House Prices, Interest Rates and Money

Keith Rankin, 20 June 2015

On 11 June, Reserve Bank Governor Graeme Wheeler reduced the Official Cash Rate (of interest) from 3.5% to 3.25%, with a promise of more reductions to come. Not a big deal in itself, but an action imbued with plenty of meaning. In essence, Wheeler has diagnosed that we need to take on more debt to maintain the health of our economy. We need money to move more, and to sit around less.

Generally this action has been welcomed, but the caveat is that most commentators believe that this will further boost the Auckland housing market.

The reality is that banks must earn income through lending and gathering interest from their customers. Otherwise, to pay interest to depositors, they would be running Ponzi schemes. (Ponzi finance is borrowing by a middleman to pay interest, as distinct from earning interest to pay interest.) So the banks, in order to earn interest, would be lending into the housing market regardless of the rate of interest.

What the reduced OCR (Official Cash Rate) does is make it easier for banks to make loans to businesses who do not have the security that property gives (albeit deceptively) to mortgage lending. What banks need to do – for their sake as well as ours – is to find business borrowers who are neither property speculators nor dairy farmers.

From 2003 to 2008, the OCR was raised from 5% to 8.25%. It had no impact whatsoever on rising house prices. If fact the rising OCR, perversely, probably fuelled the property speculation of that time. By discouraging lending to the tradable sector in particular, adversely affected by an exchange rate whose rise was linked to the high and rising OCR, the banks chose to raise the proportion of their lending that went into the housing market. That in turn increased the (artificial and temporary) capital gains on housing, thereby making interest rates of over 8% increasingly acceptable both to speculative house buyers and to banks blinded by what they saw as increasing collateral.

In those days, around 2007, ordinary bank deposits were fetching 8%. (Some people even felt that an unearned 8% was less than they were entitled to; they got greedy and went for 10% at Hanover.) Someone had to pay those 8% interest rates. The interest payers included the highly leveraged mortgagors thinking they were clever property wizzes. Clearly the bubble wouldn't last. (The interest payers also included the poor customers of the money shops.)

Lending to people on the security of financial assets is insensitive to interest rates. Lending to productive businesses is much more connected to the rate of interest. Lower interest rates enable banks to better perform their social function – of facilitating the moving of money through the real economy of goods and services.

At 3.25%, wholesale interest rates in New Zealand remain far too high. When we think of debt as simply trade across time – which is precisely what debt is – in the 2010s' global environment we have too many people not wanting to buy stuff today but thinking they might want to buy stuff tomorrow. It means that the true price in New Zealand of spending today is closer to 0% than to 3%. Indeed, in the world as a whole, negative interest rates are required to get people to buy today what today's employed workers are producing.

Speculators are people who think that assets such as city land are just a way of making money as if money was actual wealth. They are people who already have more money than they can usefully use, so they use it uselessly to gather unto themselves even more money that they cannot usefully use. Rising house prices in cities such as Auckland are a consequence of global inequality, not local interest rates.

Money is a technology, not a commodity. Money works best when it is not overpriced, and when it is possessed by people who will spend it. Watch this space for more about what money really is, and isn't.