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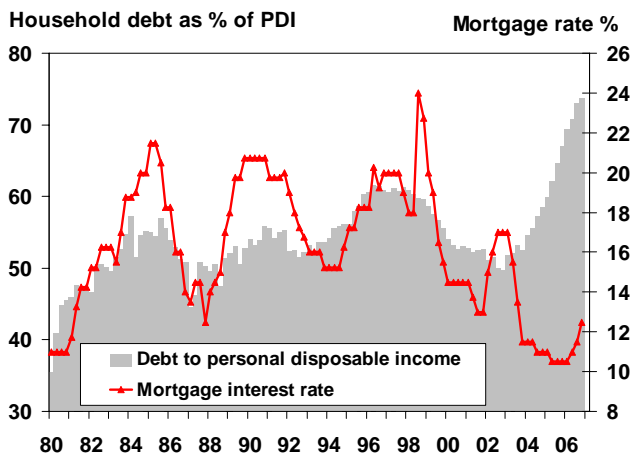
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IS CONSUMER DEBT WORRYING?

Household debt has risen strongly since 2003. As a proportion of personal disposable income it increased from a low of 49,8% in the final quarter of 2002 to 73,8% at the end of 2006. Official displeasure over banks failing to grant sufficient credit has changed to official consternation and calls for more responsible lending. How much of the rise can be justified on economic grounds and what are the implications of increased indebtedness?

Graph 1: Household debt and interest rates



Sources: SA Reserve Bank, Nedbank Group Economic Unit calculations

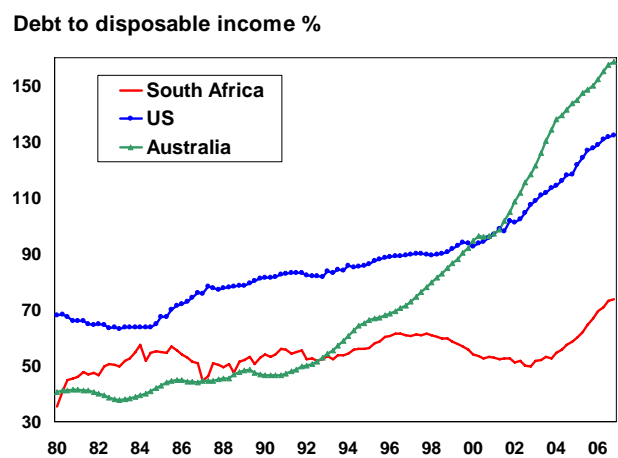
International experience

The sharp rise in credit over the past three years is similar to trends seen in many other emerging and developed countries. Financial deregulation, falling interest rates and rising household wealth internationally have all encouraged consumers to take on additional credit. In some countries the rise has been remarkable. In the US the household debt-to-income ratio rose from 67% in the mid 1980s to 101% in 2001, 110% in 2003 and is now over 130%. Australia's history is even more startling. The ratio was around 45% in the mid 1980s, rose to 101% in 2001, 130% in 2003 and is now close to 160% (see graph 2). However, the Anglophile world does not offer the strongest excesses. Although there are measurement problems that make comparisons between countries difficult, the ratio in certain European countries

exceeds 200%.

The global experience has provoked considerable debate in recent years, particularly in official circles unsure of the macroeconomic implications. The optimistic view is that there is little to be concerned about as lower interest rates have reduced debt servicing costs and the strong rise in net wealth has reduced the vulnerability of households. Comfort is also drawn from the fact that most household debt is in the form of mortgages. Lastly, in most developed countries, delinquency rates remain at low levels and well below peaks experienced in the early 1990s.

Graph 2: International comparisons



Sources: SARB, Reserve Bank of Australia, US Federal Reserve

The numbers are encouraging on the face of it. Household wealth in many countries has risen strongly over the past decade, largely because of house and equity price appreciation. A recent Organisation for Economic Co-operation and Development (OECD) working paper 'Has the rise in debt made households more vulnerable?' (Girouard et al, WP 535, 3 January 2007) shows that net wealth (all assets minus liabilities) as a percentage of annual disposable income has increased significantly over the past decade, despite rising indebtedness. For example, in the US this ratio increased from 510% in 1995 to 573% in 2005 even though household debt as a percentage of income rose from 93% to 135% over the same period. With the exception of Japan, all selected developed countries in the study saw rising net wealth,

although several have seen marginal declines in the past five years.

Increasing house prices and falling interest rates also encouraged refinancing and home equity withdrawal. In many countries this provided a ready and significant source of additional income as households locked into ever-decreasing interest rates, adding between 1% and 2% to personal disposable income each year. The added advantage of using a low-cost home loan as a form of revolving credit is that it provides flexibility and a buffer against short-term adverse spikes in expenditure or dips in income.

The difficulty with the optimistic view is that much of the good news is based on a single underlying cause. Over the past decade international liquidity has risen significantly in response to financial deregulation, lax monetary policies and the recycling of massive current account surpluses emanating from Asia and – more recently – oil producing countries. If liquidity were to dry up, the virtuous cycle of falling interest rates and rising wealth could change to a vicious cycle with heavily overleveraged balance sheets weighing consumers down and affecting the overall economy.

The recent woes in the US housing market are currently causing concern. Although much of the problem is concentrated in the so-called subprime mortgage market, which is limited to around \$1,4 trillion or 14% of the total market, falling housing starts and new home sales suggest that the US consumer may be about to become more cautious after years of providing the world with its key source of demand.

The subprime market itself is an extreme example of what can go wrong if widely held assumptions start to unravel. Lending to clients who would not normally qualify for credit has increased in recent years, partly based on the observation that house prices do not ever decline and that interest rates are unlikely to rise by much, and partly encouraged by government's desire to see credit extended to lower income groups. Unfortunately, these economic assumptions have been challenged following the Federal Reserve's decision in mid 2004 to start 'normalising' interest rates. Over the period the officially targeted fedfunds rate was raised in 17 steps to 5,25% from 1%. Borrowers entering into so-called ARMs (adjustable rate mortgages) are therefore facing considerably higher repayments due to higher interest rates, with the full effect still to be felt in many cases as low introductory fixed rates give way to much higher flexible interest rates. Understandably, delinquencies are rising, putting further pressure on house prices in this segment of the market.

South Africa's case

The pattern of increasing household debt in South Africa is very similar to the global experience. Relatively low – and more stable – nominal and real interest rates from 2004 increased affordability,

improved confidence and helped push house prices higher. However, in South Africa's case this trend was helped by three relatively unique sets of factors.

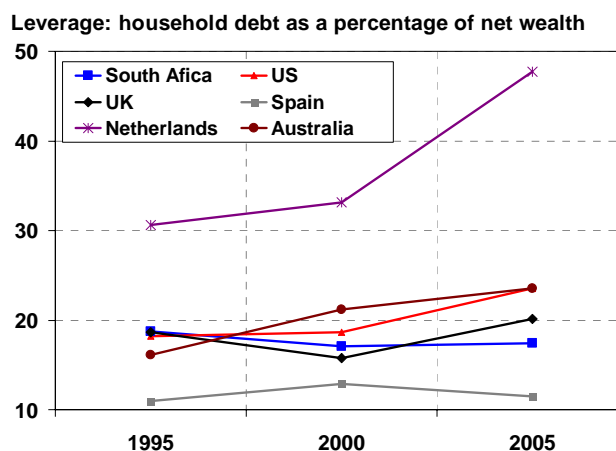
The first was that the country started to reap the benefits of structural changes made since 1994 and even earlier (see '*Is Structural Change Working? Guide to the Economy, 31 August 2005*'). This pushed underlying growth to a higher level and helped boost employment. Since late 2003 nearly 1,4 million jobs have been created, helping real personal disposable income to grow at an annual average rate of 6,6%.

The second was the rapid escalation of black economic empowerment initiatives following the release of the Mining Charter in 2002. Again, the effect was to widen the economic net and stimulate demand.

Lastly, South African asset prices were still relatively low in real and comparative terms in 2003. Real equity prices were at pre-1994 election levels with price-earnings ratios in the single digits. House prices had already started to rise, but in real terms were still lower than levels prevailing in the first half of the 1980s. As conditions improved and confidence over future prospects grew, the subsequent rise in asset prices was justifiably massive.

The combination of lower interest rates, broader economic participation and increased wealth therefore helped to encourage credit growth. The question is whether this growth has been excessive. International comparisons are not alarming. The level of debt relative to disposable income is still relatively modest compared with developed economies. Unfortunately, detailed statistics for emerging market economies are less easily available. However, the available statistics suggest that South Africa's household debt-to-income ratio is similar to countries at comparable levels of per capita income and financial market sophistication.

Graph 3: *Debt relative to wealth is not out of line*



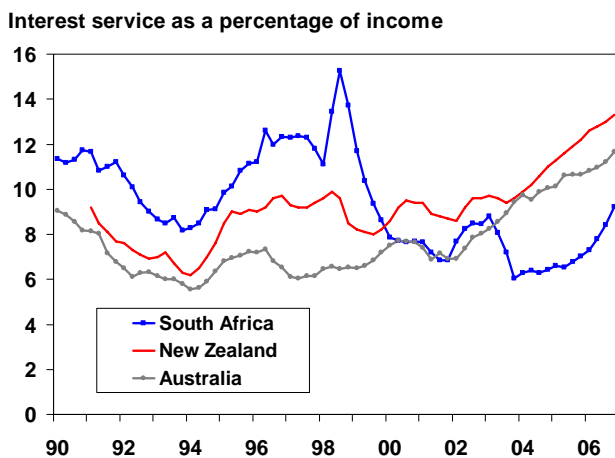
Sources: Aron et al, OECD

On leverage measures South Africa also compares favourably, although here international statistics are

even more limited. Leverage estimates how large borrowings are relative to financial and non-financial assets. A recent study (*Balance Sheet Estimates for South Africa's Household Sector from 1975 to 2005*, Aron et al, SARB WP/01/07) shows that household net wealth as a percentage of disposable income improved to around 384% in 2005, well up on earlier lows of just below 300% in 2003 and 273% in 1998. Although the rise has not been as dramatic as in many developed countries, it has still been impressive and clearly helps to explain why consumers are more willing to take on more credit. These estimates of wealth also suggest that South African households are less leveraged than they were a decade ago and compare favourably with most of their OECD counterparts (see graph 3).

On debt servicing comparisons South African households do slightly less well. Although they do not seem overstretched relative to the past, they are in relatively high territory, with only a few OECD countries such as Australia (11,7%) and New Zealand (13,3%) devoting more income to paying off debt. Interest service as a percentage of disposable income rose to just above 9% at the end of 2006, higher than the 2002 peak, but well below earlier spikes such as in 1998, when servicing rose to over 15% of income, unexpectedly and over a short period, causing significant distress.

Graph 4: Interest service as a percentage of income



Sources: SARB, Nedbank Group Economic Unit, RBA, RBNZ

Possible dangers

Comparisons with other countries and the past put the strong rise in household debt more into context and suggest that there is not too much to be concerned about. However, this is not necessarily the case. As already noted the global situation is also the subject of considerable debate and concern. That South Africa is not out of line with others may be of small comfort if many other countries are overborrowed and vulnerable.

The second key concern is that the above analysis considers the aggregated position of households

only. This hides important detail at the individual level. If the debt is evenly distributed relative to income and wealth, the current position is probably of limited concern. Unfortunately, comprehensive panel data on the incidence of debt and how it has changed is not available. However, it seems plausible that the strong rise in debt in recent years may have been relatively concentrated. If this is the case then there could be sizeable pockets where distress sets in at relatively low interest rate levels.

The third concern is that South African economic and financial conditions are more volatile than in developed countries given the economy's openness and the rand's status as a commodity currency. Higher foreign exchange reserves and favourable fiscal and monetary policies make the country less vulnerable than in the past, but there is still potential for temporary spikes in interest rates to push overborrowed households into difficulties. This is especially the case, given the predominance of flexible mortgage interest rates.

Conclusions and policy implications

South African household debt has risen in line with international trends and for many of the same reasons. Although the rise in debt has been rapid, much of this can be seen as a response to better economic conditions and prospects and improved wealth. Overall levels do not seem overly onerous at the aggregate level.

This does not mean that current trends can continue unabated, however. If credit growth and personal income expand at the same rate over the next year, the debt-to-income ratio will rise to over 80% and interest service to over 10%, levels that could start to bite more generally. Our own forecasts indicate that this unlikely as credit growth will respond to last year's interest rate rises and begin to dip during 2007, suggesting a levelling out in debt of below 80% and an interest service figure of around 9,6% in late 2007 and in early 2008, figures that are still historically high. Added to this, a sharp rise in interest rates could expose groups of borrowers who may have slipped more deeply into debt in recent years. Given the lack of disaggregated information, this risk is difficult to assess, but could be significant.

The authorities are therefore correct to be concerned. The response so far has also been measured, with gradual interest rate rises having been combined with new legislation to ensure proper credit assessment at individual level and continued exhortations to individuals to save. An important consideration is that higher debt levels imply that interest rates do not have to rise as much as in the past to choke off excessive demand.

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