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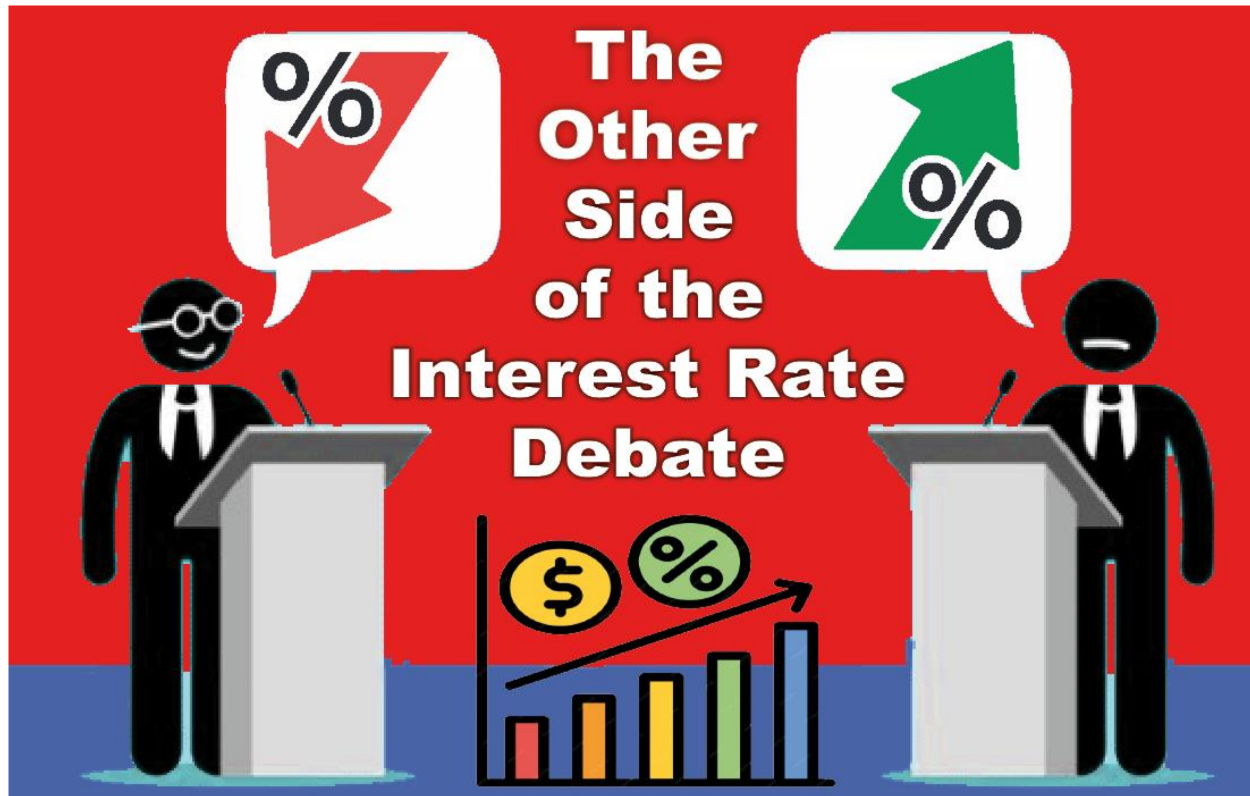

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The Other Side of the Interest Rate Debate

Increases in interest rates are always a matter of concern in the Caribbean, because of their impact on homeowners and businesses. Today's column explores these concerns, weighs them against the benefits deposit holders may gain from interest increases, and discusses the factors that influence interest rate changes.

From the householder's point of view, the most consequential impact of interest rate changes is on their ability to secure a mortgage, and the size of home they can afford. At an interest rate of four percent, the monthly payment on a US$100,000 mortgage for 20 years is US$606, or a total of US$7,300 for a whole year. A household would need to have an after-tax income of at least $18,000 to qualify for that amount, if they have no other debt However, if the mortgage rate increases to eight percent from four percent, the household has to have a net income of $25,000 to qualify, 38 percent more than at the four percent interest rate.

Looking on the other side of the coin, a reduction in mortgage interest from eight to four percent not only affords less affluent households an opportunity to own a home, it means that the $25,000 household can finance a larger and better appointed home. Their $850 monthly payment for a $100,000 mortgage at eight percent, now covers a mortgage of $140,000 at four percent.

The mortgage interest benefit becomes significant only when changes in interest rates are quite large. In the example above, a fall of just one percentage point in the mortgage rate, from eight to seven percent, reduces the monthly payment by a mere $61. In normal circumstances, changes in mortgage rates that are as large as four percentage points will materialise only over the course of years, not months or quarters. What matters for the household is the cumulative effect of persistent increases in interest rates over time, rather than quarterly or annual changes of one-quarter or half a percentage point.

Businesses large and small also benefit from low interest rates, which help to contain the cost of trade credit, inventory and other operating and transactions costs. Much like households, they are not much affected by small interest rate movements, unless increases persist for long enough to add up to a change of several percentage points.

Their impact on the affordability of mortgages and the finance costs of business operation and commerce are the only consequential effects of interest rate changes in the Caribbean. Such increases are harmful and decreases beneficial only when they are large or persistent over several years.

While movements in interest rates can have notable impacts on businesses and households with mortgages, the same is not true of deposit holders. There are no significant benefits to deposit holders from interest rate increases that might offset the losses from the reduced access to mortgage finance. Savings deposit rates are typically between two and six percentage points below the mortgage rate. With the mortgage rate at four percent, the saver can expect two percent or less on their bank deposit. A household with US$5,000 on deposit would earn no more than $100 a year. Should the mortgage rate rise to eight percent, the gap with the deposit rate may widen, with the depositor receiving no more than four percent, or $200 a year.

Caribbean governments and central banks are limited in their ability to reduce interest rates by the great extent to which the countries' trade and financial relationships are conducted in US dollars. The main factor that influences the mortgage rate and the prime rate offered to the banks' best customers is the US Federal Reserve's benchmark rate. Local loans attract an additional amount which depends on the credit risk which the bank assigns to the local currency in each country. Interest rate policy in the Caribbean boils down to maintaining a stable US dollar value of the domestic currency and prudent management of the public finances to reduce perceptions of the riskiness of domestic lending. The overall aim should be to keep domestic rates as low as the trend in US interest rates will allow, for the benefit of actual and aspiring homeowners, and to contain business costs.