity are critical swing factor in economic growth cycles. If residential building activity falls significantly, economic growth will slow significantly!

Residential building on its own doesn't make up a large share of economic activity – only 3.6% in the year to March 2010 (normally around 5%) – but it feeds many other industries including significant parts of the manufacturing sector. If residential building activity falls as much over the next few quarters as the fall in the number of REINZ house and section sales are predicting, negative economic multipliers will start filtering around the economy over the next coupler of quarters. This means that economic growth will be well below the 3.6% predicted by the RBNZ for the 2011 calendar year.

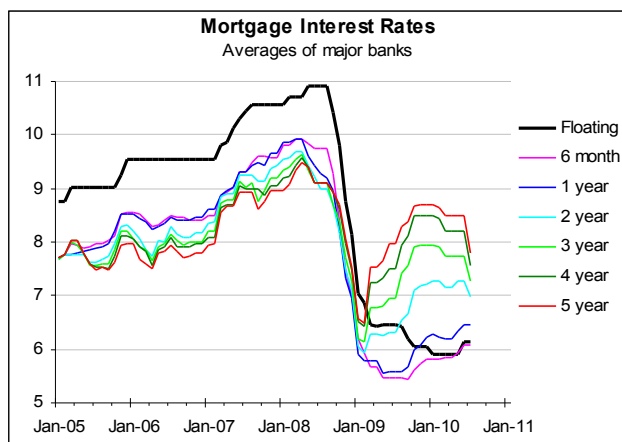
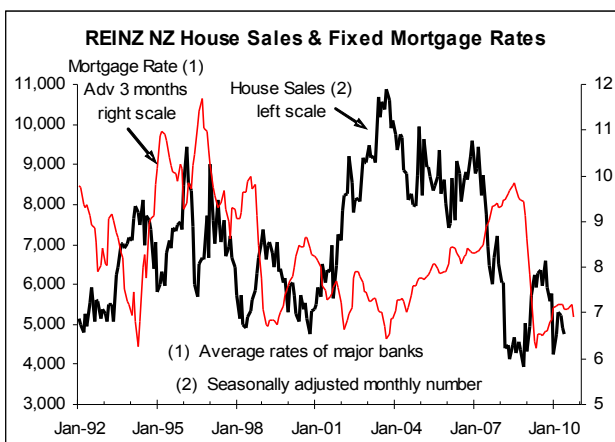


### Property tax changes mean few OCR hikes are needed

But there is more to the story than the economic forecasters having a topsy-turvy view of the relationship between interest rates and residential building activity, and them not understanding how people are responding the housing affordability nightmare. The changes in property tax introduced in the Budget have had the same impact as a 1-1.5% increase in mortgage interest rates, which hugely undermines the need for the RBNZ to hike the OCR over the next 6-12 months.

Why has the number of house sales reports by REINZ tumbled back towards the trough levels experienced during the 2008 recession? The left chart shows the inverse relationship between the number of house sales and the average mortgage interest rate discussed on pages 2-3. As discussed in the **Housing Prospects** reports, more than just interest rates driving house sales, but interest rates are the most important cyclical driver. If all other factors are stable, a 1% (one percentage point) increase in the average mortgage interest rate will result, with around a three month lag, in a 1,150 drop in the number of houses sold each month. In that context, part of the sharp fall in the number of house sales this year can possibly be attributed to the earlier increase in the average mortgage interest rate. However, with floating and short-term fixed mortgage interest rates remain low (right chart), the increase in the average mortgage interest rate driven by rising medium-term and longer-term fixed mortgage rates (right chart), shouldn't have had as large an impact as normal. And even if we assume the increase in the average mortgage interest rate had the normal impact, it still only explains around half of the fall in the number of house sales.

Falling net migration is part of the story, as discussed in the Housing Prospects report, but the main candidate for the fall in house (and section) sales is the property tax issue can came to prominence early in the year and we have no doubt drove the tumble in the number of sales in January, when investors took fright at the prospect of tougher tax treatment of property investments. In our assessment the property tax changes have had the equivalent negative impact of a 1-1.5% increase in the average mortgage interest rate. If the fall in house and section sales is roughly mirrored in the number of consents for new dwellings over the next couple of quarters then the RBNZ and economic forecasters will have to make major revisions to their residential building, economic growth and interest rate predictions (i.e. life will go on a normal).



The key question at the moment is not whether this will halt OCR hikes, but how quickly the RBNZ will realise that its forecasts are way off the mark even after suggesting they have downgraded them on 29 July. We discuss in detail in the **Interesting Times** reports (see <http://www.sra.co.nz/interesting.html> for info on these) and the **Monetary Policy Briefing** reports (see <http://www.sra.co.nz/monetary.html>), which provide the best available insights on things like economic growth and interest rate prospects, why we don't expect short-term wholesale interest rates to increase anywhere near as much as the economic forecasters are predicting. Contact me if you want to know more about any of our reports, while if anyone wants to know what really drives economic growth there are some spaces still available at the Economic Workshop we are running on 3 August (see <http://www.sra.co.nz/pdf/EconomicWorkshops.pdf> for info).