Westpac InstitutionalBank

Being effective

The new interest rate landscape: Average borrowing costs

There has been much hand-wringing, mostly by vested interest groups, as to whether the RBNZ has been premature in embarking on its journey of monetary policy tightening. To this argument we add a rejoinder: the good ship of policy tightening has yet to sail as it hasn't even cast off its mooring ropes! To flesh out this seemingly odd assertion, we need to introduce a rather unassuming passenger on the monetary policy journey: the effective mortgage rate.

Easy tightenings

There tends to be a couple of interest rates that affect the route the economy travels. For most investors and homebuyers and some consumers it is expectations of *future interest rates* that drive their decisions. Their subsequent consumption choices are impacted if there are unexpected changes in interest costs relative to their expectations.

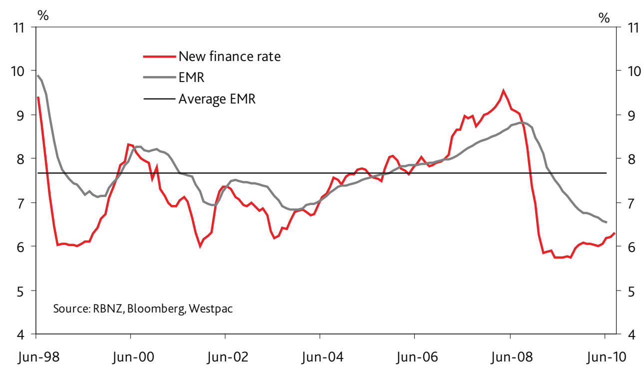
But for many consumers it is *current interest costs* that matter most. The spending decisions of these "hand to mouth" consumers are influenced by how much money they've got left in their pockets after debt servicing. For these consumers, it is the effective mortgage rate (EMR) that matters.

The EMR is the average mortgage rate that the household sector is paying at any particular time. It reflects the legacy of past fixed rates that have been locked into, new fixed rates being entered, the floating mortgage rate, and the proportion of borrowing at each term.

Since 1999, the EMR has averaged 7.7% *(see Figure 1)*. In the final effort by the RBNZ to stomp on the housing boom, the EMR peaked at 8.8% in September 2008. The global financial crisis and NZ housing downturn saw the RBNZ lower the Official Cash Rate in a hurry. The EMR, as at June 2010, had dropped to 6.5%. New customers, or those coming off fixed rate terms, are currently financing at around 6.3% (as a mixture of floating, revolving credit, 6 month and 1 year fixed rates).[1]

Because of the lags in the EMR (from borrowers rolling off previously high fixed rates onto lower current rates), we have

Figure 1: New Zealand effective mortgage rate



been in the peculiar position that monetary stimulus for many has been increasing even as the OCR was being raised. It will take at least another OCR hike (and the interest rate curve pricing in prospects of more to come) just to stabilise the EMR. We consider the first three 25 basis point hikes by the RBNZ (they've done two so far) to be the easiest: they are the tightenings when you are not really tightening.

A trip across the Tasman

The Reserve Bank of Australia (RBA) has shifted their cash rate from 3.0% at the beginning of October 2009 to 4.5% currently. In February they began to phrase the idea that they wanted to get borrowing rates back to average levels. In their March decision, they were more explicit: "Interest rates to most borrowers nonetheless remain lower than average. The Board judges that with growth likely to be close to trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average. Today's decision is a further step in that process."

[1] New customers or those rolling off existing fixed rates tend to gravitate toward the cheapest part of the mortgage curve. To calculate the 'new finance rate', we took the new customer rate for mortgages of different terms from the RBNZ's table E6. The RBNZ data does not specify which mortgages new customers entered into. We assume that, for each period, 40% of new customers took the lowest rate on offer, 40% the second lowest rate on offer, and 20% the third lowest rate. The results were relatively insensitive to different weightings.

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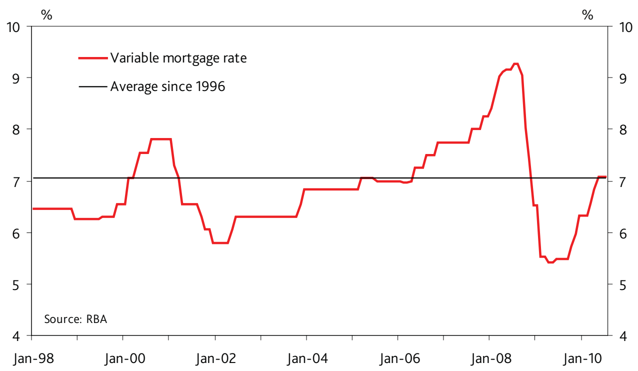
The RBA has managed to get borrowing rates back to average levels quickly (eight months, *see Figure 2*). And for them it was a relatively easy task: the vast majority of mortgages in Australia are on floating rates, so any changes in their cash rate are quick to flow into mortgage costs.[2]

Figure 2: Australia mortgage costs



Traction control

So far, the RBNZ is definitely not following the lead of Australia. In New Zealand, we have only been in the process of stabilising average borrowing rates. But what if the RBNZ eventually does follow the RBA strategy and aims to get borrowing costs back toward average? And let's assume that the RBNZ wants to take its time to get there (say, a couple of years).

First let's debunk one popular misperception that the OCR will have more bite this time around because of a greater prevalence of floating rate mortgages. For us, it is the proportion of mortgages on short term rates compared to the *start* of previous tightening cycles that is the relevant comparator. On this score, the proportion of floating or short-duration mortgages is strikingly similar to that experienced at the start of the three most recent tightening cycles *(see Table 1)*. The slope of the mortgage rate curve is similar to the start of previous cycles, so the incentive to remain floating as rates rise is no greater than usual.

Table 1: Proportion of mortgages on floating and short-term fixed at the start of previous tightening cycles

	Floating as as % total	Float + <1 yr as % total	Average term
17 Nov 1999:	42%	63%	1.00
20 Mar 2002:	43%	71%	0.72
29 Jan 2004:	36%	67%	0.90
June 2010:	36%	71%	0.74

IF the RBNZ had the objective of raising borrowing rates to average levels (the ultimate target level for this objective is of course dependent on expectations of economic growth versus potential, and the evolution of inflation expectations et al), then it would have to raise borrowing costs from 6.3% currently to 7.7%.[3] How much in the way of OCR hikes would be required to achieve this?

This is where it gets tricky because there are so many moving parts. You first have to take account of what OCR hikes are priced into the mortgage rate curve; make an assumption of where borrowers will shift along the curve; assess how much pass-through there will be from OCR changes (which will be affected by retail deposit rates relative to the OCR, and changes in the country risk premium); assess where benchmark international interest rates will land; make a judgement call as to any changes to liquidity and core funding regulations; and incorporate anticipated changes to bank margins!

Current market pricing has the OCR at 4.25% in two years' time. If that were to transpire, and if none of the vast list of factors above were to change from their current level and degree of influence, then both the new finance rate and EMR would top out around 7.25% – well short of its historic average of 7.7%. However, probably ALL of the above listed factors will be changing.

We expect that:

- as the tightening cycle gets under way in earnest, more people will migrate onto fixed rate mortgages, slowing the speed of pass-through from OCR changes;[4]
- there will be less pass-through from the OCR because the supply of loanable funds curve is now upward sloping whereas previously it was horizontal (see the first two articles in our "New interest rate landscape" series);
- country risk premium will reduce as more time elapses from the Global Financial Crisis;
- benchmark international interest rates will only slowly push up from their current low levels:
- core funding ratio (CFR) targets for NZ will be raised, but CFR targets in overseas jurisdictions will be slow to be introduced;
- bank margins (particularly for floating rate mortgages) will continue to reduce.

To our mind, most of these factors will be altering so that the OCR will have to be pushed harder to get the desired traction on average borrowing rates. We suspect that the OCR would ultimately have to head toward 5.75% over the next few years IF the objective was to get borrowing costs back to their historic average of 7.7%.

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[2] We use a simple average of the standard variable mortgage rate and the discounted variable mortgage rate as the proxy of Australian EMR because the share of mortgages on floating rate has consistently been very high.

[3] This article is not trying to ascertain what the appropriate level of borrowing rates 'should be'. We are just trying to provide a different perspective as to what the current level of market pricing implies for the future EMR, discuss how other factors may influence this, and then decide on where the OCR may have to go IF the RBNZ had the objective of gradually moving the EMR back to average.

[4] If borrowers gravitate from floating rate mortgages to lower margin fixed rates as they have in other tightening cycles, then the EMR would top out at around 7.1% on current market pricing.