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RODNEY'S RAVINGS

The massive interest rate stimulus still to come

EXECUTIVE SUMMARY

The debate over why the banks haven't passed most of the 0.5% cut in the OCR on 30 April through to lower mortgage interest rates is raging. With many individuals and firms suffering financially it is easy to have sympathy with the view that banks should be willing to accept significant shrinkage in margins and profits, with this cause being taken up by the Minister of Finance (see http://www.nzx.com/news/4918166). This is an important issue but much more important is the massive drop in mortgage interest costs awaiting the large number of borrowers who have fixed mortgages coming up for re-pricing over the next two years. If mortgage interest rates remain at around current levels for the next year, which the RBNZ seems committed to achieving, the affected group of mortgage borrowers could be $1.2b better off and inevitably a reasonable portion of this increase in disposable income will be spent.

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The argy-bargy between the RBNZ and the banks

The RBNZ fired a warning shot at the banking sector yesterday. "While some banks had passed on recent OCR reductions it was "fair to say we have been disappointed with the response to date," Deputy Governor Grant Spencer said at the release of the latest Financial Stability Report in Wellington." (Source: http://www.sharechat.co.nz/article/0872f205/rbnz-defends-ocr-disappointed-with-banks-response.html)

Tony Alexander offered an explanation for the lack of response by the banking sector yesterday. "It now costs us banks far more to borrow money than in the past because of the huge losses racked up by the Northern Hemisphere banks. This means for instance, as we have noted many times before, whereas we used to pay a premium to offshore investors about 0.1 percent above the bank bill yields and swap rates you might see, now we pay premiums near 2.5 percent. This means that as old funding rolls off it gets replaced with much more expensive money. If at the same time as this old money is rolling over the central bank cuts its cash rate the cost to a bank of funding its lending may not go down." (Source: http://www.stuff.co.nz/business/opinion/2405259/Why-rates-aren-t-tumbling).

With many individuals and firms suffering it is easy to have sympathy with the view that banks should have passed more of the OCR cut through and be willing to accept more shrinkage in margins and profits. It raises issues about whether there is enough effective competition in the banking sector although it was pleasing to see the RBNZ's warning shot had some impact yesterday with Westpac, Kiwibank, TSB and AMP trimming some mortgage interest rates today (see http://www.goodreturns.co.nz/mortgage-rates.html).

The cuts in mortgage interest rates since 30 April have been focused on the 6-month to 2-years fixed rates with floating rates remaining stubbornly up to 1% above 6-month fixed rates. Based on the March 2009 data released by the RBNZ the banking sector has $35.2b of outstanding floating mortgage loans at an average interest rate of 6.63%. If the banks had cut the 6.63% by 0.5% to 6.13% it would deliver a $176m drop in interest costs to floating mortgage borrowers. This is worth a bit of argy-bargy but it is dwarfed by the cut in interest costs in the pipeline for numerous mortgage borrowers over the next year at least.

More important is the $1.2b cut in mortgage interest costs over the next year

As at March 2009 the banking sector had $55.3b of outstanding fixed mortgages to be re-priced over the subsequent 12 months with an average interest rate of 8.16%. If mortgage interest rates remain at around current levels for the next year, which the RBNZ seems committed to achieving, and people roll the maturing $55.3b into a mix of 6-month to 3-year fixed mortgage interest rates because these rates are lower than either floating rates or 4-5 year fixed rates, then this group of mortgage borrowers could be $1.2b better off. Inevitably a reasonable portion of this increase in disposable income will be spent.

There is another $33.6b of fixed mortgages with an average rate of 8.46% coming up for re-pricing over the subsequent 12 months. If the economic recovery unfolds as we expect the OCR and mortgage interest rates will have increased at least moderately by then but it is still likely that this group of borrowers will experience a reasonably significant drop in interest costs. So even though banks are in part using the drop in the OCR to protect margins from eroding in response to rising funding costs – a la Tony' comments – there is still a massive interest rate stimulus to hit the pockets of a significant group of mortgage borrowers. As at March 2009 22.7% of outstanding mortgage loans by banks were floating, 35.6% were fixed with less than 12 months to run, 21.6% were fixed with 1-2 years to run, 11.1% were fixed with 2-3 years to run, 5.4% were fixed with 3-4 years to run, 2.6% were fixed with 4-5 years to run and the remaining 0.9% either had over five years to run or were unallocated.

The implications of the massive interest rate stimulus still in the pipeline

As covered in our **Housing Prospects** and **Building Barometer** reports the housing and residential building markets respond reasonably quickly to interest rate changes. Most people buying an existing house or building a new house have to borrow more money and so face the current market interest rates. The housing market is still to benefit from much of the drop in mortgage interest rates to date but won't get much of an added kicker as people have their existing fixed mortgages re-priced to lower rates. However, while someone who borrowed money to buy a house two years ago and fixed for two years is unlikely to shift house again just because his/her mortgage interest cost drops, he/she will experience a significant improvement in disposable income and is likely to spend a significant proportion of the increase. The retail sector should be the major direct beneficiary of the massive interest rate stimulus still in the pipeline, while it will then drip feed through to the manufacturing sector and a wide range of service industries.