Reserve Bank of New Zealand
Te Pūtea Matua

An international perspective on the financial stability implications of higher interest rates.

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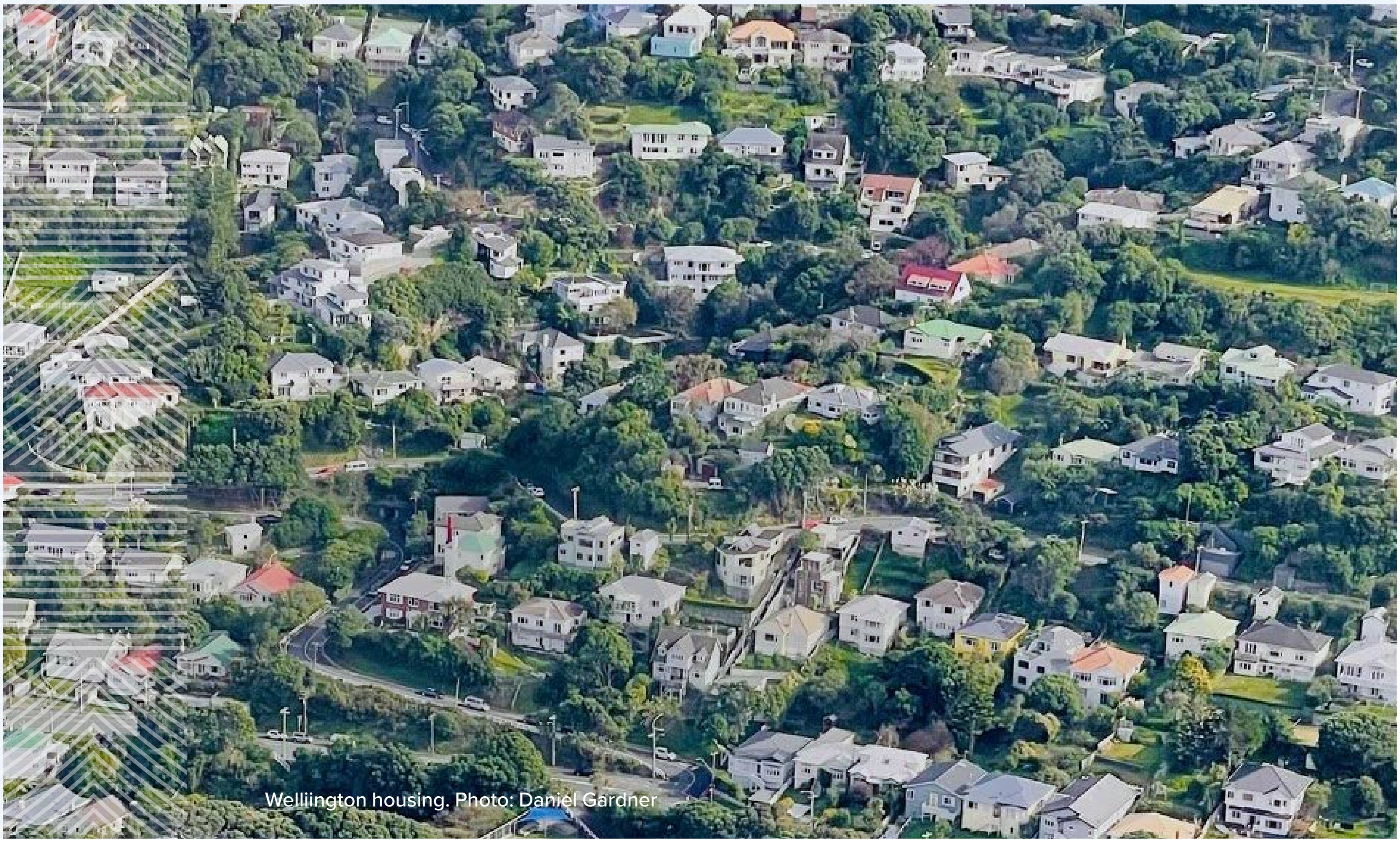


Welliington housing. Photo: Daniel Gardner

1 An international perspective on the financial stability implications of higher interest rates

Higher interest rates impact financial stability through numerous channels. In this special topic we assess how financial stability in advanced economies has been affected by the higher interest rate environment. To date, financial systems have been largely resilient to risks emanating from higher interest rates, but the full impact is still to be seen and some areas of concern are emerging. Also in this special topic we compare the effects of higher interest rates on financial stability in other advanced economies with developments in New Zealand. We find that New Zealand has many similarities to other advanced economies and compares favourably overall, although we do find that mortgage borrowers in New Zealand are relatively more exposed to higher interest rates. This is because of higher household debt levels and the relatively short fixed-rate periods of New Zealand mortgages.

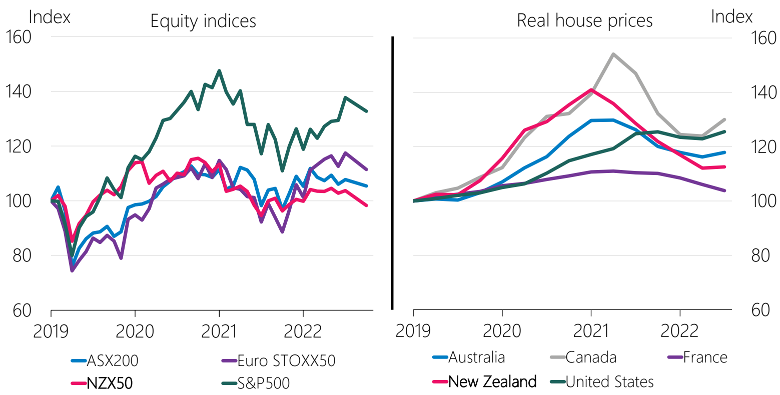
Equity markets have remained resilient despite interest rates moving higher

Although bank stocks fell following the banking turmoil in the US and Europe earlier this year, equity indices as a whole have performed well (figure 2.1). Initial concerns of spillovers from financial market volatility that could threaten global financial stability did not materialise. Equity markets have been robust overall, despite interest rate increases, for several reasons. US equity markets have been buoyed by the strong performance of the technology sector and stronger than anticipated economic activity. European equity markets have profited recently from declining energy prices that increased corporate profits.

The New Zealand equity market outperformed markets in many other advanced economies initially during the

Figure 2.1

International equity indices and real house prices



Source: Haver Analytics, Mack and Martínez-García (2011).[5]

COVID-19 pandemic, but it has weakened more recently. The recent under-performance may partly reflect the higher weighting of interest rate-sensitive sectors in the NZX50 index relative to many overseas indices.[2] In the near term, the outlook for global equity prices is likely to depend on how much economic growth slows and how fast inflation declines.

House prices have stabilised in New Zealand and in other advanced economies

Higher interest rates have increased the cost of borrowing, reducing housing demand and reversing some of the sharp increases in house prices immediately after the COVID-19 pandemic. New Zealand, Australia and Canada saw the sharpest correction in prices, owing partly to their strong run-up of house prices. Recently, house prices have steadied, supported by a stabilisation in interest rates, strong labour markets and a rebound in migration inflows, especially in countries like Australia, Canada and New Zealand.

1 Mack A, and E Martinez-Garcia (2011) 'A Cross-Country Quarterly Database of Real House Prices: A Methodological Note', *Globalisation and Monetary Policy Institute Working Paper No.99*, Federal Reserve Bank of Dallas.

2 The NZX50 is relatively small compared to other global equity indices and less diversified on a sectoral level. Furthermore, the utilities sector, which makes up a considerable part of the NZX50, typically has high levels of capital expenditures and debt, and is thus particularly sensitive to interest rate changes.

Future developments in global housing markets may vary, depending on factors such as the extent and duration of monetary tightening, the responsiveness of new housing supply to increased demand, and the share and maturity structure of fixed-rate mortgages. The widespread use of mortgages with relatively short fixed terms speeds up the pass-through of monetary policy tightening to mortgage rates. Downside risks remain if unemployment rises or if financial conditions tighten.

Global commercial property markets face considerable headwinds

Conditions in the global commercial property market are challenging in many countries, including in New Zealand. Higher interest rates and lower demand from tenants, caused by more workers choosing to work from home, have lowered asset valuations and worsened property owners' loan servicing ability. Funding is also becoming more constrained due to tighter lending standards. In the future, decreasing operating margins for property owners and growing difficulties refinancing loans are likely to raise the share of debt past due for repayment.

Financial stability risks are higher in countries where the banking sector is more exposed to commercial property loans. Some European banks engage in high loan-to-value lending, raising banks' potential losses in the event of default. In the US, the average exposure of banks to commercial property loans is significantly higher than in most other countries (figure 2.2). In New Zealand, financial stability risks are mitigated by tight lending standards, and so far signs of financial stress have been limited (see Special Topic 2).

New Zealand households are relatively more exposed to increased debt servicing costs

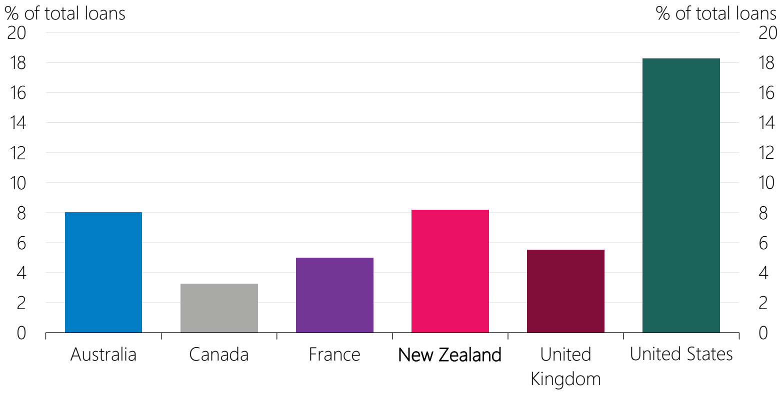
Higher interest rates put highly-indebted households with large mortgages and little savings buffers at increased risk of defaulting on their loans. Countries where households have elevated levels of debt-to-disposable income are particularly vulnerable.

Borrowers in countries with a large share of mortgages on shorter fixed terms, such as New Zealand and Australia, are experiencing substantially higher debt servicing costs (figure 2.3), putting strain on household budgets. Despite most of mortgage debt having already rolled over to higher interest rates, signs of household stress remain muted in New Zealand. Financial resilience of households has been bolstered by high employment rates.

Figure 2.2

Commercial property share of banks' total loans

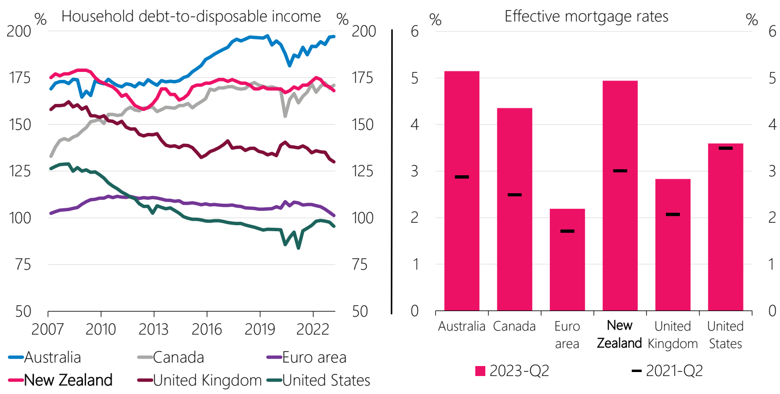
(As of 2023 Q1)



Source: IMF Financial Soundness Indicators, RBNZ calculations.

Figure 2.3

Household debt-to-disposable income ratio and effective rates on outstanding mortgages



Source: Haver Analytics, RBNZ, Bank of Canada, ECB, Bank of England, US Bureau of Economic Analysis.

Note: As most mortgages are uninsured in Canada, we use the rate on uninsured mortgages for our comparison.

In countries with a larger share of longer-term fixed-rate mortgages, such as the US and parts of central Europe, higher policy rates pass through more slowly into mortgage rates, so risks may not have fully materialised yet.

While few signs of systemic stress from the household sector have emerged so far, the outlook remains uncertain, particularly in countries with a high percentage of mortgage holders.

Despite challenges caused by rising interest rates there are few signs of widespread debt servicing stress in advanced economies. Non-performing loan (NPL) ratios remain well below levels seen during the Global Financial Crisis (GFC) (figure 2.4). NPL ratios in New Zealand and Canada are particularly low compared both to other economies and their historic levels. Nevertheless, NPLs and loan arrears are increasing slightly in most countries, including New Zealand (see Special Topic 2). In most advanced economies banks have reacted to expectations of deteriorating credit quality by increasing provisions for bad debts.

Further tightening of financial conditions may challenge well capitalised banking systems

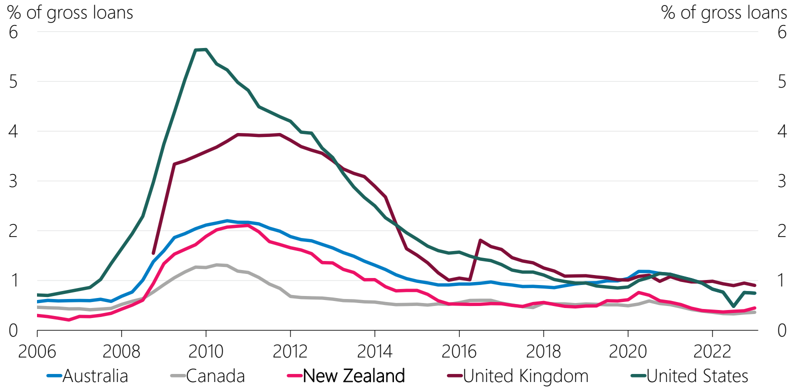
The overall resilience of global banking systems has increased significantly since the GFC. Bank capital ratios across countries are not directly comparable, due to different regulatory approaches, but levels of capital and liquidity positions have risen markedly in all advanced economies since the GFC (figure 2.5). While the banking sector turmoil earlier this year in the US and Europe led to concerns about wider financial stability, these banks' failures can mostly be attributed to idiosyncratic factors, such as poor management of interest rate and liquidity risk. New Zealand banks have been less affected by banking sector troubles overseas, owing to prudential requirements, generally prudent risk management procedures, and lending practices favouring shorter-term rates.[3]

Banks' profitability metrics have been buoyed by the effect of rising interest rates on net interest margins over the past year (figure 2.6). In recent quarters, banks' net interest margins have moderated in most countries as deposit rates are starting to rise and customers are increasingly shifting transaction deposits into term deposits offering higher interest rates (see Box C).

Figure 2.4

Non-performing loan ratios

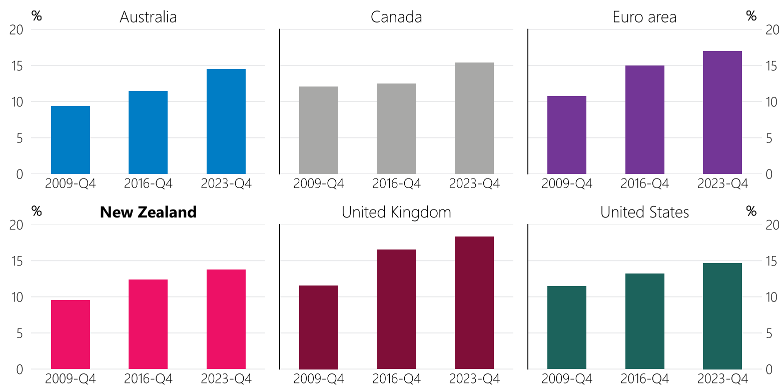
(seasonally adjusted)



Source: IMF Financial Soundness Indicators, Federal Reserve Bank of St Louis, RBNZ calculations.

Figure 2.5

Tier 1 capital ratios

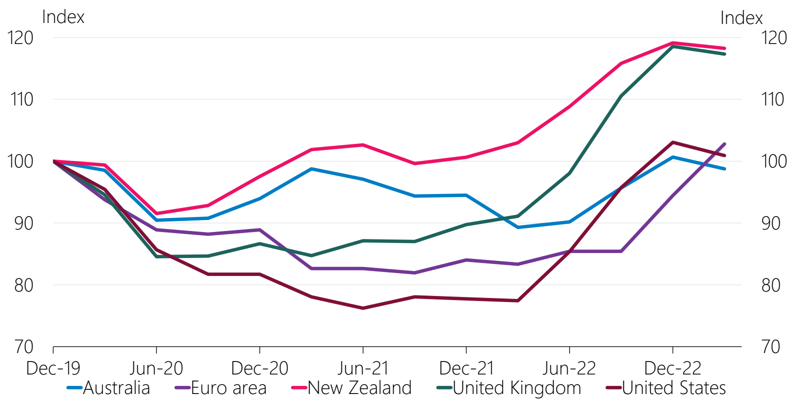


Source: IMF Financial Soundness Indicators, ECB, RBNZ.

Figure 2.6

Bank net interest margins

(indexed to 2019 Q4 = 100)



Source: APRA, ECB, RBNZ, Bank of England, US Federal Deposit Insurance Corporation.

Note: Euro area figures are calculated only for banks under the Single Supervisory Mechanism. For data availability reasons we use loans margins as a proxy for NIMs in the UK, as we are more interested in a comparison of recent trends and not in absolute profitability levels. We use net interest income as a share of total assets as a proxy for NIMs in Australia.

3 For a more detailed discussion of interest rate risk management practices at New Zealand banks, refer to Box A in our May 2023 FSR.

In some economies competitive pressures are expected to lead to a further increase in average deposit rates, putting downward pressure on profitability. In addition, slowing credit growth and an uptick in credit losses are also expected to reduce banks' profitability going forward. An abrupt tightening of financial conditions or spillover effects from strained sectors, such as the commercial property or household sector, could expose vulnerabilities in banks with an elevated risk profile. However, stress-tests in most countries indicate that robust profitability in conjunction with ample capital and liquidity buffers would support the banking sector even in the case of a material economic downturn.

New Zealand's fiscal position is relatively strong with low public sector debt levels

General government debt as a share of GDP has risen since the GFC in advanced economies. Over the course of the pandemic, public debt levels, including those in New Zealand, surged notably. As monetary policy rates have risen, borrowing and debt servicing costs for governments have also increased, straining fiscal budgets and potentially reducing the scope for further fiscal stimulus in the event of a severe downturn. Net interest expenses as a share of total government revenues have risen sharply since the start of the monetary policy tightening cycle. This is particularly an issue for heavily indebted countries. In comparison to other advanced economies, New Zealand faces relatively low levels of public sector debt (figure 2.7).

Overall, financial systems have been resilient to higher rates, but risks remain elevated

Overall, we continue to see widespread resilience of financial institutions to the higher interest rate environment in all major advanced economies. Key financial stress indicators remain mostly benign compared to expectations, although some areas of stress are emerging.

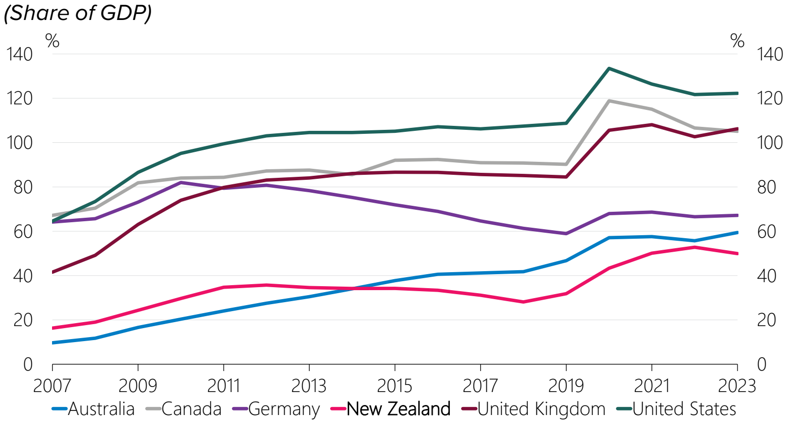
In part this reflects robust macroeconomic fundamentals, such as low unemployment rates, and past regulatory tightening across many jurisdictions after the GFC. The channels through which higher interest rates impact economies are generally the same, but the impact and transmission speed vary across markets, countries and time. Risks to financial stability will likely be most acute in countries with weakening economic fundamentals. Key downside risks to global financial stability are potentially weakening labour markets and persistently high inflation rates, raising the risk of further policy tightening.

The international comparison shows New Zealand's financial system is faced with similar challenges as other countries, but appears robust and in a good position to face potentially looming challenges. An area of relative weakness for New Zealand, like Australia and Canada, is the exposure of mortgage borrowers to higher interest rates given high household debt levels and shorter fixed-term mortgage rates.

Figure 2.7

Public sector debt

(Share of GDP)



Source: IMF World Economic Outlook (April 2023).