KIWIS LIKE BUYING HOUSES MORE THAN BUYING BUSINESSES

Talk to PricewaterhouseCoopers Annual Tax Conference
Alan Bollard, Governor, Reserve Bank of New Zealand
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INTRODUCTION

This talk looks at a very Kiwi phenomenon: householder investors who prefer to put their savings into houses rather than a broad range of financial investments, especially equities. Apart from having all their eggs in one basket, this also has implications for the level of gearing taken on by the household sector and the manner in which New Zealand's debt is funded. It has also meant that not much local equity is available for New Zealand business. The gap has been filled by foreign equity, which brings many development advantages for large businesses, but which is less conducive to supporting start-ups and other small businesses. It has also left the economy more vulnerable.

The Reserve Bank has the dual roles of promoting stability in prices and promoting stability in the financial system, to enhance economic performance. Both these concerns drive this talk.[1] The bigger picture around financial stability will be updated when we release our latest Financial Stability Report on 15 November 2006.

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[1] This talk does not represent investment advice for the household sector. Householders' needs and options differ and they should get professional advice for this.

Declaration of interest: My wife Jenny Morel runs a venture capital business, No 8 Ventures Limited.

Readers should note that there are limitations on the quality of data in this paper. The comparative statistics have been assembled from a range of sources and may be subject to inconsistencies. Reserve Bank estimates have been used where data have been unavailable from other sources.

HOUSEHOLD BALANCE SHEETS

In comparison with other comparable OECD countries, New Zealand households hold a very large part of their assets in housing. The rates of owner-occupied housing are not particularly high in New Zealand. Rather what marks us out are a number of features:

We hold relatively large holdings of second homes (and associated durables like cars and boats), usually under-utilised, and delivering low returns. In addition, over the last few years we have spent heavily on investor housing (houses and apartments), investments stimulated by expectations of exciting capital gains rather than exciting rental yields.

The household sector balance sheet – 2005

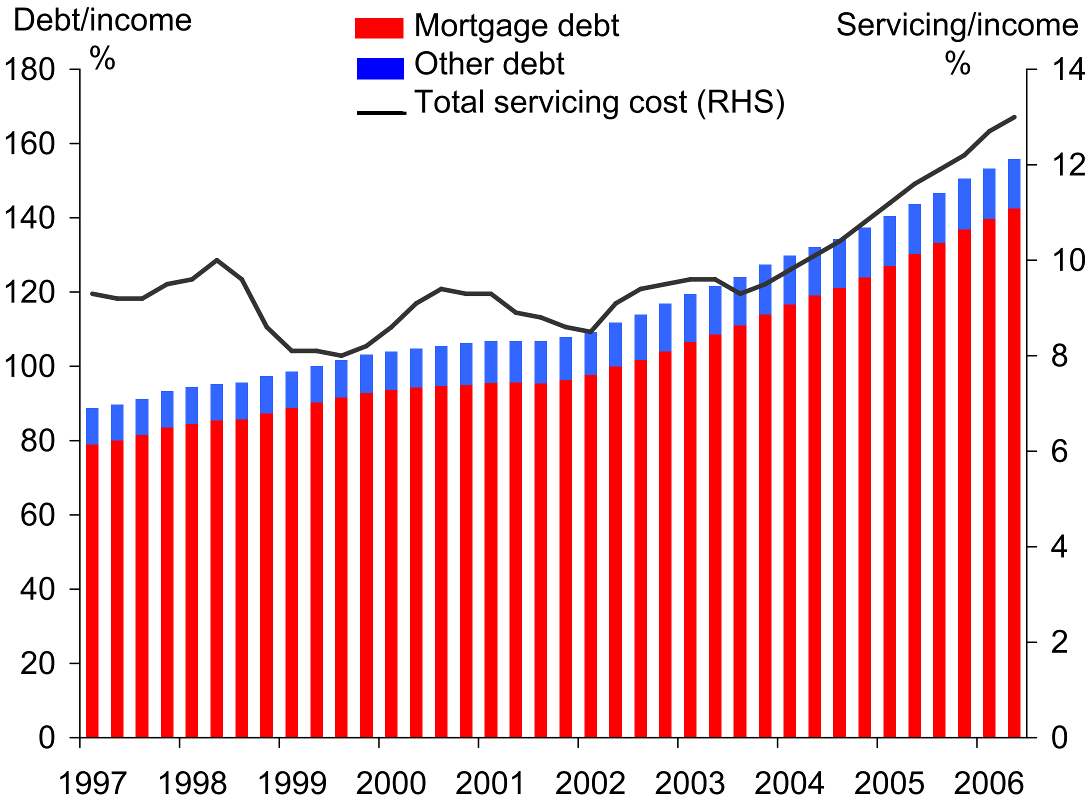
$ Billions

Deposits with financial institutions	72
Direct holdings of equities	20
Life, superannuation and managed funds	57
Other financial assets	13
Housing stock	506
Total assets	**668**
Loans secured by housing	115
All other loans	27
Total Liabilities	**142**
Household sector net worth	**526**

Source: Reserve Bank

This exposure to housing is being financed by increased mortgage debt from the banking system. The average New Zealand household's debt has risen from around 100 percent of disposable income to around 170 percent over the last five years. This imposes a heavier mortgage-servicing burden, which has been justified by the big increases in house values. The typical household now commits about 13 percent of its disposable income to service debt. This makes these households much more vulnerable than they used to be to adverse events, such as increases in unemployment and rising interest rates. These debt servicing rates are significantly higher than in other OECD countries.

Households' debt servicing costs

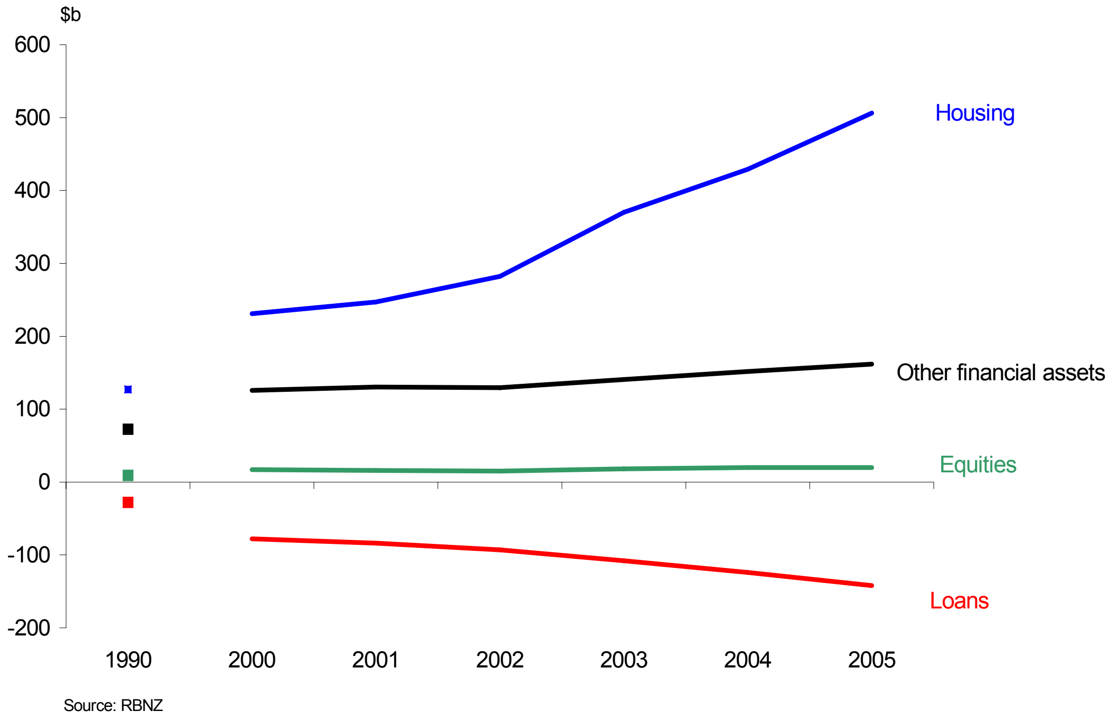


Source: Reserve Bank

Despite this vulnerability, the increases in house values have stimulated a strong wealth effect. Households feel richer (and provided house values hold up, they are richer), and have been spending with confidence. Their confidence is such that they have been prepared to dissave at an unprecedented rate.

The preoccupation with housing assets has been at the expense of other assets that one might normally expect to find in balanced household portfolios, namely financial assets, such as equities. This speech highlights the unusually small holdings of equities by New Zealanders and some of its financial and economic implications.

Household assets over time



Most of our housing stock is owner-occupied, and our behaviour here is not unusual by OECD standards. In this talk I focus on those households with sufficient resources to consider investments beyond their own occupied houses. Many New Zealand households are not sufficiently well off to consider much in the way of equity investment. For those that are, a financial advisor would look at a particular set of household circumstances and, depending on these, advise an appropriate balance of holdings split between:

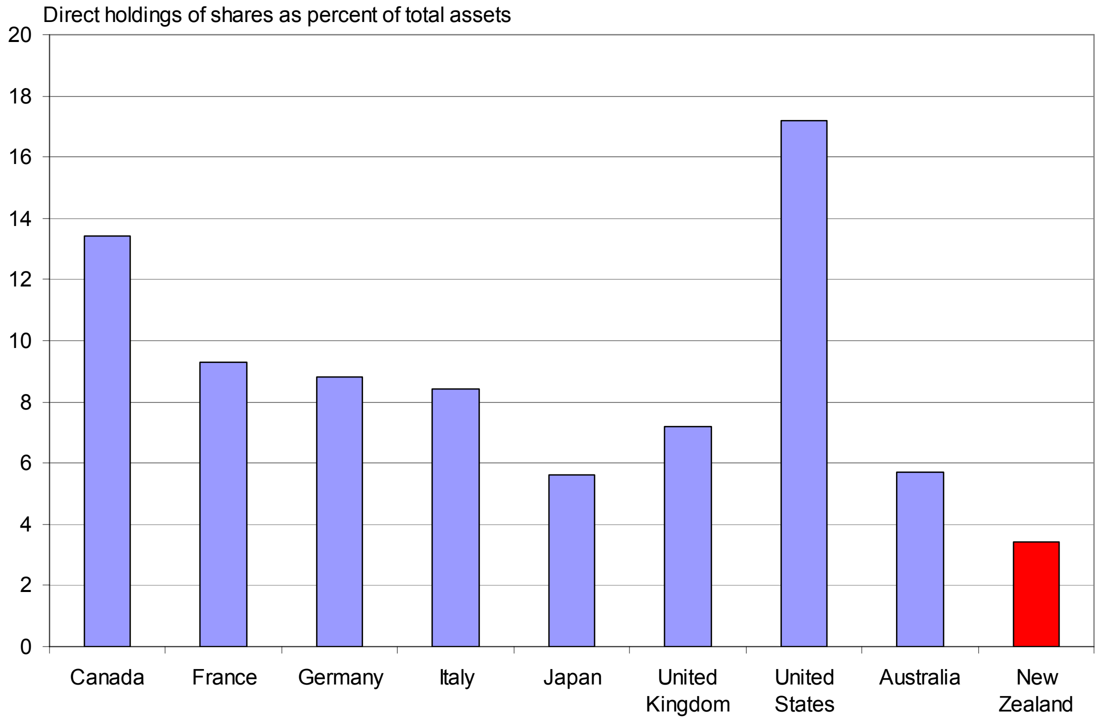
- Land and buildings in both residential and commercial sectors.
- Cash and financial debt instruments that might vary by duration and risk.
- Equity holdings, both direct and portfolio ownership, in private and public firms.

These holdings would differ largely depending on variations in income, wealth, household size, composition, and age. The situation is further complicated by the ability to hold assets directly or via managed funds; by quite different tax treatments; by decisions to invest in New Zealand or overseas; by commitments in directly held family firms, farms and forests; and by decisions by the Government to hold certain assets jointly on behalf of New Zealanders.

SOURCES OF EQUITY IN NEW ZEALAND

It appears that holdings of equity by New Zealand households are particularly low by OECD standards, with direct holdings of both domestic and foreign equities making up no more than about 4 percent of total assets. A frequent reason cited is the severity of the October 1987 stock market collapse, an event that passed by 20 years ago. In the US, despite similar pressures in 1987, troughs in the 1990s, the “dotcom bubble”, and the “tech wreck”, direct equity holdings are now around 17 percent of assets. New Zealanders’ indirect holdings of equities via superannuation funds, unit trusts and other long-term investment products managed professionally by large funds also appear to be low by international comparison.

Direct holdings of equity: international comparison

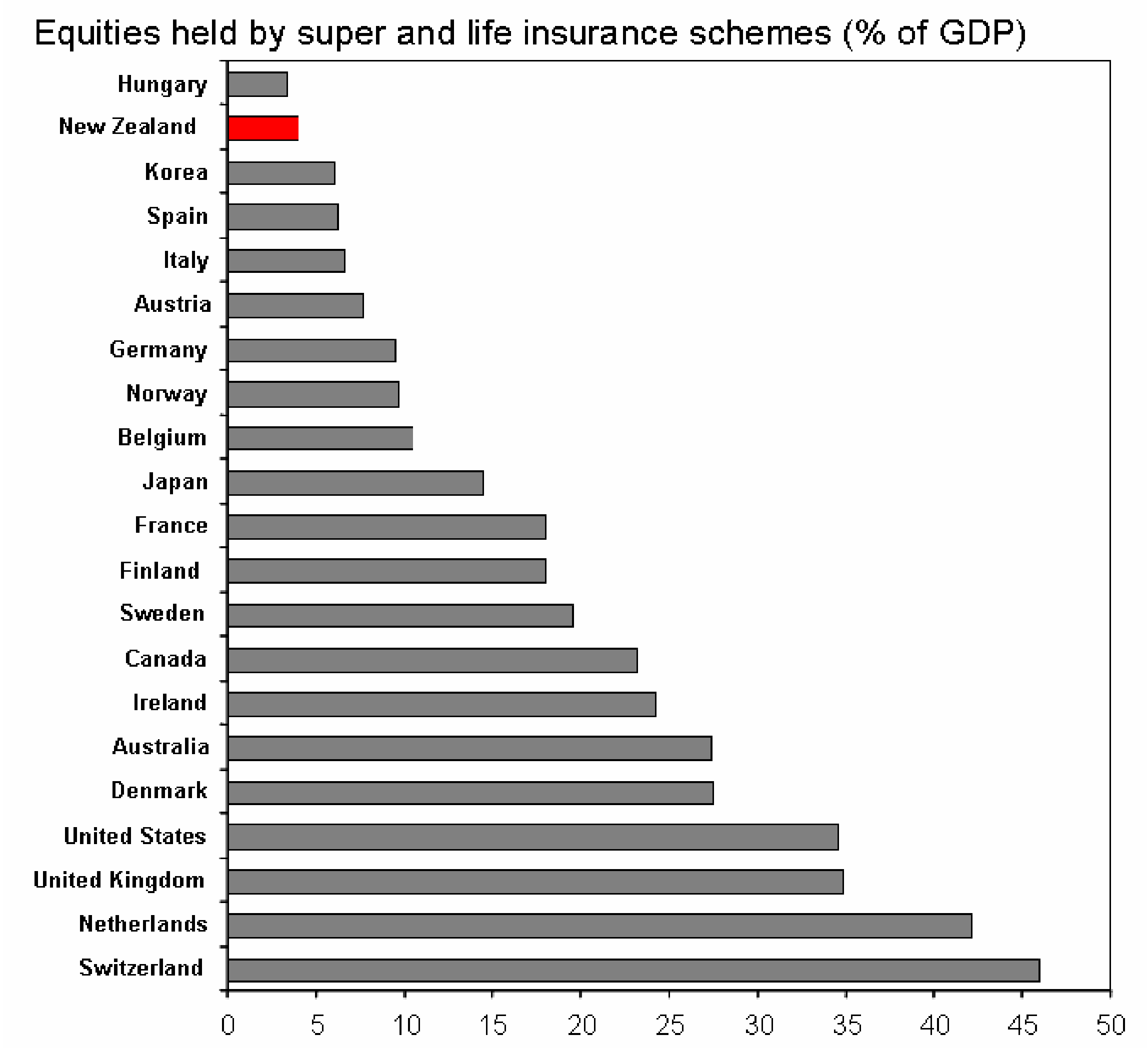


Source: OECD, Reserve Bank

Data on our holdings of equity is not conclusive. As at December 2005, the household sector held around $14 billion of domestic equities and around $6 billion of overseas equities. Indirect holdings of domestic equities on behalf of households via superannuation schemes, managed funds and unit trusts accounted for another $8 billion. The overseas equity holdings of such funds are likely to account for perhaps another $15 billion given their overall exposure to international assets.

How much equity do individual households typically own? The picture built up by the Reserve Bank of household balance sheets from various surveys confirms that equity holdings rise sharply with income, implying that the distribution of holdings is highly skewed. Based on the 2001 Household Savings Survey we estimate that the median value of direct equity holdings for those households that own shares is around $6,000. However, the same survey showed that a very significant proportion of households (around 70 percent) had no direct holdings of shares at all.

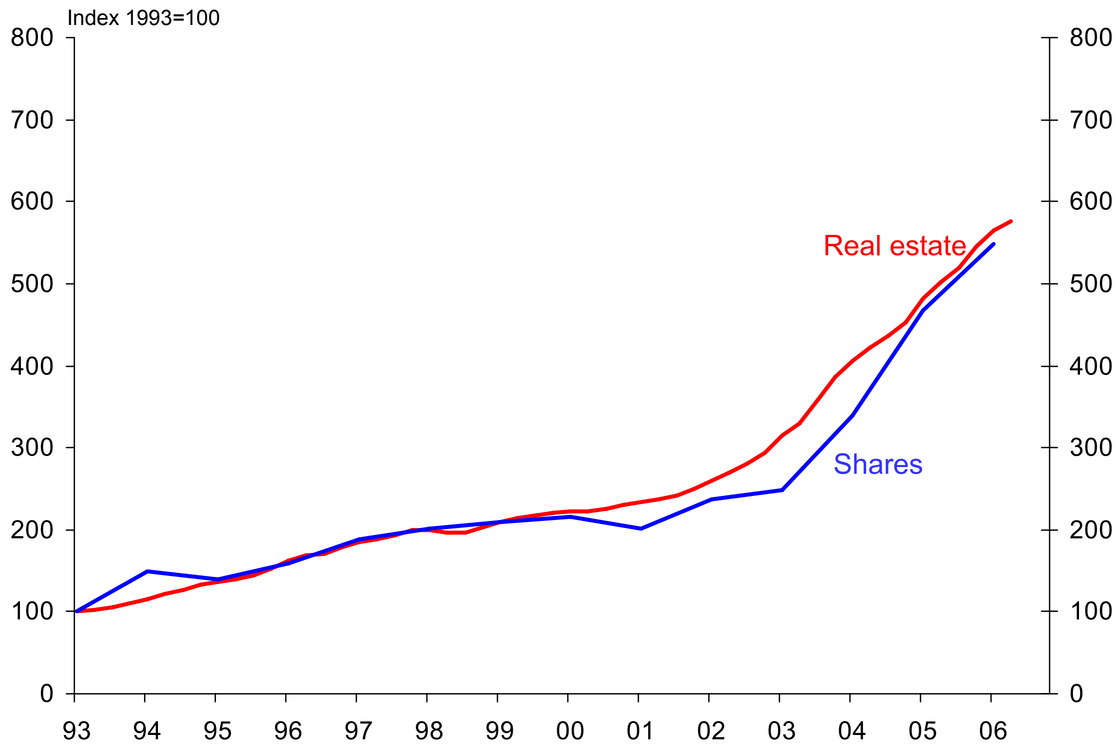
Indirect household ownership of equities also appears low by international standards



The listed public company investment opportunities available through the NZX are limited, given the slow growth of large New Zealand corporates, and the advantages some have seen in listing offshore. Some of the better-known names have delivered poorly to shareholders, or disappeared off the exchange. Despite this, the index returns have not been poor over the medium-term, and over certain periods have even out-performed housing investment in pre-tax terms.

New Zealanders invest about twice as much in equities directly compared with managed funds. This may reflect our DIY investment culture, also a disdain for advisers, fund managers and their fees. Many see equities as a shorter term, more speculative investment rather than a longer term hold. New Zealanders in general do not have a high level of financial literacy about such investments and how to manage them. Aversion to equity may also reflect some psychological traits, particularly the desire to hold and control a physical asset over a financial one, or one where the investor can contain costs by utilising their own skills in construction, house maintenance or tenant management.

Index of pre-tax real estate and equity market returns (for an initial investment in March quarter 1993)



Source: Reserve Bank. Returns calculated to include capital gains or losses plus rents or dividends as appropriate. The data are indicative only.

Tax treatment will often prove a deciding factor in decisions about housing versus equities, direct versus portfolio approaches, and onshore versus offshore investments. From this individual point of view, housing-heavy investors may look to be acting rationally. In particular, capital gains on housing assets are usually tax exempt, while those on financial assets are often not. In addition, households can negatively gear investment properties so a loss is created, which can be deducted from income for tax purposes.

But it is not the purpose of this speech to examine the implications of tax policy for household decision-making. I focus here on the wider concerns - the implications of holding too many eggs in one basket, the exposures generated by gearing decisions, and the lack of ready access to local equity by New Zealand firms.

There are specific difficulties interpreting the data on equities. In particular, New Zealand is a country of small firms and farms, almost all privately owned, most of them through families. An important form of debt is mortgage financing on the owners' house(s). This raises the statistical complication that the household sector holds more equity than is initially apparent. An additional complication comes from the inconsistent treatment of family trusts, and the assets held by them. We estimate that about 15 percent of households now hold assets through family trusts.

Furthermore, globalisation is complicating things considerably. Our official data on offshore equity holdings by New Zealanders probably under-estimates the real situation. Statistics New Zealand surveys New Zealand resident institutions as to their offshore holdings and bases their measure of direct holdings on IRD returns. As a result, offshore holdings of private equity and equity paying low dividends are unlikely to be fully captured. Migrants into New Zealand pose particular measurement challenges, especially when they retain ownership interests in offshore operations where they continue to have family or corporate ties.

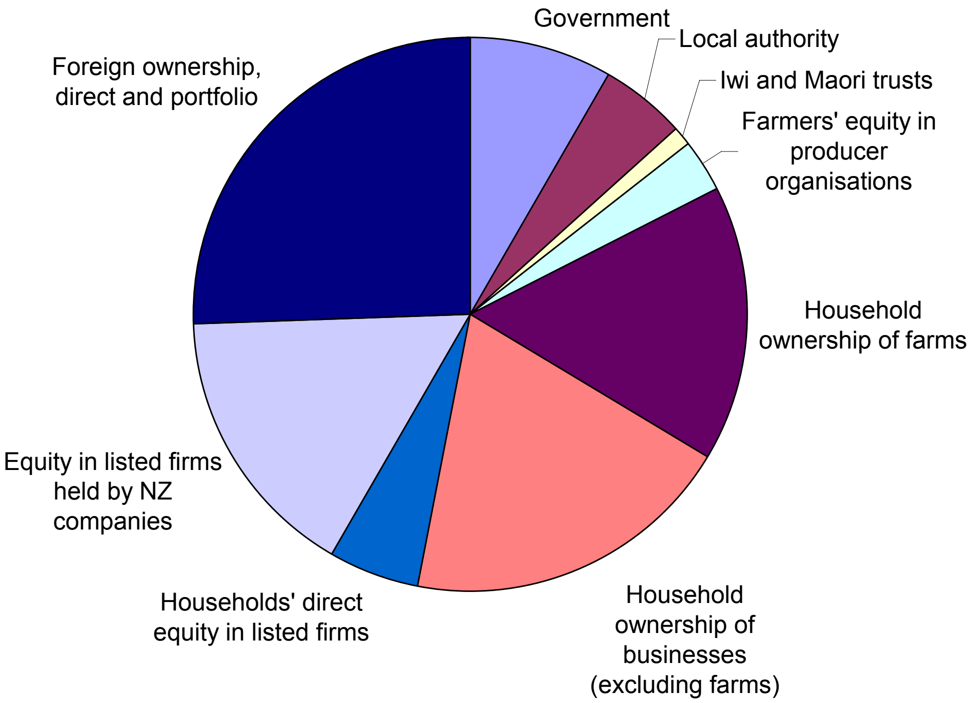
Of course the Government itself has significant holdings of equity and it would be rational for householders to take these into account in their savings decisions. Through various Crown Financial Institutions, and in particular the New Zealand Super Fund, the Government indirectly holds about $600 million of New Zealand equities onshore and about $1,800 million offshore. Through its State Owned Enterprises and holdings in Air New Zealand, it holds another $10 billion directly. Local Government also holds significant equity positions.

There are three particular types of corporate in New Zealand that have been untouched by foreign ownership because their form and modus operandi prevents this. They include State Owned Enterprises, and other Government companies and holdings. In particular, there are some very big infrastructure players among the State Owned Enterprises, with each of the top four firms having total assets in excess of $2 billion. The second corporate form of interest is the iwi or trust-owned Maori corporation, often with fragmented ownership. These are estimated to total about $4 billion. Finally, there are some large and powerful producer co-ops (especially in primary production) and retail co-ops with member ownership. These now constitute a high proportion of the New Zealand-owned corporate sector.

EQUITY FOR THE CORPORATE SECTOR

Let us turn attention to the corporate sector in New Zealand, their organisational forms, where they invest, how they are financed, and ultimately how they are owned.

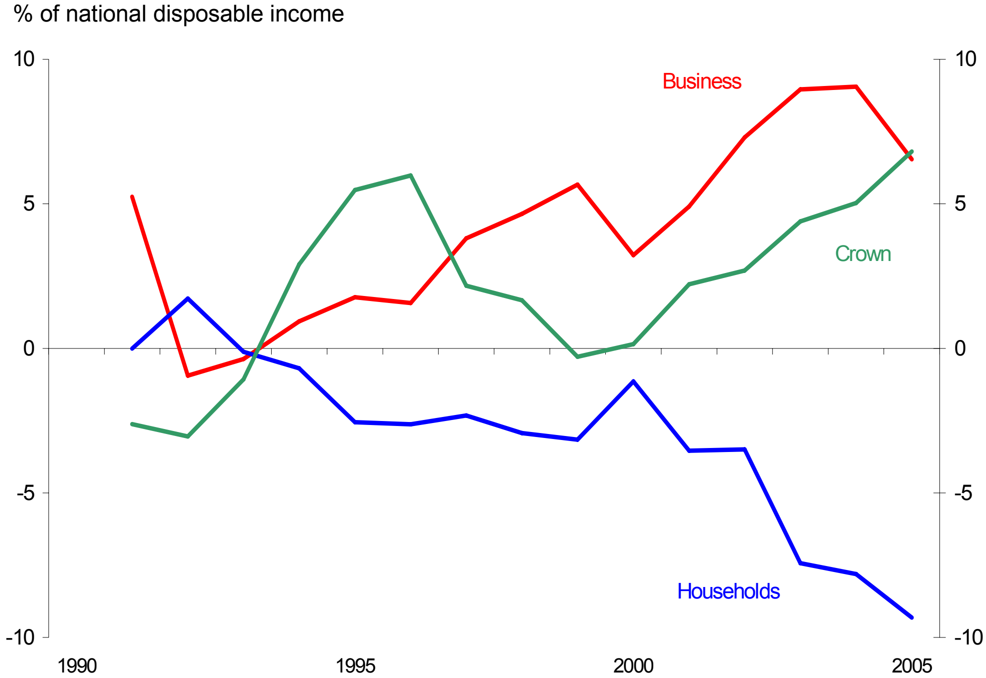
Ownership of New Zealand's business sector
Percent share of total net worth



Sources: Statistics New Zealand, Computershare Limited, annual reports, Reserve Bank calculations and estimates. Due to data limitations, the shares in this chart should be regarded as indicative only

The corporate sector, in contrast to the household sector in New Zealand, has over recent years been saving strongly; savings that ultimately are reinvested, returned to shareholders, or used for equity investment in other operations. The very low levels of household savings need to be viewed against this stronger corporate savings performance.

Saving by households, corporates and the Crown

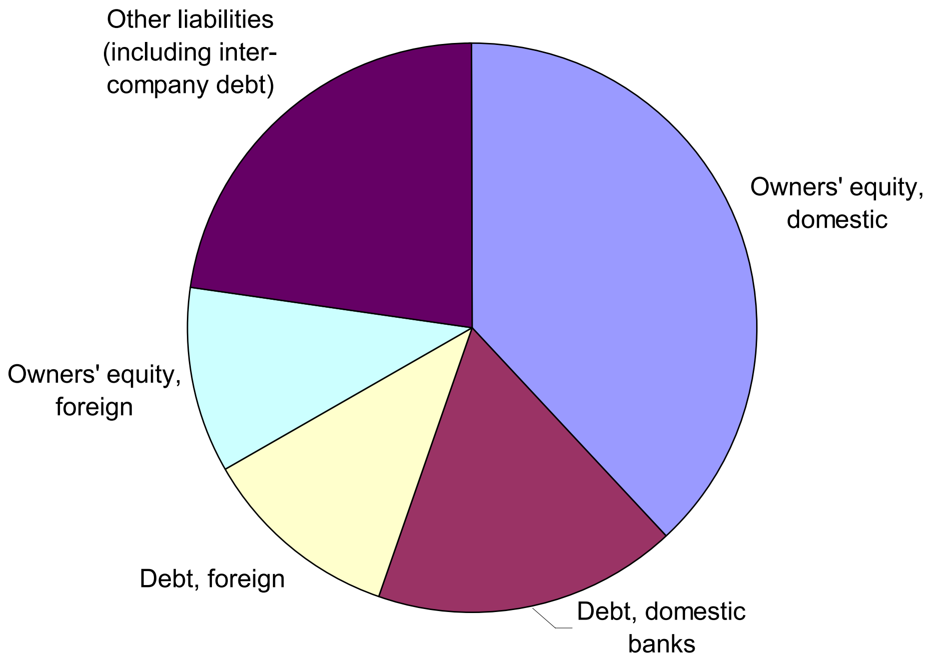


Source: Statistics New Zealand, Reserve Bank calculations

Where do New Zealand corporates get their financing from? As noted above, the family-owned firms, farms and forests turn to the household sector. New Zealand corporates raise most debt finance directly from banks, either from the New Zealand subsidiary or, if they are big enough, directly from the offshore parent bank. These debt markets appear to work well, although borrowing locally means paying rates that have traditionally been higher than in other OECD countries, even Australia. The New Zealand rates contain a premium that reflects exchange risk and the liquidity risk that is inherent in a small remote market such as New Zealand.

Compared with other comparable countries, the corporate bond market is a very thin one in New Zealand. (There are, of course, a very large number of global bonds denominated in $NZ, but most of these are Eurokiwis or Uridashis, whereby foreigners effectively provide finance for lending into the New Zealand household market.) The corporate bond market is thin because it is effectively restricted to those corporates large enough to be recognised internationally. In addition, there is a significant compliance cost to issuing bonds/notes domestically, and direct bank debt often looks an easier option. (The lack of a corporate bond market in turn means a less mature yield curve and lower quality pricing information.) For most small to medium sized businesses, the banking system is a more cost effective conduit for accessing offshore investors funds. The effect of this is to limit the onshore funding options available, and to limit the onshore financial instruments New Zealanders can easily invest in.

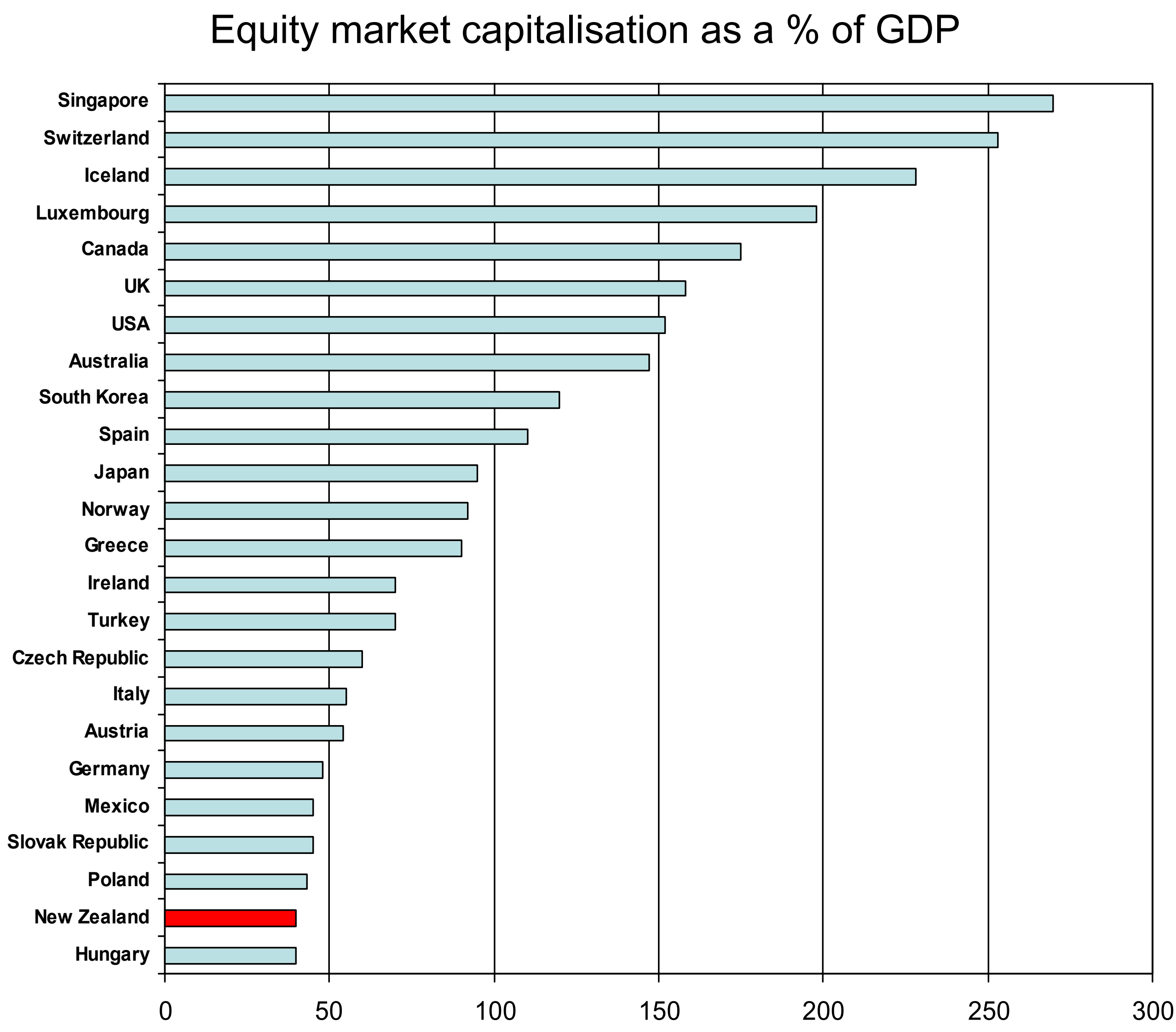
Funding of New Zealand trading enterprises



Source: Annual Enterprise Survey, Reserve Bank

Turning to the stock market, it appears that domestic corporates and New Zealand individuals have an ownership stake in publicly listed companies of around 53 percent. The remainder (47 percent) of the stock market is owned mainly by interests from the US, Australia, and the UK. This differs slightly from the international investment position, which suggests foreign interests own only around 28 percent of New Zealand assets. The lower proportion suggested by the international investment statistics reflects the fact that ownership of non-listed and unincorporated businesses tends to be rather lower than in publicly listed companies. (Australia is the largest inward investor with around 30 percent of total foreign investment.)

This is shown in the figure: due to small scale firms and private equity, the size of the stock market in New Zealand is very small, both absolutely and as a proportion of GDP. Of course some New Zealand firms list singly or jointly on the Australian exchange. Despite enjoying some good returns, the small size of this exchange limits options for both New Zealand firms and New Zealand investors.



Source: IMF

We are currently seeing a phenomenon where considerable private equity is roving the world looking for investment opportunities. Close to home, one source of this is the Australian pension schemes, which are filling limited investment opportunities onshore and are increasingly looking at markets like New Zealand. Some of this involves publicly listed New Zealand companies, while a less transparent part has been private offshore funds buying private New Zealand companies.

Offshore some of these funds have helped develop more sophisticated segments of capital markets, such as venture capital. But in New Zealand the relatively small scale and low risk appetite of institutional funds means that this market has had to rely on a small number of high wealth individuals and has developed much less as a result. This limits high growth, high risk firms' access to growth capital, particularly important in a market where home bias is strong due to the inevitable uncertainties in assessing start-up / growth firms.

SOME CONSEQUENCES OF OUR EQUITY SHORT-FALL

What are the consequences of New Zealand's households' preference for investment in housing over investment in businesses?

At the micro level it appears that small-medium firms have been less able to access New Zealand-based specialised capital market instruments, for example, in the area of private equity, and venture capital. It is hard to judge how much of a disadvantage this has been, but if it drives New Zealand corporates towards foreign financial markets and eventually towards foreign relocation, then that could be activity lost to New Zealand.

New Zealanders' unwillingness to provide equity capital has been an incentive for increased direct foreign ownership. In many cases this has been desirable, even inevitable, for expanding companies. One can see a natural progression whereby some New Zealand companies gradually outgrow the technical and market limitations of this country, and as they expand into bigger markets, take on more of the ownership attributes of international firms. But if that happens "prematurely", there is an opportunity benefit foregone for New Zealand.

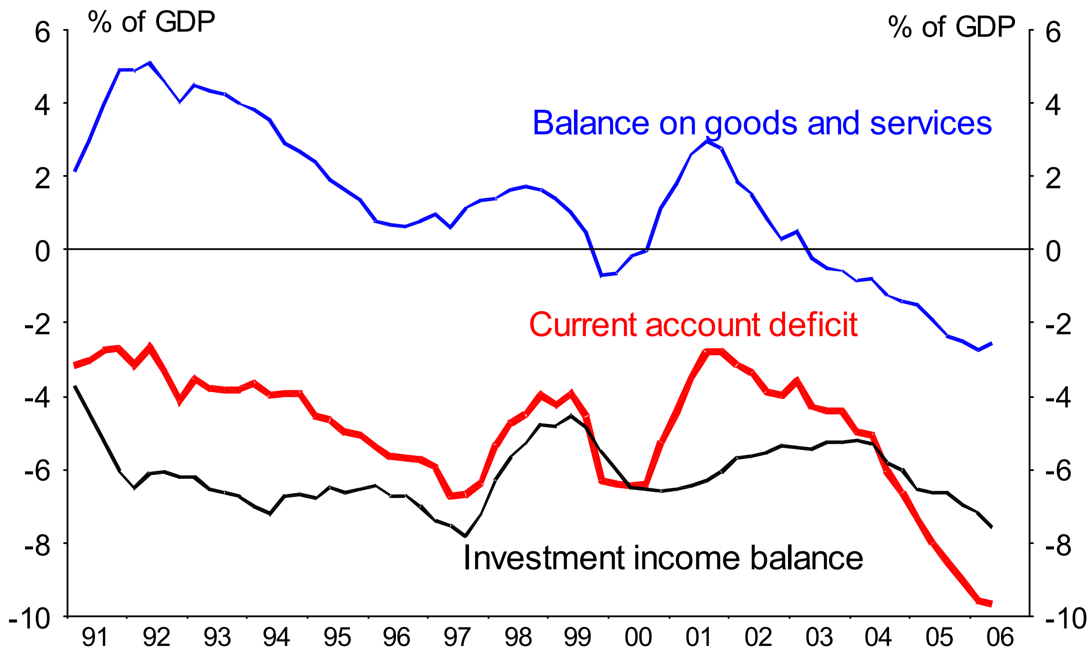
New Zealand's liberal attitude to foreign ownership has brought us many important advantages. We have enjoyed access to the world's capital, to best practice international technologies, to specialised business skills, and to marketing networks. These have brought higher productivity, employment opportunities, and have contributed to our higher growth rates.

This also has to do with the much discussed cultural tendency of some New Zealand entrepreneurs to grow their business to sales levels of some tens of millions, then exit for the "bach, boat and BMW" semi-retirement subculture, leaving overseas investors to expand the business further and develop its full value internationally.

GDP is a measure of what is produced in New Zealand, while National Income (which used to be called GNP) measures the fruits of production that actually accrue to New Zealand residents. In 2005, National Income was around $10 billion lower than GDP, as a significant part of GDP accrued to the overseas owners of New Zealand-based companies. Ultimately, it is National Income that matters for the overall economic wellbeing of New Zealanders. The wedge between GDP and National Income has some quite complex welfare implications for government, which has to balance how much its policies aim to promote activity in New Zealand, or activity owned by New Zealanders, whoever or wherever they may be.

One particular consequence is seen in our current account deficit, a measure of the external financing required by the country's investment-savings imbalance. In recent years about half the deficit has been represented by the trade imbalance. The other half has mainly been the imbalance of income earned by foreigners in New Zealand compared with that earned by New Zealanders abroad. Measurement problems apart, this appears to have been growing as a result of recent investment trends. A further decline in the ownership share of New Zealand business will worsen this deficit and put the balance of payments under continued pressure.

New Zealand's current account balance



Source: Statistics New Zealand

Interestingly, our net international investment position as a percentage of GDP has not worsened substantially in recent years. However it will be difficult for New Zealand to substantially improve the investment income component of the current account deficit in the short to medium-term because the stock of foreign ownership is already so large. If the $NZ were to weaken in the medium-term in line with many economists' predictions, then we would expect to see a further pick-up in foreign investment attracted by cheaper New Zealand assets.

Such a large debtor position, arising out of New Zealand's poor savings performance, makes the country more vulnerable to adverse shocks. We are inevitably more exposed to changes in global interest rates or sudden shifts in the investment preferences of overseas investors. At times, this can make it more challenging to maintain price stability and avoid unwanted swings in economic activity. This pattern of household investment also impacts economic performance. If New Zealanders fail to identify and invest in higher yielding equity then we condemn ourselves and the country to lower returns, and economic growth will be lower.