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Economics

Debt: A necessary evil

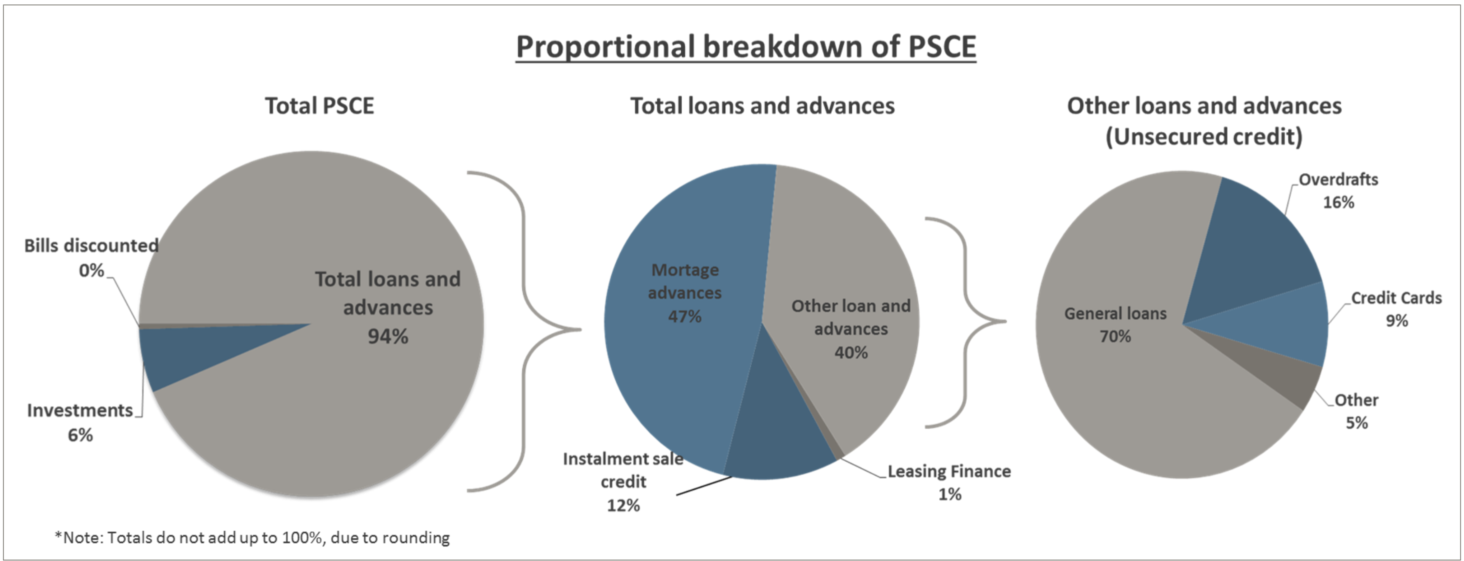
Last week saw the release of Private Sector Credit Extension (PSCE) growth for December 2012 - an increase of 10.1% y/y (slightly above consensus estimate). This brings the average growth in PSCE to 8.5% y/y, which compares well with more subdued growth of the previous two years (average 5.6% and 2.0% y/y in 2011 and 2010 respectively). However, in 2006, and just one year before the financial crisis, PSCE inflated by 24.6% y/y - a credit bubble that contributed to a substantial spike in household debt.

Household debt to disposable income increased from 52.6% in 2002 to an all-time high of 82.4% in 2008 (from 1969 to date the average was 55.8%). Following the introduction of the National Credit Act (NCA), a sudden tightening in credit availability from banks and a drastic decrease in interest rates since 2007, this level has improved somewhat. However, lower rates have intentional as well as unintentional consequences. While it is easier to pay off debts when interest rates are low, it is also more affordable to borrow money and create new debt. Debt servicing cost to disposable income of households sat comfortably at 6.5% during the third quarter of 2012 compared to 12.4% in 2008. While the lower cost of credit is something the SARB is counting on to stimulate the economy, analysts have become ever more worried that it might be fuelling another credit bubble – specifically in the unsecured lending space.

In analysing unsecured lending, it is important to understand its proportion in relation to total credit. Roughly 94% of total PSCE consists of, what the SARB calls “total loans and advances”.

The largest component of this category is mortgage advances (47%) and other loans and advances (40%). The latter category is often classified as “unsecured” while mortgages forms the largest “secured” part.

Unsecured loans refer to any type of debt that is not secured by a specific asset of the borrower as collateral. This type of credit extension suggests a higher risk to lenders. Should the borrower default on his loan, creditors usually realize less than their outstanding loan as opposed to secured creditors.



To compensate for this risk, interest rates on unsecured loans are usually much higher. In South Africa, credit card debt, overdrafts and general loans (including student loans and personal loans) to households and corporates, are classified as unsecured loans. In analysing the outstanding unsecured debt of households, a few interesting observations can be

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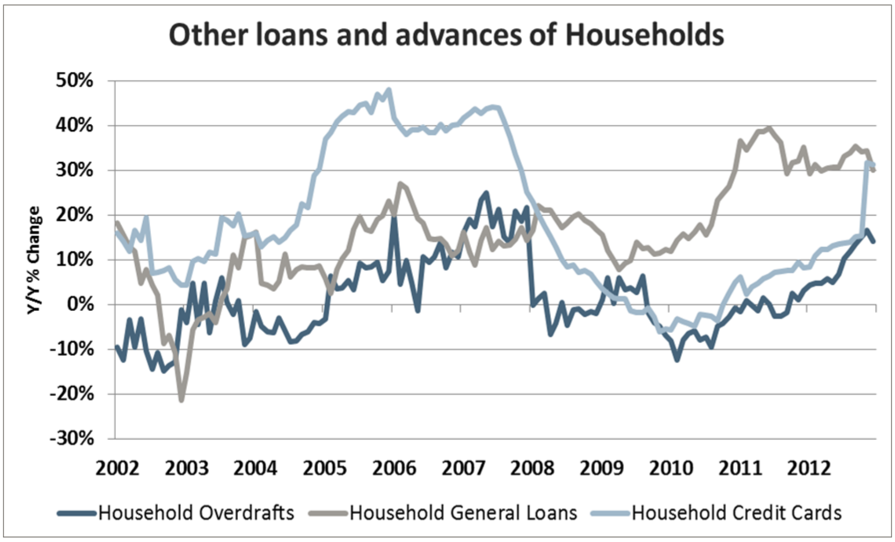
made. The rate of increase on outstanding credit card debt increased by 30% y/y in November and December 2012 compared to an average increase of 15% y/y from January to October. However, this huge rate of increase can mostly be ascribed to ABSA's acquisition of a loan book from Edcon. Nevertheless, even this fast rate of increase is lower than the 47.9% increase reported in December 2005.

Credit extended to households on overdrafts, have similarly accelerated at a significant pace; increasing from 3.0% y/y in December 2011 to reach 14.1% in December 2012. The rate of increase in general loans was 30.1% y/y in December 2012, increasing at an average pace of 33.7% y/y since the start of 2011 – this might be a source of concern despite general loans making up such a small part of total PSCE.



What is clear is that the economy is supported by a healthy increase in the demand and provision of credit. Household expenditure contributes roughly 60% to total Gross Domestic Product in SA and households have certainly been dipping into the credit barrel to support their spending habits. This causes a little bit of an economic anomaly. While cheap credit might be keeping the economic boat afloat - especially unsecured credit - this might lead to an unsustainable and dangerous credit bubble and painful adjustments when interest rates start rising again or when another crisis hits the global economy.

This is a very strong argument against further interest rate decreases. Nevertheless, for now credit demand is probably doing more good than bad to the economy despite its longer term unsustainability.