

Impact of changing interest rates on house prices

By Ming Niu – Atchison Consultants

Links between interest rates and housing prices have been complex. Reductions in interest rates generally stimulate housing markets, as mortgage payments are lowered; making the housing market more affordable for homebuyers. This indicates an inverse relationship between the direction of mortgage interest rates and housing prices with house prices rising when interest rates fall.

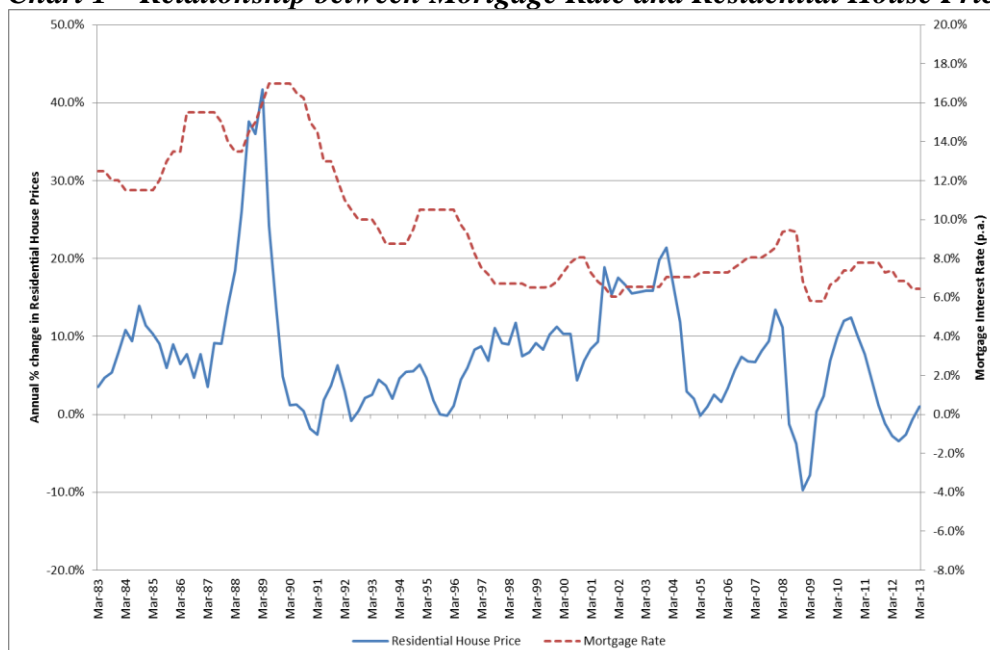
The inverse relationship was largely observable until the financial crisis in 2007. In the financial meltdown in 2007 and 2008, interest rates fell sharply, as did housing prices. The inverse relationship was broken at least temporarily.

The peak of the financial crisis period in 2007-2008 is seen as an anomaly due to the credit freeze, which started with the collapse of subprime structured loan market. Initially it was a shock to financial markets that turned into systemic stress in the economy and ultimately peaked with the collapse of Lehman Brothers and other financial companies. Interbank lending froze as banks struggled to maintain liquidity and borrowers were left without access to credit. This included home loans, with housing demand dropping due to a lack of finance.

Looking to history for answers

Revisiting historical data reveals further anomalies in the inverse relationship between house prices and mortgage rates. During the housing bubble of 1987-89 house prices rose around 40% while mortgage rates also significantly increased. The period from 2007 to 2012 highlights a timeframe where positive relationship was in place, where prices and interest rates rose and fell largely in unison though with varying magnitude.

Chart 1 – Relationship between Mortgage Rate and Residential House Price



Source: REIA, RBA

Positive correlation over the period from 2007 to 2012 raises questions about why the negative relationship between rising mortgage interest rates and rising housing prices does not always hold. Rising mortgage interest rates do not occur in isolation, as it reflects an expanding economy with growing consumer confidence and inflation. Higher borrowing costs dampen housing price increases. On the other hand, other economic factors emerge such as limited new supply and population growth that would have supported housing prices.

Aside from mortgage interest rates, other economic factors cause increases in housing prices. In a rebounding economy, growth in employment, real wages, and inflation rate are expected. This will improve affordability for the workforce and switching from renting to buying, increasing demand for houses, and consequently creating upward pressure on housing prices. In Australia the demand for employment encourages migration which also increases demand for houses and underpins prices.

On the contrary, when the economy slows, housing prices may be weak. As unemployment increases the ability of households to meet housing repayments diminishes, even with a reduction in interest rates. Affordability will be diminished until growth in employment emerges.

Is the relationship stable?

A consistent inverse relationship between the movement in mortgage interest rates and house prices is not evident. Anomalies occur, reflecting wider economic influence and variable time frames between interest rate changes and demand and supply.

With weakening economic growth in Australia, slowing employment growth in 2013-2014 and a cautious sentiment, significant increases in house prices are unlikely despite lower interest rates.

Ming Niu is an analyst at Atchison Consultants