The impact of monetary policy on household consumption in South Africa

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The monetary policy committee of South Africa’s Reserve Bank (SARB) has had to increase the repurchase rate on three consecutive occasions within a short period of time. The repo rate was increased by 25 basis points in July 2015 and again by 50 basis points in January 2016. The third increase was by another 25 basis points in March 2016. The aim is to reign in inflationary pressures generated by 13% depreciation of the South African rand since January 2015. Core inflation is forecasted to hit 5.5% in 2016 and 5.4% in 2017 if the current prevailing macroeconomic circumstances pertain (SARB, 2015). Interest rates hikes by the Federal Reserve of the U.S.A. have resulted in capital outflows out of emerging markets leading to the depreciation of emerging market currencies. In the case of South Africa in particular, a severe drought fuelled by the El Nino heat wave has resulted in severe damages to food and livestock production. South Africa therefore has to import tons of maize and other staple food produce to subsidise the shortages in domestic food production. Coupled with the weak rand this makes imports much more expensive than it should have been, fuelling import induced inflation and worsening the trade deficit. Additional risks to the inflationary outlook are inconsistent electricity supply and tariff increases which have impacted adversely on domestic output and household disposable income leading to demands for above inflation wage increases in the absence of a corresponding productivity growth (SARB, 2015).

A number of questions emerge. First, against this background of a depreciating rand, increasing inflation and interest rate hikes, what would be the impact of such monetary tightening on household consumption in South Africa? This is relevant to the South African context considering the extent to which household consumption is driven by credit in South Africa. Household debt to disposable income ratio in South Africa stood at 78.3 percent as at end 2014 (SARB, 2014). Second, the hypothesis we test in this paper is the traditional Keynesian interest rate channel of monetary policy transmission which explains that a policy induced increase in short term nominal interest rates, if nominal prices are slow to adjust translates into increases in real short term interest rates. This leads to higher debt levels and higher cost of borrowing for households and firms for that matter. Households then reduce their consumption of goods and services. Firms also cut back on investment expenditures. Consequently aggregate demand, output and employment falls (Mishkin, 1995). We focus on three periods; post political transition, after inflation targeting and during the global financial crisis. These three periods each saw a distinctly different monetary policy stance and the objective is to see how household credit and consequently household consumption responded to these changes in monetary policy during these three different periods.
1. Key findings of the study

- The results show that anytime SARB increased interest rates, such as during the period of 1994 to 1999, 2000 to 2004, household credit and household consumption declined. Anytime interest rates were reduced, household credit and household consumption increased, worsening household indebtedness.

- When the South Africa Reserve Bank increases interest rates it has 2 effects
  1. The cost of servicing existing household debt increases.
  2. It becomes more costly for households to get new credit because interest rates are high.

- Consequently household consumption declined during periods of monetary contraction - post transition, and post inflation targeting, and increased during periods of monetary expansion or passive monetary policy stance – during the global financial crisis.

- This serves as evidence of the cost of credit effect of monetary policy on household consumption in South Africa.

2. Policy Implications

- In terms of policy implications the findings of this paper show that monetary tightening affects households’ ability to borrow affordably and further worsens existing household debt, especially as household consumption in South Africa is largely driven by debt.

- For wealthy households who own assets, an increase in interest rates makes them richer. Thus some household benefit from interest rate hikes. However for the average household which does not own assets, interest rates hikes has serious implications for the servicing of existing debt and the ability to acquire new debt.

- On the brighter side, households should be encouraged to save in financial products with attractive yields thereby taking advantage of the higher interest rates to earn higher yields on their investment portfolios. This could help to mitigate household liquidity constraints over time created by the unfavourable macroeconomic outlook expected to pertain in the short to medium term going forward.

Reference