Is Easy Credit the Problem?

Keith Rankin, 24 March 2015

In the weekend I read Graham Adams' article in *North and South* (April 2015) "The Madness of the Auckland Housing Market".

Adams is right to argue strongly that the issue is much more about finance than it is about land supply. But he goes far too far by comparing house prices in near-deflationary 2015 New Zealand with hyperinflation in the German Weimar Republic in 1923. And in placing the blame on 'easy credit' Adams misses the bigger points about 'why now?'.

If banks can create credit willy-nilly without consequences they would do it all the time. The reality is that 'easy credit' arises because banks are flush with liabilities and they need profit-generating assets on their balance sheets. Bank's principal liabilities are savers' deposits. The openness of the New Zealand financial system, combined with a comparatively high 'official cash rate' (OCR) of 3.5% set by the Reserve bank means that our banks are strongly encouraged to accept liabilities from savers the world over.

Yes, NZ and foreign banks are 'investing' in land and second-hand houses in Auckland and other places such as Queenstown. And they have various systemic biases in favour of secured lending on property over unsecured business lending.

The banks will lend anywhere anytime when they see it as profitable to them. But what else should deposit-accepting banks do? Banks are supposed to be intermediaries, borrowing from the (global or local) public, lending to the public, and profiting from the difference in borrowing and lending interest rates.

The alternative is for the banks to not lend, becoming a non-earning debtor, serving its debts by taking in new deposits, and keeping quiet about how it's debt-servicing is funded. If so, if banks do not make investments, then banking would be a Ponzi scheme. And savings would not be being recycled to spenders. (At present the money recycling business is convoluted, but essentially the spending is being done by people selling houses, and people borrowing more against the security of their homes.)

The scale of bank-lending is constrained by banks' deposit base, and by their 'prudence' (which includes their lending criteria). In many countries prudence is reinforced by government-set lending limits. Such limits were abandoned in New Zealand around 1985. While these constraints are not very constraining at present, policy intervention to constrain bank lending would aggravate what is already a deflationary environment.

Bank deposits are not necessarily 'savings'. For example money held in spending 'cheque accounts' is as available to offset lending as is money held in savings accounts and term deposits. If there was very little saving, minimally constrained lending would create far too much spending overall, and highly inflationary conditions would exist. The exact opposite is the problem today.

The world is flush with an excess of savings, and so banks have to lend aggressively to forestall deflation. There are several problems however.

The first problem is that few parties want to take on debt on the required scale, even at very low interest rates. In these conditions, Keynes would have noted that only governments can take on debt on the required scale; but clearly governments today are not interested. The next problem is that unsecured lending is risky to the banks (normal risk, not the systemic risk that we see today in their exposure to property lending) – although a large amount of this (via credit cards) is undertaken, at an interest rate premium of course.

So, from the banks' point of view, the solution is to lend back to the savers. In particular, many savers – large-scale and modest-scale – like to save by buying assets that they believe will appreciate in value. (The belief soon becomes self-fulfilling.) Such assets include Auckland property. These savers have a strong sense of entitlement; that by the mere fact that they or their ancestors abstained from consumption for some time in the past that they have a right to a substantial income stream in the form of interest or capital gain. They ratchet this up in a process called 'leverage' or 'gearing'. When this process is working – as it is at present – these people think of themselves as financial wizards.

The problem is that this process of lending to savers is a global process that is far more unstable than a few Ponzi Schemes. When the music stops – when capital gains are no longer sufficient to justify the debt incurred – holders of financial assets issue the 'sell' orders. What starts as a trickle becomes a torrent. Banks as well as their creditors become highly exposed. Further, those banks that are not exposed tighten their lending criteria, depriving society of cash when society most needs it. Reserve Banks have to both create the crash and bail-out the banks. But getting people and governments to actually spend this cash, under such critical conditions, is the biggest challenge of all.

The implication of Adams' article is that savers are blameless and interest rates are too low. The truth is the exact opposite. As we have seen in Switzerland and Denmark, interest rates are now negative, and necessarily so. When Switzerland cut its OCR to minus 0.75%, money flooded *into* (not out of) Switzerland. ('Investors' were gambling on a big rise in the Swiss Franc, which duly took place, because the interest rate cut was linked to a policy to delink the Franc from the Euro.)

I heard Bernard Hickey on Radio NZ a few weeks ago claim that some mortgage interest rates in Denmark are now negative; although I think he was exaggerating somewhat, given bank margins. Nevertheless, Copenhagen does not face anything like the kind of real estate inflation that Auckland does. One article, Copenhagen - another housing bubble? (27 June 2014) suggests little more than a muted return to 2007 price levels; nothing else on Google suggests that ultra-low interest in Denmark has created an Auckland-style bubble.

Interest rates in New Zealand are significantly too high, not too low as Graham Adams implies. The problem in New Zealand is the lack of alternative outlets for our bank lending. This problem would be even greater if interest rates were higher than they are. Indeed we note that in the 2000s' decade, the then housing bubble accelerated from 2004 until the crisis hit in mid-2008. This was in the face of a substantial tightening of monetary policy, with the OCR rising from 5% to 8.25%. If we look back to the mid-1980s, an asset price bubble took place despite lending interest rates well into double-digits.

Banks have to pay interest to whom they borrow from. And they must pay dividends to their shareholders. New Zealand banks at present have little choice but to aggressively market debt to anybody with an ounce of security. The spending made possible by this debt is the only thing that forestalls deflation. To understand deflation, our policymakers and ourselves should make an effort to understand what happened in the world between 1927 and 1933. (And should not just read the revisionist Friedmanite literature, prominent in the 1980s.)

Increased frequency of asset price bubbles is an early indicator of big trouble ahead.

Ultimately the only solution is a substantial equalisation of the income distribution system, which gives ordinary people the options both to spend more and to work less. Asset price bubbles exist in an environment like today's, of high output but weak capacity to spend. The banks should not be a scapegoat. They do what they have to.
