No More Wagyu and Shiraz for household mortgage borrowers

If media reports are to be believed, interest rate rises will choke economic growth and inflation largely by crunching the budgets of households with mortgages - forcing them to slash spending on essentials. Monetary policy traditionally wasn't meant to work like this and if that is, in fact, happening, some changes in policy and bank responses are warranted to reduce the resulting hardship.

Those who can remember textbook macroeconomics of decades past (such as the IS-LM analysis) will recall that monetary policy (interest rate) changes were expected to operate primarily on real investment in plant and equipment etc (rather than household consumption) by changing asset values. Increased rates would reduce the present value of future cash flows from new real investments, causing them to be scaled back or deferred.

Existing asset values with fixed future cash flows (or expected cash flows not affected by an interest rate increase) would decline, making purchases of existing physical assets more attractive than creating new ones by real investment. And lower demand would mean that inventory stocks (such as new vehicles in dealers' yards) would increase, signaling to manufacturers the need for cut backs in production.

Those declines in asset values would also have other effects. The reduction in wealth could also induce households to increase saving to restore wealth. Banks would be less willing to make loans to entities with lower wealth to be used as collateral, and where increased interest rates imply higher repayment/income ratios.

And, traditionally, because higher interest rates were achieved by reducing the liquidity in the financial system, banks would cut back lending to restore their liquidity positions.

Higher interest rates would also tend to lead to a higher exchange rate, making exports less competitive and imports cheaper. The latter could be expected to moderate inflation, while the economy would be slowed by the reduced competitiveness and ultimately lower output of local producers.

But higher interest rates were not thought to be a major influence on consumer spending. After all, every dollar borrowed by someone is a dollar lent by someone else, such that higher interest payments by some are matched by higher interest receipts by another (or perhaps higher bank profits if the flow through is less than complete)! Only if the sensitivity of spending of lenders and borrowers to interest rate changes was different might there be some predictable effect.

It was not the usual case to expect a major channel of monetary policy to be via the reduction in free cash flows and spending ability of households with outstanding mortgages who are now facing higher loan repayments. Of course, that might be very effective. For recent borrowers in particular, interest (rather

than principal) payments are a very large part of the total meaning that large increases in payments result from interest rate increases.

For those with already high debt service (repayment/income) ratios, scope to reduce living expenses can be limited. The "Wagyu and Shiraz" example of making less luxurious dining choices hardly applies for lower income borrowers.

In theory, loan approvals by mortgage lenders should (and are required by APRA to) have allowed a sufficient "buffer" such that the borrower could still make repayments at an increased interest rate. That buffer was 2.5 percentage points before October 2021 and 3 percentage points since.

The recent RBA cash rate rises have already eaten up most of the 2.5 percentage point buffer. The recent unexpected hike in the price of many essentials suggests that the buffers may not have been sufficient (or inappropriately calculated) to prevent many cases of hardship.

If this is so – undoubtedly so in some cases, although a media "beat up" may overstate the case – it should be asked whether there are other ways the authorities could act to rein in demand. That is particularly the case if banks do not, or are unable to, extend the term of mortgage loans for those facing hardship such that current cash flow repayments are left unchanged or only marginally increased.

One option would be to take actions which reduce bank lending – thus focusing more directly on investment type expenditures financed in this way. One such approach would be direct controls on the quantity of bank lending although many would see this as a return to the "bad old days". (Although APRA has recently used loan/valuation limits to restrict mortgage lending). Of course, such actions may simply shift lending to non-bank institutions.

Another option would be to use changes in bank capital requirements, either by changing risk weights or required capital ratios, to inhibit new lending.

Current economic and financial conditions are unusual, and thus it warrants questioning whether relying on a blunt weapon like interest rate increases to achieve policy goals, which may adversely affect a significant number of households, is appropriate and desirable.

Kevin Davis
Emeritus Professor of Finance, The University of Melbourne

September 7, 2022