Spencer again

Michael Reddell | 16 April 2015 |

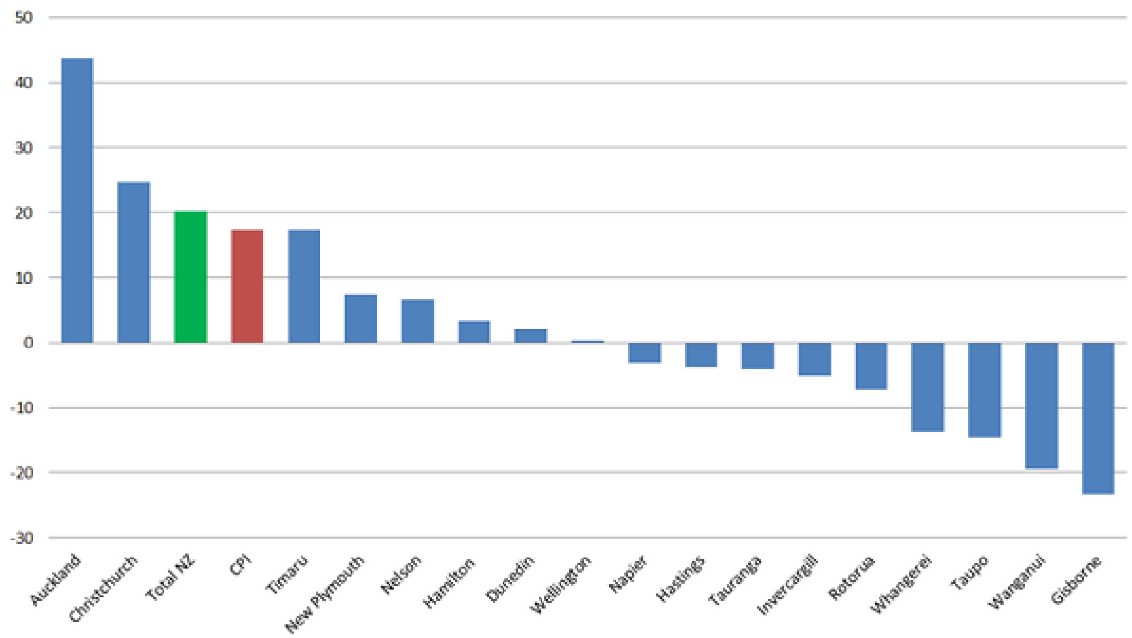
Grant Spencer's interview on Radio New Zealand's Checkpoint last night answered one of my questions. It seems that Spencer, and the Reserve Bank, now favour a capital gains tax. Previous Reserve Bank documents have always refused to take a position on the general merits or otherwise of capital gains taxes, while both pointing out some of the practical limitations, and observing that international experience (including in Australia) suggests that capital gains taxes have not made much obvious difference to housing cycles. I'm puzzled at what has led to the change of view, and have just lodged an OIA request for any recent material or analysis the Bank has produced, had access to, or pointed ministers to, on the case for (and evidence on) a capital gains tax.

Spencer noted last night that the Bank was not trying to enter a political debate, but just wanted to deal with the economic issues. So can we assume that the Bank favours a general capital gains tax (ie on all assets, and with no carve-outs for owner-occupiers)? Since any tax advantages to housing are greatest for unleveraged owner-occupiers (which is what most owner-occupiers aim to become) it could surely only be political considerations that would warrant an exclusion? Does the Bank favour a CGT regime based on annual fluctuations in market values? If, for practical reasons, it favours a realisations-based regime, how does it respond to the proposition that the resulting lock-in would reduce the efficiency of the housing market? One presumes that the Bank favours a symmetrical application, so that capital losses would result in a tax refund from the Crown (those property investors in Gisborne and Wanganui – see below – will no doubt be grateful)? Does the Bank favour inflation-indexing capital gains before taxing them, and does it favour taxing capital gains at full personal income tax rates (even though no other country I'm aware of does)? And, presuming that the Bank is concerned with wider macroeconomic stability, have they given much thought to how to manage the much greater pro-cyclicality of government revenue that would be introduced by adopting a broad-based CGT? Tax revenue would soar, even more than it does now, in boom times, only to slump more sharply in downturns. Heavy reliance on property market based revenue sources was one of Ireland's many mistakes.

The Deputy Governor mentioned yesterday that New Zealand was one of a small number of countries that had not had a large fall in house prices at some point in the last 45 years. I'm not quite sure why 45 years is chosen – I presume it must relate to some international data set. But it is worth remembering that real house prices fell very steeply – by around 40 per cent – in the late 1970s (as population growth slowed sharply), and of course nominal house prices fell significantly during the Great Depression of the 1930s. So significant falls in house prices aren't unknown here, even nationwide.

But more recently, and as I mentioned in passing yesterday, significant parts of New Zealand have been experiencing falling house prices. The chart below uses QV data and shows changes in nominal house prices for a selection of urban areas since what QV describe as the "2007 market peak". I've also shown CPI inflation since mid-2007. Only Auckland and Christchurch have seen any growth in real house prices since 2007. In Christchurch the growth in real house prices is modest (about 6 per cent) and the reason for that growth is both obvious and likely to be quite short-lived. All other significant urban areas have seen flat or falling real house prices in the 7-8 years since 2007, and many now have nominal house prices that are below levels seen in 2007. Eyeballing the various TLAs, it looks as though most of the population has experienced flat or falling real house prices since 2007, and perhaps as much as a third of the population has experienced falling nominal house prices since 2007. Perhaps the Deputy Governor should be pointing this out. And I wonder if the Reserve Bank has gathered any information on the loan loss experiences in the areas that have experienced falling nominal house prices in recent years. Are there any surprises in that data?

Figure 1: QV house prices: percent change since 2007 market peak



Spencer seemed to have a knee-jerk negative reaction to investment property purchasers. Spencer observes, disapprovingly (?), that rental yields have been falling, but doesn't seem to connect this to the fact that yields on a wide range of assets (government bonds most obviously) have been falling, and keep on surprising financial markets – and central banks –

by how low they have gone, and for how long. With the prospect of lower fixed income yields for longer – here and around the world – it is hardly surprising that fixed assets (especially supply-constrained ones) would tend to increase in price. Perhaps New Zealand interest rates (which are high by international standards) will rise at some point, but the Reserve Bank's track record doesn't suggest it is better placed than anyone else (including borrowers and lenders) to know when, or by how much. And finally, Spencer doesn't seem to connect an increased share of investors in the housing market with the Bank's own LVR speed limit. Their own analysis, conducted before the LVR speed limit was put in place, told them that if life was made more difficult for first home buyers – who have always (and sensibly) tended to be disproportionately those who take out high LVR loans – other buyers would replace them to some extent. Investor purchasers were always the most likely replacement purchasers. There is a real danger here of one control begetting another, and another.

Spencer claims that 39 per cent of total dwellings in Sydney are apartments, whereas in Auckland only 25 per cent are. I'm not sure what the definition of "apartment" he is using here, but even if his numbers were right, what should we take from them? Everyone knows that Sydney house prices are absurdly high – on Demographia numbers, relative to incomes, even higher than those in Auckland. And planning restrictions, and suggestions of corruption around the process, are even worse in New South Wales than those in Auckland. No one should look to Sydney for positive guidance on housing supply. More generally, there is no evidence that the vast mass of people in Australasian cities want to live in apartments. Instead, apartments – which use less of the regulatorily-constrained factor, land – become a second or third best endogenous response to exceedingly high prices. Don't get me wrong, I'm all for ensuring that planning laws are sufficiently flexible to accommodate apartments and greater urban density to the extent that private preferences call for that sort of housing, but we shouldn't be using planning law to prioritise one type of dwelling over another. As I noted a couple of weeks ago, as cities get richer they tend to become less dense over time.

The speech is puzzling. Spencer claim to want fast-acting measures, and laments that supply changes are likely to cut in only slowly. And yet he is reacting to short-term phenomena – the latest pick-up in house prices in the last six months, and the effects of a surge in migration that – as all previous ones have been – will probably prove short-lived. Spencer surely knows that far-reaching RMA reforms are unlikely in the near-term. And significant tax changes are also unlikely. We shouldn't be making fundamental changes in the tax system based on short-term developments in a single asset market, the current government has been quite clear in its opposition to a CGT, and even if it were not so, it is unlikely that any such regime could be put in place in less than 18 months.

Migration policy should also not be determined primarily by short-term swings in the housing market, but actually the target for non-New Zealand migrant inflows is set by ministers, and could be altered quite readily, without the need for legislation. If the issues are really as urgent as Spencer suggests – and from a financial stability perspective their case is still not made - it is puzzling that the Bank is not more supportive of exploring winding back the target level of non-New Zealand inflows.

If the Bank is really worried about the financial stability risks, they have relatively neutral non-distortionary tools at their disposal. For example, increasing the required minimum capital ratios (or even just housing risk weights, or Auckland housing risk weights) would build bigger buffers to cope with the risk of an eventual nasty correction. That is less ambitious than attempting to directly controlling high LVR loans, or loans to investors, but it is also much more realistic about the limitations of the Bank's (and everyone's knowledge). The Bank has no better knowledge than anyone else as to when, say, population pressures might ease or supply responsiveness might be permanently increased. But adopting such measures would require them to front up more directly and explain why such additional buffers are necessary when the results of their own stress tests suggest that the banking system's assets, and capital, are robust to even substantial adverse shocks. Rapid credit growth is the most important factor in heightened crisis risks. We don't have that across the country as a whole, and all our major institutions are nationwide lenders. The risk of severe loan losses is also much higher when there is extensive overbuilding - whether housing, or commercial property. Again, we don't see any sign of that.

In the end I'm wondering if the speech should best be seen as defensive cover for the next round of regulatory interventions, which the Bank keeps alluding to, but which we have yet to see details of. Perhaps we'll be told not to complain about further quite intrusive restrictions imposed by a single unelected official if the political process won't tackle the Bank's view of a policy reform agenda? I didn't think that was how democracies were supposed to work.

Michael Reddell spent three decades as an economic adviser and manager at the Reserve Bank of New Zealand. He helped devise the inflation targeting regime, ran the Bank's economic forecasting, was Head of Financial Markets, and more latterly was a Special Adviser across a range of policy and analytical functions. Michael also spent time as resident economic adviser at the Bank of Papua New Guinea, the Bank of Zambia, and on secondment at the New Zealand Treasury. From 2003 to 2005, Michael was New Zealand's representative on the Board of the International Monetary Fund. Read more from Michael Reddell at Croaking Cassandra.
