Do low interest rates make houses more affordable?

There's something that intrigues me about the financing behind the house price xxxxxx (rhymes with double) going on in Sydney, Melbourne and other parts of Australia?? (link WSJ).

All the commentary in the personal finance media, and all the behaviour from auction bidders, suggest a particular belief—that when Glenn Stevens lowers interest rates 25 basis points, buyers can afford to pay a little more for the 2-bedroom fixer upper that they and 40 other people desperately want to buy.

But can they? In Australia, most buyers utilise plenty of debt (mortgages). And the great bulk of mortgage structures are floating rate—even if you fix the first five years of a 30 year loan and continue to refix every five years, you're still at the whims of the interest rate market for the last 25 years of the mortgage.

Buyers seemingly believe that whatever Glenn Steven thinks is the right rate for the broader economy today somehow gives them insight into interest rates over the life of their mortgage. Lower interest rates this month must mean lower average rates over the next 30 years. Lower interest rates this month must mean that the worst case scenario (say interest rates of more than 10%) is less likely. This strikes me as extremely myopic thinking.

It doesn't work this way everywhere. US borrowers mostly have fixed rate loans. Actually, they're better than that—the rates are fixed for the life of the mortgage if that suits you, and are refinanceable if it doesn't suit you.

Much of Europe has capped rates. We have friends who bought a beautiful Altbau apartment in Vienna in 2007 for €300,000. I'm guessing at the specifics of their loan, but if it was like most they would have been paying a fixed rate of 5-6% for the first 7-10 years of the loan, then moving to variable rates that are capped at a maximum of 8-9% for the life of the 30 year loan.

Today's buyer would pay nearly double for that same apartment. A little bit of that is justified by higher rents generally, but most of it comes down to financing—and it's not irrational. Today's buyer would be able to take out a loan at 2-2.5% fixed for 7-10 years, with the mortgage then switching to floating rate, never to go higher than about 6%.

If you sit down and model those repayments over a variety of possible scenarios, comparing them to what our friends have and will pay on their mortgage, you quickly see something. Over the life of the loan, today's buyer is paying more, but certainly not twice as much as what our friends paid.

Australian buyers get no such certainty. House prices have also probably doubled in many regions since 2007. But today's mortgaged new buyer will, over the life of their loan, pay a price that cannot be determined today, and is uncapped.

For Australian buyers, today's interest rate is just one data point in the series that really matters—how interest rates are going to fare over the life of their loan. So I don't think it's right to assume that today's low interest rates make today's sky high prices more affordable. They might make today more affordable, but what about three years from now?

Put another way, here's a chart showing variable interest rates in Australia over the past 56 years.

And here is my artistic interpretation of what today's buyer thinks the next thirty years will look like, (perhaps with a few pleasant rate cuts thrown in from time to time):

Hey, they might be right. But I wouldn't want to bet my house on it.

There's something that intrigues me about the financing behind the house price xxxxxx (rhymes with double) going on in Sydney, Melbourne and [other parts of Australia](#).

The commentary in the personal finance media and behaviour from house buyers suggest a widespread belief—that when Glenn Stevens lowers interest rates 25 basis points, buyers can afford to pay more for the 2-bedroom fixer upper that they and 40 other people desperately want to buy.

But can they afford more?

In Australia most buyers, whether owner/occupier or investor, utilise plenty of debt. And all Australian mortgages are effectively floating rate—even if you fix the first five years of a 30 year loan and continue to refix every five years, you're still at the whims of the interest rate market for the last 25 years of the mortgage.

Buyers seemingly believe that whatever Glenn Steven thinks is the right rate for the broader economy today somehow gives them insight into interest rates over the life of their mortgage. Lower interest rates this month must mean lower average rates over the next 30 years. Lower interest rates this month must mean that the worst case scenario (say interest rates of more than 10%) is less likely. This strikes me as extremely myopic thinking.

It doesn't work this way everywhere. US borrowers mostly have fixed rate loans. Actually, they're better than that—the rates are fixed for the life of the mortgage if that suits you, but can be refinanced if it doesn't suit you (i.e. if rates go down).

Much of Europe has capped rates. We have friends who bought a beautiful Altbau apartment in Vienna in 2007 for €300,000. I'm guessing at the specifics of their loan, but if it was like most they would have been paying a fixed rate of 5-6% for the first 7-10 years of the loan, then moving to variable rates that are capped at a maximum of 8-9% for the life of the 30 year loan.

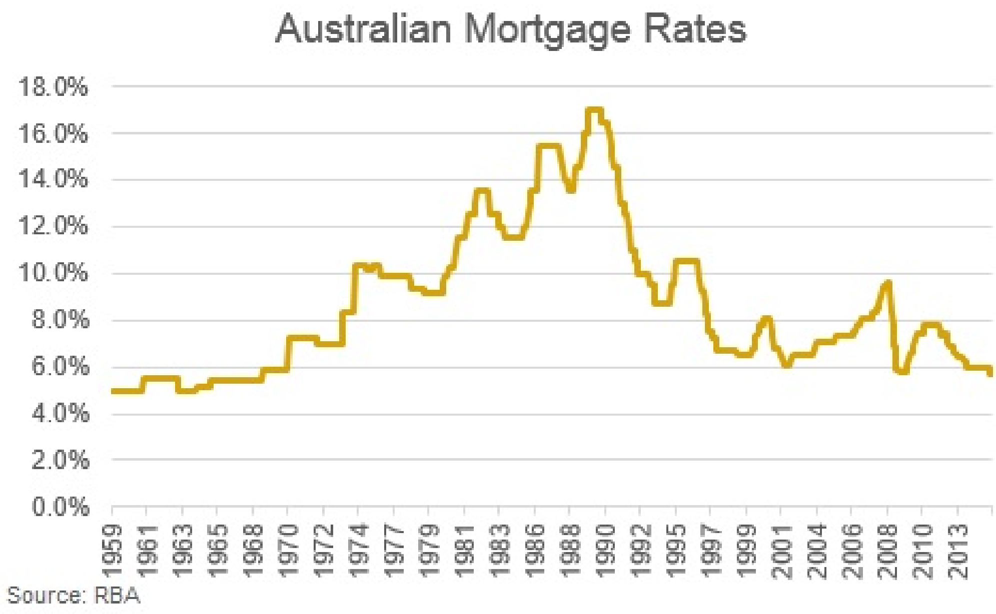
Today's buyer would pay nearly double for that same apartment. A little bit of that is justified by higher rents generally, but most of it comes down to financing—and it's not irrational. Today's buyer would be able to take out a loan at 2-2.5% fixed for 7-10 years, with the mortgage then switching to floating rate, never to go higher than about 6%.

If you model the repayments for today's buyer, over a variety of possible scenarios, and compare them to what our friends have and will pay on their mortgage, something becomes apparent. Over the life of the loan, today's buyer is paying more, but certainly not twice as much as what our friends paid.

Australian buyers get no such certainty. House prices have also doubled in many regions since 2007. But today's mortgaged new buyer will, over the life of their loan, pay a price that cannot be determined today, and is uncapped. It's not possible to say that they'll pay lower rates overall than the 2007 buyer.

For Australian buyers, today's interest rate is just one data point in the series that really matters—how interest rates are going to fare over the life of their loan. So I don't think it's right to assume that today's low interest rates make today's sky high prices more affordable. They might make the mortgage more affordable today, but what about three years from now? What about in 2025?

Put another way, here's a chart showing variable interest rates in Australia over the past 56 years.



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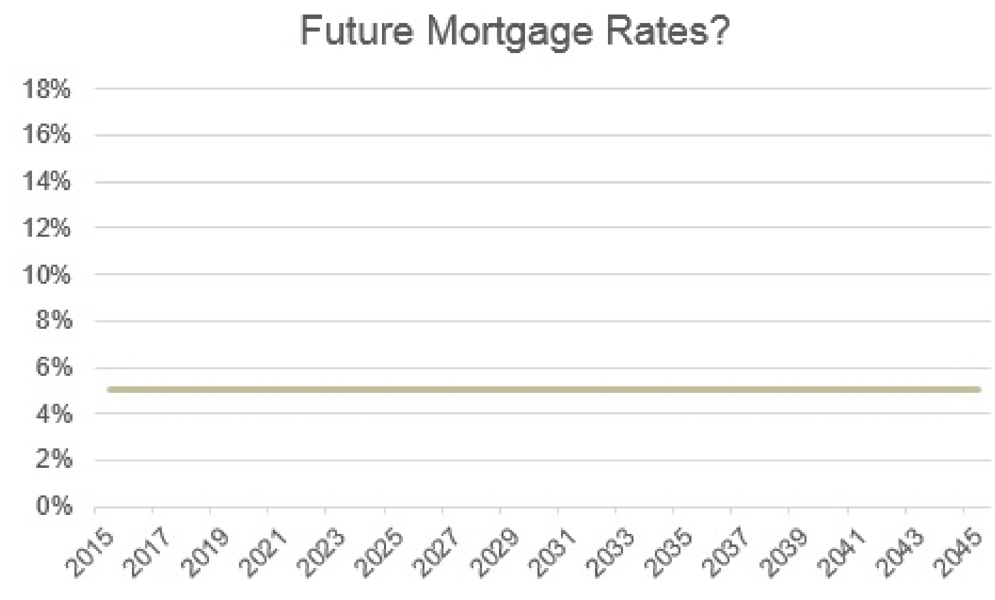

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