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Economic Research note

Wave of Kiwi home loan resets should ease households' pain

- **RBNZ officials are "disappointed" banks are not passing on official cash rate (OCR) cuts**
- **Fixed mortgage rates, however, are about to be reset at much lower levels**
- **Lower effective mortgage rates and stabilization in housing market should support consumer spending**

New Zealand experienced an unprecedented housing boom between 2001 and 2007. House prices surged over 90%, before beginning to fall in early 2008. The weakness that emerged in the housing sector early last year quickly spread into other areas of the economy, which soon began to contract. GDP since has fallen for five straight quarters. The homegrown recession was compounded by global woes offshore. The worst of New Zealand's economic troubles, though, stemmed from long-running, heavy reliance on household debt that was exposed by global recession.

In response to the recession, the RBNZ began cutting the OCR aggressively in June 2008, and since has delivered an unprecedented amount of policy easing—the OCR has been slashed from 8.25% to a record low 2.5%. Effective mortgage rates, though, fell less than the OCR, owing to the predominantly fixed-rate mortgage structure in New Zealand, and the reluctance of banks to pass on reductions in the OCR to floating rate mortgages. Homeowners should feel some relief in 2H09 as house prices stabilize and a significant number of fixed rate mortgages reset at lower levels.

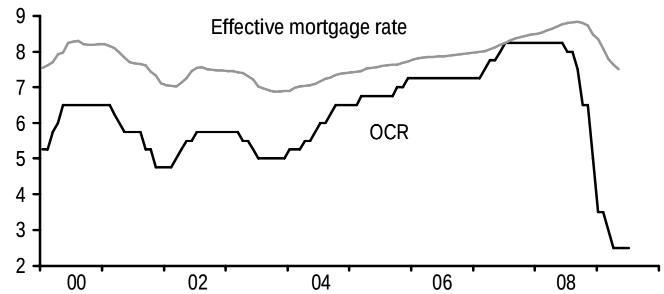
Housing market particularly vital in NZ

Around two thirds of mortgages in New Zealand are held at fixed rates, a remnant of very low interest rates earlier this decade, when many borrowers locked in rates for up to five years. The relative impotence of monetary policy under this regime is particularly troublesome for the Kiwi economy given the precarious state of households' balance sheets. Sustained periods of house price appreciation have encouraged speculation, such that New Zealanders now are among the biggest dissavers in the developed world, with a debt to disposable income ratio of 160%.

Similarly, the ratio of housing value to households' net financial wealth has grown inexorably over the last decade (chart), creating a vicious cycle in which the interests of

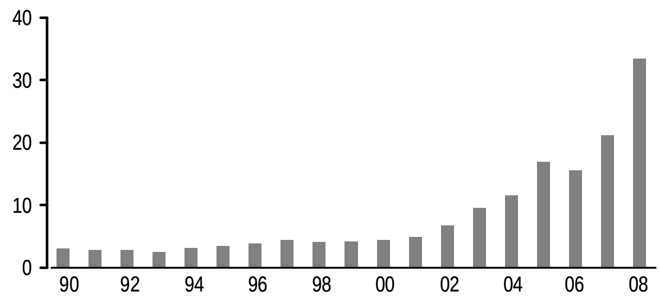
Effective mortgage rates and the official cash rate (OCR)

%p.a.



Housing value to net financial wealth

Ratio



mortgage holders periodically commit the RBNZ to the maintenance of low interest rates; this then encourages households to fix loans, essentially limiting the transmission of future policy changes. Given the lessened exposure of most households to conventional policy stimulus, it is vital the RBNZ gets "bang for its buck" through the floating-rate structure. This has not been the case during the current easing cycle. Floating rates are now around 6.4%, meaning that only 75% of the 575bp OCR reduction has been passed through to floating-rate mortgages.

Rising funding costs again to blame

Despite pressure from the RBNZ, the predominantly Australian-owned Kiwi banks recently have not budged on their floating rate mortgages and have, in fact, increased their longer term rates (mainly 3- to 5-year terms). The banks' motivation is their rising cost of funds. Before the credit crisis, the premium paid for short-term offshore funding was about 10pts over the expected OCR, before rising to 300pts last September (mid-crisis).

As in Australia (see "Rising mortgage rates unlikely to force RBA rate cut," *GDW*, July 2), New Zealand banks have emphasized the extent to which funding costs have increased in the wake of the demise of Lehman Brothers. Since the spread between marginal funding costs and floating mortgage rates has widened (i.e., in the banks' favor), the RBNZ has raised issue with the banks apparently "crying poor." The banks' margin measure of choice however—the spread of mortgage rates to *average* funding costs, the latter computed over a longer time frame—is narrowing, putting downward pressure on banks' profits.

RBNZ "disappointed" with banks' inaction

The RBNZ Governor has expressed disappointment that OCR cuts have not been fully passed on by the major banks. In a statement released early July, the RBNZ said that banks' fixed-rate lending rates are "reasonable," but that floating-rate mortgage rates are unusually high, adding there is "some scope for further reductions in these rates without compromising the viability of this lending."

The RBNZ's reasoning that marginal rather than average costs are the relevant factor for lending decisions, however, ignores institutional constraints that apply to lending policy. Banks cannot change their lending facilities and mortgage rates simultaneously with fluctuations in short-term market rates. Coordination constraints within each bank (management, risk, and compliance departments, for example, usually must consent) create lags in the implementation of rate changes. Similarly, menu costs (i.e., advertising) would be prohibitive, and customers likely would be irritated and less able to compare options under a more volatile floating-mortgage-rate structure.

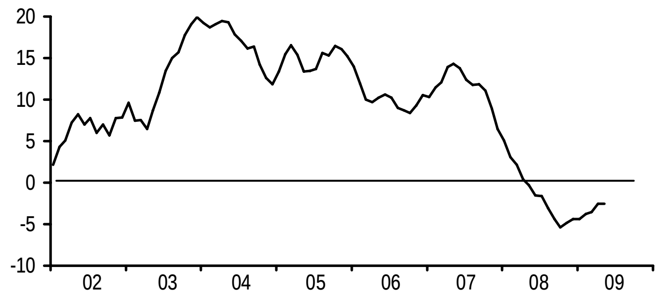
Wait for the wave of rate resets

RBNZ Governor Bollard vows to continue discussions with lending institutions on this matter, with the most likely outcome being that banks will continue with their existing lending policy. Further relief for mortgage holders nevertheless is on the horizon, as fixed-rate mortgages (which, somewhat unusually, are fixed for extended periods, rather than for the life of the loan) are reset at lower rates and house prices begin to rise. Much of the benefit of the OCR cuts has yet to flow through to borrowers, but, as of March, 46% of fixed-rate mortgage debt was due for an interest rate reset within a year. Borrowers now paying 8%, for example, will move to mortgage rates of 6.4%, a significant boost to households' coffers.

Kiwi consumers will be supported further by signs of stabilization in the housing market. House prices rose 0.7%m/m in June and the number of days to sell a house declined further. As continued policy support filters through to the housing market, RBNZ policy should be viewed as handicapped, rather than ineffective.

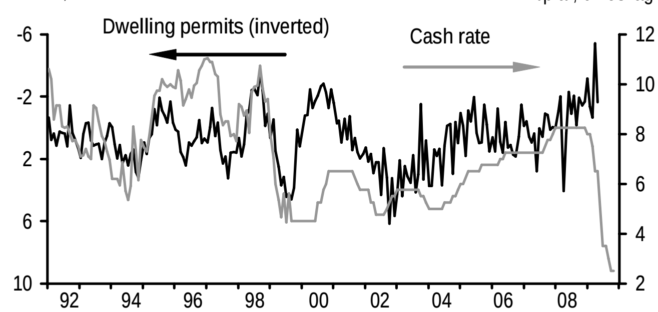
REINZ house prices

%oya



RBNZ official cash rate and dwelling permits

%m/m, 12mma %p.a., 6mos lag



RBNZ's easing cycle is over

Governor Bollard appears comfortable with current policy settings. Recent RBNZ verbiage has highlighted the improvement in economic and financial conditions, rising confidence, signs of stabilization in the housing market, and a strong turnaround in net migration as reasons for leaving the cash rate steady. On the latter, annual immigration increased to a two-year high in the year to May, further propping up domestic demand and the housing market.

The RBNZ has left the door open to further policy easing, saying that the OCR will remain "at or below" the current level until end-2010. Our forecast calls for rate hikes from mid-2010. Regardless, the RBNZ probably will not be concerned about overstimulating the housing market by leaving the OCR too low for too long. If the perception is that the OCR already has troughed, there ordinarily would be an incentive to fix one's mortgage, especially given that long-end rates will be higher, owing to extensive government borrowing. However, 5-year mortgage rates have risen around 150bp since January to over 8%, meaning that fixing now is relatively less attractive. Alternatively, if people believe that the OCR has not yet bottomed, commercial banks probably will not pass on further cuts, leaving floating mortgage rates unlikely to drop much below 6%.