

## Mission Statement

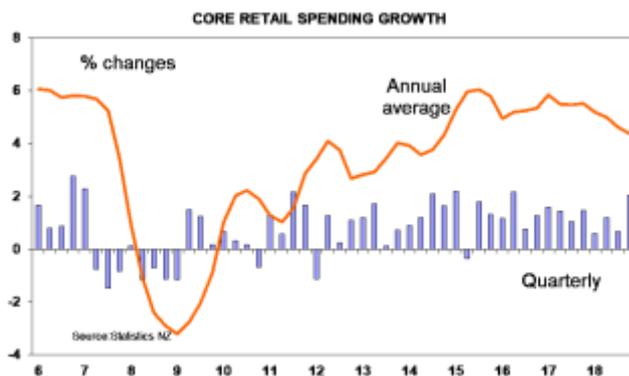
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

## Our Economy

### Strong Retail Spending Growth

I recall writing recently about the debit and credit card data used for making early estimates of retail spending growth, how they are highly volatile, can give misleading insight into what is really happening in retail, and need to be extensively smoothed out. And so it has come to pass that this week's release of the definitive Retail Trade Survey shows that the December quarter card data suggesting gross weakness in spending were massively off the mark.

Those data suggested only 0.6% nominal spending growth in the quarter for core sectors. Actually core spending excluding motor vehicles and fuel jumped by 2% inflation adjusted after rising 0.6% in the September quarter. Retail spending growth accelerated into the end of 2018, it did not slow down.



What this means is that just as we need to treat the monthly migration numbers as virtually worthless, so too should we ditch any pretence toward treating the monthly and even three monthly smoothed Electronic Card Transaction data seriously in any way. But if you are at Statistics NZ reading this, don't feel bad. Plenty of people feel the most recent United States monthly retail trade numbers are rubbish. These are just surveys after all, and adjusting for usual

seasonal variations is just mathematised guesswork.

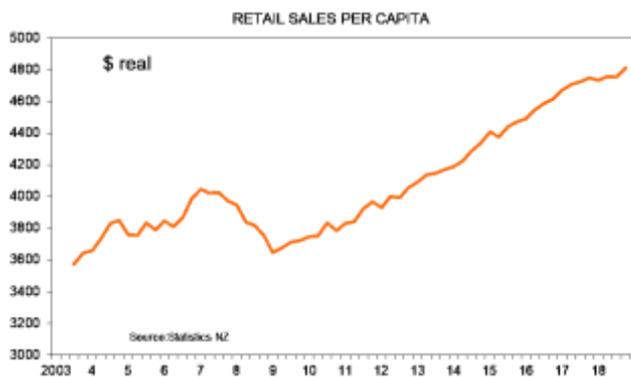
The retail data show consumers to have been in good heart late last year with 4.6% growth in spending on electrical goods, 4.2% growth in spending on food services, and 1.8% growth in spending at supermarkets.

However, before we start concluding that typical NZ shoppers really pulled the stops out late last year, it pays to note that spending on durable goods only advanced about 0.7% following a 1.4% rise in the September quarter. This is important because when you and I are really confident about our futures we tend to sign up to spending money on things which yield a service over a long period of time (durable) and we may be paying for them over a lengthy period as well. If we are pessimistic we tend not to buy extra couches and fridges. We wait until they are totally decrepit before tossing them out and getting something new.

The data are interestingly at odds with what many – though not all – retailers were saying a couple of months ago. This might be because of the huge turbulence in the retailing sector occasioned by new and different forms of competition, and increasing fickleness of us buyers.

Looking ahead, with the jobs market strong, house building firm, net immigration continuing at a high level, interest rates low, and consumer confidence above average, good growth in retail spending near perhaps an average pace is likely to continue. But as we have noted many times in the past, this will not prevent many operators from falling over. The sector is hugely competitive and increasingly dynamic.

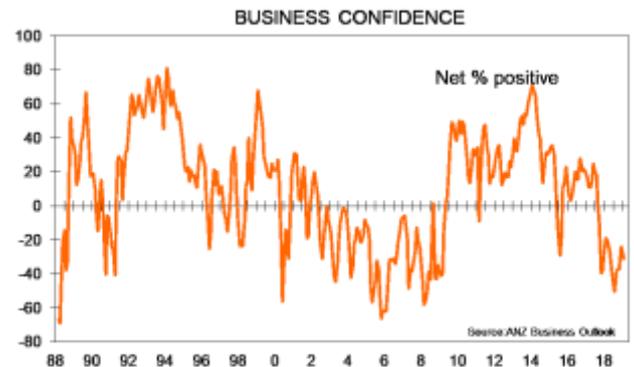
That means great business for people putting new shops together such as in Queen St in Auckland recently, but big losses for operators who are either too optimistic with regard to how many will embrace their new offering, or too complacent with regard to old customers continuing to come back – like Cadbury's maybe as they carve away their heritage. Love those Rainbow marshmallow eggs from Timaru.



We actually got an up to date gauge of retailer sentiment this afternoon in the form of the monthly ANZ Business Outlook Survey. A net 26% of retailers have a bad outlook for the economy, unchanged from the last survey in December but better than net 61% pessimism back in August. A net 6% plan hiring more people which is above the long-term net 3% average for retailers.

For all business sectors the survey shows sentiment in February slightly worse than in December, revealing that the improvement in things from the mid-winter blues has not continued over summer. A net 31% of businesses are pessimistic about the economy for the next 12 months. A net 3% only plan hiring more people with weakness most notable in agriculture and services. Only a net 2% plan boosting investment versus 14% on average. And only a net 11% have a positive outlook for their own level of activity as compared with the economy's which is well below the net 31% average.

Taken at face value one would conclude recession is imminent if not here already. But businesses are largely reacting to the new government and its lack of understanding of business sector concerns and intention to make running a business more difficult and less profitable through a range of measures planned, and others which might come out of the many, many reviews underway.



We still see some good underlying drivers of growth in the economy stretching across the primary sector, tourism, construction, aged care, health care, the digital economy, with above average consumer confidence and good retail spending growth, good net immigration, low interest rates, and a strong labour market. For businesses however profitability is proving harder and harder to maintain these days in a world of rapid change, cost increases, yet limited ability to raise selling prices.

### Housing

There is huge debate about the potential impacts of a capital gains tax regime as proposed by the committee the Labour government set up to look into it. And while the government is trying to downplay the report, we have to remember that they explicitly instructed the working group to come up with a CGT recommendation after the Interim report was released last September. <https://www.stuff.co.nz/business/107131315/capital-gains-tax-would-have-pros-and-cons-says-tax-working-group>

Here are some thoughts in no particular order, about which the important point to note is this. All the effects noted are relevant at the margin. Some of the effects will likely be quite small. But logic nonetheless suggests they will happen.

One impact of a CGT will be to boost road congestion. Why? People will be discouraged from working from home because if they claim tax deductions for the home office proportion of their property applied to council rates, electricity etc. then they won't be able to avoid CGT when they sell the house. People will be disincentivised to work from home and incentivised to go back to working in town – at a time when we can't find enough bus drivers, yet more cars mean more

congestion. People will face an incentive to move closer to city centres if that is where they work.

The government claims that it wishes to improve fairness of the tax system. Yet already 70% of net tax is paid by the top 10% of income earners. Getting "fairer" beyond that risks becoming simply punitive on those who dared stick their necks out and advance beyond the grey blobs they went through school with.

Taxing businesses when sold will tend to discourage such sales. Yet as our business environment gets more dynamic in an accelerating world of change the shelf life of small businesses will and needs to decline as innovation becomes the key driver of business success. A CGT will therefore not just act as a disincentive to set up a business in the first place, it will impede the extremely vital process of creative destruction which lies at the heart of well-functioning economic ecosystems.

Taxes tend to drive people toward areas of activity which are not taxed. In this case the system as proposed would discourage investment in businesses and investment property and encourage investment in family homes (which account for two-thirds of the housing stock), boats, jewellery, artworks etc. Could you turn your business into an artwork? Get Banksy to draw on your wall maybe?

Another key problem if introduced as proposed is that a CGT would make it much harder for investors to protect themselves against inflation. Historically in New Zealand you have been able to do that with property – not paying tax on rises in prices reflecting general inflation. But with no such inflation deduction possible then holding property in an era of high inflation will lead to a wealth-sapping tax bill of much the same destructiveness as current wealth lost through holding term deposits when inflation is high.

The only way to gain inflation protection will be to invest in one's own home with a plan to realise the untaxed gain and inflation-compensating protection of wealth by selling one day and downsizing. Or ship your money out of New Zealand.

The effect in conjunction with some investors selling lower priced rental properties and builders seeing even more profit potential from building high-specced new houses rather than affordable

accommodation, will be to open up a gap between entry level housing and the next two layers. This is something we already expect to see happen anyway as a result of government efforts to try and shift construction toward lower priced properties. At the margin a CGT will incentivise construction of bigger, not smaller more affordable houses.

The message to entry level house price buyers should the CGT regime come in as proposed is this. Be very sure the house you buy can take care of all your anticipated needs for at least the next 20 years because jumping to the next level is going to get a lot harder.

As proposed the CGT will reduce the flow of funds into NZ shares and reduce creation of and investment in New Zealand businesses. This is because the tax an investor will pay on the same capital gain from investing in overseas shares as NZ shares or an owned business will be much less – the Fair Dividend Rate versus marginal income tax rate.

So if the goal of a CGT is to deepen the capital pool in NZ it will have exactly the opposite effect. The problem here is a key one which has been around for a long long time. People seem to believe that if they can discourage investment in property then all that huge pile of money will go into productive assets. But they are mistaken.

First, most money going into property investment is borrowed. That is why the 40% minimum deposit requirement was so effective. We banks are not going to lend to you to invest in shares and we will lend far less for someone to try and make a buck by growing their business than investing in property because the risks are much higher. We hardly ever lose money on housing. Every day of the week we lose some money on lending to businesses.

Second, as already stated, financial exposure to shares and businesses is much more risky than housing. The vast majority of investors who might be dissuaded from investing in housing by a CGT (or ring fencing etc.) are not going to place their deposit amounts into local shares or businesses. They will either seek an offshore share portfolio because of the tax incentive to do so, or will seek out higher yielding local bonds with some term deposits. Or they may grab an off the shelf family lending contract and finance their young relatives into a house – for probably a tax free interest rate

return. At the margin a CGT will worsen the housing situation whereby young folk with help from parents can gain a foot on the ladder which will be denied to those from poorer families. Investors will be incentivised to finance their kids and relies into houses with agreement to split tax free capital gains when the kids and relies sell.

A basic motivating factor behind support for a CGT regime is to lower house prices and to encourage expansion of the country's capital base. But as structured the proposed CGT will shrink our capital base. And the impact on house prices will be minimal because of the long list of other factors I have highlighted since 2011 as underpinning the rise in house prices, and because rents will rise. Are Labour and the Greens willing to accept further deprivation of those on lower incomes dependent upon rental accommodation in order to satisfy an ideological desire for revenge against those who are so up themselves as to dare grow their wealth through means other than or in addition to working manually 40 hours a week?

Another bad aspect of the CGT is absence of allowance for inflation. Why? Because not doing so adds to the fiscal creep benefit the government already enjoys from rising inflation pushing people into higher tax brackets. If general inflation pushes asset prices up, say, 2% a year as theory would suggest, then an asset owner will eventually pay tax on that with no underlying gain in their real (inflation adjusted) net wealth.

The government will reinforce its position as a beneficiary of higher inflation and it would be good if the Reserve Bank and Treasury – once they drag themselves away from discussions arboreal and happy smiley – could focus on the high inflation incentive the CGT regime as proposed would deliver.

How can a person then insulate themselves against high inflation if that is what they fear? Invest in foreign shares.

Nonetheless, is it possible to design a CGT system which ensures that all sources of wealth gain are treated equally? Probably, in theory somehow. But in an economy with insufficient depth in the capital stock, severe lack of businesses growing themselves from small to mid-size to big, dire need for increased business turnover to boost productivity through resource reallocation, and a sharemarket struggling for

relevance, adding an extra roadblock is very unhelpful. That unfortunately is what a government containing Labour and Green MPs with no business experience or understanding will fail to grasp – and that Prime Minister is why the reaction to the CGT regime as proposed is so shrill. Arguing the merits calmly won't get through the ideological blinkers. Greenpeace know that.

In the end, chances are the proposals will be so watered down the government will default to simply extending the five year brightline test to seven years then ten years. Notice the lack of much government playing up of the tax cuts for low income earners which in theory a CGT might allow if not avoided.

### CGT In Summary

For issues of taxation system equity there should be a capital gains tax regime in New Zealand. But people need to realise that all taxes alter behaviour and in summary some of the alterations at the margin which one could expect include these.

- Lower NZ share prices as investors switch to shares offshore.
- Higher foreign ownership of the NZ sharemarket as Kiwis sell.
- Extra investment in one's own house, stretching the gap between entry level housing and the next steps up the family home ladder. Extra family financing of home purchases widening the gap in wealth and home ownership between those with parents able to spare cash and those without.
- Reduced construction of new houses for rental purposes.
- Extra initial house sales by some investors and reduced availability of rental stock as young people currently crammed in at home buy and shift out. Tenants get displaced. Reduced relative rental stock availability will place upward pressure on rents and government payments of the Accommodation Supplement.
- Reduced setting up of new businesses.
- More running of businesses to maximise cash withdrawals while discouraging business growth through long-term investment in assets.
- While some tax sensitive battered down property investors may sell, others may hold onto their properties and businesses while Labour are in power waiting for a National government to abolish the tax – probably while leaving any

personal income tax cuts in place as the fiscal accounts are in good shape. History suggests National would not however reverse this reform and I have yet to find any businessperson in recent days who believes their promise to reverse a CGT.

-Reduced use of homes for work purposes leading to greater demand for offices, greater road congestion, and greater demand for properties close to city centres.

A CGT tax regime would not be the end of the world for NZ. But in the context of a country needing to encourage rather than discourage deepening of the capital stock, encourage the local sharemarket, facilitate faster business failure in order to boost productivity growth, and address issues of housing availability and cost, other policies should probably take priority. And were I one of the coalition partners considering which elements of the working group recommendations to support, my focus would be on achieving desired goals through other means which would be more targeted.

### **Pity the Tenants**

It is admirable that the quality of New Zealand's rental stock is to be lifted by the requirement announced on Sunday that within four years private sector owners must properly ventilate and insulate their dwellings with a living room heater, draught stoppers etc. The downside however is twofold.

First, the extra costs will be passed on into higher rents where possible and given stories of queues of people looking at rental properties such increases will be easy to achieve in some locations. Second, as the government makes landlords explicitly consider the comfort of their tenants more than the returns they may eventually make, some will opt to no longer be landlords because of this extra moral responsibility.

In addition, there are situations where houses due for demolition get rented temporarily and they add to the housing stock. But if they do not meet the new heating and ventilation standards the owner is very unlikely to upgrade them therefore they will sit empty – perhaps for some years. Expect to eventually see some years down the track articles about houses left to fall apart because the value is in the land which is being held for eventual long-term use or sale and the house is essentially a

legally unusable asset. No problem a government might say. Let's introduce another tax on land left unused!

So the announcement on Sunday will have the same effect as the likely extension of the brightline test, removal some years ago of the ability to claim depreciation expense, removal of the ability to use LAQCs etc. Some will sell up. This will be good for people who can afford a dwelling but currently do not have one. But it will in net terms make the situation worse for tenants because at the moment a lot of the people seeking a home to buy will be crammed in with friends or family.

As they move out two families in one house now spread out as two families in two houses. That leaves no house for the tenants.

The underlying fundamental for New Zealand's house prices, rents, the situation of tenants and young home buyers etc will not change and has not changed as a result of the various pro-tenant anti-landlord measures introduced over the past few years. There is a growing shortage of houses in New Zealand in the locations where people want to live or have to live for work, and the cost of adding new houses to the existing stock keeps going up and up.

So just as noted here with regard to the earlier imposts like depreciation removal etc. my big picture macro view remains unchanged. Average house prices have shifted or (in the regions) are in the process of shifting from equilibrium points in the early-2000s to new equilibriums. Auckland is there, the rest of the country will follow. Now rents are doing the same thing and equilibriums in rental markets for practically all locations lie above current levels.

Parents, if you do not have enough money to fund your young into a house then best invest in extra space to house them and their spouse because high rents mean they will struggle to raise a deposit and will need to stay at home longer.

### **Housing Lending**

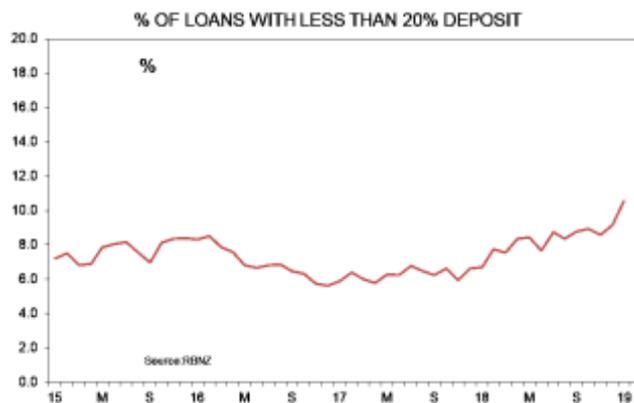
We received data from the Reserve Bank this week telling us that in January the proportion of bank lending going to first home buyers was at a record high since data collection started in mid-2014 at 17.3%. In contrast the proportion of

lending going to investors was 17.9%, down from a peak of 35% reached in June 2016. In July 2016 the Reserve Bank told banks that all investor borrowers bar 5% would need a 40% deposit officially from October but in practice straight away. Notice how the blue line plunges from mid-2016.



In contrast, in Australia in November (latest data) bank lending to investors accounted for 31% of home lending, down from a peak of 46% in May 2015 and 35% a year ago.

10.6% of lending now goes to people with less than a 20% deposit, up from 6.7% a year ago and the highest proportion since these records started in mid-2014. 40% of first home buyers have less than a 20% deposit versus 0.3% of investors.



### Your Strategy

-Things to consider in your next annual strategy session.

This week one focus in the field of labour shortages in New Zealand was the tourism sector. Lots more people are projected to be needed in the next few years as the sector targets an ever increasing number of people to come to New Zealand to spend money here and provide jobs – which it looks like we don't need. Apart from some particular crime-ridden depressed places around New Zealand which some investors think represent house buying opportunities, we don't seem to need companies expanding and delivering more jobs.

Now, the problem with that statement is that actually we do because in the normal course of events companies are failing left right and centre and employees need to find new jobs. Churn is not just something to be understood in terms of people choosing to move from one job to another. Churn is also what happens and increasingly needs to happen in our business sector with failures failing fast and providing space for new and expanding ventures to grow.

The trouble with tourism is that although the sector can easily suck up people laid off from virtually any other job in New Zealand, the positions they offer tend to be insecure with low pay, minimal training beyond very specific on the job requirements, and often horrid hours.

And there is more to come. All logic of rising incomes offshore and continued marketing from New Zealand suggests tourism labour demand will continue to grow. Good part-time work in cafes maybe for older people who have shifted to the regions.

## If I Were A Borrower What Would I Do?

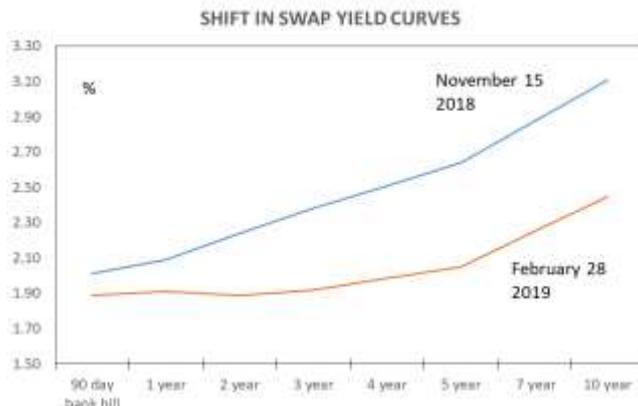
A few weeks back we noted here that in the event the Reserve Bank does require banks to raise more capital and this pushes up funding costs, then there will not be a full flow-through effect into higher mortgage rates. The reason is that rising rates without a change in the inflation outlook will represent a tightening of monetary policy which the Reserve Bank would not want, so they would cut the official cash rate to compensate. And that is what the RB Governor and Deputy Governor both said last week.

“If we were worried, and thinking we were undershooting inflation, undershooting maximum sustainable employment, then we would obviously look for an OCR change...that is the implication,” the RB Governor said.

<https://www.reuters.com/article/us-newzealand-economy-rbnz/rbnz-proposes-raising-top-banks-capital-ratio-to-16-percent-open-to-rate-cut-idUSKCN1QB0H4>

The big change regarding financial markets over our summer just ending has been not just a slight downgrading of world growth forecasts, but a slashing of monetary policy tightening expectations. Heading into November rate tightening through 2019-20 was expected in the likes of Australia, UK, EU, US etc. Now virtually all central banks have revised their inflation forecasts downward and pulled back from warning about rates probably rising soon. In the United States the Federal Reserve have said they will be “patient” and the markets are pricing in rates going down rather than up.

This change in the global interest rates cycle view has manifested itself here as a 0.5%+ fall in NZ swap rates for three years and beyond from November to now. This graph shows the swap rates yield curve now and in mid-November.



Now let's look at a graph showing changes in mortgage interest rates between November and now.



Not quite the same are they? Have anticipated higher funding costs to meet the Reserve Bank's proposed near 50% hike in bank capital bases already been partially passed on? Probably not, but in the absence of a single number giving us insight into how non-swap funding costs are changing for banks scope is left for all sorts of theories.

Were I borrowing at the moment I would be inclined to wait a tad to see if the big reductions in the costs of bank funding will be at least partially fed through into retail lending rates.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. **This edition has been solely moderated by Tony Alexander.** To receive the Weekly Overview each Thursday night please sign up here. <http://feedback.bnz.co.nz/forms/IFdYSs5FGEq4kAjP95uzTA> To change your address or unsubscribe please click the link at the bottom of your email. [Tony.alexander@bnz.co.nz](mailto:Tony.alexander@bnz.co.nz)

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