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CONSUMER BANKING BAROMETER – SARB INTEREST RATE DECISION APPROACHING

Interest rate hiking is not what consumers necessarily want to hear, but we believe it may resume next week, and that there are some good arguments for it in terms of its longer term impact on the consumer

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After having repeatedly warned South Africa of the need to continue to "normalize" interest rates upward, we expect that the Reserve Bank (SARB) may resume interest rate hiking at next week's Monetary Policy Committee (MPC) (interest rate announcement on Thursday 23 July).

The SARB has a CPI (Consumer Price Index) inflation target of 3% to 6%, and while the June CPI inflation rate was only 4.6%, it has been rising steadily in recent months. In addition, low base effects created from an oil price drop in the 2nd half of last year are expected to take the rate higher in the coming months, possibly breaching the upper target limit of 6% before year-end. This probability, we believe, could lead the SARB to behave pro-actively, raising interest rates 25 basis points next week and by half a percentage point in total within the next 12 months.

Half a percentage point hardly seems something to worry too much about, and indeed it probably shouldn't be. "Gradual" appears to be the SARB motto, trying to raise rates without any significant "shock" to a fragile economy.

It is important to raise interest rates in order to restore the macroeconomic imbalance. South African runs a huge current account deficit on the balance of payments. This means that our mediocre Gross Domestic Investment, crucial for long term economic growth, far exceeds Gross Domestic Savings. The shortfall needs to be funded by foreign capital inflows. These inflows have been insufficient in recent years, causing the rand to experience frequent bouts of weakness, and the expected start of US interest rate hikes may constrain these foreign capital inflows even more.

Rand weakness is undesirable from an inflation point of view (The SARB's key focus), and undesirable from an economic point of view.

But what does all of this have to do with the consumer, and is it necessary to hike interest rates from a Household Sector point of view? We believe the answer is yes. Admittedly, there is little sign of "exuberance" amongst households. The FNB House Price Index's 5.2% year-on-year June growth rate reflects a well balanced and rational residential market whose growth has gradually cooled over the past year and a half. There are various signals of a more conservative home buying attitude in the market emerging, with the high end having slowed, a smaller percentage of households upgrading to better homes, and a declining percentage of the more financially limited 1st time and single-status buyers.

Household credit growth, too, shows little in the way of "crazy" behaviour, and is only just above 3% year-on-year according to the monthly SARB figures. But it is important that it is kept at such low levels in order that the debt-to-Disposable Income Ratio, at a still high level of 78.4, resumes its declining trend after a surprise increase in the 1st quarter of 2015. This is important in order to reduce the Household Sector's high level of vulnerability to future shocks.

But there is more. The consumer is very much part of the Current Account Deficit problem. Consumer Spending is the largest component of Gross Domestic Expenditure. While Household Disposable Income growth is currently very slow, as is Consumer Spending growth, the reality is that the level of consumer spend is such that Gross Saving by Households is so low that it doesn't even cover the depreciation on fixed assets. This means that we are in a situation of Household Net Dissaving to the tune of -2.3% of Disposable Income. This is a "shocker" with regard to households' building of financial independence and preparedness for retirement, but is also troublesome in terms of households' saving contribution to overall domestic savings to fund fixed investment in the country.

While the "consumer culture" of modern day consumers appears tough to break, we believe that the SARB should at least raise interest rates in order to constrain consumption expenditure growth and hopefully "coax" net dissaving back into net saving.

In short, rate hiking is not what consumers want to hear. Indeed, there are some who argue that the consumer is too financially "fragile" to be able to handle any interest rate hikes, and this is a reason why the SARB should not do it. But others would argue differently. A key reason as to why the consumer is so financially weak may well be the relatively low interest rates since the beginning of last decade, which sparked a massive consumer and credit boom. I tend towards the latter argument, and believe that a very slow pace of rate hiking won't do major damage, will allow the household sector to adapt slowly to higher rates by gradually adopting more conservative spending and borrowing habits, which will serve them well in the longer term.

In addition, the SARB can do it slowly and proactively, or alternatively wait for some type of shock to drive inflation sharply higher, and then take more drastic action. I would believe the slow and pro-active way to be better option.

Finally, interest rates can be a useful tool with which to smooth out the sometimes volatile economic cycle, a worthy "cause". But that means that in the relatively good times, and the present time could be viewed as such, central banks have to "build up the ammunition" by raising interest rates in order that when some negative shock to economic growth hits, which can mean recession, they can cut rates and provide stimulus.

Gradual interest rate hiking in the near future may not feel great, but we may be grateful for it, and the change of behaviour that it brings, at a later stage.

JOHN LOOS:
HOUSEHOLD AND PROPERTY SECTOR STRATEGIST
087-328 0151
John.loos@fnb.co.za