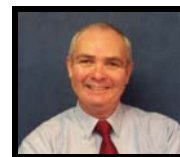


CAN WE KEEP MONEY IN OUR POCKETS? - Allistar Walker



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I derive an income from helping people into debt and arranging protection in the form of insurance for that debt. Yet we are now recommending to our clients to exercise restraint in committing to debt, particularly where it is consumer orientated, that is for the things in life that quickly devalue.

Research by the Chicago Booth School of Business suggests that the growth in household debt preceding the financial crisis was the primary driver of the onset and deepening of the current recession. While our economies are vastly different there are definite parallels from this research as lessons for our own economic cycles.

Firstly, the availability of cheap mortgages and highly leveraged mortgages increases the demand for housing, which can push up house prices. In turn, as demand increases and house prices go higher, lenders become overconfident. They then begin offering mortgage credit on even cheaper terms, fuelling a violent cycle where household valuations become increasingly unrealistic. In such a credit cycle, the growth in house prices reflects cheap debt, not the underlying earnings power of households. In the States where house prices increased the most, those areas had the largest percentage of sub-prime borrowers. Treating house price growth as independent of mortgage credit availability is naïve at best and dangerous at worst. Maybe the RBNZ should regulate loan to value ratios to help prevent future bubbles.

Second, the growth in house prices has a real impact on the economy. US research found that homeowners extract \$0.25 to \$0.30 in cash from their houses for every \$1 of growth in-house price. The analysis suggests that the home-equity withdrawals are primarily used for consumption or home improvement, which temporarily boosts economic growth. But when a credit induced housing bubble drives economic growth on the upside, the consequences on the downside will be necessarily painful. Our observation would tend to suggest a similar, if more conservative, pattern in NZ.

Thirdly, political consideration can distort policy response to a financial crisis. For example, the electorate demands action during economic downturn which can promote excessive public spending. Another example is the Government guarantee for Finance Companies and Banks. The biggest worry is that the private debt problem is simply replaced by public debt.

Going forward to fully appreciate the effects of household finance on economic cycles, we should perhaps ask two questions.

First – Why does lending for real estate increase so dramatically when credit is flowing freely? This is the banker syndrome of providing an umbrella while it is sunny and taking it away when the rain comes. Possibly the value of collateral is artificially inflated and the real risk of real estate lending is not so apparent.

Second – Why do households borrow so aggressively when they get access to credit? Many of us borrow like there is no tomorrow when times are 'good', and are now regretting that with the current tightening.

The US study goes on to say that the pattern of boom-bust cycles in household leverage suggests that people borrow for reasons other than their long-term economic well-being – a sort of I want it all and want it now factor. Unfortunately in this country as well, we have lenders who structure financial products to capitalise on this lack of individual self-control.

This is not the first time that household leverage has led to a severe economic downturn and probably will not be the last. We believe that New Zealanders are entering a new financial phase where the emphasis on saving and prudent expenditure will become more apparent. Let us see whether the passage of time proves that to be correct. Maybe we will all come down with the 'short arms, long pockets' syndrome.

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