Economic Bulletin.

9 April 2021

Shifting foundations – an update of our housing and economic forecasts.

- We have reviewed our forecasts in the wake of the Government's housing policy announcement in March.
- We now expect house prices to flatten out over the rest of this year, with moderate falls in the following years as longer-term interest rates start to rise.
- The key is that while highly-leveraged investors may be hit hard by the policy changes, they will no longer be the marginal price-setters in the market. Homebuyers and unleveraged investors will now take the fore.
- For the same reason, we don't expect a significant rise in rents.
- A moderate drop in house prices would not be a major concern in itself, but it is a significant downgrade from our previous forecasts.
- Consequently, we have also revised down our forecasts of real activity, particularly household spending.
- Monetary stimulus will need to remain in place for longer, in order for the Reserve Bank to meet its inflation and employment goals.
- We now expect the OCR to remain at 0.25% until 2025 (previously 2024).

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This Bulletin provides a fuller update of our economic forecasts, following the Government's housing policy announcements on 23 March. We now expect house prices to flatten out over the rest of this year, and to gradually decline in the following years. This is a substantial downgrade relative to our previous forecast, and has knock-on effects for our views on household spending, activity and inflation pressures. The upshot is a slower pace of recovery from the Covid-19 shock, which in turn will delay the Reserve Bank's progress towards its inflation and employment goals.

We now expect no OCR hikes until early 2025 (previously early 2024). This would act to slow the rise in longer-term interest rates, softening the impact of the tax changes on our house price, output and inflation forecasts.

We did consider the case for further easing – the RBNZ has emphasised that it is both willing and able to do more, including taking the OCR below zero, if conditions warrant. Our view is that OCR cuts would require evidence of a sudden lurch lower in consumer spending or homebuilding. If it's more the case of a slower recovery, we suspect that patience and a steady hand would be more appropriate.

The house call

The planned changes to the tax treatment of property investors are perhaps the most meaningful intervention into the housing market in decades. Our review on the day of the announcement set out what this means for house prices: removing interest deductibility tilts the playing field away from highly-leveraged investors, and towards homebuyers[1] and cashed-up investors. The willingness to pay of these buyers will set the pace for the housing market from here onwards[2].

In that article, we concluded that:

"House prices could settle around 10% lower over the long term. However, there could be much greater effects in the short term as some investors exit the market."

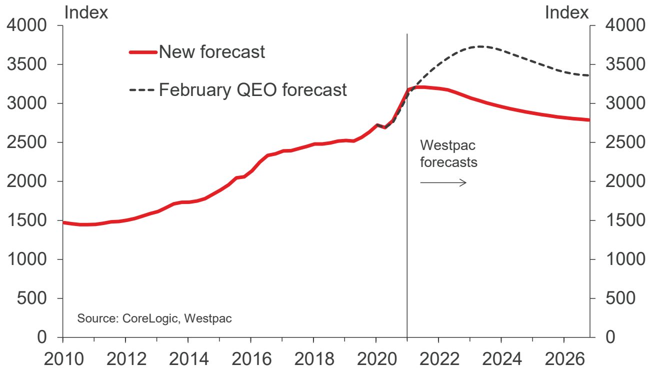
Since then, we've had the chance to work through our conclusions in more detail. We have changed our minds on one aspect: we're less concerned now about a sharp drop in prices in the near term. Sales will certainly slow, since leveraged investors are unlikely to be adding to their portfolios from here. But the phased removal of tax deductibility, plus the already-existing bright-line test, would argue against a rush to sell.

A better description would be that the tax changes have removed the upside for prices that we were previously expecting. The plunge in mortgage rates to record lows last year had a powerful effect on the value of housing as an investment, and we concluded that this had even further to play out. But homebuyers are in the driver's seat now, and their willingness to pay doesn't stretch as far. We're now forecasting house prices to flatten out over the rest of this year, an abrupt change from the rapid price gains we've seen over the past nine months.

The first part of our conclusion still stands, however. Mortgage rates have reached their lows for this cycle, and longer-term interest rates are already heading higher around the world as economic sentiment improves. As fixed-term mortgage rates start to rise – and this will precede any actual hikes in the OCR – house prices are likely to fall. By the end of 2024 we expect a cumulative 10% decline in prices from their current levels.

To be clear, a drop in house prices over the longer term has been a feature of our forecasts for some time; indeed it featured prominently in our most recent quarterly *Economic Overview*[3]. The tax changes have just brought the timing forward.

House price index forecasts



A sidebar on rents

The removal of interest deductibility will mean a higher tax bill for landlords. This has led to speculation (or accusations) that they will try to claw this back through big increases in rents. The reality is that, even in hindsight, it's hard to say how much policy changes contribute to rent increases. Rents rise over time anyway, and more so in areas where underlying housing shortages are worsening (compare the rapid rise in Wellington rents with the muted increases in Auckland over the last few years).

We come down on the side of no big increase in rents. The reasoning behind this is similar to our reasoning on house prices: leveraged investors are no longer the marginal price-setters in the market. They don't have to be 'made whole' in this new equilibrium – if they exit the property market, there are enough homebuyers and unleveraged investors to take their place.

In the short run this will mean some reshuffling, as investors sell to other investors or to homebuyers, and as tenants move or buy. And this is where some arguments employ a kind of sleight of hand, where this reshuffling somehow leaves us one house short. Don't be fooled: tax changes have no effect on the number of occupants or the number of dwellings. It's easier to see this if we shortcut the reshuffling process and imagine that tenants buy the house that they're currently living in[4].

In fact, landlords might get a better deal by offering to sell to their tenants, than by trying to push through large rent hikes. At current mortgage rates the average homebuyer's willingness to pay is, if not as high as sellers might have hoped for, then probably not far below recent sale prices. The biggest affordability hurdle for first-time buyers has been saving up a large enough deposit, and that's easier to do when prices aren't constantly running away on you.

1 We refer to 'homebuyers' in general throughout this article. There is nothing in the tax changes that favours first-home buyers per se.

2 www.westpac.co.nz/assets/Business/economic-updates/2021/Bulletins/Gov-housing-policy-update-Mar-2021-Westpac-NZ.pdf

3 www.westpac.co.nz/assets/Business/economic-updates/2021/Other/Economic-Overview-Feb-2021-Westpac-NZ.pdf

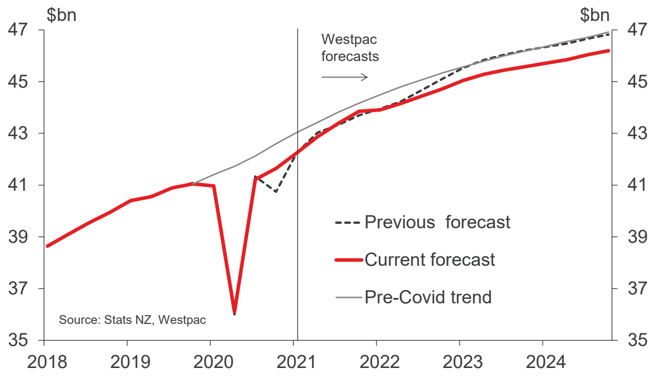
4 Some people obscure the issue further by arguing that the average household size for renters is larger than for homeowners. But this is simply an observation, not a law of nature. As renters become owners, the average household size of both groups will change.

Economic forecasts

Previously, we had expected house prices to rise by a further 10% by the end of 2021, with further moderate gains expected in the following years. However, we now expect house prices to flatten off over the remainder of 2021. Looking further ahead, we expect longer term interest rates will creep higher over time in response to the firming in global activity. And as that passes through to domestic borrowing rates, we are likely to see modest falls in house prices of around 3 to 4% per year over 2022 and 2023.

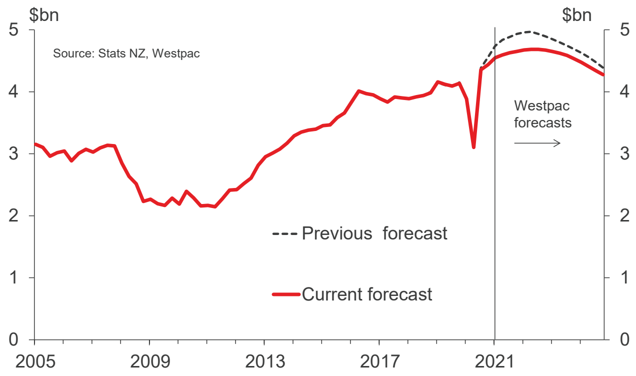
The expected easing in house prices is fairly modest compared to the more than 18% rise since June last year. Even so, that's a stark change from what we anticipated before the policy announcement. That's important as the housing market plays a key role in shaping demand conditions in the economy more generally. Now with a policy-related cooling in house prices on the cards, we also expect that household spending (which accounts for around 60% of total economic activity) will recover more gradually than previously assumed.

Quarterly consumption forecasts



A weaker house price track will also have a dampening impact on residential construction. However, this drag is likely to be more modest. New builds are exempt from the extension to the bright-line test, and may have other tax advantages over purchasing an existing property (for instance, the Government may allow interest costs on new builds to be tax deductible for a limited period). The weaker outlook for house prices also signals downward pressure on land prices, which are a key hurdle for many housing developments. Overall, we still expect high levels of home building over the coming years, with a large number of projects already in the pipeline.

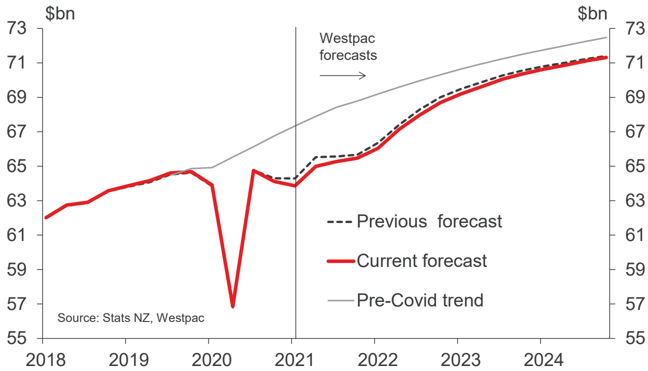
Quarterly residential investment forecasts



With the tax changes expected to weigh on household spending and the demand for credit over the coming years, we are also likely to see lower interest rates than otherwise. Over time, lower borrowing costs will help to support a lift in capital expenditure by businesses (effectively 'crowding in' investment spending). However, in the near term we still expect that businesses will remain cautious about undertaking major projects.

Even before the housing policy changes were announced, recent months had seen the economy losing steam. GDP fell by 1% in the December quarter (a sharper contraction than the 0.3% fall we had expected). And as we've moved through the March quarter, we've seen a cooling in retail spending and some gauges of business activity.

Quarterly GDP forecasts



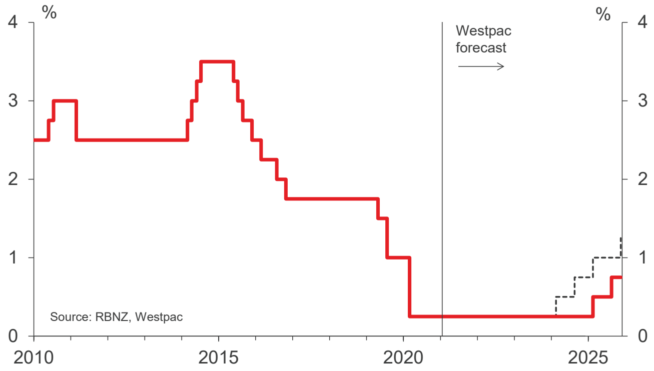
Digging under the surface, conditions across the economy remain mixed. Weakness in activity remains heavily centred on parts of the services sector that are closely linked to the international border, such as hospitality and tourism. The drag from the loss of international tourist dollars has been particularly acute in recent months, with summer the usual peak season for tourist inflows. The recently announced travel bubble with Australia has been a welcome development for the tourism sector and has come about a little sooner than we had expected. However, with arrivals from other countries still off the cards, conditions in the hospitality and tourism sectors will remain weak for some time yet.

In contrast, conditions in domestically focused sectors have been firmer. Most notably we're continuing to see high levels of residential consent issuance and spending on household durables. On top of that we've seen a lift in the number of businesses planning to increase their staff numbers.

Overall, the economy as a whole is still operating well below the level we would have expected if there had been no outbreak. Quarterly economic output is around 0.9% below the levels we saw in December 2019, while unemployment is sitting at 4.9% (compared to pre-Covid levels of around 4%). And now, with the housing changes likely to weigh on domestic demand, a full recovery in economic activity and employment is likely to take even longer than previously expected.

These developments will make it harder for the RBNZ to keep inflation around the 2% target on an enduring basis. As a result, we now expect that the RBNZ will keep the OCR on hold through to 2025 (previously we had expected gradual OCR hikes to begin from the start of 2024).

Official Cash Rate

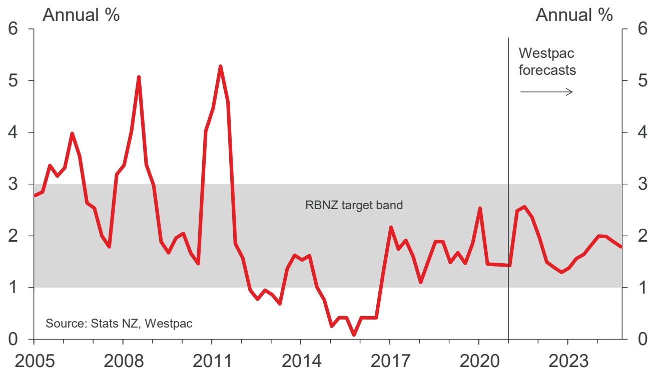


We're expecting inflation to rise to around 2.6% this year, as a result of disruptions to production and shipping in the wake of last year's outbreak. The impact of those disruptions now looks like it will be more enduring than we previously expected. We've already seen higher prices (or at least smaller than usual discounts) for many retail goods. We're now hearing increasing anecdotes of supply shortages passing through to higher costs of production for local businesses. That's seen the number of firms who are planning on raising prices rocketing higher since the end of last year despite the headwinds for activity.

But while the pickup in cost and pricing pressures has been stark, it is still likely to be temporary. Global production levels have been ramping up in recent months, and the disruptions to local and international distribution networks will eventually clear. As that occurs, we expect will inflation drop back through 2022, falling to around 1.3%.

Importantly, a temporary rise in inflation related to supply disruptions will not sway the RBNZ from its current highly accommodative stance. As the current supply constraints pass, the RBNZ will be faced with an economy that is still operating well below trend. Continued very accommodative monetary policy will be needed for the foreseeable future to offset the related underlying shortfall in inflation and employment.

Consumer price inflation



Final thoughts

There are some aspects of the Government's housing announcement that are still up for consultation. The final decisions on these matters could mean further tweaks to our forecasts at the margin.

First, the Government is looking at making interest costs deductible for a limited period for investors who buy new builds, in order to keep up investment in the housing supply. What hasn't been decided yet is how long that period will be – is it five years, 10 years, 20, years, until the next change of ownership? The longer the period, the more attractive it will be for property investors to move into new houses market – though the trade-off is a greater risk that homebuyers are crowded out of the new-build market.

Second, the Government is considering whether to make interest costs deductible if investors sell within the ten-year 'bright-line test' period. Our estimates suggest that the removal of interest deductibility is broadly equivalent to a capital gains tax at the 33% income tax rate. In other words, for most investors the impact would be about the same both before and after the 10-year period. So if the Government does go with this option, why not go a step further and remove the bright-line test altogether? Remember that the bright-line test was only ever a compromise measure, because a full-blown capital gains tax was considered politically infeasible.

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