New Zealand Interest Rates: ‘Too High’ Or ‘Too Low’?

An address to the Christchurch Club Dinner on 22 July 1993 by Dr Don Brash, Governor of the Reserve Bank of New Zealand (with minor editing and up-dating).

In New Zealand, as in most other developed countries, monetary policy operates in large part through the various effects which interest rates have on the economy. Because of this, an informed public understanding of interest rates is an important ingredient of an informed public understanding of monetary policy.

Unfortunately, there is very considerable public confusion and misunderstanding about interest rates. Borrowers, and those who speak for them, are absolutely convinced that interest rates are too high. Savers are equally convinced that interest rates on deposits are now so low as to make saving hardly worthwhile. Both groups are convinced that the real culprits are the banks.

Some of those who claim an understanding of the issues complain that the real reason why interest rates are so high is the Reserve Bank’s obsessive focus on price stability. Today I want to put some of these concerns in context.

First, some history. Graph 1 shows 90-day bank bill rates from the early seventies until the present, and it is obvious that, at present levels, bill rates are lower than at any time since 1973. They are substantially less than a quarter of the level rates reached in 1985, and indeed only about one-third the level of bill rates in 1990.

Graph 1

Ninety Day Interest Rates

[Graph showing interest rates from 1974 to 1994]
The same sort of picture emerges in Graph 2, which shows 10-year government bond yields since the early seventies; and in Graph 3, which shows residential mortgage rates over the same period. Clearly, interest rates have fallen enormously in recent years, with present levels lower than for the best part of two decades.

Graph 2
Ten Year Government Bond Yields

Graph 3
Mortgage Interest Rates

Source: RBNZ, Statistics New Zealand

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But, some argue, interest rates in New Zealand are still far too high in inflation-adjusted, or 'real', terms. Some critics go so far as to suggest that, in inflation-adjusted terms, New Zealand interest rates are still among the highest in the world. Table 1 shows the position as at 15 March 1994 for 90 day bank bill rates and yields on 10 year government bonds (comparing mortgage rates internationally is complicated by different practices with regard to front-end fees and the tax deductibility of interest on residential mortgages, and by the fact that most mortgages in New Zealand, and in some other countries, carry variable interest rates).

**TABLE 1**

<table>
<thead>
<tr>
<th>90 DAY BILLS</th>
<th>10 YEAR GOVT BONDS</th>
</tr>
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<tbody>
<tr>
<td><strong>Nominal Yields</strong></td>
<td><strong>Inflation Adj Yields</strong></td>
</tr>
<tr>
<td>Singapore</td>
<td>3.0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.3</td>
</tr>
<tr>
<td>US</td>
<td>3.7</td>
</tr>
<tr>
<td>Germany</td>
<td>5.6</td>
</tr>
<tr>
<td>UK</td>
<td>4.8</td>
</tr>
<tr>
<td>Japan</td>
<td>2.2</td>
</tr>
<tr>
<td>France</td>
<td>6.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>5.9</td>
</tr>
<tr>
<td>Austria</td>
<td>4.7</td>
</tr>
<tr>
<td><strong>New Zealand</strong></td>
<td><strong>5.3</strong></td>
</tr>
<tr>
<td>Italy</td>
<td>8.2</td>
</tr>
<tr>
<td>Spain</td>
<td>7.8</td>
</tr>
<tr>
<td>Australia</td>
<td>4.7</td>
</tr>
<tr>
<td>Sweden</td>
<td>7.0</td>
</tr>
<tr>
<td>Canada</td>
<td>3.8</td>
</tr>
</tbody>
</table>

* Inflation-adjusted yields for 90 day bills calculated using the latest CPI inflation forecast for 1994 by 'The Economist' poll of forecasters, except for Singapore (where the latest year to date inflation figure was used) and New Zealand (where the latest Reserve Bank survey of inflation expectations was used). Inflation-adjusted yields on 10-year bonds were calculated on a similar basis, except that the average forecast of 1994 and 1995 CPI inflation was used.

It is clear from this table that, in inflation-adjusted terms, New Zealand short-term interest rates are somewhat higher than those in a number of other countries, though they are not materially higher than those in Spain and Denmark and are somewhat lower than those in France, Italy and Sweden.

Inflation-adjusted yields on 10-year bonds in New Zealand are also higher than in several of the other countries in the table, though our yields are only marginally higher than in Denmark, France, and Austria, virtually identical to those in Spain, Italy, and Australia, and slightly lower than those in Sweden and Canada.
So are our interest rates too high, as many borrowers claim, or too low, as many savers claim?

In trying to answer this question, it is important to remember first that interest rates are nothing more and nothing less than the prices at which some people are willing to lend their savings to other people. Put another way, interest rates reflect the supply of savings and the demand to borrow (other people’s) savings. If people are reluctant to save in New Zealand dollars, but keen to borrow New Zealand dollars, interest rates will tend to rise. And both the supply of savings and borrowing demand are influenced to a considerable extent by the expectations people have about future inflation. This is the connection between market interest rates and inflation.

- Note that it is the expectations of future inflation which affect people’s willingness to save and eagerness to borrow - not last year’s inflation rate. If people expect inflation to be high in future, there will be a natural inclination to spend now (reduced supply of savings), and borrow to spend even more before prices go up (increased demand to borrow other people’s savings). Not surprisingly, the price (interest rate) at which there is a balance between the reduced supply of savings and the increased demand for borrowing goes up.

I well recall a conversation with the chief executive of one of New Zealand’s largest corporates in May 1989, which illustrates the relevance of future inflation to the interest rate required by savers. He complained aggressively that, despite the fact that the inflation rate in the year to March 1989 had been only 4.0 percent, his company was paying 18 percent to borrow from its bank — an inflation-adjusted rate of 14 percent, which he clearly regarded as outrageous.

I expressed sympathy for him, and also some puzzlement that New Zealand interest rates were as high as they were. I noted that five year bonds in New Zealand dollars were yielding over 13 percent, whereas five year bonds in United States dollars were around 8 percent, despite inflation in New Zealand being closely similar to that in the United States. If I were a United States pension fund manager, I observed, I would be buying New Zealand dollar bonds at 13 percent rather than United States dollar bonds at 8 percent.

“Hell,” he said, “I wouldn’t: as a matter of fact, I have all my own money invested in the United States.”

I asked him to explain. “Well,” he said, “I am expecting inflation in New Zealand to rocket away again next year before the (1990) election, and then the New Zealand dollar will fall sharply. So I’d sooner have my money invested in United States banks than in New Zealand even though I could get 5-6 percent more in interest in New Zealand than in the United States.”

I pointed out to him that, since New Zealand interest rates were not high enough to persuade him as a saver to save in New Zealand dollars, the likelihood was that, if other savers shared his view, the interest rates at which New Zealand banks lent would remain unchanged or even rise in the months ahead, not fall, irrespective of the inflation rate in the previous year.
Obviously, actually achieving low inflation has an influence on people’s views of future inflation, and this is shown both by the fact that recent surveys of inflationary expectations suggest a considerable fall in New Zealanders’ views of future inflation and by the very considerable fall in interest rates which we have seen in recent years, as already noted. But it takes time, as the relatively high inflation-adjusted yields still available on long-dated instruments makes clear. It is no accident that, after some 20 years of high inflation, New Zealanders are a little slow to be persuaded that price stability is sufficiently certain in the future to accept lower rates of interest on their savings.

I want to emphasize this connection between the expectation of future inflation, with its impact on the supply of and demand for available savings, and interest rates. It is a source of amazement to me how frequently commentator and others call for banks to reduce interest rates every time a quarterly inflation figure leaves year-to-date inflation within the price stability range. The fact of the matter is that last year’s inflation has no direct effect on interest rates, and banks can be expected to ignore such information. Banks respond not to inflation data but to the supply of deposits in relation to the demand for borrowing, and that is entirely proper. To do anything else would lead to rationing, and the emergence of the problem obviously feared by the President of the Real Estate Institute of New Zealand when he expressed a concern some months ago that bank interest rates might fall to the point where banks could no longer attract the deposits needed to fund their mortgages.

Only as people’s experience of low inflation changes their willingness to save, and desire to borrow, by changing expectations of future inflation is there an inflation effect on interest rates.

If interest rates in New Zealand were “too high” in some fundamental sense, we would see savings increasing strongly and bank lending falling sharply. The reality is rather different. As a country, we are still spending more than we produce — saving less than we invest — and as a consequence we continue to be users of foreign savings, and until recently heavy users of foreign savings.

Over the year to December 1993, gross lending by so-called M3 financial institutions — mainly the banks — to New Zealand households for housing purposes rose by almost 17 percent. Somebody doesn’t see the present level of interest rates as too high!

If savers saw present interest rates as ‘high’, we would not only see the total amount of savings rising strongly, we would also see savers investing in long-term fixed interest instruments, to lock in these ‘high’ yields. Indeed, it is an exercise I can recommend next time you’re talking with a group of friends who complain about high inflation-adjusted interest rates: ask how many of them have locked in these high yields by investing in long-term bank deposits or, say, 5-year bonds. Unless your friends are very different from mine, not many will have done!

Because I believe the Reserve Bank of New Zealand Act 1989 does provide a high degree of confidence that price stability will be maintained over the long term, present yields on long-dated instruments do seem attractive. But most New Zealand savers don’t yet feel sufficiently confident of this to put their savings in such investments — given our history, who can blame them? It is probably no accident that, while local investors
(mainly institutions) held nearly 80 percent of all New Zealand dollar government bonds on the market at the end of January 1994, they held only 38 percent of those maturing in 2004, the longest bonds on issue.

Those who complain about the present level of bank lending rates are by implication complaining either about the ‘excessive’ interest rates paid to depositors, or about the ‘excessive’ margins which banks are taking.

As far as the interest rates paid to depositors are concerned, there is no doubt that, over the last few years, depositors have been getting a better rate of return on their deposits -after tax and inflation - than at almost any time in the last 20 years. This is illustrated in Graph 4.

**Graph 4**

*After-Tax Real Interest Rate and Nominal Interest Rate*

(After-tax real interest rate calculated using 6 month deposit rate, top marginal tax rate and 12-monthly CPI inflation rate.)

Part of the problem banks have is that savers don’t *feel* better off! Indeed, they often feel very hard done by, and resent the fact that today’s lower interest rates force them to dip into their savings in order to maintain their standard of living. They often fail to recognise that inflation was dipping into their savings in the past, as illustrated in a hypothetical example in Table 2.
<table>
<thead>
<tr>
<th></th>
<th>Mid-eighties</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate on bank deposits</td>
<td>15 percent</td>
<td>6 percent</td>
</tr>
<tr>
<td>Inflation rate, say</td>
<td>10 percent</td>
<td>1 percent</td>
</tr>
<tr>
<td>Therefore, inflation-adjusted interest rate</td>
<td>5 percent</td>
<td>5 percent</td>
</tr>
<tr>
<td>Tax rate on interest income, say</td>
<td>33 percent</td>
<td>33 percent</td>
</tr>
<tr>
<td>Pre-tax interest income on retirement savings of $100,000</td>
<td>$15,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Less Tax</td>
<td>($5,000)</td>
<td>($2,000)</td>
</tr>
<tr>
<td>After-tax interest income</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td><strong>New deposit required to maintain real value of retirement savings after inflation</strong></td>
<td>($10,000)</td>
<td>($1,000)</td>
</tr>
<tr>
<td>Amount available for spending without using up retirement savings in real terms</td>
<td>Nil</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

Even if, as is sometimes argued, the inflation rate facing those who are retired is higher than that facing the total population, it is hard to avoid the conclusion that savers are better off today, with low inflation and low interest rates, than they were a few years ago, with high inflation and high interest rates. (Note that this is the case even though the inflation-adjusted interest rate is the same in both situations, because of the way in which tax is applied to nominal interest.)

With the exception of the last few years, New Zealand savers have been severely penalised for their thrift for almost two decades. And unfortunately, in this area as in so many others, once bitten twice shy! At the end of the day, savers have plenty of investment options open to them, in New Zealand and overseas, and unless the reward offered them for saving in New Zealand dollars is perceived by them to be adequate, taking into account all the other options, they will invest in other ways. As they do, the funds available to borrowers are reduced.

But what about bank margins? Banks have become excessively greedy, critics claim, perhaps because of their need to recoup large losses made as a result of silly lending decisions in the mid and late eighties. This is a very widespread view, and is even repeated by supposedly well-informed commentators as if it were self-evident truth.

Let me immediately acknowledge that banks are presumably aiming to maximize the profits they earn for their shareholders, in the medium-term if not on a month by month basis. In that, they are absolutely no different from other businesses.

Let me also acknowledge that a number of banks (by no means all) did make some very silly loans in the middle and late eighties, and incurred very large losses as a result. Inevitably, the management of those banks will be especially eager to restore profitability as a way of ensuring their survival.
But the reality of the New Zealand banking industry is that it is intensely competitive: New Zealand has no fewer than 19 registered banks — and even excluding those which are subsidiaries of other registered banks (such as PostBank and Rural Bank), there are 15 separate banking groups. The door is always open for sound new banks to enter the industry if they wish, and in recent years several have done so.

And because most of what all banks borrow and all banks lend is identical — New Zealand dollars — no bank can for long offer interest rates on deposits, or charge interest rates on loans, which are markedly different from those offered or charged by other banks.

It is this competitive pressure which ultimately controls the interest rates which banks offer on deposits and charge on loans, not any desire to make good the loan losses of the late eighties, no matter how understandable such a desire might be.

It is relevant to note that, since the New Zealand banking industry was opened up to new entrants, the gross earnings margin of the eight largest New Zealand banks (ie the margin between total fee and interest income on the one hand and total interest expense on the other — which totally abstracts from the bad debts incurred) has steadily declined as a proportion of total assets, from 6.85 percent in 1987, to 5.27 percent in 1992 (see Graph 5). While not for one moment doubting that banks would very much like to widen their gross earnings margin, the reality is that competitive pressures have, over the last six years at least, made this impossible.

Graph 5
Gross Earnings Margin
New Zealand’s Eight Largest Banks

Source: RBNZ

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It is perhaps also worth noting that, in the year to December 1992, the latest for which the Reserve Bank has comprehensive data, the average after tax profit earned by all New Zealand banks was only 0.37 percent on total bank assets — not an earning rate which provides huge scope for reducing bank margins. (Even excluding one large bank which incurred a substantial loss as a result of adopting a new approach to loan provisioning in 1992, the ratio was only about 0.7 percent.) The reality is that, when banks increase or decrease their lending rates, it is savers/depositors who are the principal winners or losers. Demanding a reduction in bank lending rates is therefore essentially a demand that borrowers should be helped at the expense of savers.

To digress briefly, this makes it all the more surprising that there always seems to be more public demand for lower interest rates than higher interest rates: numerically there are more people who save with banks than borrow from banks. Indeed, the chief executive of one bank, admittedly a bank which tends to specialize in residential mortgage loans, told me recently that his bank had about 20 deposit accounts for every mortgage on the books. And in aggregate, total household deposits with M3 financial institutions exceed total household borrowing from M3 financial institutions ($31.9 billion of deposits against $30.5 billion of borrowing as at the end of December 1993). But it is concern about interest rates on bank loans which is most often featured in the media; perhaps most reporters are borrowers!

But what of credit card rates, and interest rates charged to small businesses? Surely these at least are outrageous? A number of commentators who accept that, taken over all, bank margins are maintained at a reasonable level by the pressure of competition nevertheless feel grave concern about credit card interest rates and the rates charged to small businesses.

The odd thing about the cost of credit card credit which few commentators seem to have noticed is that well over half of the amount charged on credit cards creates a credit to the buyer on which the bank charges absolutely no interest at all. In other words, most people who use a bank credit card take care to pay off the ‘loan’ before any interest is payable (sometimes as long as 55 days after the product or service is purchased). For at least one major bank credit card operation which went public with its figures recently, some 30 percent of credit card outstandings at any point of time carry no interest, so that, for example, with the interest rate on the interest-bearing component of total outstandings being 17-18 percent, the average interest rate on total outstandings was 13-14 percent. For one other bank credit card operation, the comparable average interest on total outstandings is, I am told, currently 11-12 percent. Not surprisingly, banks try to recoup the cost of extending free credit by charging a high rate to those who utilize credit going beyond this free period. Almost by definition, such credit is unsecured and relatively high risk. It should not be at all surprising that it costs substantially more than the pre-arranged, fully secured, credit available on a home mortgage.

The interest rates charged to many small and medium-sized businesses do seem high. But several points should be kept in mind. First, many medium-sized businesses, and indeed even some small businesses, are now able to borrow at interest rates geared to bank bill rates rather than the much higher base lending rates. For these businesses, the base lending rate has in fact become substantially irrelevant. Secondly, many small businesses are high risk — often under-capitalized and run by people with limited business experience. High interest rates for such businesses often reflect banks’ reluctance to lend to them at all. Because as depositors we all want banks to lend only
where there is a high probability of being repaid, banks will normally take care to avoid taking essentially equity risks on small businesses. Thirdly, given the low overall profit which banks make on their total assets, any major reduction in the lending rates for small business would inevitably be reflected in lower interest rates on deposits or higher interest rates for some other category of borrower.

Having said that, my own judgement is that the interest rates charged to small and medium-sized businesses reflect in part also the much greater caution which descended upon the banking industry, here and abroad, after the excesses of the mid-eighties. Hopefully, as the trauma of that experience fades into the past, and banks develop more expertise in appraising business cashflows (as distinct from valuing bricks and mortar), the cost and availability of credit to small and medium-sized businesses will improve, albeit at probable cost to depositors or other borrowers. I have little doubt that a highly competitive banking sector is the best chance of producing that outcome.

What of the future? In principle, one would expect New Zealand interest rates to be much lower in the nineties than in the late seventies or eighties because of our much lower inflation rate, and indeed that is clearly the case now, as illustrated.

Our real (inflation-adjusted) interest rates could also be expected to decline further from present levels, provided there is no upward pressure on world real interest rates. At least in recent periods, countries with consistently low inflation have tended to have not only the lowest interest rates in nominal terms but also the lowest inflation-adjusted interest rates. As indicated, the real interest rates on longer-term New Zealand bonds are already similar to those in some other countries. I would expect this gradual decline in real interest rates to continue over the years ahead.

But it is important to be realistic. New Zealand is a small and vulnerable economy. It has one of the highest ratios of foreign debt to Gross Domestic Product (GDP) in the Organisation of Economic Co-operation and Development (OECD). It has had persistent fiscal deficits for many years — and, with our first fiscal surplus in a very long time now in sight, still has strong public pressure for government to spend more. Under all the circumstances, it is not too surprising that savers tend to invest for relatively short terms. Only as we convince savers that price stability will be an enduring part of the economic environment will real rates of interest continue trending downwards.

Whatever the longer-term trend in real interest rates — and on balance I would expect that to be downwards - it is important to recognise that there will always be fluctuations around that trend from time to time, as the supply of and demand for savings move about, and the Reserve Bank adjusts monetary policy to ensure the continued achievement of price stability.

These adjustments to monetary policy will sometimes result in increased short-term interest rates, as in January 1993, and sometimes in reduced short-term interest rates. We can be relied upon to tighten monetary policy again (ie push short term interest rates up again) if the outlook for inflation threatens the top of the 0-2 percent target range which Government has set us. Equally, we can be relied upon to ease monetary policy (ie push short-term interest rates down) if the outlook for inflation threatens the bottom of that range.
By leaving all New Zealanders in no doubt about this, we make our best contribution to the longer term trend reduction in real rates, and our best contribution to growth and employment in the New Zealand economy.

It was Karl Otto-Poehl, former head of the Bundesbank, who once advised me that the best prospect for keeping real interest rates down in the long term is for the central bank to convince everybody that it would not hesitate to raise interest rates, regardless of public or political pressure, if that were necessary to defend the purchasing power of people's savings. Leave savers in no doubt that we will take whatever action is required to defend price stability and real interest rates will trend downwards. Create doubt on this score and watch real interest rates trend upwards.

So let nobody be in any doubt about our commitment to stable prices. Let nobody assume that now is the time to borrow to the hilt because prices can only go up. Let nobody concede an increase in wages not justified in full by a productivity increase, in the expectation that prices can be increased to cover the difference. New Zealanders have incurred too much pain and dislocation achieving price stability to let us for one moment contemplate losing it again.

Two final points. First, a corollary of what I have said is that one thing which would tend to increase New Zealand's real interest rates would be any perception that the Reserve Bank had become more interested in political popularity than in maintaining price stability. In other words, any suggestion that we ease monetary policy — reduce short-term interest rates — in response to political or public pressure would actually tend to increase interest rates in the longer-term. Accordingly, we will take particular care not only to avoid the reality of responding to such pressure, but also to avoid creating any perception that we respond to such pressure.

Secondly, precisely because financial markets now understand so well the framework within which monetary policy works, with a target for price stability which has both a top and a bottom, most of the tightenings in monetary conditions, and most of the easings also, occur ‘automatically’, without direct Reserve Bank intervention, as markets anticipate our moves. Thus, for example, as the exchange rate appreciated somewhat early in 1994, financial markets recognized that at some point that appreciation would threaten to push the inflation rate below zero, and that this would be resisted by the Bank through an easing of policy. As a direct result, interest rates declined quite sharply, and the appreciation in the exchange rate slowed. Those calling for the Bank to ease policy under these circumstances failed to notice that the easing of monetary conditions which would be a result of such a change in policy had already occurred. Happily, as a consequence of these largely automatic market developments, in turn based on markets’ full understanding of our policy objectives, the prospects for continuing price stability are very good.