

Interest rate

[Finance](#), [Investment](#)



The impact of interest rate increasing on real estate market Generally, the increasing of the bank's interest rate has crowding-out effect on the asset bubble. But how does interest rate affect the real estate market? We can analyze the effect of interest rate increasing on different market entities from micro-perspective. For One That Having Bought The House: Monthly payment increases and the assets may shrink. Most of the housing mortgage loan is floating interest rate now. According to the rules, if the interest rate increases, the mortgage loan contract which has been signed will use the new interest rate since the January 1st next year.

Assuming the owner has bought a real estate at a price of 1million RMB by using a 30-year, 80 percent mortgage loan. According to the 5.04% interest rate in 2008, his monthly payment is 4314.15 RMB. If the interest rate increases to 6%, 7%, 8% in the following years separately, and his income does not increase in these three years, his monthly payment will rise to 67% of his income. The owner is likely to face a hard situation. Relatively speaking, 20-year mortgage loan is a bit riskless.

In the above circumstance, his monthly payment in the following three years will rise to 107.86%, 116.1%, 124.11% of the first year separately. Besides the monthly payment increases, in some cities that have bubbles in house price, the real estate that the owner owned is likely to devalue, as a result of the bubbles being crowding out in some way. And the speed of the devaluation may be surprising. The special case of the house price bubble deflated in Hongkong 1997, the price of the house shrunk by two-thirds. That means, the housing of 1million dollars only worth 300 thousand dollars or so.

Of course, the range of the devaluation is positively relative to the bubble of the house price.

So such a great devaluation in house price will not come to our country, even though some areas has been thought to be already in a foam of the real estate industry. For One Who Want To Buy A House: the capacity to pay decrease. Monthly payment proportion in a family in general ranges between 30% and 50% will be appropriate. We assume the income of a family is 8630 RMB, the saving of the family has the capacity of down payment and prepares to use 50% of its monthly income to support the monthly payment. As the upper calculation, this family has the capacity to buy a house of 1million RMB.

If the interest rate rises to 6%, 7% or 8%, the capacity of buying a house will down to 86.36%, 77.83%, 70.57% separately. In other words, the family can not afford the house of 1million RMB. And this decreasing in the purchase capacity will definitely shift the demand curve of the whole market. If the supply maintains, the house price will certainly fall. But the mental burden will make the mainly effect on the buyers. Some may wait the interest rate down again, and choose not to buy the house now. While some may fear the interest rate goes up continuously, and they can not afford the monthly payment.

So even if the interest rate falls again, they still fear it go up again, and not to buy. That may worsen the real estate market. For The Investors: the cost of financing increases, and the return on investment decreases. If the capital structure of the investor is 60% loan from bank and 40% self-owned capital, the return on property investment is 8%, the interest rate of the <https://assignbuster.com/interest-rate/>

mortgage loan is 5%, therefore the return on self-owned capital is 5%. If we assume the interest rate rise to 6%, 7% or 8%, and hold other conditions unchanged, the return on the self-owned capital will fall down to 11%, 9. % and 8% separately.

So the decreasing in return is quite obvious, and it must lead to the decreasing in investment demand, and it will also decrease the house price in some way. It means when the interest rate increase, the cost of management of the investors will increase, because of the limited self-owned capital, the expected return will decrease. The return decreases directly means that the investment will cut its investment scale so as to decrease the risk and avoid risk. In the short run, the demand of the house inventory will fall.

For Developer: the interest rate of construction loan increases, the expected price changes. A. It will decrease the investment scale. For a real estate developer, if it want to develop a project, it should own some self-owned capital to develop, and in order to improve the efficiency of the capital, it will get some construction loan from the bank.. And as the interest rate increases, the cost of the capital increases. And the developer has been calculated this cost into the cost of management. If the sale price unchanged, the profit of the developer falls, and the return on assets follows to decrease.

When the objective return equal or even lower than other industries, to some middle and small entities with high debt ratio, single financing ways and high management cost may choose to quit, and switch to other industry. Some may go bankruptcy. To some big entities, they may cut their investment

scale on real estate and increase their investment on other industry of high return so that they can maintain the previous return on assets. And on the other hand, they will shift this management cost to the sales price of the house, so the consumption will burden this cost increasing, and they will get little impact. B.

It will decrease the number of the real estate developers. Most of the developers achieve the indirect financing by loan from bank.. So the increasing of the interest rate will cause the developers' financial cost increases. And the financial cost increasing will increase the difficulty of the developers to turn over the capital. And the developers are forced to speed up the turnover rate of the project development, decrease the profit, cut down the price to avoid the risk of the construction. After the interest rate goes up, the cost of the developers increases, and the opportunities of getting profit decreases .

So the expected return decreases, and the number of the entities will relatively decrease. Firstly, Some entities who want to enter the real estate market may quit as a result of the decreasing or no profit of the investment. So the number of the entities will not go on increasing. Secondly, some small entities with low profit will be forced to other industries to avoid risk because of its high financing cost and bad capacity of balancing capital on construction, and they can not have enough capital after the interest rate goes up.

So the number of developers will obviously fall after the interest rate increases, and it help to establish the mechanism for developing the superior and weeding out the inferior, and improve the distribution of the resources,

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so that to make the real estate market more efficient. In the short run, small increasing in the interest rate may not make some entity to quit entering the real estate market, because of its high profit and monopolistic characteristic. But continuously increasing in interest rate may change the psychology and behavior of making decision.

So the impact of the increasing interest rate on real estate market will make qualitative change, restrain too much investment being paid on the real estate market, and will stabilize the house price. For Banks: default rate may increase. Some families will be tempted to choose payment default, and some trapped in the cash flow trouble are forced to payment default temporarily because of the house price shrinking and monthly payment increasing, like Shenzhen's payment default house. Some developers' loss as a result of the unexpected change of their capital will also damage the security of the construction loan.

All will increase the banks' risk. On the whole, increasing interest rate will help the bubble of the assets' price crowding-out, and will help the real estate market develop well in the long run. Especially, our residents haven't experience the complete house price fluctuation cycle since the house market began to be backed by financial market in 1998. Residents haven't realize the hidden risk of the low interest rate, so the first time to increase the interest rate will help them build a mature consumer psychology and increase the risk consciousness. So increasing interest rate may cause the sales of house falls down in the short run.