What Determines Interest Rates in Australia's Mortgage Market?

As with the rest of the world, interest rates in Australia are set to rise in attempt by the RBA to curb expected inflation rates due in large part to supply chain constraints triggered by the pandemic and is also exacerbated by the current Ukraine-Russian conflict. Consequently, commercial banks will also be forced to raise interest rates on loan products such as mortgages which would increase the cost of home ownership in Australia and eventually see property values fall. In fact, this may be made worse given the fact that banks may be compelled to lift interest rates they charge on mortgages higher than any rate increase by the RBA. The reason for this is due to Australia's historically low saving ratio, and thus, a unique banking sector that relies heavily on international funding whereby domestic banks raise additional capital to deposit funding in offshore markets to meet ever growing credit growth. This funding source is commonly referred to as international wholesale funding and is generally priced on overseas interest rates before being swapped back into to AUD and hence any increase in international interest rates will increase the cost of wholesale funding which in turn forces Australian banks to pass on the higher costs to their mortgage loan customers.

This research has gone some way towards enhancing our understanding of the disconnect between domestic monetary policy and funding costs of the Australian banking sector. The results are of high importance to regulators, and policy makers

Key findings:

- To fund the ever-growing demand for Australian bank credit fuelled by excessive demand for property, Australia's appetite for bank wholesale funding is the largest anywhere in the world (see table).
- This project investigated whether domestic and foreign monetary policy impacts the costs of wholesale funding using debt funding issuance data by the four largest Australian banks.
- Using wholesale funding data across five major currencies, this research showed that the cost of a large portion of wholesale funding of Australian banks do not depend on the RBA policy rate but rather are impacted by the decisions of foreign monetary authorities.
- Therefore, Australian banks "import" international monetary policy through the wholesale funding channel thus, feeding into bank loan pricing decisions.

Implications for the Australian financial sector:

- Australian banks relying on international capital may lead to contagion and spill-over effects between Australian and foreign financial markets and hence lead to instability of the Australian banking sector.
- Reducing effectiveness of the cash rate as the main tool for monetary policy leading to issues around credibility for the RBA in managing the Australian economy
- Loan pricing decisions, particularly mortgages made by Australian banks may be based on interest rates prevailing overseas and not representative of the domestic economy

Funding composition across countries (in %).

Country	Wholesale funding ratio
Australia	34
Canada	23
Euro area	23
Belgium	*9*
France	*20*
Germany	*20*
Italy	*23*
Hong Kong	8
Japan	21
Sweden	33
Switzerland	21
United Kingdom	24
United States	13

Sources: RBA (2012, p. 35), BIS.

Reserve Bank of Australia, 2012. Financial stability review - September 2012 1-66

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The Future

To investigate the existence of default risk spillovers from global banking systems on economies that rely heavily on international capital.