BC4111

October 2014

Auckland Economic Quarterly

Chief Economist's Newsletter

Auckland Council
Te Kaunihera o Tāmaki Makaurau

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Image credit: Jay Farnworth

From the Chief Economist Unit

Welcome to the latest edition of the Auckland Economic Quarterly. The latest GDP data shows that the Auckland economy experienced another solid quarter of growth in the three months to June and the labour market has continued to strengthen. There are a few key points that I would like to highlight:

1 The service sector was the key driver of growth through the quarter, with all eleven subsectors contributing positively. Construction activity was still an important driver of growth in the June quarter and will have contributed to further solid growth across a number of sectors, including manufacturing; finance and insurance; rental, hiring and real estate; and retail trade. However, following a very strong March quarter result, the construction sector's contribution to quarterly growth moderated in the June quarter.

2 Unlike many places elsewhere in the country, house price growth in Auckland has weakened in recent months, but remained solid. However, the sharp downturn in sales activity highlights that the Auckland market has been affected by the same negative factors affecting sales elsewhere, namely the LVR restrictions and rising interest rates. The downturn in sales has seen demand transferred to the rental market. Rental inflation has firmed through 2014 on the back of strengthening demand and rising interest rates.

3 The labour market continued to strengthen in the June quarter, with employment 2.9 per cent higher year-on-year. The unemployment rate is still high, despite annual average employment levels increasing 38,800 over the year to June 2014; decade high net migration levels and rising participation levels drove a 4.5 per cent increase in the labour supply through the year. Net departures to Australia have continued to slow, but we've also seen a pick in net migration from overseas arrivals.

4 Last, the exchange rate pushed below $US80 in September, to its lowest levels in a year. This is good news for Auckland's exporting and importing-competing businesses and will help stimulate broader economic growth. However, it also raises the costs of imported consumer and capital goods, as well as inputs to production. On balance, the positives outweigh the negatives for the Auckland and New Zealand economies, but the loss of the dollar's inflation busting qualities will be a negative for tradables inflation at a time when domestic cost pressures are rising.

This edition includes an article from Auckland Council's Research and Investigations Monitoring Unit which explores geographic variations in affordability for first home buyers across Auckland over time and then looks to see if similar patterns are observed in the rental market.

As always, we welcome your comments and feedback.

For more information including chart packs for this edition please visit aucklandcouncil.govt.nz/chiefeconomist

Rachael Logie
Acting Chief Economist

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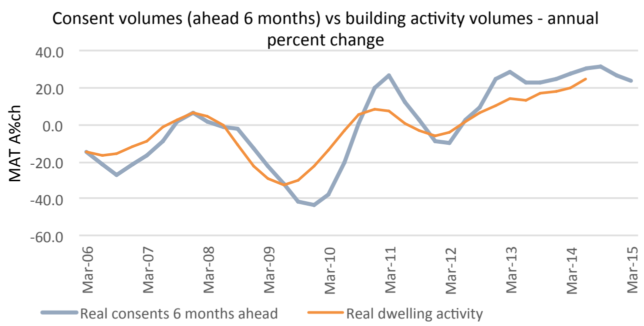
Impetus to growth from housing appears to be slowing – where to for growth?

Introduction

These are interesting times for the Auckland Economy: output grew 3.1 per cent in the June quarter year-on-year, leaving annual growth unchanged at 2.4 per cent, and the labour market continued to strengthen, with the unemployment rate dropping to 6.2 per cent. The housing market lost momentum through the first half of the year and the Auckland economy will not be immune to the effects of lower dairy incomes. However, net migration levels continue to rise, a strengthening labour market is bolstering incomes and spending and businesses are increasingly looking to invest in plant and hire additional workers. The outlook for domestic demand therefore remains solid, but domestic capacity pressures are slowly building. The dollar also eased back through September which will boost the competitiveness of the external sector but also feed into higher tradables inflation.

Service sectors key growth drivers in June quarter, with support from construction-related activity

Chart 1: Consent volumes (ahead 6 months) vs building activity volumes



Source: Statistics NZ

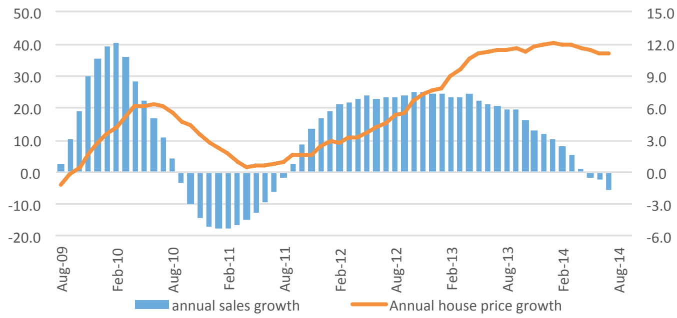
Construction activity was still an important driver of growth in the June quarter and will have contributed to further solid growth across a number of sectors, including manufacturing, finance and insurance, rental, hiring and real estate and retail trade. However, following a very strong March quarter result, the construction sector's contribution to quarterly growth moderated in the June quarter.

The service sector was the key driver of growth through the quarter, with all eleven subsectors contributing positively. Strengthening household incomes, high levels of net migration and a pick up in spend per tourist have helped bolster activity in the retail, and accommodation and food services sectors; meanwhile, continued strong household demand for motor vehicles and strengthening business investment in plant and equipment have benefited the finance, wholesale, retail and transportation sectors.

The June quarter saw stronger growth re-emerge for both the professional, scientific and technical services sector and the administrative and support services sector following three quarters of soft growth.

Consenting activity is still climbing, but house sales numbers continue to fall

Chart 2: Annual growth in median house prices and sales



Source: REINZ

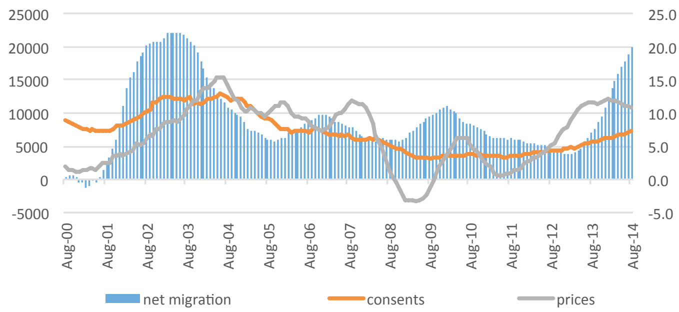
Dwelling activity, in real terms, was 30 per cent higher over the year to June 2014. The pace of growth in consents slowed over first half of 2014, but July and August were both strong monthly results. There were 7,318 consents issued over the 12 months to August 2014, of which 2,014 were for flats and apartments. These are the highest levels seen since 2006, but are still well below the levels prevailing during 2003 when annual consents exceeded 12,000, of which over 4,000 were for flats and apartments.

Housing sales have been affected by the timing of the general election and a delayed seasonal spring surge is expected in the final quarter. Nevertheless, sales have been weakening since late 2013 despite debt serviceability levels being high and demand having been bolstered by net migration. The volume of sales recorded by the Real Estate Institute of New Zealand (REINZ) in the year to August 2014 was 7.9 per cent lower than a year earlier.

Unlike many places elsewhere in the country, house price growth in Auckland has weakened in recent months but remains solid. The sustained strength of Auckland house price growth reflects a shortage of listings and strong demand. However, the sharp downturn in sales activity highlights that the Auckland market has been affected by the same negative factors affecting sales elsewhere, namely the LVR restrictions and rising interest rates. For regions where prices are falling affordability is now on the rise, but there has been little respite for prospective buyers in Auckland.

Net migration providing a fillip to demand

Chart 3: Annual net migration and dwelling consent numbers vs. annual house price growth



Source: Statistics NZ, REINZ

Over the 12 months to August net migration boosted the population by 19,959. Net departures to Australia have continued to slow and are at their lowest levels since 2003. However, we've also seen a pick up in net migration from outside of Australia, which is also now running at decade highs.

The sustained strength of net migration could breathe life back into the housing market. To date, there hasn't been a noticeable fillip to housing activity from net migration, as it's been swamped by the negative impact of the LVR restrictions and the deterioration in affordability.

The Reserve Bank looked at the impact of the upswing in net migration through 2013 and their analysis suggested the initial impact would be less than in earlier periods of strong net migration because it has been predominantly driven by New Zealanders, and many of these people would already have accommodation. However, the pick up in international net migration would be expected to have a more immediate effect on housing demand.

And strong demand and rising interest rates are beginning to show up in rents

While house price inflation has lost momentum through 2014, rental inflation has firmed. Demand for rental housing has been bolstered by prospective homeowners locked out of the housing market by the LVR restrictions and deteriorating affordability, as well as by high net migration levels. The strength of demand, in combination with strengthening incomes, has accommodated a pick up in rental growth and allowed landlords to pass on some of the increase in interest payments seen over the first half of the year.

The feature article in this publication looks at house price trends and housing affordability through time and compares geographical house price affordability and rental yields

Inflation contained in the June quarter

Annual CPI inflation remained contained in the June quarter at 1.6 per cent, with non-tradables inflation running at 2.7 per cent and tradables inflation running at 0.1 per cent.

The New Zealand unemployment rate dipped to 5.4 per cent in the June quarter, its lowest level since 2008, but growth in the labour cost index was a modest 1.7 per cent in the June quarter. Businesses are reporting increasing difficulty in sourcing labour, but the supply of labour has been strong, supported by high net migration levels and rising participation rates. Household inflationary expectations have also remained well anchored.

But recent depreciation in the NZ dollar will feed into higher tradables inflation

The tradables sector is finally experiencing some relief from the NZ dollar, which was trading below $US0.80 in the final days of September. The depreciation in the dollar will boost the competitiveness of exporting and import-competing businesses. However, on the downside, a depreciating dollar raises the cost of imported goods and therefore tradables inflation. An appreciating NZ dollar saw tradables inflation fall over the two years to June 2013, with prices flat over the year to June 2014. Non-tradables inflation has also been contained over this period as the economy has been absorbing excess capacity. The low CPI inflation outcome has allowed the Reserve Bank to keep interest rates at historic lows for an extended period to stimulate growth, but the recent fall in the dollar will see tradables inflation firm alongside non-tradables inflation.

Strengthening incomes supporting retail activity

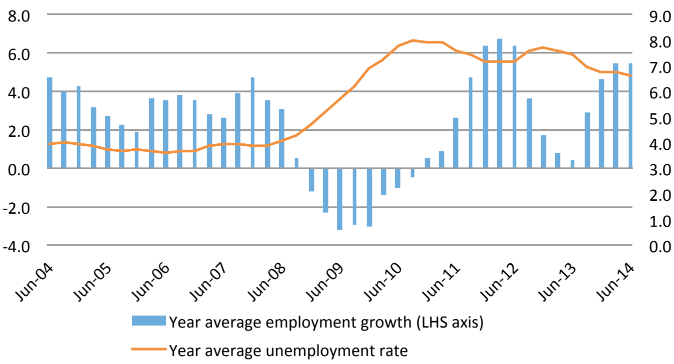
The June quarter saw further solid growth in retail spending, up 5.5 per cent in nominal terms on the same quarter of 2013. Growth was also strong in real terms, up 3.8 per cent. Demand for motor vehicles remains particularly robust, with new vehicle registrations up 20 per cent year-on-year in the June quarter, taking growth through the year also to 20 per cent. High levels of net migration, low interest rates, the high dollar and strengthening incomes have all played a role. We've also seen a further year of strong growth in new commercial vehicle registrations (30 per cent higher over the year to June), with businesses taking advantage of the same market conditions to expand and update their fleets.

The Westpac McDermott Miller Consumer Confidence Index edged up in the June quarter to 128.3, its highest level since 2005, but the uncertainty surrounding the election is likely to have weighed on confidence in the September quarter.

Retail spending firmed through the first half of 2014 on the back of strengthening incomes, but nationally we are also seeing the start of a recovery in household credit usage, with credit card balances bearing interest and personal lending both on the rise. Interest rates remain low, but we're not expecting to see a significant pick up in the share of debt-funded consumption given the high levels of prevailing household debt, the outlook for rising interest rates and the fact that households remain more reticent about debt in the post-GFC environment.

Signs growth has peaked – net migration may further bolster demand, but inflation on the rise

Chart 1: Unemployment rate vs. employment growth



Source: Statistics NZ

On balance, we're not expecting to see the housing cycle regain significant momentum in the near term: debt serviceability remains high and borrowers have been taking advantage of low fixed interest rates, but the LVR restrictions and a lack of affordability will continue to weigh on demand. That said, if net migration continues to build – or is sustained at current levels – this would boost demand for housing. Construction activity is not currently running at sufficiently high levels to meet these higher levels of demand and it will take time for the sector to ramp up supply in response. In the meantime, the additional demand would be reflected in rents and house prices.

Inflation is comfortably within the Reserve Bank's 1 to 3 target range, with capacity pressures largely confined to the construction sector. High net migration levels have boosted labour supply, taking pressure off wages growth and household inflation expectations have also remained well anchored. There is still slack in the labour market, with the unemployment rate at 6.2 per cent, although firms are reporting increasing difficulties sourcing skilled labour. Construction inflation eased in the June quarter, but net migration could potentially bolster both house prices and dwelling activity.

The Auckland economy was able to grow strongly emerging from the downturn because it was carrying excess capacity. That excess capacity has now been largely absorbed. Strengthening business investment will help ease emerging capacity constraints; the pick up in machinery and equipment spending will provide relief in the short term and we expect to see the start of an upswing in investment in non-residential construction from 2015. However, domestic inflation is firming and the NZ dollar has lost its inflation busting qualities, so tradables inflation will also start to trend upwards.

Overall, the outlook is for solid, but not spectacular, broad-based growth. There are however plenty of risks on both the upside and downside, particularly from net migration, overseas growth and the exchange rate.

To buy, or not to buy? Understanding housing prices in Auckland

Robust population growth and geographic constraints will place ongoing pressure on Auckland's supply of dwellings and infrastructure. This is a good challenge to have, as it reflects our productive economy, our diverse and growing population, and high amenity. But it will still require careful management backed up by good information and analysis.

Strong demand for housing from current residents and new migrants is reflected in rising prices. This benefits many Auckland homeowners and supports innovative development partnerships such as Waterfront Auckland's revitalisation of Wynyard Quarter. However, there are risks. High house prices pose a barrier to young, highly mobile New Zealanders who are choosing between staying in Auckland and moving overseas. They can represent a drain on household budgets and our pool of investment capital.

If Auckland is to continue to offer a high standard of living for its residents and opportunities for young Aucklanders and potential migrants, it must tackle housing prices. It is therefore necessary to understand what is happening in the Auckland housing market, and why. Here, we review several recent pieces of research that look behind the headline price and sales numbers.

What can we learn from housing prices?

The June 2014 Massey Home Affordability Report showed that house prices are continuing to rise faster than incomes. But how should we interpret price changes? House prices and rental prices provide an indication of the interaction of supply and demand at a given point in time, but a number of factors simultaneously contribute to these prices. Everything from the location and quality of the dwelling to buyers' expectations about future migration patterns and housing supply are potentially embedded within house prices.

Table 1 summarises the factors that potentially influence house prices, after controlling for quality factors such as a dwelling's size, condition and location. This framework allows us to interpret recent changes in housing prices observed in Auckland. It suggests that rising house prices could result from a combination of:

- An excess of housing demand over supply, which would also increase rents
- Lower interest rates or risk premiums for buyers, which reduce the (perceived) cost of servicing a mortgage
- Changed expectations about capital gains from future price growth.

	Change in house sale price from changes in other variables:	
Factors	Increase	Decrease
Rents	↑	↓
Future price expectations	↑	↓
Interest rates	↓	↑
Risk Premium	↓	↑

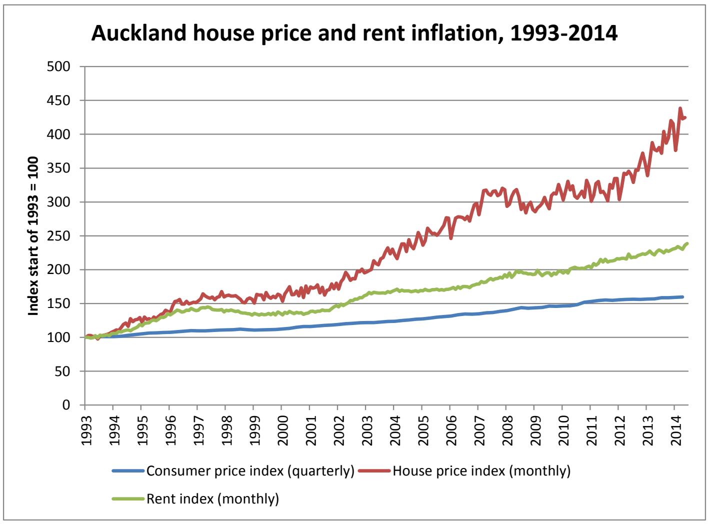
The regional perspective on Auckland's housing market?

Figure 1 retells a familiar story about the Auckland housing market. It compares house price inflation and rental price inflation with overall inflation over the past two decades. Between 1993 and 2014:

- The consumer price index (CPI) rose by almost 60%
- Average rents in Auckland rose by 130%
- Average Auckland house prices rose by over 300%.

House prices increased fastest between 2001-2007 and 2011-2014, but rents did not accelerate greatly during either period. This data paints a worrying picture, although some price increases may actually reflect improvements in housing quality or size.

Figure 1: Auckland house prices, rents, and consumer price inflation, 1993-2014

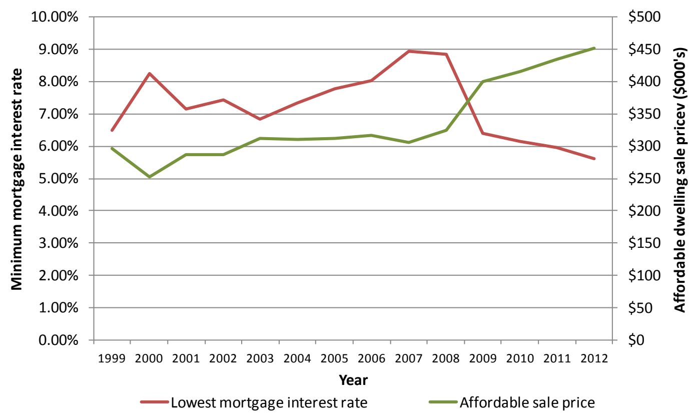


The role of interest rates

What impact have financial factors, such as mortgage interest rates, had on housing costs? A recent Auckland Council research paper (Hitchins et al, 2014) investigates changes in housing affordability for first home buyers . It found that changes in interest rates have had a pronounced effect on affordability.

Figure 2 shows that a rapid drop in interest rates from 9 per cent to 6 per cent following the Global Financial Crisis raised affordability for first home buyers. Cheaper credit has enabled buyers to pay more for houses – which has contributed to recent price increases. We would expect some of these gains in affordability to unwind as the Reserve Bank tightens monetary policy.

Figure 2: Affordable dwelling sale price for Auckland first home buyers and minimum mortgage lending interest rates, 1999-2012



Data source: Statistcs New Zealand, LEED data; Reserve Bank of New Zealand, Mortgage Interest Rate series.

[1] A house was considered 'affordable' if housing costs (including financing) were less than 30 per cent of the average household income for first home buyers (defined as employed couples in the 25-34 age group).

The changing geography of housing affordability

House prices vary significantly within Auckland. Although national factors such as migration and interest rates influence the whole Auckland market, a detailed geographic analysis reveals the effect of localised factors such as accessibility to employment and amenities and land use policies.

Hitchins et al (2014) explores geographic variations in affordability for first home buyers across Auckland over time and they found there was a large reduction in the overall number of affordable sales over this period, especially in the Auckland isthmus and North Shore. Over the 2011-13 period, affordable options for first home buyers were largely concentrated in west Auckland, south Auckland, and the western edges of the North Shore. However, recent research also shows that lower housing costs in these areas are offset by higher transport costs from longer commutes (Nunns et al, 2014).

The geography of rental yields

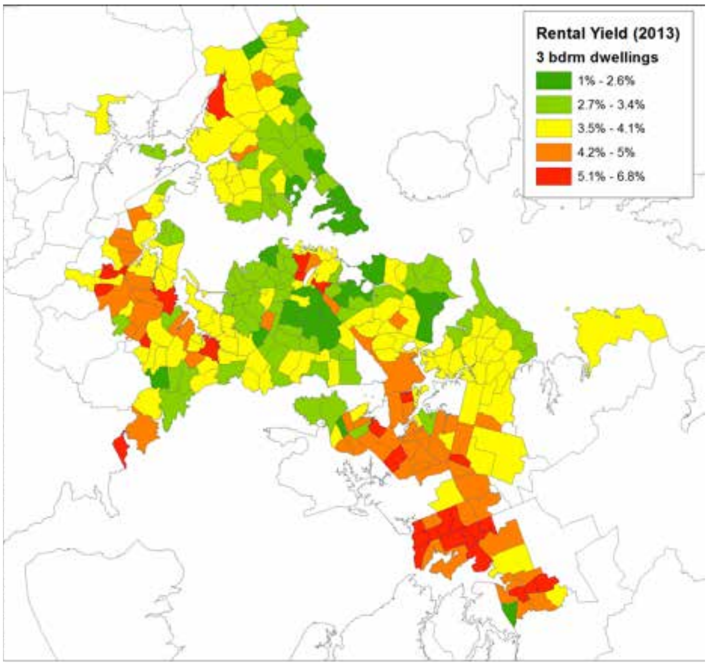
Can we observe similar patterns in the rental market? A forthcoming Auckland Council research paper (Nunns and Hitchins, 2014) examines the relationship between house prices and rents at a detailed geographic level.

Figure 4 shows the geographical variation in indicative rental yields, a measure of the relationship between prices and rents, in Auckland in 2013 . Darker colours indicate higher yields and lighter colours indicate lower yields.

- Indicative rental yields vary significantly within Auckland, with some areas having yields that are two to four times higher than others. We find that rental yields were lowest in the inner Auckland isthmus, the eastern bays and the east coast of the North Shore, and highest in the city centre as well as west and south Auckland.

While interpreting variations in yields is difficult, due to the possibility of unobserved housing quality features, this analysis suggests that expectations about future price increases may vary within Auckland. Landlords in areas with rents that are low relative to house prices may be seeking a return from capital gains rather than from rents.

Figure 4: Indicative rental yields for three-bedroom dwellings by Auckland area unit, 2013



Housing choices and trade-offs

Recent Census data shows that an increasing number of Aucklanders are choosing rental accommodation over home ownership. This may be driven by the fact that renting has remained a relatively affordable option even as house prices have increased.

However, there are a number of unanswered questions about the relationship between home ownership and the rental market. In short, is renting a good substitute for home ownership?

Previous research suggests that rental dwellings tend to be in worse condition than owner-occupied dwellings, and that tenure security is a significant concern for renters (Buckett, Jones and Marston, 2011). In order to deepen our understanding of these issues, Auckland Council's Research, Investigations and Monitoring Unit is currently leading research into the trade-offs between renting and buying. This research asks Auckland households to choose between options for renting or buying dwellings in different areas of Auckland, taking into consideration their budget constraints.

Housing policy options for Auckland

Good information and analysis on Auckland housing prices can inform better policy. Auckland Council is addressing housing affordability by implementing policies that seek to provide flexible, responsive zoning that enables new housing supply, to ensure that affordable housing is provided in new developments, and to make the rental market a better long-term option for households. Three particular areas are worth highlighting.

First, the Proposed Auckland Unitary Plan (PAUP) aims to enable new housing supply and also to enable greater choice in the size and types of dwelling. It does so by reducing barriers to infill development and medium density housing and implementing a flexible rural-urban boundary to facilitate greenfield land supply as needed.

Second, the Housing Project Office (HPO) is delivering fast-tracked special housing areas in partnership with central government. Early application of PAUP zoning rules and a fast-tracked consent process in these areas will give developers more certainty, allowing them to bring dwellings to market sooner.

Finally, and importantly given the rising role of renting, Auckland Council is examining options to improve the quality of rental accommodation. This includes participation in a pilot Rental Warrant of Fitness scheme (Bennett et al, 2014) and the successful Retrofit your Home programme which provides low cost loans to homeowners and landlords to improve the insulation and heating (Rohani et al, 2014). However, more work may be needed to make long-term renting an appealing option, given a recent report by the New Zealand Institute for Economic Research that finds that renters in New Zealand have little security of tenure or ability to personalise their accommodation (Eaqub, 2014).

The complete report 'Auckland's housing market: spatial trends in dwelling prices and affordability for first home buyers' can be viewed at knowledgeauckland.org.nz

[2] Based on Census area units.
The average area unit in Auckland contains around 3,000 residents

Auckland Economic Scorecard

New Zealand Economic Indicators		Date	NZ
Inflation[1]	Annual % change	Q2	1.6%
Official Cash Rate[1]	%	Sept	3.50%
NZD/USD[1]	Month average	Sept	0.82
TWI (5 currency)[1]	Month average	Sept	78.35
ANZ Commodity Price Index[2]	Annual % change	Au-gust	-7.2%
Current account as % of GDP	%	Q2	-2.5%
NZ population	at 31 March 2014		
Auckland population	at 30 June 2013		

Disclaimer

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		10 yr trend	Date	Auckland	Year-on-Year change	Rest of NZ
Headline Indicators						
Employment	Number (000s)	674	Q2	749	↑	1,570
	Annual % change	2.3%	Q2	2.9%	n/a	4.1%
Unemployment	%	5.8%	Q2	6.2%	↓	5.0%
Real GDP (expenditure)[3]	Annual average % change	2.4%	Q2	2.4%	↑	2.9%
Real wages	$ / week (average)	$1,096	Q2	$1,149	↓	$1,058
Jobs						
Youth unemployment – 15-19 year olds	%	22.5%	Q2	23.4%	↓	19.1%
Youth unemployment – 20-24 year olds	%	10.3%	Q2	12.0%	↑	9.8%
Industries						
Manufacturing (employment counts)*	Number (000s)	..	Q2	79	↓	167
Financial and insurance services (employment counts)*	Number (000s)	..	Q2	30	↑	38
Retail sales	Annual % change	3.5%	Q2	5.5%	n/a	4.0%
Housing and construction					↑	
House sales – dwellings[4]	Annual total sales	27,328	August	28,842	↓	44,843
Real average private rent[5]	$ / week	$429	August	$462	↑	$322
Rent to wage ratio[5]	%	39.1%	Q2	40.2%	↑	30.4%
Real median house sale price[4]	$	$506,142	August	$614,050	↑	$420,000 (NZ)
Residential building consents – new dwellings	Annual total	5,585	August	7,318	↑	16,659
Non-residential building consents – new floor area approved (sq. metres)	Annual total	806,456	June	747,276	↑	2,972,591
Global connections						
Tourism – guest nights	Annual total	5,831,796	July	6,842,000	↑	26,965,000
Net migration	Net annual flow	8,361	August	19,959	↑	23,524
Arrivals	Annual flow	34,704	August	42,868	↑	61,007
Departures	Annual flow	26,344	August	22,909	↓	37,483
Real exports ($2013)	Annual total	$12.6b	August	$11.5b	↑	$41.3b
Real imports ($2013)	Annual total	$26.2b	August	$29.5b	↑	$19.2b
Confidence surveys						
QSBO - General business situation[6]	net %	n/a	Q2	33.5%	↓	30.5%
Westpac – Regional consumer confidence[7]	Index	113.8	Q2	128.3	↑	121.2 (NZ)

Notes:
All data is from Statistics New Zealand and is not seasonally adjusted, unless otherwise specified. Other sources of data: Reserve Bank of New Zealand (1) ; ANZ (2) ; Infometrics, Regional Economic Database (3) ; Real Estate Institute of New Zealand (4) ; Ministry of Business, Innovation and Employment (5) ; New Zealand Institute of Economic Research (6) ; Westpac (7). Data presented with the assistance of the Research, Investigations and Monitoring Unit, Auckland Strategy and Research Department.
'.. denotes data not available. GDP data is not available due to revisions in methods employed by Statistics New Zealand.
Calculations:Annual % change is calculated as (Quarter - Quarter-4 - 1)*100 or (Month - Month-12 -1)*100; Annual average % change is calculated as (Year/Year-1 -1)*100
'* Growth in the manufacturing and financial and insurance services sectors is proxied by growth in employment counts in these industries.
'6 - Figures presented are the net percentage of respondents that believe the general business situation will improve in the next six months
'7 - Figures greater than 100 represent optimism at the consumer/household level.