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HOUSEHOLD SECTOR – WHAT TO MAKE OF INTEREST RATES

Market expectation is for unchanged interest rates this week, and many speculate on rate cuts in next year. But it would be wise not to take anything for granted, and for households to continue the "balance sheet" clean-up.

7 November 2011

This week sees the Reserve Bank's (SARB) Monetary Policy Committee (MPC) meeting to deliberate on interest rates again, in what is its last scheduled meeting for the year.

MOST ECONOMISTS APPEAR TO EXPECT UNCHANGED INTEREST RATES EXPECTED THIS WEEK

For this week's MPC meeting, no rate move is generally expected. In the INET-Bridge consensus forecast survey, published last week, all except one participant economist anticipated interest rates to remain unchanged this week. The one dissenting voice expects an interest rate cut. The reasoning for the unchanged interest rate expectation, as opposed to cutting rates further this week, is arguably largely the fact that in September, consumer price index (CPI) inflation was still rising from a previous months' 5.3% to5.7%, and getting very near to the Reserve Bank's upper target limit of 6%. ***The Key drivers of upward pressure on Consumer price inflation*** *remain accelerating food price inflation and rising transport cost inflation as a result of a series of petrol price hikes, while municipal rates and tariff hikes (most notably Electricity) have been very high for a few years.*

But why not expectations of interest rate hiking then? *The expectation of interest rate cutting is based on something of a "forward looking" view into the 1st half of 2012. Economists' expectations of renewed interest rate cutting in 2012 are based on the expectation that CPI inflation will peak in the first half of next year, within or not far out of the target range, and start to decline once more. The expectations are based on signs of weakness in the global economy, which has slowed the commodity price surge, and we have indeed been seeing declining year-on-year commodity price growth already in recent months. The expectation is also for limited "second round" effects to CPI emanating from recent commodity price surges.*

Locally, further mildly "good news" for CPI inflation came from weakening residential rental growth, a key item in the CPI. Actual rental inflation slowed from 5.9% in August to 4.7% in September, while owner occupied rental inflation slowed from 4.6% to 4.4%. This helped the largest sub-index, namely the Housing and Utilities sub-index, to slow its inflation rate slightly from 6.8% previous to 6.7% in September at a time when other major ones were accelerating.

Therefore, those who expect future interest rate cutting, or at least no imminent hiking, are seemingly basing their views on us getting past the next few months, in which CPI inflation may still suffer from the lagged impacts of commodity price surges earlier this year. Thereafter, there are some encouraging signs that CPI inflation may turn for the better (lower), hopefully before the SARB deems it necessary to hike interest rates. Indeed, Firstrand's expectation is also one of unchanged rates this week, and then slightly lower early next year.

BUT IT IS IMPORTANT TO TAKE NOTHING FOR GRANTED

The SARB's greater transparency in setting interest rates over the past decade or so, compared to prior decades, is to be welcomed. The sense I get is that many members of the public follow the discussion and speculation surrounding interest rates closely in the media. There may, however, be some unintended consequences to this, one of them being that I often hear people talking as if the "next rate cut" is a fait accompli, because this is what many economists speculate. Some cautions should be issued in this regard. Remember, expectations and forecasts can often be wrong.

Despite all of the speculation that the next move in interest rates may be down, or at least stay the same for a protracted period of time, the fact is that CPI inflation has been rising in 2011 and is near the upper target limit of 6%. Given that the CPI is the most important variable for the SARB in setting interest rates, we would be wise NOT to take it for granted that the Bank won't decide on the seemingly most unlikely option in the near term, i.e. to hike interest rates.

To illustrate just how hazardous forecasting is at best, we don't have to look far back for a good example. In its Monetary Policy Review of May 2006, the SARB (along with many of us) forecasted a relatively benign CPI inflation peak *of around 5% in early 2007, thereafter remaining just above the 4.5% mid-point until end-2008. No apparent need for any interest rate hiking at the time one would think. One month later interest rate hiking commenced. Just over 2 years later, as at mid-2008, prime rate had risen to 15.5%, from 10.5% in mid-2006. and CPI inflation peaked shortly afterwards at a massive 13.7% in August 2008, driven by a huge commodity price surge. The rest was history, as they say, and the results were disastrous for a highly- indebted household sector and for the housing market.*

There are good arguments to believe that this time around inflation shouldn't become troublesome in the near term, arguments that I, too, subscribe to. *But the fact that CPI inflation has recently risen to near to the 6% upper target limit must not be ignored. We also must not ignore the fact that interest rates are currently at multi-decade lows, and they never stay there for ever.*

SOME SUGGESTED CONSIDERATIONS FOR HOUSHOLDS

1. Make provision for future interest rate hikes: *Despite significant expectation of no interest rate hike this week, and the possibility of further interest rate cutting in the not too distant future, it would probably always be wise for a household, when borrowing money, to make provision in its financial planning for the virtual certainty that interest rates will go up at some future stage. Such provision is arguably more important when interest rates are at relative low points in the cycle, such as appears to now be the case.*

How much should one provide for? Here again there are no certainties, but the past 2 interest rate hiking cycles were 4 and 5 percentage points in magnitude respectively. Perhaps that would be a starting point, although the more of a cushion one has the better. It doesn't necessarily mean not making one's desired purchases, but may mean lowering one's aspirations in terms of the home or car that one may have been considering purchasing if there is no "buffer".

2. The second important consideration is that of fixed interest rates. *I will* ***NOT*** *attempt to persuade people to fix or to float interest rates. There is no right or wrong answer regarding this. However, there are some factors worth considering in this regard. Firstly, I am of the opinion that fixed interest rates should not be seen as a tool that can be used to "beat the market" On average, they probably won't beat the market. Rather, they should be seen as a service provided by a bank, where the bank provides a household with greater certainty over a portion of its cash flows related to debt, and the household can be expected to pay for having the bank offloading this risk. The bank in turn has to undertake certain transactions, known as interest rate swaps, in order to reduce the floating interest rate risk that is has taken on from clients who fix their rates. The cost at which it can offload this risk is dependent on where the market expects interest rates to move to over the term of the fixed rate. The fixed interest rate that the client is thus offered by the bank is thus heavily dependent on the market's expectations of future interest rate movements. Cutting a long story short, therefore, is that the more attractive fixed interest rates are often on offer when the interest rate cycle is nearing its bottom but there still exists a market expectation that rates could go lower.*

On the other hand, once the SARB actually starts hiking interest rates, the market has normally already built in a series of expected interest rate hikes, and fixed rates on offer are not that attractive. Sadly, it is usually only when the SARB starts hiking its repo rate that banks' are inundated with enquiries from nervous clients about fixing interest rates. By then, the attractive fixed rates on offer are often long gone.

Now fixing interest rates depends on the individual, whether he tends towards the risk averse of the risk taking, or it depends on her financial situation and how much scope exists for her to absorb interest rate hikes. But if fixed interest rates are an appealing option to an individual, it may be clever to be investigating what's on offer at the present time.

3. Carry on with the balance sheet clean up: *Currently slowing household credit growth, and a declining trend in the debt-to-disposable income ratio from 82% peak in 2008 to 75.9% as at mid-2011, are encouraging signs of a household sector slowly improving its debt situation. It is important, though, that the currently low interest rate levels don't prematurely end this "clean-up" of the household balance sheet. I am of the opinion that the debt-to-disposable income ratio needs to go significantly lower in order to provide an "acceptable" cushion to be able to absorb the next interest rate hikes whenever they should arrive.*

But finally, and importantly, although the primary focus is on CPI, the slow rate of household and private sector borrowing may perhaps be one important factor persuading the SARB to keep interest rates as low as they are.

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