House Prices and Monetary Policy

Keith Rankin, 11 July 2013

Expectations are that, from 2014, the Reserve Bank will raise interest rates. This is principally on account of the house price bubble that is now well-established in Auckland, and incipient in much of the rest of the country.

House price watchers know that this decade has a sense of deja-vu about it; a sense of predictability.

The word 'expectations' has both a statistical meaning and a moral meaning. Statistical expectations are what people think will happen. Amongst economists and in the marketplace, these expectations are formed by reading the nuances of the Reserve Bank's press releases and policy statements, and by reading the same tea leaves that the Reserve Bank governor reads.

What has happened in recent weeks is a surge in the 3-year and 10-year government bond interest rates. This is reflected, more slowly, in rising mortgage and bank deposit fixed term rates for periods of 2-5 years.

Financial commentators are largely arguing that this incipient tightening of monetary policy will be a good thing; that it is what ought to happen as well as what is statistically likely to happen. I disagree with this moral 'ought to' argument.

If we look at the 2000s' decade, we see a housing boom that began in 2002, after a few years of stability in the housing market. The Reserve Bank was quick to raise interest rates, believing that, at the margin, rising interest rates would deter house buyers'.

Except for a brief easing in 2003, monetary policy remained tight for six years, until mid-2008. The six-year housing bubble almost exactly coincided with this period of rising interest rates. In 2004 commentators believed that the Reserve Bank had nipped it in the bud. Instead, as policy tightened the housing bubble gained its second wind, confounding predictions.

The scapegoat became the brief period of monetary easing in 2003. Financial commentators and even many economists pointed to this as the 'great mistake'. It defies belief that a small blip in an otherwise consistent policy trend can be totally or even substantially to blame for the undesired financial outcomes. Maybe the policy trend itself was mistaken?

In fact, the easing of interest rates in 2003 was entirely necessary, as a way to slow the surging New Zealand dollar in that year.

The principal cause of house price bubbles is the money that is fed into the housing market. We saw this in most countries in the mid-2000s, regardless of whether a country had a comprehensive capital gains tax, and regardless of local land-supply issues.

This fuelling of the housing market results from banks' preferences to fund house-purchases relative to other types of lending. And it depends on the throughput of the banking system. Banks make profits in rough proportion to their volume of business. So they like their inflow of funds to be high, even when there are not a lot of obvious investment opportunities in their host economies.

In New Zealand in 2002-08, the inflow of funds into banks increased substantially, thanks to rising interest rates and rising domestic and global inequality.

Rising interest rates have a bigger deterrent impact on non-housing borrowers than on housing borrowers; they diminish the proportion of lending to businesses. In that period, lending on mortgage increased as a proportion of total lending.

Total borrowing by the private sector increased substantially from 2002 to 2008, despite rising interest rates, and because of the huge inflows of funds into our banks. A large part of the inflow of funds was from overseas, evidenced from the rising exchange rate through those years.

New Zealand's all-important tradable sector – arguably the most important half of the New Zealand economy – was in recession for the entire second half of the 2000s, as Bill English was quick to point out in his earlier Budgets. This mass of money coming into our banks had to be deployed somewhere.

A huge proportion of it was 'invested' in lending to purchase assets that already existed, such as houses and shares. In other words it wasn't invested at all. Investment means the acquisition of new assets, such as factories and newly-built houses.

Both borrowers and lenders believed that house prices would just keep rising. Borrowers purchasing appreciable assets were willing to pay high interest rates, given this psychology. Banks had little choice but to lend in this way, given the interest rates they were required to pay to their funders. The money lent would be spent on consumables by the people selling houses and shares. Or it would be fed, unspent, back into the banking system.

It would be great if we could learn something from our recent history. Another bout of artificially high interest rates will end much as it did last decade.

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