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Keith Rankin: Time to cut interest rates

COMMENT

Reserve Bank Governor Dr Alan Bollard today makes one of his six-weekly announcements on monetary policy. On the surface, there appear to be sound reasons both for raising the Official Cash Rate (OCR) and for reducing it. The likely outcome will be that, like the Grand Old Duke of York's army, the OCR will be "neither up nor down".

The argument for raising interest rates is that house prices are rising too quickly, thereby increasing the risk that inflation will rise above the 3 per cent limit set in the Policy Targets Agreement. A rise in interest rates will, it is argued, reduce the ardour of domestic home buyers who see today's interest rates as low.

Foreign investors, on the other hand, see our interest rates as very high. Many have prospered from their past New Zealand investments, and are eager to further take advantage of our high rates of return.

The downside for us of all this foreign attention is that the New Zealand dollar has risen 50 per cent against the greenback in three years and looks to continue rising further, especially in the coming export season. It's a bit like being a favourite for the upcoming Melbourne Cup, and therefore being subject to a punitive handicap. The high and rising exchange rate acts as a millstone around the necks of our exporters and of those firms that compete with imports that are getting cheaper by the month.

The legislation that Dr Bollard must work to suggests that he should give priority to keeping inflation below 3 per cent, and that, if necessary, we must pay a high cost to secure this benefit.

I believe that the OCR should be reduced. The New Zealand dollar should not be allowed to appreciate further. Dr Bollard's decision is easier than it seems, because the link between interest rates and house prices is actually more tenuous than is commonly believed.

As Brian Gaynor showed ("Aggressive banks drive housing boom", Business Herald, September 27), the rise in house prices is being driven by banks' lending policies as well as by rapacious buyers.

In the distant past, banks were banks and mortgage companies were mortgage companies. Now banks have become mortgage companies, with mortgages rather than business finance becoming their preferred form of lending.

So how do banks respond when interest rates rise? They reduce their business lending. Especially, they reduce their loans to businesses in the tradeable sector; the sector that ultimately sustains New Zealand.

But the banks still have plenty of money to lend. Indeed, they tend to be flush with funds coming in from overseas at times of high interest rates. So, if interest rates rise, banks will want to lend to anyone except to the firms that are perceived to represent high risk. That means they will want to lend more, rather than less, to residential home buyers.

Further, it is hard to see many home buyers being deterred by a one percentage point increase in mortgage interest rates. Home buyers are either looking for a place to live or they expect capital gains. Real estate is therefore much less sensitive to interest rates than is business finance.

Just as higher interest rates can encourage more mortgage lending (which is what did happen in the mid-1990s and in the mid-1980s), we may find that a lower cash rate may reduce mortgage lending.

If Dr Bollard cuts the OCR, then banks will lend more to businesses, and therefore less to home buyers. This reorientation in favour of business lending will be accentuated once banks come to expect a fall in the exchange value of the New Zealand dollar. Only a fall in the OCR will bring about the required change in bank lending strategies.

For me it is clear-cut. Dr Bollard should bring our interest rates more in line with those of our trading partners.

In the 1990s, economists in the countries we trade with tended to overstate the risks of having low interest rates. Despite such advice, central banks in other countries generally chose to keep interest rates low. The promised inflation did not eventuate.

The way to manage the property boom is not to raise interest rates. It is to encourage banks to lend more to business.

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