FINANCIAL REVIEW

When economic theory and market forces collide

People are assumed to behave rationally in their actions. When it comes to houses, shares and crypto, demand and interest increases as prices rise and value diminishes.

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Economics falls under the social sciences but calling it a science is far from appropriate.

Given such a questionable theoretical backdrop, one would think policymakers would be highly circumspect before interfering in the economy and livelihoods. Instead, they express confidence that their policies will have assured and favourable results.

Most Western economies are largely free market, capitalist economies. The pricing mechanism is assumed to be governed by market forces, with justifiable intervention by governments to limit monopoly power, or to protect the environment or basic rights such as freedom from slavery.

Market forces do not work properly when there is essentially unlimited supply of something that should have a value. That is the case with fiat currencies, particularly as central banks are freely printing money or increasing the money supply by buying government debt (effectively practising modern monetary theory, a theory endorsed by few reputable economists).

Central bank control and manipulation of interest rates, perhaps the most important price in the economy, leads to inevitable distortions. The capitalist system no longer operates as effectively, with excessive risk being taken, moral hazard and limited creative destruction as uneconomic businesses are not allowed to fail.

Australia has had a pleasingly rapid recovery from a brief recession. Much of this has been attributable to government spending and subsidies with soaring housing approvals, and direct household income support.

Businesses are now experiencing skills shortages.

Almost-free money has led to inflation of asset prices around the world, stretching from houses to equities and commodities.

If interest rates were set by the market, such rampant inflation in so many prices would have seen interest rates rise substantially. A normal assessment of risk would require interest rates above inflation. It is unlikely people would then be committing to ever higher house prices.

Markets are rational

Matthew Wilson of Evans and Partners calculates that average mortgage payments consume around 30 per cent of gross household income, close to previous peak levels, despite interest rates being much lower. Sensitivity to interest rate rises has increased, making households vulnerable should inflation force interest rates higher.

Markets are rational. People are assumed to behave rationally in their economic actions, leading to a stable economic equilibrium. When purchasing goods and services consumers mostly adhere to the theory, buying more at low prices and less at high prices.

When it comes to financial assets such as houses and shares (and speculative play things like cryptocurrencies), demand and interest increases as prices rise and value diminishes. Booms and busts are common.

Policymakers avoid restricting booms, indeed they often foster and cheerlead such booms. However, they always step in and attempt to minimise the busts that are the inevitable result of excessive speculation.

The truth is that rising house prices seem to be a plank of policy. House prices have been pushed up relative to incomes by low interest rates, longer mortgage terms, negative gearing, stamp duty concessions and first-home buyer grants.

Without the rise in credit availability – if banks only lent up to a traditional multiple of income – house prices could not have risen as much as they have.

There are downsides to higher house prices: council rates and land taxes go up in excess of inflation, as does stamp duty. Unless a house is sold to move to another country with cheaper housing, the benefits are limited.

Workers worse off

The most certain downside is that there is a generation of people who feel that they will never be able to own their home. Low interest rates help the little guy or man on the street. Clearly, low interest rates do not help people reliant on interest income, like retirees who have seen interest on their term deposits evaporate.

Credit card and payday loan rates have not fallen materially but mortgage rates have fallen. However, mortgage payments are historically high relative to gross household income because of the rapid rise in house prices, pushed up by confidence and the greater affordability initially created by low interest rates.

If low rates push up other prices too, as perversely wished for by central bankers, history has shown wages often lag inflation, leaving workers worse off.

Why do such myths perpetuate? Policymakers are understandably unwilling to accept blame for promoting inequality. It is convenient to postulate housing supply shortages rather than admit to monetary settings being too easy for creating a bleak financial outlook for most young people.

Humans also cling to a vision of rationality and prefer intelligent causation over herding behaviour, both by individuals and authorities, in understanding markets.

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