HOUSEHOLD SECTOR – JULY INTEREST RATE DECISION

Unchanged interest rate decision probably means little further improvement in household debt-servicing performance, while also keeping the cumulative impact of monetary and fiscal policy on the household sector negative.

18 July 2013

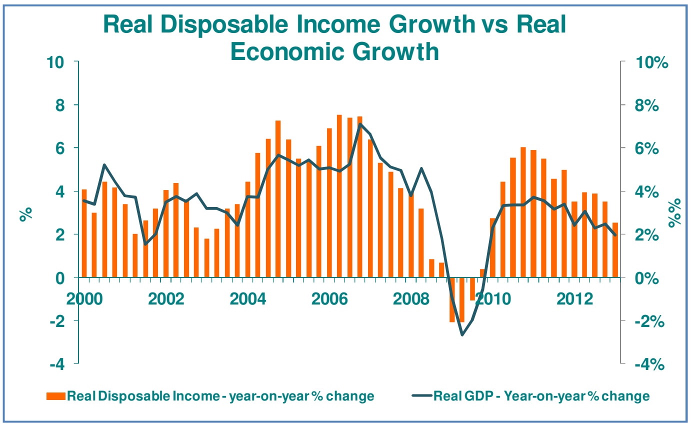
The Reserve Bank 's(SARB) Monetary Policy Committee (MPC) concluded its interest rate meeting today, and the outcome was a decision to leave its policy Repo rate unchanged at 5%, not surprising with consumer price inflation still not far from the upper target limit (6%) at 5.6% in May.

The Governor yet again pointed to downside risks to local economic growth, already battling along at below 2% year-on-year, and the Bank actually lowered its 2013 GDP growth forecast to 2.0% from 2.4%. Weak growth is a factor that has kept interest rates at multi-decade lows for some time now, and which leads us to believe that interest rate hiking is some way off. However, while seeing downside risks to economic growth, the SARB still sees upside risks to inflation, with the threat of a wage-price spiral, as a result of high wage demands, still there, while a volatile rand has also been in play. Indeed, at the present time, the Consumer Price Inflation rate of 5.6% hugs the SARB's upper target limit of 6%, and the average wage settlement (according to Andrew Levy) accelerated from 7.6% in 2012 to 7.9% in the 1st quarter of 2013. Such pressures, leave the Bank little room to maneuver in terms of rate cutting.

Implications for the Household/Consumer Sector

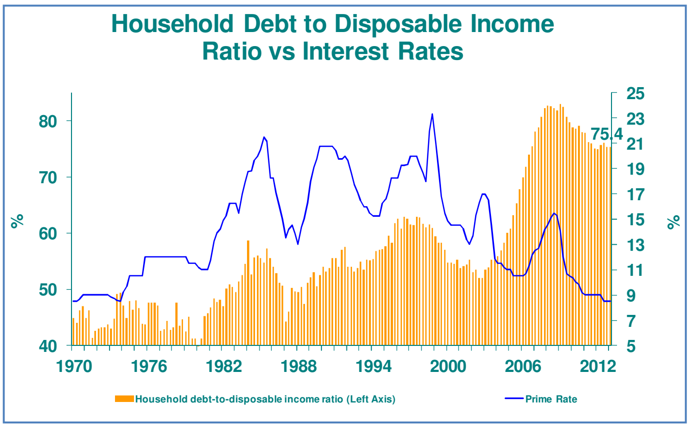
- ***Expect real disposable income growth and real household consumption growth to continue to slow:***

  An unchanged interest rate decision appears more or less neutral for household /consumer demand at present. Little movement in interest rates since 2009/10 means that the stimulus to economic and real household disposable income growth from prior interest rate reduction has more or less worn off, and we've seen a tapering off in real consumer demand growth and in real retail sales growth. This broad slowing in real consumption growth, especially the durable goods component, is expected to continue in the near term as the lagged positive impact of prior interest rate cuts continues to wear off.



- ***At current interest rate levels, the household sector debt-to-disposable income ratio is expected to move more or less sideways in the near term, and only downward at a later stage****: Household sector credit growth has begun to slow in recent months, from a peak of 10.4% year-on-year in November 2012 to 9.4% by May 2013.This slowing has much to do with slowing growth in the more consumption-related non-mortgage components of credit. This is in part due to a lack of further interest rate cutting in recent times, but also perhaps due to heightened concerns regarding the rampant growth rate in unsecured credit, and resultant "verbal intervention", aimed at the lending industry, by especially National Treasury not too long ago.*

  However, it may take a while before we see the direction of the Household Debt-to-Disposable Income Ratio start to decline noticeably, with nominal disposable income growth also having slowed recently as the economy comes under pressure, largely matching the slowing rate of credit growth. Therefore, in the near term it is believed that unchanged interest rates implies



further slowing in both nominal disposable income growth as well as household credit growth, translating into a more-or-less sideways movement for the debt-to-disposable income ratio.

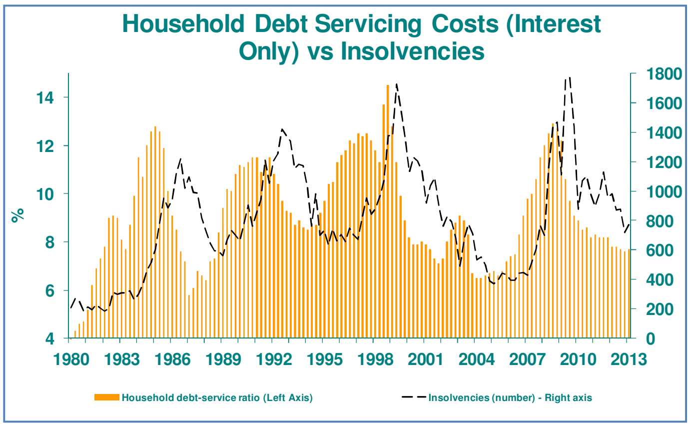
- ***A combination of sideways movement in interest rates and in the debt-to-disposable income ratio may imply a slight upward movement in debt-servicing costs relative to income:***

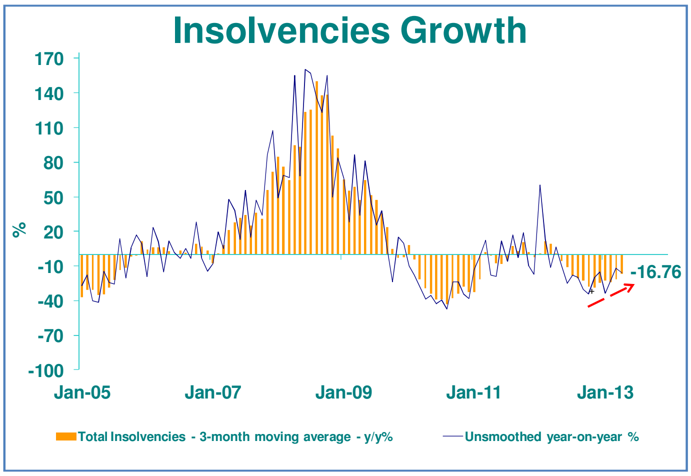
The 1st quarter SARB Quarterly Bulletin showed its estimate of the household debt-service ratio (the cost of servicing debt, interest only, expressed as a percentage of disposable income) as rising slightly from a previous 6.6% to 6.7%.

This rise as yet is insignificant, although it does suggest that the improving (decline) trend in the debt-service ratio appears to have all but come to an end for the time being.

Should rates remain on a sideways track in the near term, and the debt-to-disposable income ratio too, this could conceivably mean a mild rise in the debt-service ratio, due to the faster credit growth components also being where higher interest rates are charged by lenders, as opposed to the major mortgage credit component which is growing at a snails pace.

With the debt-service ratio being a good predictor of the levels of arrears and non-performing debt in the household sector, sideways to upward movement in this ratio suggests that the improving part of the credit cycle has virtually come to an end for the time being. In insolvencies data, we have been witnessing the pace of year-on-year decline subsiding for some time, and the end of this decline is anticipated late in 2013.

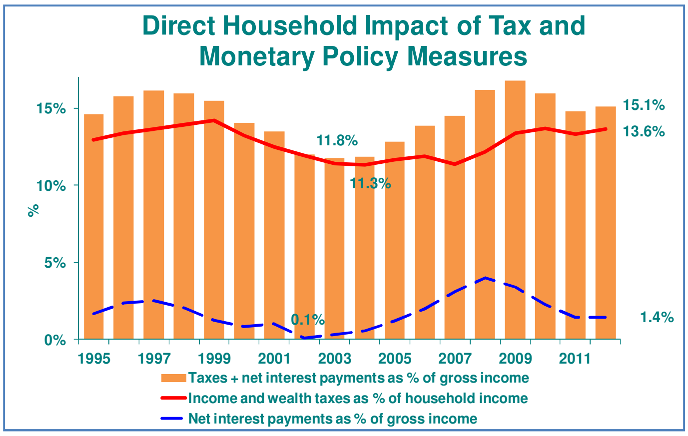




- ***The unchanged interest rate decision keeps the overall monetary and fiscal policy impact on the consumer negative:***

While the monetary policy impact on households in the near term may be more or less neutral, it keeps the "combined monetary and fiscal policy impact" on the household sector firmly negative.

The reason is a pressured government fiscal situation, which is leading to it imposing rising effective tax rates on the household sector. This is done through often not providing sufficient annual tax relief to fully compensate for inflation-related "bracket creep". So, from a low point of 11.3% of household income in 2004, household income and wealth taxes have risen to 13.6% by 2012, the highest percentage since 1999, and 2013's small tax relief of R7bn suggests further increase to come in this percentage in 2013.



Put the tax and net interest costs together, and we see a total tax and net interest payments bill of 15.1% of household sector income in 2012. This is admittedly down from the interest rate-driven highs of 2008/9 but now rising once more since 2011 due to a rising tax burden, and is now far higher than the lowly 11.8% reached in 2003.

This tax rate, of course, does not include municipal rates or utility tariffs. Latest CPI inflation numbers still show these growing well above overall inflation, electricity tariffs at 10% year-on-year in May, and "water and other services" (which includes municipal rates) by 9.2%.

However, not all the blame for the rise in the taxes and net interest burden can be placed on the authorities. Higher levels of indebtedness relative to household deposit levels has meant that, although interest rates are now lower than in 2002, that year saw net interest payments of only 0.1% of household income, with interest received being almost equal to interest paid by the household sector, because household deposits were significantly higher relative to debt back then.

So if the household sector wants to become less dependent on low interest rates (and less sensitive to interest rate hikes) it is necessarily to develop more of a savings culture.

Outlook

In summary, the implications of today's unchanged interest rate decision are believed to be a further slowing in real household disposable income, as the effect of prior rate cuts wears thin, a more-or-less sideways movement in the household debt-to-disposable income ratio, and no further meaningful improvement in household debt servicing (repayment) performance.

An unchanged decision also means that the combined fiscal and monetary policy impact on household sector finances remains negative, with the effective personal tax burden relative to income rising further in 2013.

The FNB view is that we are now in a lengthy period of stable and unchanged interest rates that is expected to last through the rest of 2013 and well beyond. With consumer price inflation near the upper target limit of 6%, the SARB has little room to move in the form of further interest rate cutting at present.

Key inflationary risks are posed by:

- *High wage demands*
- *A currently volatile rand*

The best option for the household sector?

We remain of the belief that the household sector should actively try to lower its debt-to-disposable income ratio while interest rates are low.

A scenario of a rising personal tax bill along with utilities tariffs, relative to income, probably means that a lower level of household sector indebtedness is now appropriate from a financial health point of view. So, while the normal response is often to borrow more when interest rates are low, a more preferable option may well be to use the low interest rate environment to lower the debt-to-disposable income ratio.

While the most recent debt-to-disposable income ratio for the household sector stood at 75.4%, which is down from the 2009 peak of 83%, it remains high by SA's historic standards.