Bernard Hickey looks at how to think about whether to fix or float, how long to fix and what the Reserve Bank may do about house prices

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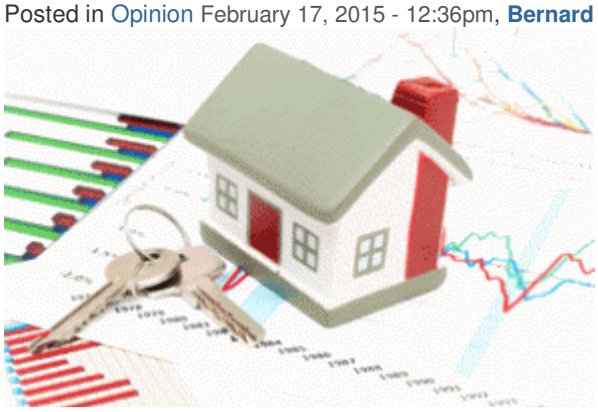

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By Bernard Hickey Interest rates

We live in a very strange world at the moment.

New Zealand's economic and employment growth is rollicking along at over 3% and Auckland house price inflation is accelerating again into the double digits. The median house prices in Manukau and Auckland City were 25% higher in January than a year ago.

Normally that sort of growth would generate enough inflationary pressure to force the Reserve Bank to put up interest rates to cool things down and keep inflation between 1-3%. Instead, fixed mortgage rates are falling and the Reserve Bank can't hike the Official Cash Rate (OCR) because prices in New Zealand and around much of the world are falling.

Something appears different or broken in the bowels of the economic machine which means growth doesn't seem to be creating as much inflation as it used to. Central banks in Europe, Japan and China have responded to this lack of inflation and often outright deflation by cutting interest rates. Those who have already cut their rates to 0% are having to print money to buy Government and other bonds in the hope they can drag down longer term interest rates and fire up lending and economic activity.

The European Central Bank and the Bank of Japan are the main protagonists at the moment, launching and ramping up their programmes of 'Quantitative Easing', which is a fancy name for creating money out of thin air to buy Government bonds. So far it's been effective at firing up lending to buy assets such as bonds, stocks and property, but hasn't driven as much 'real' investment in new factories, jobs and new products and services, particularly in Europe and Japan. It appears to have worked better in America, although its inflation rate is also still slumping.

The Reserve Bank has estimated 2015 will be the biggest year for central bank Quantitative Easing since 2011. This has driven long term interest rates in Europe in particular to their lowest level since the 1400s. Swiss two year bond yields, for example, now offer a yield of minus 1.2%. That means savers are effectively paying money to banks and Governments to look after their money. Bond yields have collapsed over the last six months as investors in the world's most liquid markets bet that central banks will keep printing for years to come and that inflation will remain very, very low to the point of deflation. There are now US$2 trillion in invested in bonds and bank accounts that offer negative interest rates.

Earlier in February ANZ New Zealand was able to borrow 750 million euros from those same European investors experiencing negative interest rates. It borrowed at a rate of 0.625%. ANZ had to pay a bit more to swap that money back into New Zealand dollars, but would still have had plenty of margin to offer a keen fixed mortgage rate.

That's the backdrop for our mortgage rates, which have fallen as much as 1% over the last 9 months. As recently as the beginning of January, the average two year mortgage rate was 5.98%. In recent weeks banks have been offering 2 year specials of as low as 5.19%. One bank, HSBC, is now offering 5.29% for every single fixed mortgage from 1 year to 5 years. Just nine months ago, the average five year fixed mortgage rate was 7.3%.

One bank, TSB, is now even offering a 10 year mortgage at 5.89%.

Could they go lower?

The slump in fixed mortgage rates has made it much more difficult to justify paying the 6.74% offered by most banks for floating rate mortgages. The question then is: how long to fix?

The answer to that question depends on your view on where inflation in New Zealand and locally is going, and what you think central banks will do about it.

The jury is in overseas. They are treating this very low inflation and deflation as a cyclical issue that needs to be addressed with even lower interest rates and money printing. The People's Bank of China has also eased monetary policy in recent weeks, as has the Reserve Bank of Australia. The Reserve Bank of New Zealand is an outlier and despite the strong growth is seen unlikely to hike interest rates again for the forseeable future -- at least until well into 2016. So far in 2015, **Reuters reports** 17 central banks have eased monetary policy.

So the global trend over the last six months has been for interest rates to fall ever lower. It's not just about falling petrol prices. There is now a growing debate about whether the deflation is structural and linked to changing technology, the globalisation of services and ageing populations. For now, central banks think it's cyclical. The wisdom of crowds in financial markets, particularly bond markets and stock markets, suggest it might be structural.

Structural or cyclical?

If it is structural then interest rates could remain low and possibly fall even further. Remember that interest rates averaged around 3% for all of the 1800s during the first age of industrialisation as new machines lowered the cost of production.

Some argue the world is entering a second age of industrialisation that delivers a similar type of 'supply shock' that lowers prices of goods and services for decades to come. The age of the smart phone has clearly driven down prices for many services, including shopping, accounting, music, telecommunications and taxis. Could we see many other areas such as education, health and financial services similarly transformed in a deflationary way?

Fix or float? And for how long?

My view for several years has been that interest rates stay lower and for longer than most economists have forecast.

That makes me more likely to fix for a shorter than a longer term.

The idea of a 10 year fixed mortgage scares me witless. That rate of 5.89% might look good now, but what if the long term average for mortgage rates is in the process of a structural fall to more like 4-5% instead of the 7.4% we've seen over the last decade? Imagine the break fees on a 10 year mortgage.

What the Reserve Bank might do about it

There's growing speculation the Reserve Bank will resort to new 'Macro-Prudential' measures to try to slow house price inflation without putting up the Official Cash Rate. Its first stab at 'Macro-Prudential' measures was its high LVR speed limit introduced in October 2013. That worked to halve the annualised house price inflation rate for just over a year, but it's wearing off now and Auckland's housing market is clearly in resurgent mode, thanks to a shortage of 15,000 to 20,000 dwellings, record high net migration and unfettered buying by cashed-up non-residents.

Reserve Bank Governor Graeme Wheeler warned in early February he was watching how the banks' activities were pumping up house prices and said the bank would talk more about the housing market in months to come.

Wheeler is worried New Zealand's house prices are among the most over-valued in the world relative to the history of incomes and rents and that any 'correction' could shake the stability of the banking system he is responsible for.

Most now expect he will introduce some form of new measures to slow mortgage lending. **See more detail here in Gareth Vaughan's excellent summary** of the current thinking.

Calculating the gains

There is a way to work out which mortgage and which rate saves you the most money, relative to floating rates. See the table below for the latest calculations on a NZ$500,000 mortgage.

Here's a table that shows the benefits of moving a NZ$500,000 mortgage of moving from a floating rate of 6.75% to the various fixed options, assuming different interest rate tracks. The gains are indicated as a positive and the losses are negative. The middle track for the OCR is in line with market expectations. See all mortgage rates **here.**

The latest estimates, given the drop in fixed rates in recent months, suggest fixing is cheaper than floating across the board.

OCR rate by mid 2016	One year fixed (5.39%)	Two year fixed (5.19%
OCR at 4.0% (low)	+ NZ$6,826	+ NZ$11,263
OCR at 5.0% (middle)	+ NZ$9,775	+ NZ$14,213
OCR at 5.8% (high)	+ NZ$13,011	+ NZ$17,449