Impact of (Nominal) Interest Rate Hikes may be More Psychological than Real

Stephen Chung
Senior Vice President / Director of Real Estate Analysis
Zeppelin Property Consultants Limited
May 2000

Last year, the author along with a few university friends had done some very rough statistical analyses on some of the probable factors affecting private residential home prices in Hong Kong. Factors showing a relatively stronger correlation with the price trend tend to be related to economic growth and so on. The interest rate, however and perhaps to the surprise of some, is not one of them. Thus, and subject to further studies, the impact of interest rates may be more psychological than actual. If anything else, perhaps it is the “real” interest rate which should deserve attention.

In any event, AND assuming that even nominal interest rates may (seem to) have some impact on the price level in the short run under certain circumstances, to prospective investors and home-buyers, **an interest rate hike does NOT automatically lead to heavier financing burden and vice versa**. We may look at the following examples to see why:

a) **Situation prior to interest rate changes**: say we have a $2M home with a $1.40M mortgage (being 70% of the value). The term is 20 years and the interest is 8%. The monthly mortgage payment (principal and interest included) will be around $11,900.
b) **Interest rate goes up 1% to a total of 9%**: say the prospective home buyer/owner is not willing or unable to increase the monthly payment, then this means the mortgage he/she could not afford will become less at around $1.3M. Assuming this represents the same 70% of home price, this implies the home price may have to come down to around $1.86M, i.e. a decrease of 7%.
c) **Interest rate goes down 1% to a total of 7%**: say the prospective home buyer/owner is willing to maintain the monthly payment of $11,900, then this means the mortgage he/she could afford will become larger at around #1.5M. Assuming this represents again 70% of the home price, this implies the home price may go up to around $2.16M, i.e. an increase of around 8%.

Naturally, the above is put forward in a simplified format and things like transaction fees etc have not been taken into account and again we stress that prices do not necessarily have to respond in the way the ones in the above examples have. The main point to make here is that for prospective buyers, an interest rate hike does not essentially imply heavier financial burden IF prices in general for one reason or another drop more than proportionately (and sometimes they do). In the above example, any decrease in prices by 7% or more will more than compensate the interest rate hike. Likewise, an interest rate decrease does not automatically imply lighter burden.
