WHAT CAN STOP SURGING DM HOUSE PRICES?

Suttle Economics Notes #145

- After some initial wobbles, the C-19 crisis has been a boon for DM house prices
- Easy financial policies have been the main support and are unlikely to change soon
- This leaves lots of scope for house prices to run, especially in the United States
- New Zealand is an interesting case study of a modern version of the "impossible trinity"

Chart 1
DM house prices *
%m/m; sa for US and UK; nsa for others

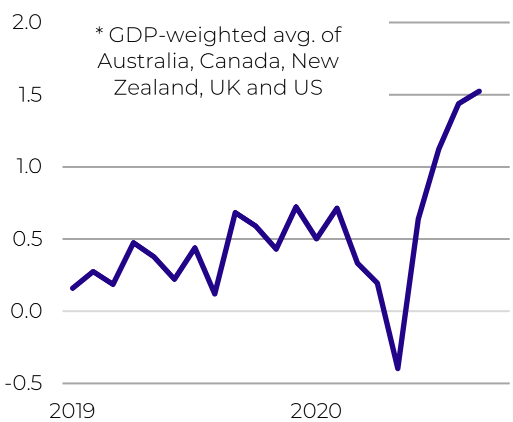
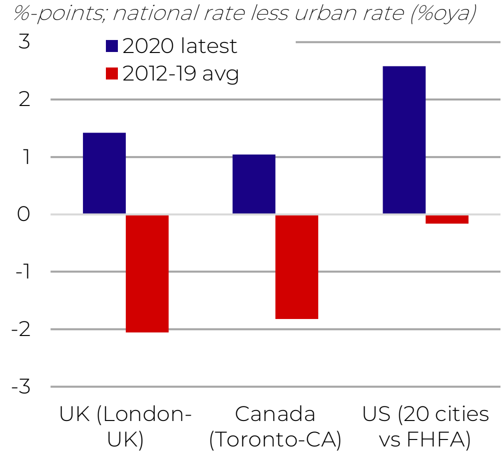


Chart 2
National-urban home inflation spread
%-points; national rate less urban rate (%oya)



The COVID (C-19) crisis has produced some significant relative shifts in fortune between sectors. One of the general winners has been the housing sector in DM economies. After a couple of rough months for both pricing and activity in April and May, the sector has been stimulated by the easy money and credit policies put in place from March onwards (Chart 1).

This should be no surprise since housing is always at the sharp end of the transmission mechanism from monetary policy to the broader economy. This time around, there have been some side-effects specific to C-19, including a rotation in housing preferences away from inner-city living to more suburban and rural areas. This has shown up in relative house price inflation rates in recent months (Chart 2). Living in apartment complexes closer to restaurants, theaters and the office has suddenly become less attractive, especially relative to a house offering more scope for the whole family to work from home.

The key issue now is how the forces that have been in play since 20Q2 will play out. One uncertainty is how durable the wish for more space well be. In my view, this shift was likely anyway; C-19 accelerated it.

Importantly, there seems little likelihood that the stimulative monetary and credit policies put in place over recent months will be reversed any time soon. DM central banks are in a phase where they are trying to convince markets of their determination to hold the policy taps wide open into a recovery—even more so than was the case after 2010. House prices will thus either rise or need to be constrained by other factors. The first is affordability. On this basis, US house prices have the most scope to run among the major DM economies. The second constraint (following on from the first) might be policies deliberately aimed to curb housing excess. New Zealand is closest to this, with the re-elected government recently asking the RBNZ to investigate ways that rampant house price inflation might be curbed to help affordability.

Chart 3
US, UK and Germany: house prices
%oya, both scales

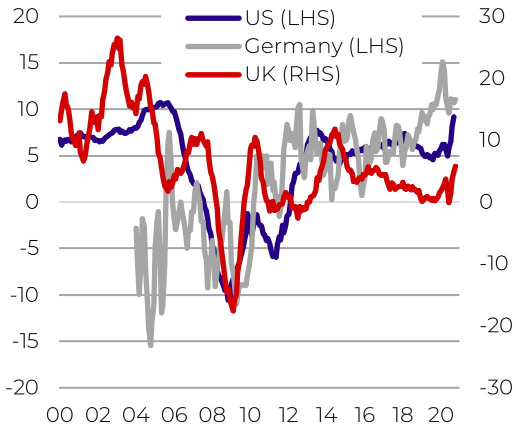


Chart 4
Canada, Australia & NZ: house prices
%oya

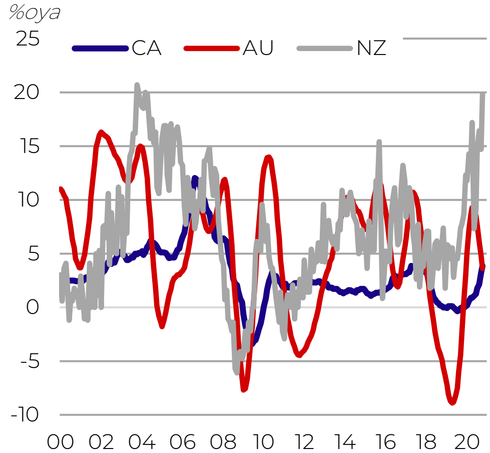
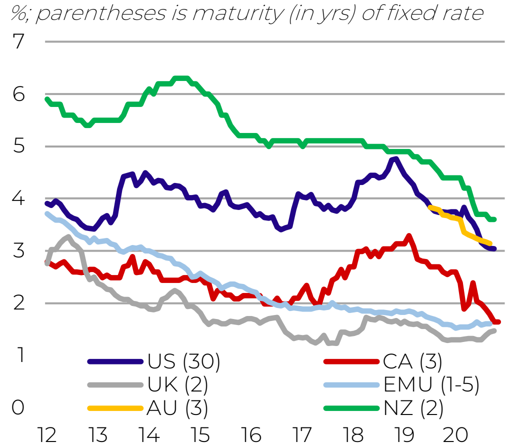


Chart 5
DM benchmark mortgage rate
%; parentheses is maturity (in yrs) of fixed rate



DM house price inflation was accelerating into C-19
Among the major economies, an uptick in house price inflation (on a year ago basis) ahead of the C-19 was most evident in Germany, where house price inflation accelerated from 6.5%oya in mid-2018 to a peak of 15.1%oya in February 2020 (Chart 3). This acceleration (which many not unreasonably saw as a clear manifestation of inflation pressure in a negative interest rate environment) was galling to many Germans, since housing costs barely enter into the calculation of the official inflation index (the HICP). As elsewhere, C-19 briefly knocked German house prices lower from March through May, since when they have moved higher again: prices are up 11%, ar, on both a 6-month and 12-month change basis.

US and UK prices have followed a similar dynamic. An acceleration was underway from September 2019 onwards, as the renewed easing in monetary policy began to show up in housing. After a short-lived C-19 panic dip, annual house price inflation has moved higher in 20H2. The US rate is now at its highest since February 2006. Canadian house price inflation has also firmed up in 2020 (Chart 4). Australian house price inflation (as measured by the Corelogic data, which broadly tracks the official quarterly series) has been more affected by swings in relations with China, which have been damaged directly by the C-19 crisis and subsequent political jostling. The most notable acceleration in house prices has come in New Zealand—again, a development underway from mid-2019, but one that has intensified sharply in the aftermath of the C-19 crisis.

Mortgage markets come through C-19 crisis intact
Benchmark mortgage interest rates have come down significantly in Australia, Canada, New Zealand and the United States since March (Chart 5). By contrast, conventional mortgage rates in both the UK and Euro area have edged up (from very low levels).

Two aspects of the post C-19 mortgage market are worthy of note. First, and most importantly, credit intermediation through the mortgage market was not affected by the (short-lived) credit market crunch in late Q1/early Q2. The rise in residential mortgage delinquencies has been limited by generous welfare support payments and policies to encourage forbearance from lenders (this tactic has been widely used in the Euro area). There were no obvious mortgage excesses ahead of the C-19 crisis. In the United States, in particular, housing equity had risen and lending structures that produced higher rates as the crisis unfolded (as in 2008-09) had been banned.

Second, central banks (and other policy makers) targeted support for the housing market, even though it was not at the center of the crisis (in contrast to 2008-09). The Fed has bought $637 billion,

Chart 6
US and UK home mortgage data
Jan 2018 = 100, sa; number of applications

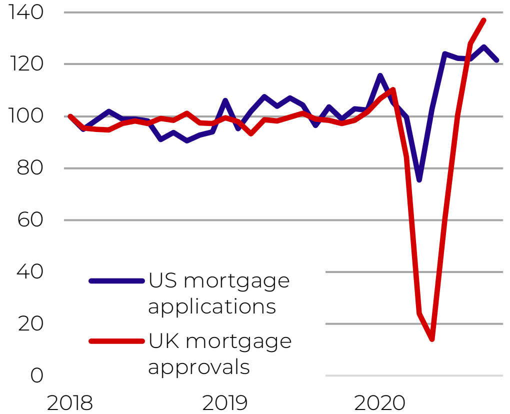


Chart 7
Housing permits/approvals
January 2019 = 100, sa

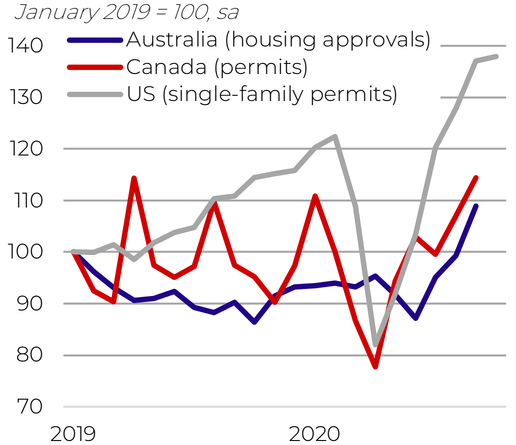
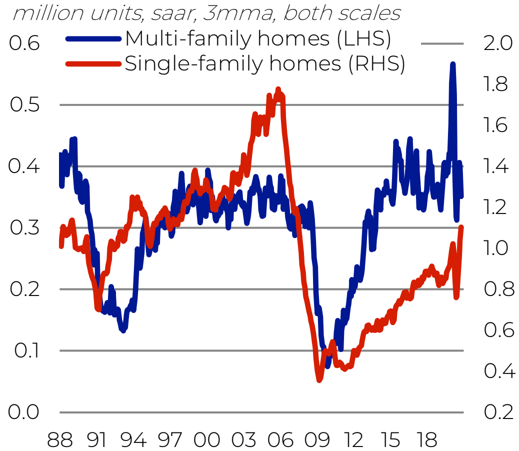


Chart 8
US housing starts by type
million units, saar, 3mma, both scales



net of residential mortgage backed securities since mid-March. Both the RBA and RBNZ have pressured banks to trim mortgage lending margins over official base rates, in part by developing new bank funding schemes. The Riksbank has been a more aggressive buyer of mortgage (covered) bonds. By contrast, the ECB has skewed its non-government securities purchases more towards corporate bonds in 2020. It made its bank funding scheme far more supportive.

The UK has used fiscal support. In early July, a 3% tax (stamp duty) on home purchase was suspended on transactions up to £500k until the end of March 2021. The lockdown had meant that mortgage transactions collapsed in April and May. The tax holiday has helped lift them well above their pre C-19 path in recent months, although some of this boom simply reflects catch-up for transactions put on ice during the lockdown. In 2020-to-date UK mortgage approvals are down 13.6%oya, whereas US mortgage applications for purchase are up 7.4%oya (Chart 6).

Tracking the housing activity response
In the short-run, housing is in inelastic supply, so any initial boost to demand shows up mainly in prices. In time, supply responds to higher prices, which underlines that one of the key mechanisms that tempers any housing boom is an increase in supply. In markets and countries where (for example) land and planning restraints limit the supply response, the price boom is apt to be more sustained, and require other developments (considered below) to tame it. In much of Western Europe, where the housing supply response is most inelastic, the housing investment channel will be least effective.

As would be expected, the housing activity response to easier policies has so far been most pronounced in the United States (Chart 7). Additionally, the demand rotation mentioned earlier—away from apartments towards single-family homes—is clear from the latest US housing activity data (Chart 8).

Affordability in perspective
It generally takes years, not quarters for housing expansions to buckle under their own weight. In countries with an elastic property supply (the US and, to a lesser extent, Australia and Canada) the emergence of an eventual supply glut plays a key role. In many other jurisdictions, prices play the main role. They eventually move high enough to make a home purchase far less affordable, causing a rotation back to renting. One quirk of this adjustment mechanism is that measures of consumer prices that use rents as the key input to the housing component often show a perverse outcome, with rents weak when housing prices are at their strongest. This perversity was

Chart 9
US: home inventory and affordability

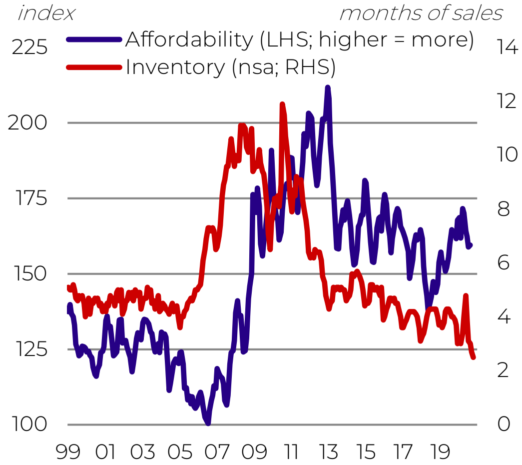


Chart 10
DM house price-income

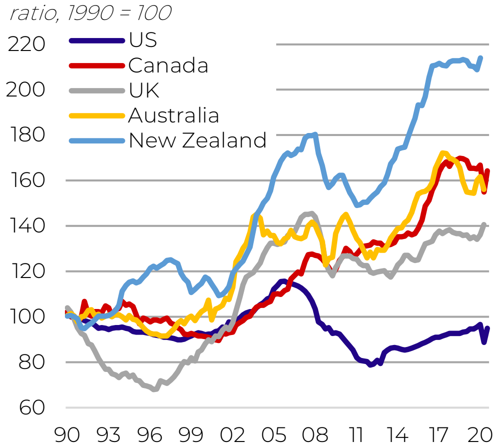
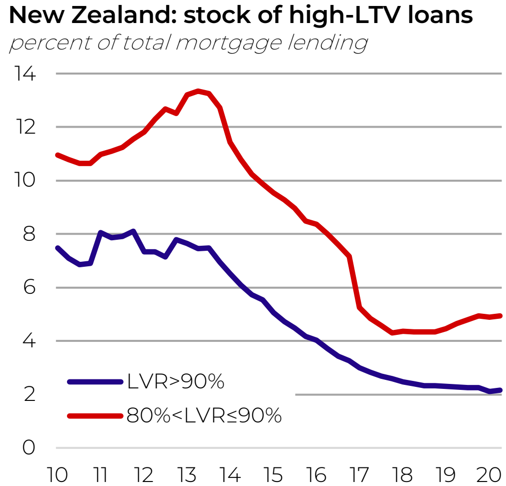


Chart 11
New Zealand: stock of high-LTV loans



evident in the United States in 2003-05 and has become evident once again in 2020.

The US National Association of Realtors (NAR) measure of housing affordability is driven primarily by prices and mortgage rates (Chart 9). On this measure, US housing has become less affordable since January, although only marginally so. Moreover, the NAR's measure of housing inventory is at an all-time low, suggesting that there is plenty of scope (years, not quarters) for the current US housing expansion to run, absent a change in financial policies.

The price-earnings ratio is another metric that assesses affordability, although this gives no weight to the role of lower mortgage rates (Chart 10). Once again, US housing stands out as most affordable on this basis. By contrast, the P/E ratio in New Zealand is over double what it was 30 years ago.

Hard to rely on the macro-prudential brakes alone

The renewed rise in New Zealand's house prices from an already-elevated level has led to a surprising falling out between the Treasury and the central bank. Last week, the Finance Minister wrote to the RBNZ arguing that the bank needed to think about stabilizing house prices as part of its monetary policy thinking. This tension highlighted the modern version of the "impossible trinity (IT)": CPI inflation at target; low unemployment; and stable house (and other) asset prices (the original IT had been fixed FX, independent monetary policy and a free-flow of international capital).

In the last expansion, it became popular to argue that this policy dilemma could be addressed through the appropriate use of macro-prudential policies, most notably policies to limit the use of high loan-to-value (LTV) mortgages. In New Zealand, this policy worked to temper high LTV lending, but not prices (Chart 11). LTV restrictions will soon be tightened further in New Zealand, although (as with capital and credit controls in the 1970s), it is not clear that they alone can provide sufficient restraint. In the near-term, this policy rift has served to further diminish market expectations for negative rates in New Zealand in 2021.

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