INFOMETRICS newsletter

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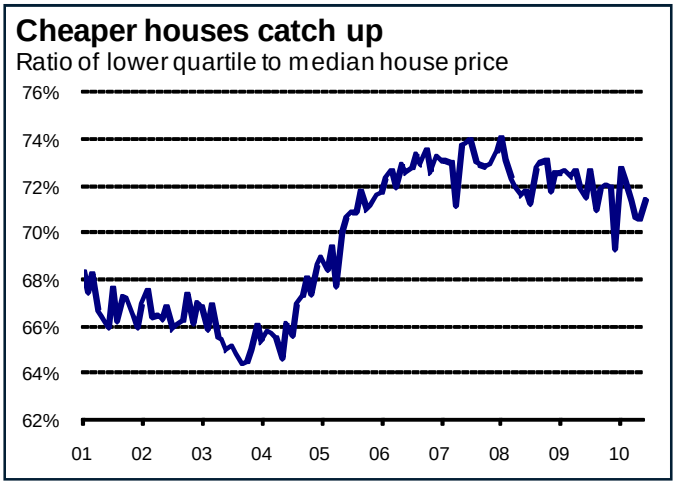
Price pressures on cheaper houses?

One of the likely effects of the government's recent changes to the tax treatment of rental property is the need for investors to get a better cash flow out of their property. With landlords no longer able to claim depreciation on buildings and thus get a tax refund from the government, investors with leveraged property could find it more difficult to keep their head above water.



In theory, an improvement in the yield on rental property (and, thus, an improvement in the cash flow) can be achieved through either higher rents or lower house prices. Over the last decade, house prices have risen significantly faster than incomes and have run well ahead of their long-term growth rate. So if we think that housing is overvalued, it would seem reasonable for the bulk of the adjustment to come through lower house prices.

Some analysts have pointed out that the growing popularity of residential property investment over the last decade has led to bigger price rises in lower-valued property – and if prices are going to fall in response to the tax changes, some of this "compression" that has occurred in property values will be undone.

At first glance, this conclusion appears reasonable. Our graph shows that, between mid-2004 and the end of 2007, the ratio of the lower quartile to the median house price rose from 65% to 74%. In other words, lower-value houses rose 1½ times as fast as the average property during this period, presumably as landlords became less concerned about yield and more focused on capital gains.

If there is any substance to the claim that prices for lower-quality property have risen more quickly over the last decade as demand for investment property has increased, then areas with a high proportion of rental property would be expected to have recorded the largest price gains on average. But the correlation between the proportion of rental properties and house price growth between 2001 and 2007 is almost non-existent. In fact, there is a much stronger correlation between how cheap property was in 2001 and how far prices rose during the following six years.

So the apparent lift in the lower quartile house price has been driven by regional variations. With the housing boom taking longer to show up in provincial areas, and then being more pronounced in those

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More households renting here

	Rental dwellings as % of total stock	Average house price ($000)
Auckland	43.9%	751.0
Ruapehu	42.0%	163.0
Waitomo	40.3%	153.9
Queenstown Lakes	40.1%	579.2
Wellington	39.5%	567.1
Hamilton	39.3%	379.2
Wairoa	38.9%	182.4
Gisborne	38.2%	267.1
Opotiki	37.4%	289.7
Otorohanga	37.3%	282.5

Price pressure on cheaper houses?

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regions, the closure of the gap between the lower quartile and median house price is largely a reflection of property values in Manawatu/Wanganui (for example) catching up to the national average.

However, the effect of the tax changes on lower-quality property values over the next 1-2 years could still vary across different regions. Our table shows the territorial authority areas with the highest proportions of rental dwellings at the 2006 census. Of these areas, those with higher house prices, and thus more highly leveraged investors, may experience more downward pressure on low-end property prices in coming quarters.

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The direct and indirect effects of climate change

Research we have recently undertaken for the Ministry of Agriculture and Forestry looked at the direct effects of climate change on New Zealand agriculture and the wider economy. The provisional conclusion was that a change of one standard deviation in the number of days of soil moisture deficit (DSMD, a measure of climate change effects on agriculture) reduces agricultural gross output by less than 5% in most cases. The flow-on effect on New Zealand's real gross national disposable income (RGNDI) of such a change is around 0.1%. However, the effects are not linear. A change of three standard deviations in DSMD reduces national RGNDI by about 1%.

Another, possibly more important, dimension of the impact of climate change on New Zealand is via an indirect international effect. In broad terms, this effect has two components.

- How the impacts of climate change on other countries, and other countries' reactions to those impacts (such as through trading arrangements and production subsidies), affect the prices of the goods that New Zealand exports and imports
- How other countries deal with the task of reducing emissions, such as through carbon prices or protective policies against free-riding countries

One mechanism by which the former can affect New Zealand is through the effect on international agricultural commodity prices. Our preliminary research shows that over the next 50 years or so, New Zealand will generally benefit as adverse climate change in other countries reduces global agricultural output, causing international commodity prices to rise – to our advantage.

The effect on New Zealand's RGNDI could be more than 2%, or about twice as large as the direct negative effects of climate change on New Zealand.

However, a countervailing influence is the carbon fertilisation effect, whereby greater photosynthesis occurs under elevated levels of CO_2. The stronger this effect is, the worse off New Zealand would be. This result is perhaps counter-intuitive. It arises because other countries also benefit from carbon fertilisation, which puts downward pressure on international commodity prices.

A caveat to these findings is that the estimates do not include economic loss from short-term catastrophic events such as floods and landslides. Not much is known about the effect of climate change on the frequency and extent of floods and other extreme events. Depending on where extreme events occur, the effects on New Zealand could be positive or negative.

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