Hot Money Part 1 – real-estate
By Mark Sibthorpe

Macau gambling revenue, according to James Mackintosh, a Financial Times writer, 'moves closely with the size of China's $3.6tn of currency reserves. Both can be seen as ways to recycle foreign investment, with the central bank mopping up inflows and buying dollars, while individuals take excess domestic liquidity and gamble it...to acquire hard currency?'

Canadian and London real estate, like Macau, may also be a convenient means for China's elite to move money offshore; with the deleterious effect of driving up home values. Louise Shelley`s research concurs. In a published paper written for the National Defense University, Shelley argues that money laundering in real estate (MLRE) increases prices.

While actual money laundering with respect to current foreign home purchases in Canada, and London`s (UK) for that matter, has not been established. Regardless, with respect to non-residents driving prices, this has been demonstrated by Arnold L. Redman and N.S. Gullet, and published in the Journal of Financial and Strategic Decisions. They found a 'significant' correlation between foreign buyers and prices. The conclusion being '...that prices were about 20% higher with foreign buyers in commercial markets than otherwise. Also, property capitalization rate, growth in expenses, occupancy rate, building size and two property types (retail and office) are significant.'

Minister of Finance, Jim Flaherty has voiced his concern over housing risks, which according to the IMF places Canada as 'The most overvalued housing market in the world'. Apart from foreign investment, two other key factors distorting home values in Canada include:

- Historically low interest rates;
- The CMHC policy whereby the majority of Canadian homes risk is taken by government.

Despite other factors, the impact on prices by foreign buyers cannot be dismissed. To quantify this, consider that '49% of Canadian home sales of homes worth at least $1 million in the first half of 2013, were bought by foreigners, according to Sotheby's. This information, which was gathered as part of an international Realty Canada report and survey of brokers' as seen in the Financial Times.

London, UK has experienced a similar trend of foreign buyers. Here is a 2012 breakdown of non-resident buyers according to a Knight Frank study recently published (see attached):

- Singapore 23%
- Hong Kong 16%
- Chinese 5%
- Malaysian 4%

Certain US markets are also experiencing foreign buying pressure, but the buyers are from entirely different regions and with different motivation according to Wall Street Journal and NY Times articles. Highlights of the articles follow:

Miami

- The city's condo boom has been even stronger, fueled by foreign investors who typically pay cash and are looking to hold rentals, instead of flipping for profit as investors did in the last cycle. About 85% to 90% of new-construction buyers are foreign, mostly Latin American, estimates Alicia Cervera Lamadrid, managing partner at Cervera Real Estate, which is handling sales for 16 condo projects.
- "The payment structure really separated the speculators from the well-funded," Ms. Cervera Lamadrid said.
- Buyers say they are drawn to Miami's increasingly cosmopolitan vibe and cultural offerings such as the Pérez Art Museum Miami, which is set to open Dec. 4. They also consider such investments more secure than leaving their money in more economically volatile places like Argentina and Venezuela.

NY

- With an initial pool of 70 million Australian dollars raised from investors (the group now controls 380 million dollars from more than 3,700 Australians), Mr. Dixon and his team bought their first homes in Hudson County, N.J., in 2011. They moved into Brooklyn about a year ago. While his fund has sold a few properties already, Mr. Dixon says the general idea is to hold onto the properties, deriving steady

> income from rents. Mr. Dixon says that in the early years, as the fund invests in homes, renovates them and rents them, he expects returns could average about 5 percent each year. But as property values and rents increase, he estimates those returns could climb to 12 to 18 percent annually. If the homes are held for five years or longer, the income for the Australian investors will be taxed at a rate that Mr. Dixon says equals about 7.5 percent.

Clearly foreign buyers, whether they are hiding, preserving or seeking better returns, have a significant impact on prices. Not all countries see benefit in this. France for example, are open to foreign home ownership, but they do not tolerate speculation. To discourage such practices, France apply tax on property gains, a tax which has increased to 34.5% from 19% for European Union residents, although deductions can be made for every year of ownership after the first five years. For example, years six to 17 give a 2% reduction, years 18 to 24 give a 4% reduction and years 25 to 30 give an 8% reduction. French notaries have been told to deduct the tax directly upon completion of the house sale. France is not the only country to recognize the consequences of foreign buyers on prices. In order to cool its frothy market, Britain will also introduce a capital gains tax for gains made by non-residents. However, Britain`s tax is not quite as imposing as those in France. According to Forbes, ' It is important to note that the change to CGT rules brings the UK in line with other key investor markets, such as New York and Paris, where equivalent taxes can approach 35% – 50%, depending on the owner's residency status.'

In Canada, the Canada Revenue Agency (CRA) do apply tax on homes, but they do not place residential real estate in a special category. According to CRA documents (see link above) taxes are applied on capital gains, similar to gains made through other assets, and tax treaty exemptions apply. Essentially, though, to a non-accountant, these taxes appear much lower than the 35%-50% applied to New York and Paris properties sold by non-residents.

In conclusion, foreign buyers inflate prices and Canada has the most over valued real estate market in the world. Britain has just announced adjustments on property sales tax for non-residents to protect residents from price inflation, and other markets impose high tax premiums to discourage speculation. Given this, and considering Flaherty's public stance to cool Canada's housing frothiness, this begs the question of, 'why not impose non-residence property tax similar to France?'

Perhaps a contrarian perspective in answer to this question would hold that Flaherty fears the possible repercussions. The fact is that foreigners bought 49% of high value home sold in Canada. Without these buyers these homes would likely not have sold, or sold for less money. Take Montreal, for example, only 5% of homes in Montreal sold for more than the asking price, and of the total inventory, most of these homes actually do not sell.

Therefore, despite the concern that, 'offshore bids price Canadians out of housing market' taxing these buyers might prove to be the final chop stick that breaks the camel's back.

BankNews.TV is the publisher of the Financial Services Industry Monitor (FSIM). To subscribe to reports contact mark@banknews.tv