Waiting on interest rates

Local economic update: August 2011

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What the South African Reserve Bank Monetary Policy Committee meeting means for consumers

The South African Reserve Bank Monetary Policy Committee (MPC) met in July to discuss the economic data available to them in order to make an interest rate decision. The Bank decided to leave rates unchanged with the repo rate at 5.5% and the prime overdraft rate at 9.00%.

The primary mandate for the MPC is inflation targeting: ensuring that inflation remains within the 3-6% target range. In the expanded mandate given to them by National Treasury earlier this year, the MPC is also expected to conduct inflation targeting in a way that supports economic growth, among other things. Inflation and economic growth were, therefore, key to the committee's final decision.

Keeping an eye on inflation

Inflation has been on an upward trend for a few months now. In June the inflation rate (CPI) increased to 5%. In comparison, inflation averaged 4.3% in 2010.

Food and transport prices were two major drivers of the increase and unfortunately these form a substantial portion of the inflation faced by lower income groups. In fact, inflation faced by this sector has already breached 6%. This statistic confirms the often repeated truism that inflation actually hurts the poor most.

It's important that South Africans understand that, by fighting inflation the bank is protecting the poor and low-income earners. This group is largely represented by trade unions, which are currently demanding wage settlements in the double-digit range, which of course poses a risk to inflation.

In addition there are administered prices like electricity and municipal rates which are currently growing at rates way above the upper band of the inflation target. As a result, overall CPI will breach the target later this year and remain out of target for a quarter or two.

If inflation will breach the target later in the year, why did the MPC not raise interest rates now? Because the breach will be temporary until Q2 2012 and inflation has not spread across all goods and services.

Economic recovery weak

First quarter GDP growth was very strong at 4.8%. However, high-frequency data like manufacturing and retail sales indicate that the second quarter will be nowhere near as strong.

The weakness in retail sales indicates that consumers have not recovered sufficiently to spend in a way that will support further growth. If the unemployment situation is not addressed as a matter of urgency, it will pose a threat to full economic recovery.

Uncertainty about global economic developments also poses a risk to the domestic economy. An interest rate increase at this point would not have been the best option for the economy.

What does this mean for consumers?

Pay down debt

This is a good time for indebted consumers to work down their debts while rates are still low. Household debt as a percentage of household disposable income is still very high at 76.8%.

Test affordability

Consumers entering into new debt contracts should bear in mind that interest rates will go up. Add about 2.5 percentage points to interest payments to know if you can afford the debt. What seems affordable now may not be a year from today when interest rates – and repayments – go up.

Good news for pensioners

Consumers who depend on interest income can breathe easier because their income will increase when rates go up later in the year. It's unfortunate that we concentrate on the indebted consumers instead of highlighting the plight of those who save and might be discouraged from doing so because the return is very low in the current low-interest environment.

Get advice

It is important to get the help of a qualified financial adviser to help you put your savings in a vehicle suited to your needs which will yield reasonable returns no matter what the interest rate level is.

Borrow carefully while rates are low

Not all debt is bad debt, particularly if it's going to finance investment which increases the economy's future production capacity.

When interest rates go up the cost of borrowing increases. Currently, as rates remain unchanged at a low level it is cheaper for companies and consumers to borrow, provided they do so prudently.