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Steve's Soap Box

The following is yet another contentious piece of opinion Steve has written for the newsletter. As we have warned previously, these pieces are on current issues affecting New Zealand and will be hard hitting and sometimes controversial. Steve is not known for his diplomacy and political correctness, and we have given him an opportunity to say it as he sees it. The opinions stated in these pieces will be his own and not necessarily those of the company or other staff members. We hope you enjoy them as much as Steve enjoys writing them.

Is There a Housing Crisis?

The Reserve Bank has recently announced a third round of lending restrictions (loan-to-value ratio or LVR) for residential property lending. These restrictions are:

- A nationwide "speed limit" on investor lending capping it at 60% LVR.
- A tightening of the "speed limit" for owner occupied lending with a maximum of 10% of new lending permitted to have on LVR greater than 80%.

The Reserve Bank also reiterated that they are looking at debt-to-income ratios. So, why are they doing this? What are they hoping to achieve?

In my opinion, the term "crisis" applies correctly to the housing situation. Stratospheric house price appreciation, particularly in Auckland, has all the hallmarks of a financial bubble which will at some point collapse. My concerns, and the concerns of the Reserve Bank, are:

- when prices do adjust they might inflict significant damage to the banking system.
- social equity - it is accepted that high rates of home ownership are desirable for a stable and prosperous society. Home ownership has now morphed from providing housing for families, to an investment which more closely resembles a **Ponzi Scheme**.

The amount of bank lending against NZ houses has doubled in 10 years and now represents more than 50% of all bank lending. In Auckland, house prices are now amongst the most expensive in the world when measured against household income, and are over twice the long run average and are dearer than Sydney.

'In Auckland, house prices are now amongst the most expensive in the world'

Given this "bubble", it is not surprising that the Reserve Bank is taking action. The Reserve Bank has one very clear goal when announcing

these restrictions. They are trying to avoid a **banking crisis**. They are trying to ensure that our banking system is resilient to a fall in house prices, if and when it occurs. Will the banks have sufficient funding, sufficient capital to absorb losses from bad loans? It is **not** their objective to lower Auckland, or New Zealand, property prices.

So, what could be done to avoid this crisis? Obviously the property equation is complicated and has two clear, and often opposing, factors. The first is **supply**. I could write a book on the inability of our local councils to plan adequately for growth, and their total incompetence over the decades. Suffice to say that central government intervention to force local councils to do their jobs is well overdue. The second factor is **demand**. I could write an even bigger book on this issue, however here are three demand related causes to ponder:

1. Tax

A staggering 45% of houses are now being bought by investors. In some parts of Auckland this is 80%. This is not surprising given low interest rates and the tax advantages. A negatively geared rental property requires heavy borrowing, tax losses can be offset against other income reducing the investor's tax bill, and then the investor does not pay any capital gains tax on the property when finally sold. Surely it is time to review this tax advantage?

2. Bank Lending Restriction

The Reserve Bank has commenced moving down this track. In China the central bank has gone much further and by the time you purchase your 4th property it has to be 100% cash funded. This was recently highlighted to me when a client with low income accumulated over $1.0m in debt buying 3 properties leveraged against each other. This is simply **insane lending**. Clearly we cannot trust our Ozzie owned banks to do the right thing by New Zealanders and lend money sensibly!

3. Capital Requirements of Banks

Banks are only required to have just over $3.00 equity for every $100.00 of loans they make on residential property. Is this adequate given that during the GFC we saw other countries had to bail out banks?

As my wife always reminds me – this will end in tears for someone.

New Zealand – What We Earn & What We Spend

New Zealand Incorporated (NZ Inc.) has a balance sheet and a budget just like all of us. Admittedly there are a few more zeroes, however the principles are the same. If we as individuals owe more than we own, we would be insolvent. If we spend more than we earn we have a deficit which would need to be funded by borrowing from the bank, or selling some of the assets we own. NZ Inc. is no different. If, as a country, we spend more than we earn we go into deficit. This deficit would have to be funded by borrowing, normally by the Government issuing bonds (e.g. Government Stock), which would have to be repaid one day when the country was no longer spending more than it is earning. For the first time since the GFC, NZ Inc. will earn more than it spends this year.

Where does NZ Inc. gets its income?

Individuals paying income tax	$ 32.5 b
GST	$ 19.1 b
Corporate tax	$ 11.6 b
Other indirect tax	$ 6.5 b
Other revenue	$ 3.3 b
Interest and dividends	$ 3.3 b
Other direct tax	$ 2.2 b
Total	**$ 78.5 b**

What will NZ Inc. spend this year?

Health	$ 16.2 b
Education	$ 13.5 b
NZ Superannuation	$ 12.9 b
Social Welfare	$ 12.3 b
Core Services	$ 4.9 b
Law and Order	$ 3.8 b
Interest costs on government debt	$ 3.7 b
Other spending	$ 10.1 b
Total	**$ 77.4 b**

So – who is paying income tax… and how much?

Annual individual taxable income	Number of people		Tax paid $m	
no income	317,000	9%	0	0%
$1 - $10,000	368,000	10%	169	1%
$10,001 - $20,000	625,000	17%	1,151	4%
$20,001 - $30,000	497,000	14%	1,645	5%
$30,001 - $40,000	348,000	10%	1,781	6%
$40,001 - $50,000	354,000	10%	2,444	8%
$50,001 - $60,000	268,000	7%	2,544	8%
$60,001 - $70,000	215,000	6%	2,682	9%
$70,001 - $80,000	161,000	4%	2,515	8%
$80,001 - $90,000	108,000	3%	2,045	7%
$90,001 - $100,000	74,000	2%	1,661	5%
$100,001 - $125,000	119,000	3%	3,269	10%
$125,001 - $150,000	55,000	2%	1,960	6%
$150,001+	96,000	3%	7,339	23%

(Stats are projected for 2017 financial year and provided by Treasury from data collected by statistics New Zealand)

There are some interesting stats you can pull form this table. Individuals earning over $100,000 pa make up 8% of the tax paying population, yet they pay 40% of all income tax. Those individuals who earn less than $30,000 pa make up 50% of the tax paying population, yet they pay only 10% of all income tax collected by the Government.

The Brexit Dilemma

"Brexit" is the popular portmanteau formed by blending together "British" and "Exit" and was created solely in relation to the seemingly far-fetched idea that Britain might one day consider leaving the European Union (EU).

Sometimes reality is stranger than fiction. On 23 June 2016, the UK held a public referendum to determine if they should support a Brexit from the EU (or if they should Bremain). Against almost all predictions, the British public decided with a thin majority of 52% to 48% in favour of Brexit. Apparently the time had come for Britain to turn the economic clock back to 1973 and stand alone once more. Unfortunately, almost no one knows what this result is likely to mean for the UK or the rest of Europe, either economically, politically or culturally.

In order to withdraw from the EU, Britain first needs to invoke Article 50 of the Treaty on European Union. Article 50 sets out how a country might voluntarily leave the EU. Invoking Article 50 would trigger negotiations between Britain and the other 27 EU countries over the precise terms of their withdrawal. This would include agenda items like whether the UK will remain in the European single market (the European Economic Area), and whether it will continue to accept unrestricted immigration from other EU countries. Despite the outcome of last month's referendum, Britain still hasn't formally started the process of withdrawing from the EU. There are many reasons for this, but one of the biggest is that it's exceptionally difficult for any British leader to initiate this process without causing either a political or economic crisis.

With respect to the exit itself there are three possible avenues the negotiations could take, and each looks to have some significant flaws.

1. A clean break

In this scenario, the UK just leaves the EU without negotiating any alternative arrangements. EU leaders would be powerless to stop it, even though this option would be highly disruptive for many EU citizens and businesses. On the other hand, Brexit supporters in the UK would probably find it acceptable. The flaws: Just quitting would probably trigger an immediate recession in the UK, as the British economy depends on free access to the European common market (44% of British exports go to the EU, and the UK financial sector depends on free movement of capital between Britain and Europe).

2. A negotiated deal to stay in the European Economic Area (EEA)

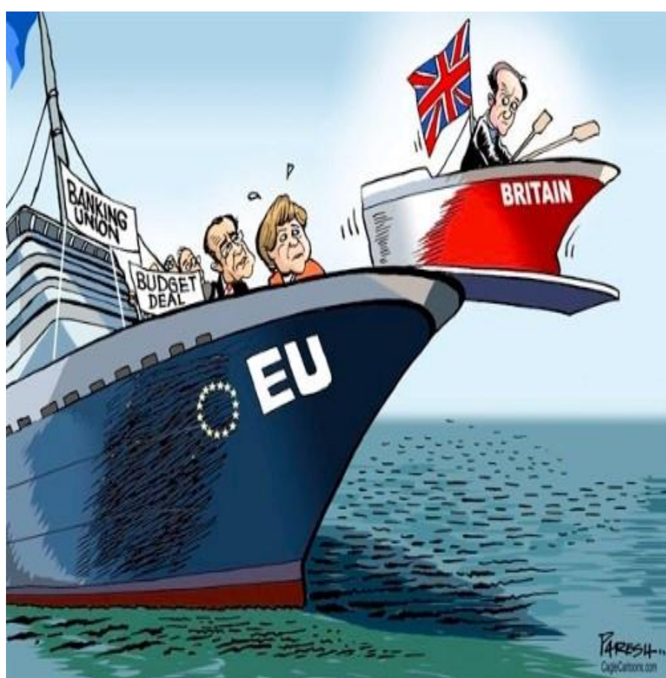
In this scenario the UK negotiates a deal with the EU, allowing it to remain in the EEA but exempting it from other EU rules - most notably the free migration rules that the majority of Brexit supporters hate. The flaws: EU leaders are highly unlikely to agree to this. They certainly won't want to reward Britain's Brexit vote with favourable exit terms for fear that voters in other countries (such as Greece, France, or the Netherlands) take it as a sign that they too could get a sweetheart deal. While this scenario would appease British voters and be acceptable to British political leaders, it will be wholly unacceptable to European leaders.

3. Ignore the vote

In this scenario, British leaders 'take a mulligan' on the outcome of the first referendum and simply refuse to invoke Article 50. This would prevent the new UK leadership from going down in history as being the ones responsible for the potentially disastrous economic consequences of Brexit, and European leaders would celebrate it as an important step away from the brink.

'Nothing has been resolved and yet almost all equity and bond markets are now higher than they were before the Brexit vote'

The flaws: The 52% of Brexit supporters in the UK would rightly feel betrayed and very angry, and even some of the Bremain supporters might see it as undemocratic and, dare we say it, un-British. The political backlash against a future UK prime minister who chose to ignore the referendum could be incalculable.



Intriguingly, in the last week or two it has been reported that a prominent UK legal firm is taking action against the government to ensure that Article 50 cannot be triggered without an act of parliament. With a clear majority of MPs having voted to remain in the EU, there is a lot of interest in how this legal action might play out.

What this all highlights is that the options available to the UK leadership right now seem to fall somewhere between **politically unpalatable** or **economically unbearable**. In the meantime, markets have moved on. Nothing has been resolved and yet almost all equity and bond markets are now higher than they were before the Brexit vote. There is still great uncertainty about the road ahead for the UK and even the EU. However, apart from the British pound, which looks unlikely to strengthen any time soon, the resilience of the markets is effectively saying Brexit is not the end of the world, and, whatever happens, we will be fine.

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