PROPERTY BAROMETER - WEEKLY COMMENT

It may not be popular, but ongoing gradual interest rate hiking in 2016 can be key in gradually reducing Household Sector vulnerability to economic shocks, at a time when the risk of such shocks is on the rise.

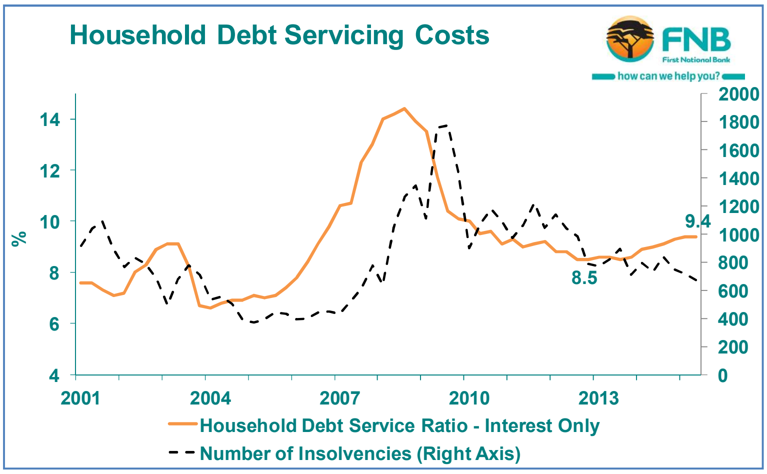
25 January 2016

From a Household Sector financial well-being point of view, interest rate hiking never seems to make sense to those with debt. But ongoing gradual rate hiking can be key to slowly guiding this high-indebted Household Sector to lower levels of vulnerability to economic shocks. And at a time when the risk of such economic shocks is rising, this may be crucial.

This week, the SARB (South African Reserve Bank) Monetary Policy Committee (MPC) meets for the 1st time in 2016 to deliberate on interest rates. Another rise in CPI (Consumer Price Index) inflation in December, from a previous month's 4.8% year-on-year to 5.2%, contributes to our expectation of another 25 basis points Repo Rate hike on Thursday when the interest rate decision gets announced. This would raise the Repo Rate to 6.5%, and Prime Rate to 10%.

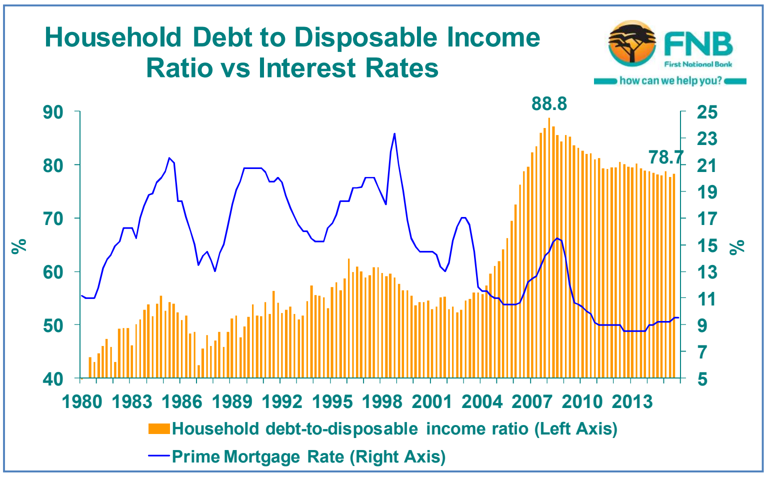
Our expectation is not only based on that December inflation number, though, but also on the fact that the Rand has depreciated again sharply as of late, raising import price inflation, as well as a drought lifting certain food prices, all of which are expected to lead to further CPI inflation rise in the coming months.

But we believe that, regardless of whether it sees inflation as a major problem or not, the SARB would do well to continue with its gradual interest rate hiking for the foreseeable future for other, more household finance-related, reasons. The slow pace of hiking should serve to make the Household Sector more cautious in its borrowing habits over time. Hopefully this will keep Household Sector Credit growth very slow, below the growth rate in Disposable Income, and the Debt-to-Disposable Income Ratio on a broad declining trend.



Household credit growth is not an official target of the SARB. But we believe that at the moment it would promote future household financial stability should rising interest rates sustain the downward pressure on the Debt-to-Disposable Income Ratio.

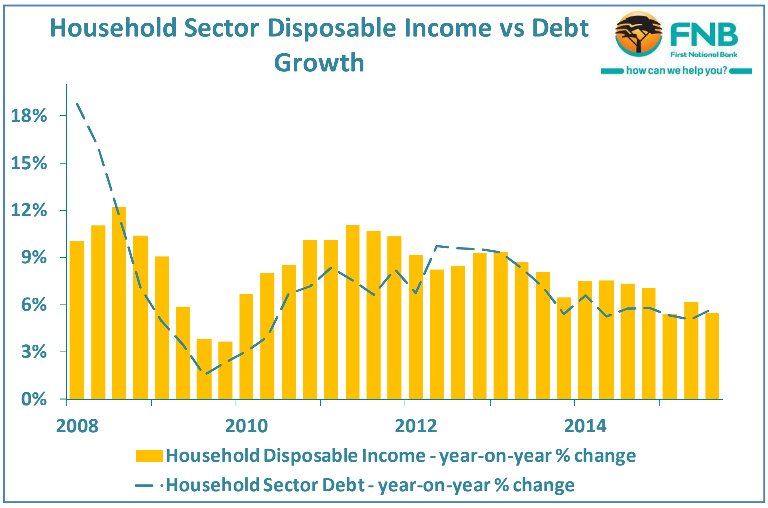
We say this because of the multi-year deteriorating path which the economy finds itself on. The Household Debt-to-Disposable Income Ratio, combined with the level of interest rates on Household Debt, determines the all-important Debt-Service Ratio, i.e. the cost of servicing the Household Sector Debt expressed as a percentage of Household Sector Disposable Income. This ratio, in turn, is key in determining the general level of Household Sector Credit Health.



The Debt-to-Disposable Income Ratio has come down from its 88.8% high back in early-2008, to 78.7% by the 3rd quarter of 2015, due to household sector credit growing at a slower pace than disposable income.

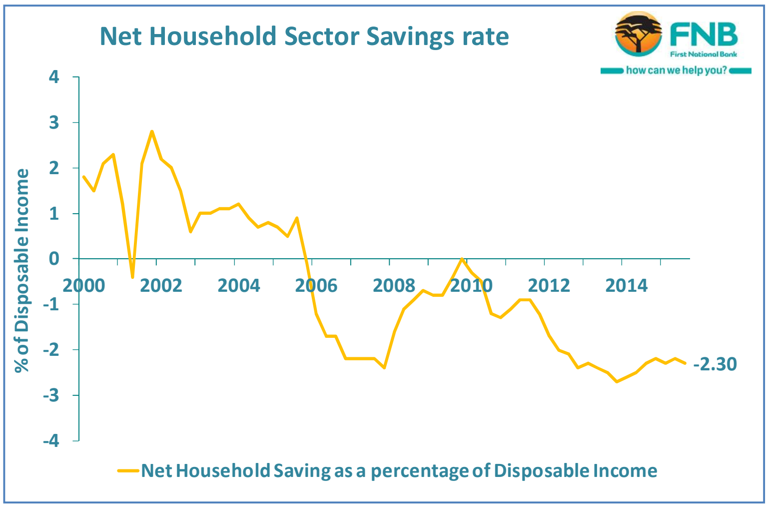
Whilst this is a key positive development in reducing Household Sector vulnerability to unwanted "shocks", such as interest rate hikes or through economy-related shocks to disposable income, the reality is that the ratio remains high by our country's historic standards.

And as the growth performance of the country stagnates, and investor capital flows get increasingly volatile, the risk of economic and interest rate shocks rises. Sharp deteriorations in capital flows, translating into bigger Rand depreciations, can conceivably force the SARB into a faster pace of interest rate hiking at some future stage. Lowering the Household Sector Debt-to-Disposable Income ratio before such an event possibly occurs is thus the appropriate pre-emptive action.



However, lowering this ratio further is not that easy anymore. Whereas back around mid-2011, Household Sector Disposable Income growth had touched 11% year-on-year (in nominal terms), by the 3rd quarter of 2015 this rate had more-or-less halved to 5.5%. Credit growth needs to remain slower than Disposable Income growth for the Debt-to-Disposable income Ratio to continue to decline, and this is becoming tougher to achieve given slowing economic growth, with a rising risk of recession, and its impact on slowing household income growth.

There's only one thing to do under such circumstances and that is to "cut the coat according to the cloth" by containing credit growth. And gradually raising interest rates can assist greatly.



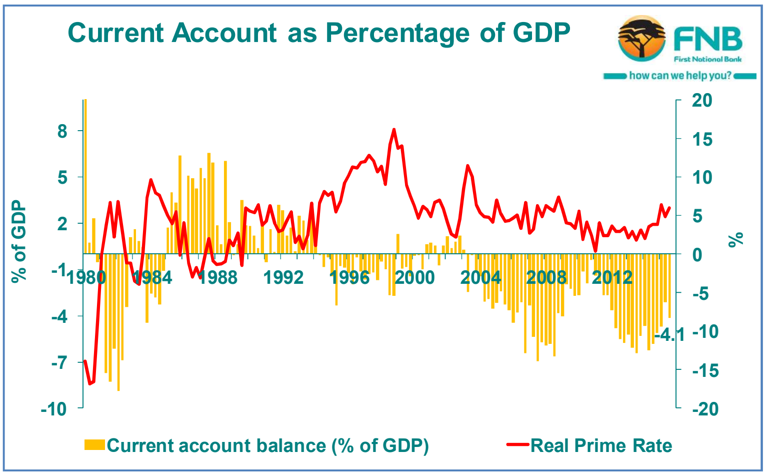
The potential benefit goes further, however, and there exists the possibility that rising interest rates can turn the dismal Household Sector Savings Rate for the better. In 2008/9 the net savings rate began to improve, or at least begin to look as if it could head out of "net "dissaving" territory onto positive ground. That improving trend was short lived, however, and deteriorated once more when the SARB began to cut interest rates aggressively, the economy came out of recession, and relative happiness returned to the consumer once more. It would appear that higher interest rates and tighter financial times for consumers are the possible recipe for a higher savings/lower consumption rate. The SARB's gradual rate hiking may be able to assist in this regard too.

On a higher level, rising interest rates can curb the growth in the country's Gross Domestic Expenditure, thereby pulling it down into line with the country's Gross National Income, translating into a smaller Current Account Deficit on the Balance of Payments. That in turn would mean a lower net foreign capital inflow required to fund the deficit, possibly reducing pressure on the Rand. This would promote, though not guarantee, greater macroeconomic stability.

In short, under the current circumstances of investor jitters, a lack of foreign capital and high levels of currency volatility, the best medicine the SARB could possibly give us is a pro-active gradual lifting of interest rates, nudging both the household sector, and indeed the entire economy, towards living within its means, lowering debt burdens and raising savings rates. This is not "growth-positive" in the short term, but can reduce the impact of "external" shocks in the longer run.

And what about much needed economic growth, you may ask? Yes, very much needed, but that's not up to the SARB.

Growth constraints in South Africa are largely related to other policy areas. Addressing issues such as a skills imbalance in the labour market, a lack of healthy well-structured competition in key areas of the economy, or service delivery, cannot be addressed with interest rates.



Interest rates should be focused largely on addressing important macroeconomic imbalances. Currently, we have such an imbalance, as seen in the Current Account on the Balance of Payments. The Household Sector contributes to this deficit with its high rate of consumption, and low level of savings. But it is not the only contributor, with General Government Saving also too low.

Keeping interest rates low to merely boost borrowing/spending alone can never be a long term sustainable growth solution in such an environment.

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