MacKay ON INFLATION

BY FINANCIAL PLANNER CHRIS MACKAY

AND WE THINK DR BOLLARD HAS AN ONGOING PROBLEM WITH INFLATION. POOR CHAP. HE'S GOT A MANDATE TO KEEP THE ANNUAL CONSUMERS PRICE INDEX (CPI) RATE IN A ONE PER CENT TO THREE PER CENT RANGE. HE BELIEVES IT COULD HIT FIVE PER CENT IN THE NEXT CALCULATION AND HE'S WORRIED. NOT AS WORRIED AS THE GOVERNOR OF THE RESERVE BANK OF ZIMBABWE THOUGH. ZIMBABWE'S OFFICIAL INFLATION RATE HIT A RECORD 2.2 MILLION PER CENT (THE GUARDIAN JULY 17 2008) AND THEY HAVE RECENTLY PRINTED A BILLION DOLLAR NOTE JUST TO GIVE THE WHEELBARROWS A BREAK. REMINDS ME OF MY SCHOOL C HISTORY YEAR STUDYING PRE-HITLER GERMANY.

Comparatively speaking therefore, you could say Dr Bollard is doing a good job, in fact a very good job. And the worst thing which could happen to him is he gets the bullet and has to take an early tax free pension if he doesn't perform. Mugabe's money men, if they fail, probably also get the bullet. In their case, literally.

Dr Bollard lowered the Official Cash Rate (OCR) in July and hopefully will do the same in September in order to not be accused of well and truly stalling the economy. Apparently we have the second highest OCR among the Organisation for Economic Co-operation and Development (OECD) countries behind Iceland! It seems to me and to most commentators his historical and main motive for constantly pushing the OCR up was in order to take the heat out of the "over inflated" property market.

Many people think the inflation or CPI calculation takes all property data into account, including the increased value of existing houses. In fact the only property statistics included in the CPI "basket" are rented dwellings, purchase and construction of **new** dwellings, maintenance materials and services, property rates and related services.

"Compared to Zimbabwe Dr Bollard is doing a good job, in fact a very good job. And the worst thing which could happen to him is he gets the bullet and has to take an early tax free pension if he doesn't perform."

In other words, the fact your existing Lower or Upper Hutt Capital Value (CV) went up, on paper anyway, approximately 50 per cent over the three years ended September last year does not directly actually figure in the official inflation/CPI figures.

The purchase and construction of new dwellings – yes, but existing houses – no.

And also just because the value of your house may have dropped 10 per cent or 15 per cent in the past six months since those new CVs, does not mean property inflation as measured by the CPI has gone down at all either.

What has driven inflation up over the past quarter and year has been petrol and food prices. Food makes up 17.38 per cent and petrol 5.38 per cent of the basket. Food went up 2.2 per cent for the June quarter. Petrol 12.8 per cent. Other vehicle fuels and lubricants went up a whopping 25.8 per cent. But I do not believe any tinkering with the local OCR makes an ounce of difference to external pressures we cannot control.

If we stop buying petrol because interest rates are too high, will that encourage the oil companies to drop the price in New Zealand? No way. It is driven by the offshore price. Likewise with the overseas cost of fertilizer pushing up the cost of food production.

When I studied Economics at Uni the definition of inflation was "too much money chasing too few goods". Supply and demand. In other words, for example in a small community, if 100 people wanted a new car, had the money to pay for one, and could only buy one locally, and there were only 80 cars available, then the car yards could get away with charging more for the vehicles and you would have classic inflation.

I remember my dad trying to buy a brand new six cylinder 4 litre silver grey Ford Falcon station wagon in 1970 when it was impossible to acquire the new model. In order to do this he had to come up with "overseas funds" (Aussie currency) in the form of selling some BHP shares he had somehow acquired previously. This provided the full amount for the carded and controlled new car price, but then he also had to "throw in" his 1966 Vauxhall Victor virtually for nothing as a trade-in. He could not have bought a new car without the overseas funds and the trade-in. I remember when he took delivery of the Falcon, he was so delighted despite having being completely screwed over by Fords he had me deliver a bottle of Scotch to the local Stevens Motors manager "Lofty" Henderson as an additional thank you. I loved that car too!

Bad example maybe because the true "price" of that new car was not shown anywhere in the statistics figures, but a good example of having to pay more (inflation) because excess people wanted a new car (demand) than the availability (supply). Sounds funny in 2008 doesn't it, when six cylinder gas guzzlers are not very popular and they are easy to buy.

My theory on why residential property prices went up so drastically over the past few years apart from the increased migration and foreign buyers' demand is because of residential property speculators and investors being mesmerised by the prospect of a quick gain. Heaps of "free" property seminars run by salesmen selling Queensland, Queenstown or Auckland apartments. Blue Chip type property deals being promoted and books by guys like Robert Kyosaki suggesting the way to quick wealth and a king hit was via residential property investment.

What inexperienced investors did not take on board very well was Kyosaki's supposition the property should be generating surplus (passive) income on top of outgoings or at least covering costs. The reality is this. A residential investment property over the past few years, whenever I see the numbers, is generating about four per cent rental return after rates, insurance, accounting fees and a modest sum for maintenance. Interest rates are between eight per cent and 10 per cent, so on an average entry level rental worth say $250,000, the average punter is $10,000 to $15,000 cash flow negative on an interest only loan. (More for a principal and interest loan.) Sure it is tax deductible (not the principal repayments though) so knock 33 per cent or 39 per cent off those figures.

On top of this, one can claim a non cash expense in the form of depreciation to further reduce the tax. This tax refund has to be paid back when the property sells but most investors overlook this, being glassy eyed with wonder at the potential riches available through negative gearing, which I will go into in some future article.

My contention is this ridiculous depreciation allowance has lured investors into a false belief. On paper, it seems it is not costing them anything to hold on to the rentals, barring any major maintenance expenses that is.

Why can't your kids buy their first, entry level house? It is because some well intentioned investor got there first and was prepared to pay whatever it took to own it, knowing that next year it may be worth 15 per cent or say $40,000 more. The increases won't stop, will they? They are not making more land are they? Property can never go down in value can it? Yeah right! Just look at Sydney, Melbourne, Queensland, Hong Kong and London and you will see houses historically having a roller coaster ride.

My suggestion and one I have made often to Government and indeed to Dr Bollard, is that in order to take the heat out of this one section of the property market, remove the annual depreciation allowance on the house part of second hand properties. Make it claimable at time of sale if it sells for less than was paid. At least I got a reply from Peter Dunne, the Minister of Revenue, even if it did tell me basically the house part of a property over time goes down in value. I may be dumb but how can one explain how an ex State house in Naenae which may have cost £5,000 ($10,000) in 1950 now has a market value of $200,000 to $300,000? All of that is not just land price. I am still waiting for a reply from Dr Bollard!

But I am a patient and tolerant sort of chap. I just want what's best for New Zealand and my fellow Kiwis. Home ownership is good for Kiwis. The percentage owning their own homes is going down, not up and it needs to change.

Finally, back to the OCR. I do not believe it has as much influence on the CPI as the Reserve Bank would make us think.

All a high OCR seems to do is to penalise and make it hard for families to pay their mortgages. A high OCR drives up our currency which makes our manufacturers and farmers more uncompetitive with our exports. A high currency makes overseas travel cheaper but does not encourage tourists here. A high currency does make imports less expensive but how much does this translate into decreasing the CPI and how much cheap Chinese made stuff from The Warehouse do we need anyway? **A low OCR makes our exports more attractive and means the average Kiwi can afford their mortgage.**

Perhaps we could get a few billion dollars by exporting Dr Bollard to Mr Mugabe? Zimbabwean dollars of course.