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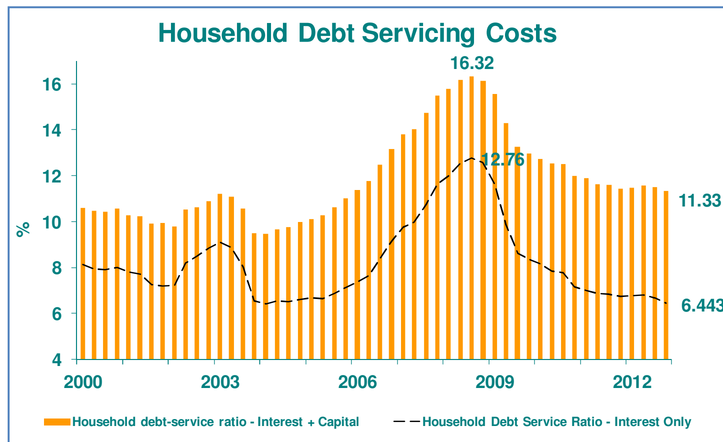
HOUSEHOLD SECTOR – MARCH INTEREST RATE DECISION

At different times, unchanged interest rate decisions have different impacts. The Reserve Bank left interest rates unchanged today. This sideways movement in interest rates may be mildly positive for the housing market at the present time

20 March 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 testing the upper target limit (6%) at 5.9% in February..

The unchanged decision may appear of no consequence, but could perhaps be slightly negative from a debt servicing cost point of view as well as from a housing affordability point of view, while being mildly positive in the near term from a near housing market performance point of view.

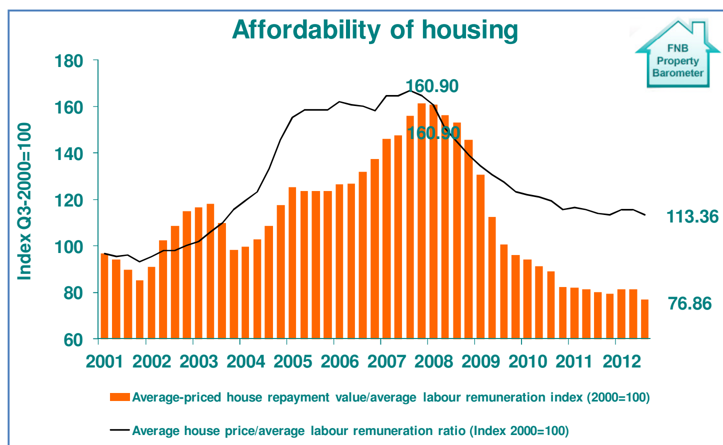


"Technically", interest rate cutting is a stimulus for credit-driven spending, whereas sideways movement should be neutral, with no change in the cost of servicing household debt. But that depends on the movement of other relevant variables, and the cost of servicing debt is a function of interest rates as well as the level of debt and disposable income.

In 2012 we saw a mild rise in the debt-to-disposable income ratio of households which, if it hadn't been for a rate cut in the 3rd quarter, may have led to some increase in the debt-service ratio (the cost of servicing the household debt burden, expressed as a percentage of household sector disposable income).

Given our FNB expectation of interest rates moving sideways for the entire year, household sector credit growth now at 9.9% year-on-year, and nominal household disposable income having slowed to below that at 9% as at the 4th quarter of 2012, it would appear as if there is very little downside scope for the debt-service ratio in the near term. This ratio looks set to move sideways to slightly upward in 2013, implying that unchanged interest rates could lead to a mild rise in debt-servicing costs relative to disposable income if the debt-to-disposable income ratio indeed rises further this year. This, however, depends on household credit growth exceeding disposable income growth, which I believe it may by a slight margin.

In addition sideways interest rate movements may have a limiting impact on housing affordability improvements.



The 2 traditional measures of housing affordability are the Average House Price/Average Labour Remuneration ratio (In Index format with year 2000=100), and the Installment Value on the Average Priced House/Average Labour Remuneration Ratio (also in index format).

The latter ratio is relevant to interest rate levels, and this affordability measure's index has declined (improved) massively by -52% from a late-2007 peak to the 3rd quarter of 2012.

Through 2011 and 2012, however, slowing average remuneration growth, some moderate house price growth, and very little interest rate cutting, has caused this affordability measure to move almost sideways, and only slightly lower, with the main improvements being

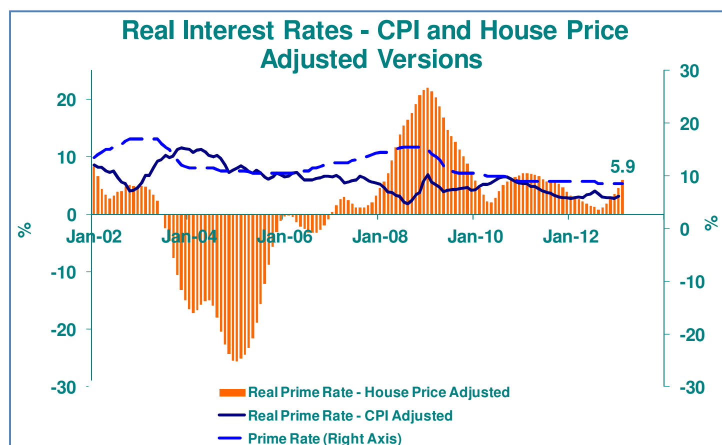
from 2008-10.

Sideways movement in interest rates would thus appear to be a fairly neutral factor in terms of promoting housing affordability in recent times.

This could turn to a negative factor for home affordability should the lengthy sideways movement positively impact on housing demand and thus house price growth, and that appears to be what has been happening in recent times.

In the 1st half of 2012 the FNB Estate Agent Survey recorded a noticeable increase in home demand, and in the 1st quarter of 2013 an even more noticeable "step up". Such recent improvement may be, to some, tough to explain, given a pedestrian economy, and virtually no recent movement in interest rates. But the answer perhaps lies in the human trait of "Recency Bias", which suggests that humans place a greater emphasis on recent events when evaluating risk, as opposed to events further in the past. The 2008 recession and high interest rates are thus likely being gradually forgotten, and more households' confidence levels are increasing as a result, causing a greater interest in residential property.

Therefore, the SARB may right now be providing an increasing effective stimulus to the residential market merely by doing nothing for a lengthy period of time. I would thus say that right now, sideways movement in interest rates is becoming mildly positive in terms of stimulating residential demand. "Mild" is the key word though. Only strong economic and household income growth can boost the market strongly, and we don't have that at present…….barring the existence of widespread speculative behavior that is.



And speaking of residential speculative behavior, the SARB's current monetary policy stance certainly doesn't provide a great environment for that.

Using an alternative calculation for REAL interest rates i.e. using house prices instead of CPI to adjust nominal prime rate to real prime, we see that this version of real prime rate was positive at 5.9% in February. So, while money is cheap in absolute terms, relative to still-low house price growth it is not, and there is thus little benefit in borrowing money to speculate on short term house price growth. The environment was ripe for that back in 2003-2006, where this calculation of real interest rates was strongly negative.

So, in a nutshell, at different times, an unchanged interest rate decision can have differing impacts on the housing market. I believe that in the current environment, leaving interest rates unchanged in the near term could have the following effects:

- ***It could be negative in terms of contributing to a debt-service ratio increase in 2013, given that household credit growth has recently been slightly outstripping disposable income growth.***
- ***It could positively contribute to housing demand and slightly higher house price growth than recent levels, largely due to households slowly gaining in confidence with regard to home buying as the recession and high interest rates are gradually forgotten.***
- ***A slightly positive contribution to house price growth could in turn imply a negative impact on housing affordability.***
- ***And finally, the current interest rate stance remains fairly positive in terms of restricting unhealthy speculative behavior in the residential market, although that would change should house price growth increase substantially without any interest rate hike.***

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