

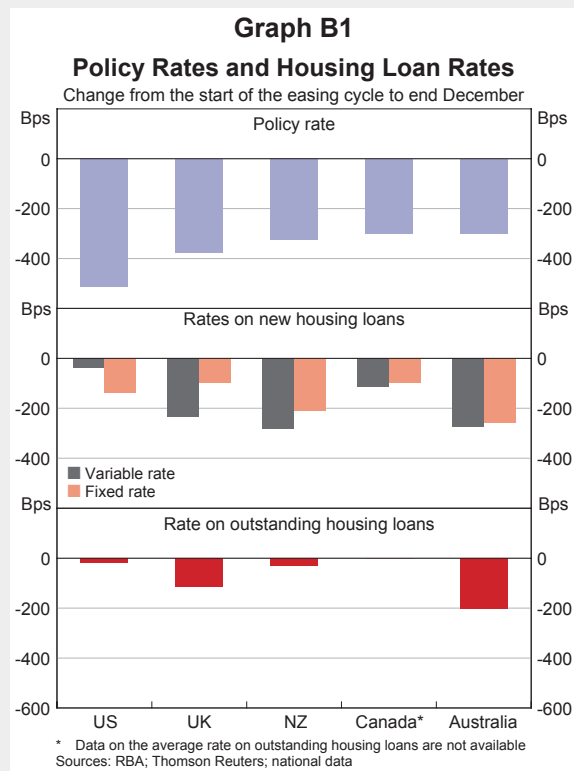
Box B: An International Comparison of Pass-through of Policy Rate Changes to Housing Loan Rates

An important channel for the transmission of monetary policy easing to economic growth is through reductions in interest rates paid by households on their housing loans. Lower interest rates on existing loans reduce households' interest payments, which increases the income available to indebted households who tend to have a higher propensity to consume. Lower rates on new loans also boost demand for dwellings, thereby supporting house prices and residential building activity.

Many countries, including Australia, have reduced their policy rates significantly over the past year or so. However the pass-through to outstanding housing loan rates has been much greater in Australia than in most other developed countries. During the second half of 2008, the RBA lowered the cash rate target by a cumulative 300 basis points, and the average rate on outstanding housing loans decreased by 200 basis points (Graph B1). In comparison, the policy rate in the United States was reduced by about 500 basis points between August 2007 and December 2008, but the average interest rate on outstanding housing loans has fallen by just 15 basis points. Similarly, in New Zealand and the United Kingdom, policy rates were reduced by 325–375 basis points during 2008, but average rates on outstanding housing loans are only 30 and 115 basis points lower.

The greater pass-through of policy rate changes to average rates on outstanding housing loans in Australia than in other countries reflects both the high share of variable-rate loans and the fact that financial institutions have passed on most of the recent declines in wholesale rates to their rates on new and existing variable housing loans and new fixed housing loans.

In Australia, three-quarters of outstanding housing loans are at variable rates. As well, almost all of the remainder have relatively short fixed-rate terms (between one and five years)



so that a reasonable share are continuously coming to the end of their fixed term and are reset according to current interest rates. Variable housing loan rates decreased by 275 basis points between August 2008 and December 2008, only a little less than the 300 basis point decrease in the cash rate, and rates on new 3-year fixed housing loans were lowered by 260 basis points, broadly in line with the fall in the 3-year government bond yield.

In contrast, in the United States, about three-quarters of outstanding housing loans are at long-term fixed rates (typically 30 years), with borrowers generally having the option to refinance their loan without penalty if interest rates fall. The remaining housing loans are ‘adjustable rate mortgages’, which often have a fixed rate for the first 1–5 years, and thereafter are adjusted periodically. Up until very recently, there had been very little pass-through of the large decline in the federal funds target rate to outstanding housing loan rates because rates on new 30-year fixed rate mortgages were little changed from their mid-2007 levels, notwithstanding the decline in longer-term government yields. In part this reflected the increase in the cost of funding for the large housing agencies, Fannie Mae and Freddie Mac, due to growing concerns about their financial viability. Because of this lack of transmission to lending rates, in November the Federal Reserve announced that it would commence buying agency debt. This, combined with the sharp fall in bond yields, saw rates on new 30-year fixed-rate mortgages fall by 140 basis points. This has led to a pick-up in refinancing activity, which should boost pass-through in coming quarters. Variable borrowing rates have only fallen by 40 basis points since August 2007, partly because many of these loans are benchmarked to US dollar LIBOR or the various Cost of Funds Indices, which have fallen by considerably less than the federal funds rate.

In the United Kingdom, variable rate and 1–5 year fixed-rate loans each account for about half of outstanding loans. The reasonably high share of fixed-rate loans has slowed the pass-through of policy rate reductions to average rates on outstanding housing loans since November 2007. Moreover, financial institutions have passed on only about half of the decrease in wholesale rates to their housing rates. Rates on new 3-year fixed housing loans declined by 100 basis points, compared with a 195 basis point fall in the equivalent government bond yield. Rates on new variable rate loans have fallen by 150–230 basis points, compared with a 375 basis point reduction in the Bank of England’s Bank Rate, as lenders have increased their margins significantly. Rates on outstanding variable rate loans have fallen by more, though pass-through has still been limited. Even on tracker loans, where the pass-through of changes in the bank rate should be automatic, some loan contracts have clauses which allow lenders to widen their margins if the bank rate falls below a certain level.

In Canada, about three-quarters of outstanding housing loans are at fixed rates, with five years being the most common term. This high share of fixed-rate loans has likely slowed the pass-through of policy rate reductions to average rates on outstanding housing loans over 2008, though reliable data are not available. Pass-through has been further reduced because rates on new 5-year fixed and variable housing loans have fallen by only about 100 basis points, compared with the 300 basis point reduction in the policy rate and the 220 basis point reduction in the government bond yield. ↗