# Economic Note

Household sector outlook

23 September 2021

## Prepare for higher interest rates

- We expect the OCR to move up soon, taking mortgage interest rates with them. Uncertainty is pronounced, but a historically low peak in average mortgage interest rates is expected this cycle.
- Moderately higher interest rates are unlikely to derail the household sector, but the RBNZ will remain watchful.
- Borrowers should budget and prepare for higher interest rates.

### Summary

We expect the OCR to move up soon. Our forecasts have 50bps of OCR hikes by the end of the year and assume a historically low OCR endpoint of 1.50% by late 2022. Mortgage interest rates have already been on the move and look set to continue to climb. We envisage a historically low peak in average mortgage interest rates this cycle.

How will moderately higher interest rates impact the household sector? There are 3 channels:

1) House prices - higher mortgage interest rates should sharply slow housing market momentum, with prices largely expected to flatline over 2022.

2) Economic activity - the gradual pace of OCR hikes that we envisage is unlikely to derail the economic expansion and so shouldn’t significantly weigh on household incomes and employment.

3) Cashflow - The average mortgage rate for housing lending of just under 3%, a record low, which has bolstered household debt servicing. NZ households are net borrowers from financial institutions, so an increase in customer interest rates will reduce household cashflows. Our estimates suggest a 100bp increase in customer interest rates will reduce household cashflows by roughly $2.6bn per annum, approximately 1% of household disposable incomes. It’s not immaterial, but our assessment is that the increase in debt servicing costs should be manageable for most households. Borrowers with large debt exposures will clearly fell the cashflow hit. Some will struggle.

Due to mortgage fixing and the incremental nature of expected rises in mortgage interest rates, it will take time for the full impact of OCR hikes to flow through to household borrowers. The size of this shield is not particularly large, with close to 80% of mortgage debt due to roll over in the next 12 months and with an average duration on mortgage lending of around 10 months. We envisage that the average interest rate paid by mortgage borrowers will be around 130bps higher by late 2023 (roughly 4.20%), taking it back to late 2019 levels.

For borrowers, we reiterate our earlier messages that it would be prudent to budget and prepare for higher debt service costs in future.

### Recap

Our base case scenario is for the household sector (and economy in general) to bounce back from the recent community delta outbreak. This should see capacity pressures intensify and prompt RBNZ hikes. We expect 25bp OCR hikes in October (to 0.50%), November (to 0.75%) and February (to 1.0%), with the OCR ending 2022 at 1.50%. Uncertainty remains high and the economy (and interest rates) can follow a number of paths.

While the OCR remains at a record low 0.25%, swap yields have shifted up as markets have factored in higher interest

Mark Smith – Senior Economist (649) 301-5657 mark.smith4@asb.co.nz

rates further down the track (NZ swap rates are 85-130bps higher since the start of the year).  Carded mortgage interest rates are off their lows, with more pronounced lifts in longer-term fixed rates. What's more, our updated home loan report expects new carded mortgage interest rates to move higher.

Higher interest rates will impact the household sector via a number of channels, including:

- Asset prices.  Our latest housing view is that provided the recent delta variant outbreak community outbreak is contained, it is unlikely to have a lasting impact on the house price outlook. However, higher mortgage interest rates will be pivotal in sharply slowing house price growth from around 22% over 2021 to just 2% next year.
- Economic activity. OCR hikes will reduce interest rate support, but with the OCR set to remain below circa 1.50%-1.75% neutral levels over at least the next 12 months or so, the increases are unlikely to derail the economic expansion and significantly weigh on household incomes and employment.
- Debt servicing. Cashflow impacts will be key. While *new* carded mortgage interest rates are off their lows, latest RBNZ figures place the *average* mortgage rate for housing debt just 2.90%, a record low as borrowers have continued to roll off higher fixed mortgage interest debt to lower rates. This has helped serviceability. NZ households are net borrowers from financial institutions, so an increase in customer interest rates will reduce household cashflows. The impacts will be uneven across the household sector.

## How much will mortgage rates go up?

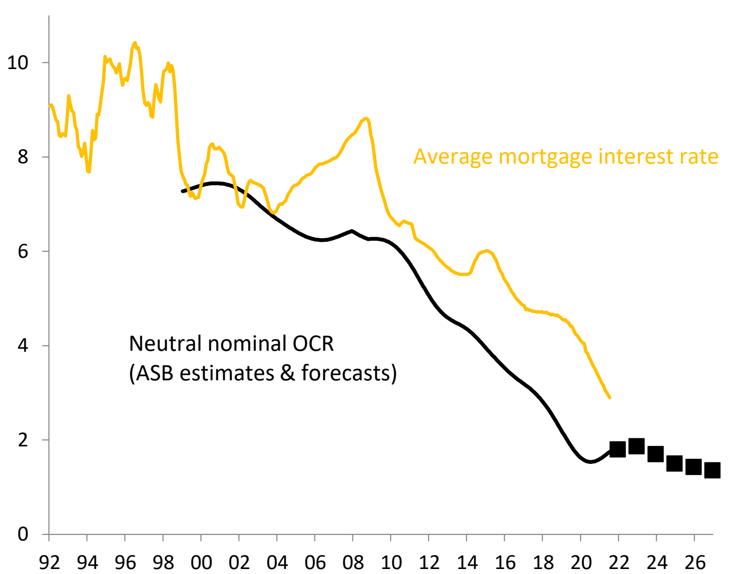
**Our hunch is that although mortgage interest rates are heading upwards, the peak this cycle will be historically low, with future increases roughly on par with the magnitude of OCR hikes (roughly 125bps).** This would take them back to just over 4%, which is close to our assessment of where interest rates have more of a balanced impact on household spending.

The level of mortgage interest rates has dropped substantially over the past few decades, broadly tracking that of the neutral OCR (see chart). There is a clear link between the downward trend of both. This is unsurprising considering the household sector constitutes the bulk of economic activity and mortgage debt the majority of private sector bank borrowing.

Moreover, as we covered in an earlier note, **household debt servicing look to be manageable and households in aggregate should have a reasonable buffer to cope with modestly higher mortgage interest rates.** Banks tend to put in place floors on test interest rates used in their serviceability assessments. These floors are typically higher than where we think mortgage interest rates are expected to head over the next year or so.

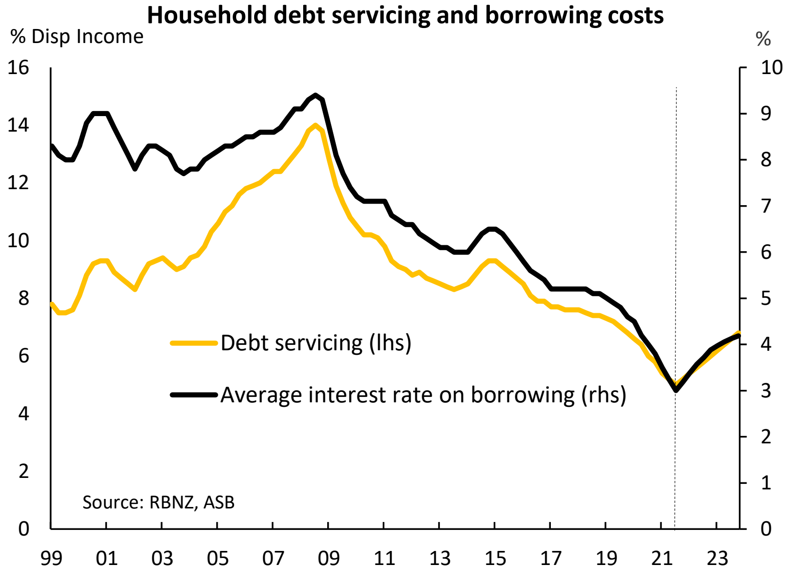
**Moreover, many households have maintained their debt repayments at a time of falling mortgage rates, paying off additional principal and building up a larger buffer.** RBNZ figures suggest that since the end of 2019, mortgage holders made more than $22bn in excess repayments. Household could choose to lengthen the duration of their lending when borrowing rates climb, smoothing through the impact.

**Neutral OCR and average mortgage interest rate**



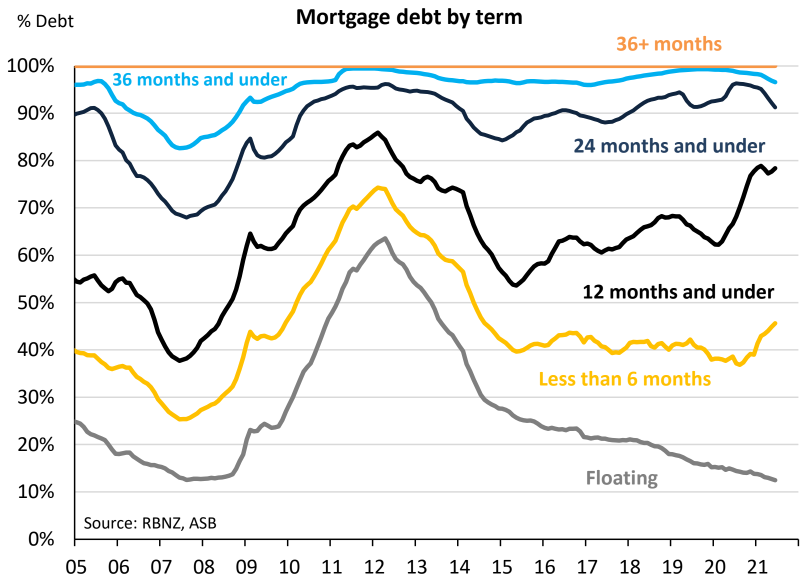

Source: Bloomberg, RBNZ, ASB

**Household debt servicing and borrowing costs**



## What about overall household cashflows?

Latest RBNZ figures (July) suggest the actual average borrowing interest rate paid by mortgage holders was 2.9%, a record low. Our estimates suggest that on a net basis **every 1 percentage point increase in customer interest rates would reduce household cashflows by roughly $2.6bn, roughly 1% of disposable incomes.** Every 1 percentage point lift in mortgage interest rates would raise household debt servicing costs by around $3.3bn per annum. However, a 1 percentage point increase in term deposit interest rates (assuming a 17.5% marginal tax rate) would likely deliver an additional after-tax cash flow of $675m per annum.

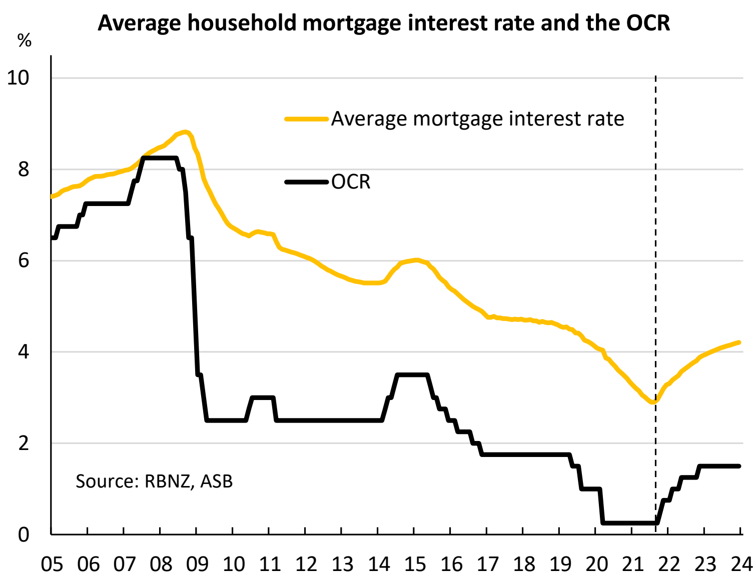



## How quickly would this impact?

This will depend on a number of factors, including how much new lending there was, how quickly fixed rate cover rolls over and the gap between the new and previous mortgage interest rate being charged on borrowers. Our updated home loan report expects new carded mortgage interest rates to rise 10-50bps across the curve before the end of the year and a total of 30-125bps by late 2022. We expect these increases to come through in a number of steps (particularly for short-term rates) rather than one big jump. **By late 2022, these increases would take new carded rates broadly back to where they were in late 2019.**

Due to mortgage fixing, borrowers will be temporarily shielded by the increase in mortgage rates. **This shield is not particularly large, with close to 80% of mortgage debt due to roll over in the next 12 months (average duration roughly 10 months).** There might be more mortgage stimulus in the pipeline as households roll off higher fixed rates onto lower ones, although we look to be at (or close to) the trough in the average effective mortgage rate.

**Assuming household borrowing habits don't change, our forecasts have average mortgage interest rates climbing by roughly 35bps by the end of the year (50bp of OCR hikes).** The average rate faced by mortgage borrowers at the end of this year would still be very low (around 3.30%), about 75-80bps below early 2020 levels. **The average effective mortgage interest rate is then expected to climb a further 65bps or so over 2022 (to roughly 3.90%), slightly above the 50bps of OCR hikes we expect over 2022**. **Although we don't expect OCR hikes over 2023, our estimates suggest the average effective mortgage rate will rise a further 30bps or so over 2023 to around 4.20%** (see chart). Our rough forecasts are broadly consistent with recent RBNZ research showing impacts will take time to accrue.




**All up, we expect average mortgage interest rates to rise roughly 130bps from now until the end of 2023, taking them back to late 2019 levels.** The higher debt servicing costs should be manageable for most households, but those with large debt exposures would feel the cashflow hit.

**What mortgage interest rates actually do could be quite different.** Rates may not move up as much. However, mortgage interest rates could move up more quickly and peak at higher levels. **For borrowers, we reiterate our earlier messages that it would be prudent to budget and prepare for higher future debt servicing costs**.

| ASB Economics & Research | | | Phone |
|---|---|---|---|
| Chief Economist | Nick Tuffley | nick.tuffley@asb.co.nz | (649) 301 5659 |
| Senior Economist | Mark Smith | mark.smith4@asb.co.nz | (649) 301 5957 |
| Senior Economist | Jane Turner | jane.turner@asb.co.nz | (649) 301 5853 |
| Senior Economist | Mike Jones | Mike.jones@asb.co.nz | (649) 301 5660 |
| Senior Economist, Wealth | Chris Tennent-Brown | chris.tennent-brown@asb.co.nz | (649) 301 5915 |
| Economist | Nat Keall | nathaniel.keall@asb.co.nz | (649) 301 5720 |
| **www.asb.co.nz/economics** | | | **@ASBMarkets** |