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South African Reserve Bank Economic Notes are typically short economic analyses initially written for internal discussion and to stimulate debate. They are written by staff members of the South African Reserve Bank or visiting fellows and are released publicly on an occasional basis.

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Chris Loewald

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Enquiries
Head: Research Department
South African Reserve Bank
P O Box 427
Pretoria 0001

Tel. no.: +27 12 313-3911
0861 12 SARB (0861 12 7272)

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What is keeping housing inflation below the inflation target midpoint?

Koketso Mano, Patience Mathuloe and Nkhetheni Nesengani [1]

Abstract

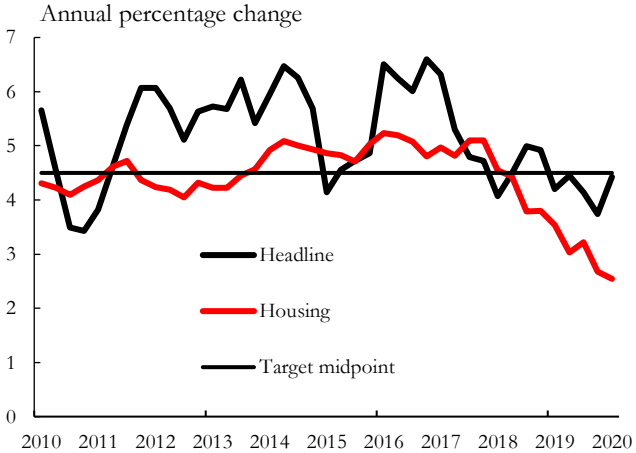
With a weight of 16.84%, housing is one of the largest components in South Africa's CPI basket. Inflation for this component has slowed since the start of 2018, reaching an all-time low of 2.5% in December 2019, and has assisted the disinflation in total services and headline inflation. Current information points to a subdued property market. SA's residential property market remains under severe pressure from weak demand and oversupply, and house prices are declining in nominal and real terms. In addition to a rise in residential buildings supply, a prolonged period of tighter credit standards that prevailed until recently, weak employment growth, subdued economic growth, low levels of disposable income, and relatively high levels of household debt, are other factors that continue to put strain on the property market. The year-to-date 225 basis points cut by the SARB MPC will provide relief to consumers and ensure liquidity remains sufficient during the COVID-19 outbreak, but is unlikely to stimulate property demand. Over the long-term, a moderation in residential property construction and population growth should support the housing market on condition that economic growth recovers.

1. Introduction

With a weight of 16.84%, housing is one of the largest components in the South Africa (SA) CPI basket. Inflation for this component has slowed since the start of 2018 and current information points to a subdued property market. Supply of property has increased while weak credit uptake and financial pressure on households speak to less demand. In the first quarter of 2020, housing inflation recorded an all-time low of 2.5% (Figure 1). Lower housing inflation has assisted the disinflation in total services, which declined by a full percentage point from the start of 2018 to end-2019 (Figure 2). From an inflation perspective, this welcome development has contributed to lower headline inflation. Housing inflation forecast errors contributed 0.7 to the cumulative 3.4 percentage points error in headline inflation rate between the November 2018 MPC and the January 2020 MPC. To reduce forecast errors going forward, a better understanding of the housing market is important.

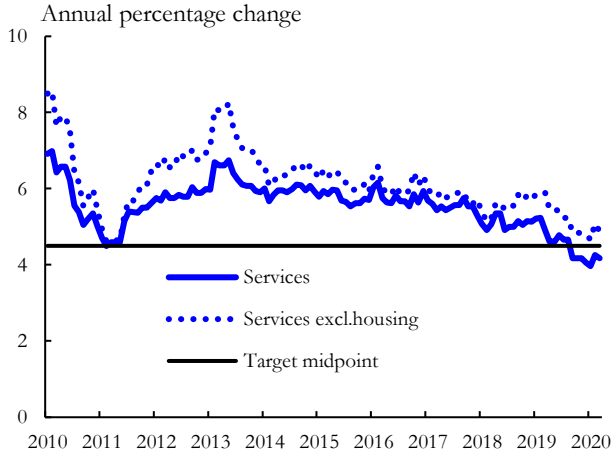
[1] Special thanks to Rowan Walter, David Fowkes, Jean-Francois Mercier and Theo Janse van Rensburg for valuable comments and supervision of this research. Thanks also to Siphamandla Mkwanazi (FNB) and Theo Swanepoel (TPN) for continuously sharing data.

Figure 1: Headline and housing
Annual percentage change



Source: Stats SA, SARB

Figure 2: Services and housing
Annual percentage change



Source: Stats SA, SARB

2. Dynamics of housing inflation

Housing is a combination of actual rentals (rentals) and owner's equivalent rent (OER), which weigh 3.52% and 13.32% respectively.[2] The different weights reflect different definitions and survey methodology which will be discussed shortly. From 2010 to date, OER inflation averaged 4.3% and rentals inflation averaged 4.8%. Both indicators are now below the bottom of the inflation target band of 3%, with OER sitting at 2.6% and rentals at 2.7% in March 2020. With housing inflation below the 4.5% inflation target midpoint, services inflation should remain well anchored near the midpoint itself.

From 2009, StatsSA has conducted fieldwork to collect rental data which is used to compile the rental index. This data is collected by means of a real estate agent survey that covers the formal property rental market in urban areas. The surveyed property types include flats, townhouses and houses. Properties are further matched according to location and physical characteristics, these matches are then used to determine the rental equivalent for similar properties.

Rentals are the actual amounts paid by tenants to a property owner or landlord for the provision of accommodation.[3] Less straightforward, OER is the cost of using a housing service, i.e. when owners choose to live in their own houses rather than letting to tenants, there is an opportunity cost associated with the lost rental – this is OER.

Economic theories suggest that house prices are linked to residential rentals (Gallin, 2004).[4] Data from 2010 to 2019 indicates a strong contemporaneous correlation between house prices and rental prices.[5] The

[2] Rentals and OER collectively account for over a third of services CPI, respectively 6.86% and 25.96%.
[3] Statistics South Africa. (2017). *Consumer Price Index: The South African CPI Sources and Methods Manual.* Pretoria: Statistics South Africa.
[4] Gallin, J. (2004). The Long-Run Relationship between House Prices and Rents. *Fed: Finance and Economics Discussion Series.*

[5] The house price series is based on FNB Quarterly Provincial Metro, and the rental prices are sourced from https://www.tpn.co.za/Group/

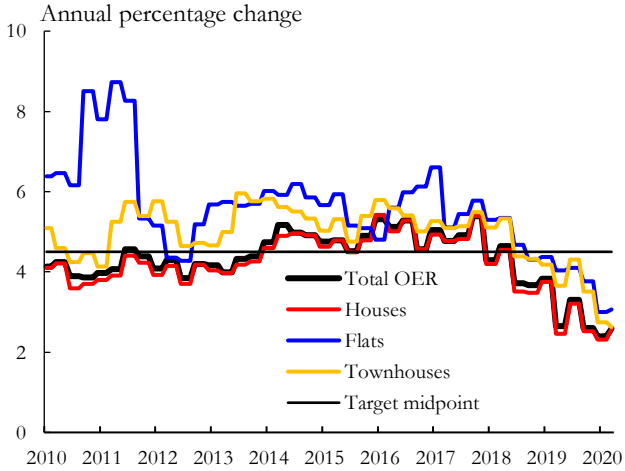
coefficients range from 0.943 in the Gauteng Province to 0.9781, 0.9945 and 0.9978 in the Western Cape, KwaZulu-Natal and national respectively.[6]

Getting shelter is one reason for buying houses, another is investment in the rental market. Hence, profitability in the housing market will also be based on the rental yield. We therefore calculate the rental yields nationally and for the three provinces with large metropolitan areas. In our approach we consider the gross, and not net rental yields.[7] The rental yields in the Gauteng Province have remained higher than in the Western Cape Province, with both provinces having recovered from the 2014/15 lows. House prices in the Western Cape are generally higher as a result of areas that are attractive to affluent buyers, this tends to suppress rental yields. Over the same period, the national yields remained broadly flat.[8]

The Stats SA indices, OER and rentals, also have a strong correlation of nearly one between 2010 and 2019, this general co-movement supports our proposition that there are core factors driving the entire housing market which are worth exploring.

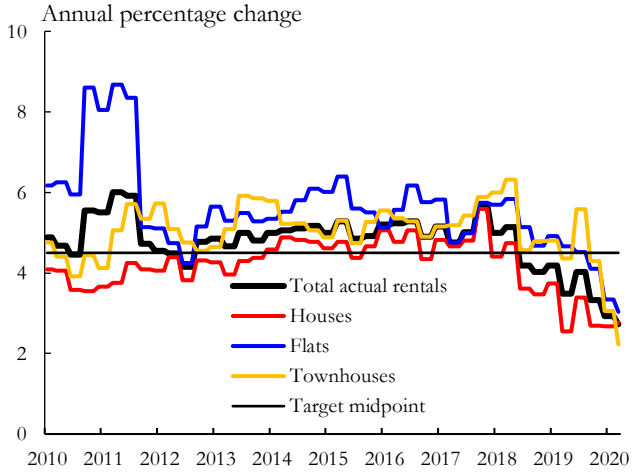
As shown in Figures 3 and 4, OER and rental sub-categories (especially houses) have moved relatively sideways since 2010 and only recently dipped to inflation rates close to 2%. We believe that the property market fundamentals of increased property supply, coupled with household measures to reign-in expenditure (lower demand), have limited inflationary pressure. Demand was also dampened by stringent credit provision. These fundamentals are also evident in declining house prices.

Figure 3: Owners equivalent rent
Annual percentage change



Source: Stats SA, SARB

Figure 4: Actual rental
Annual percentage change



Source: Stats SA, SARB

3. Drivers in the housing market

The value in analysing the structure of the housing market will help in understanding how diverse factors affect the housing categories (small, medium and large houses) differently. For example, tough economic

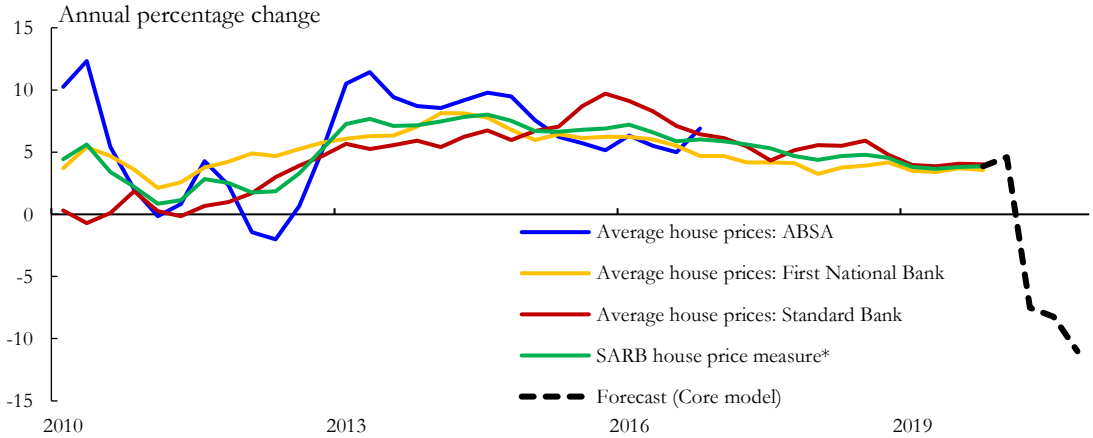
[6] This correlation analysis is based on average prices in each provinces, correlation may not be consistent across all housing segments. See Figure 16 in the Appendices.
[7] The gross rental yield is calculated as ((monthly rental*12)/house price)/100. But the net rental yield takes into account other expenses such as cost of administering rent and renovations.
[8] The national average is based on unweighted house prices and rentals across the nine provinces of South Africa.

conditions could induce home owners to downgrade from large homes to smaller ones. This raises the demand for small and medium houses which can increase house and rental prices in these categories.[9]

Other factors to be considered include increased supply of property owing to emigration and construction commitments that are made when the market is doing well but come on-stream when the market has turned. Meanwhile, financial difficulty, stricter credit policy, and until recently –rising interest rates also affected household credit profiles and may have reduced the demand for property ownership. House prices have been declining and this could either indicate an oversupplied market or lower demand.[10] We will later show that the property market is experiencing both. The impact of COVID-19 should drive a steep dip in house price inflation, a development we will delve into later (Figure 5).

Over the long-term, factors such as population growth and other policy interventions affecting land ownership become important considerations. These will however not be investigated in this paper.

Figure 5: House prices



Source: Stats SA, SARB

3.1 The demand side

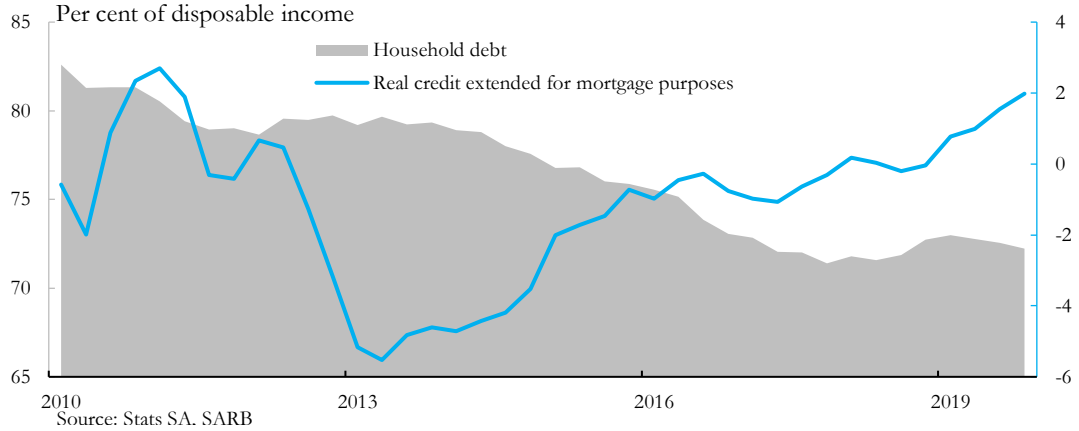
First, households have not borrowed at a faster pace to buy property. In fact, the growth in real credit extension for mortgage purposes has averaged -1% between 2010 and 2019 while household debt has steadily declined (Figure 6). Research by Botes and Mercier (2015) also found that since the GFC, households have been deleveraging through less investment in housing while consumption has remained stable.[11] This could be on the back of credit regulation changes to protect consumers as well as more prudent bank behaviour following the implementation of Basel 3. Another prominent reason for investors possibly diverting from the property market could be the risk emanating from land expropriation without compensation, a policy that is currently before Parliament.

[9] This could potentially affect CPI weights going forward, which would be a shift in weight from larger houses to smaller ones or from rentals of houses to other categories, townhouses and flats.

[10] Demand could also be limited by a rising trend in communal property purchases, where people buy property jointly in order to share repayments and expenses. Source: FNB Estate Agents Survey, April 2019. https://propertywheel.co.za/wp-content/uploads/Estate-agents-survey-1Q19.pdf

[11] Mercier, J., & Botes, E. (2015). *South African households – how to deleverage without saving.* Pretoria: South African Reserve Bank.

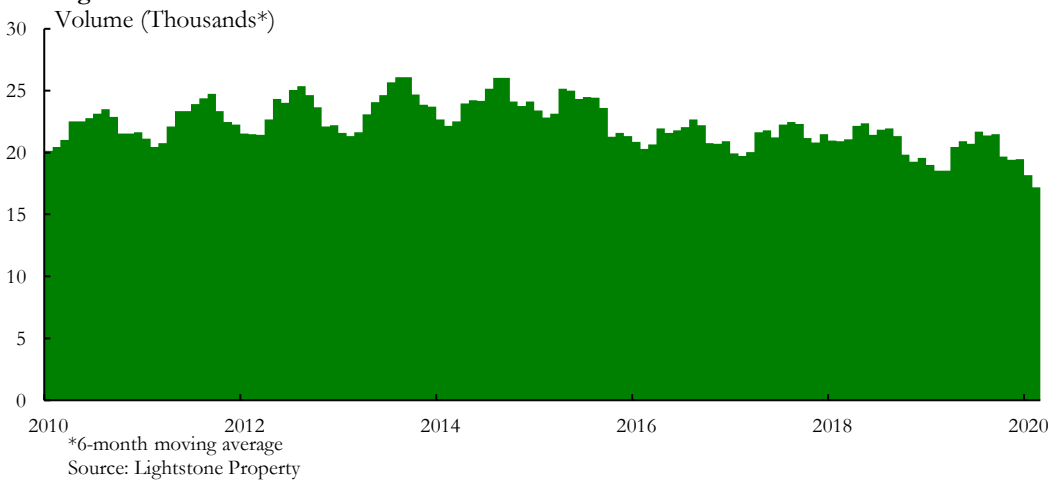
Figure 6: Household credit



A downward trend is noted in property transfer activity (Figure 7). Transfer volumes have trended lower (in terms of a 6-month moving average) and have fallen from a sample peak of 26 thousand houses in the second half of 2013 to 18 thousand houses recently.

The FNB Estate Agent survey has revealed a few interesting findings.[12] The lower-value market did well in 2019, where such dwelling units were taking roughly six weeks to sell, but the average market still signalled difficulties. Property market activity has been fairly subdued when compared to historical performance, and the bulk of this slowdown is especially evident in the high-value market. The number of property sale viewings slowed from an average of approximately 12 "serious viewers per show house prior to sale" to 9.5, and the number of weeks that a property remains on the market has also risen from a historical average of about 13 weeks to 15 weeks in 2019.[13] In early 2019, most sellers (over 95%) have had to reduce their asking price by over 9% in order to secure a deal.

Figure 7: House transfers



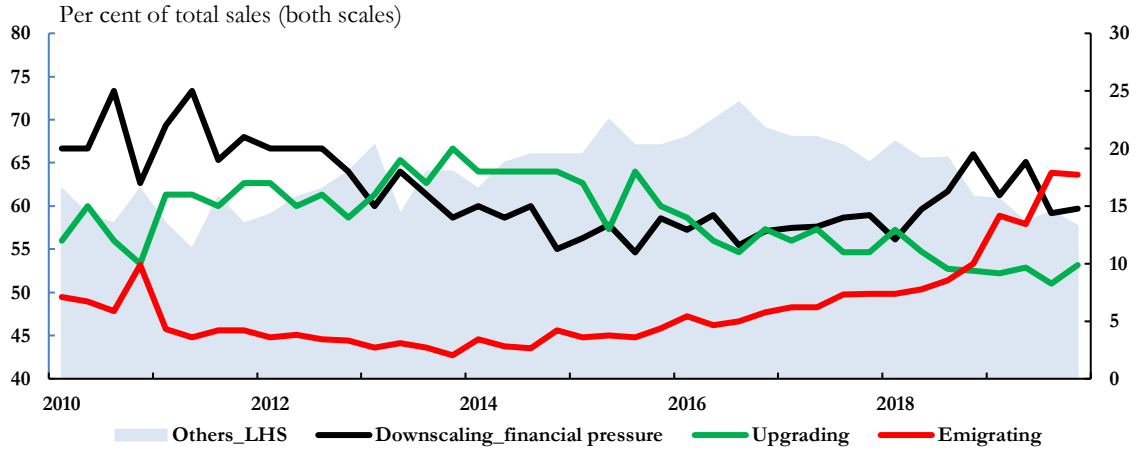
Second, households have been downscaling due to financial difficulties. FNB's survey also reveals that most property owners place their homes on the market primarily for two reasons: "emigrating", and

[12] https://dl.airtable.com/.attachments/ecaae9de07c34049df39fa9a84a7bb07/95de64ec/Property-barometer-Q4.pdf
[13] See Figure 22 in the Appendices.

"downscaling due to financial pressure". Together, they represent over half of the responses (Figure 8). Emigration, in particular, has featured prominently in the high-value market. This factor not only explains lower demand but also contributes to rising supply of property in the market.

Across all the income groups, the share of "upgrading" as a reason for selling property has been declining since 2018Q1. There is also a decline in people "moving to be closer to work or amenities", which can be interpreted in different ways. Either the tight job market does not present opportunities for job shifts, or subdued property demand has not enabled commuters to sell favourably and speedily. It could also be that financial constraints force people to remain in cheaper suburbs and travel longer for work, rather than move closer to work which may be in more expensive neighbourhoods. The movement in various categories support the argument for economic difficulties contributing to the overall subdued housing market in recent quarters.

Figure 8: Reasons for selling - all housing segments
Per cent of total sales (both scales)



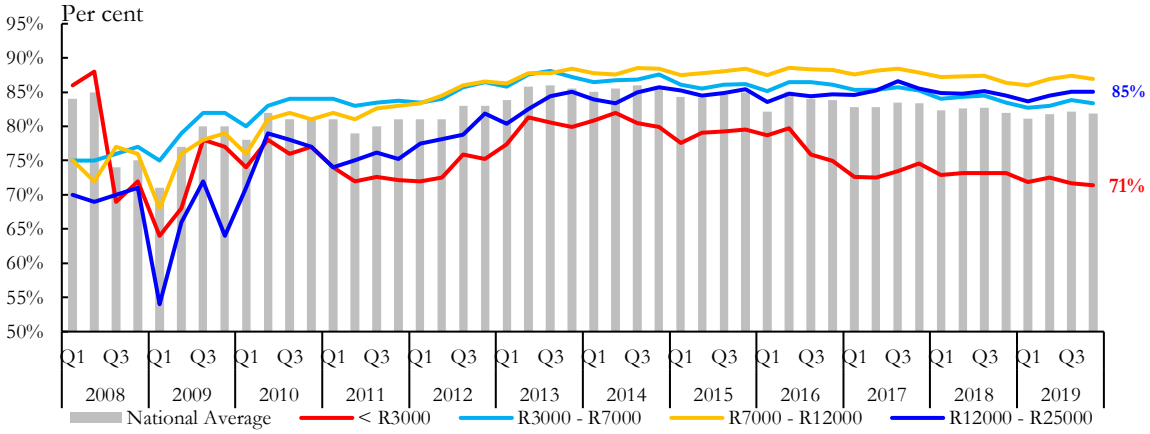
Source: FNB

Despite financial pressure and subdued demand for property purchases, people still need accommodation and one would therefore expect the rental market to improve. However, the FNB survey reveals that only half of these respondents opt for rentals while the remainder moves into a lower-value house segment.

TPN's rental survey shows that many tenants struggle to pay rent. In particular, in the low value markets, tenants' ability to pay rent has deteriorated to levels last recorded in the wake of the GFC. In addition, vacancy rates are rising, currently at a survey history high of 9% in 2019Q4 relative to the 2016-2019 average of 7.3%. Here the high-value market is hardest hit, once again indicating the financial constraints that consumers are facing (Figure 9 and 10).[14] Already in their 2019 third quarter report, TPN noted tough competition for tenants and that landlords were opting to maintain zero rental inflation just to retain tenants. Landlords were also offering rent-free months and free Wi-Fi.

[14] https://dl.airtable.com/.attachments/a06b3fe7c8e9e77c2d1caf42d9f757f9/1daa6586/ResidentialRentalMonitor2019Q4.pdf

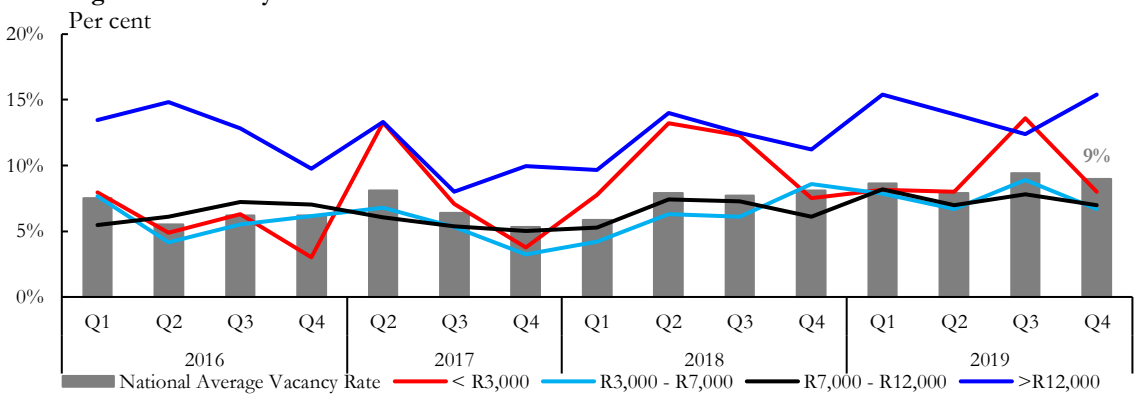
Figure 9: Rental Good Standing*: by Rent Value



*Good Standing is a combination of the proportion of tenants that have paid on time and those that paid late

Source: TPN

Figure 10: Vacancy rates



Source: TPN

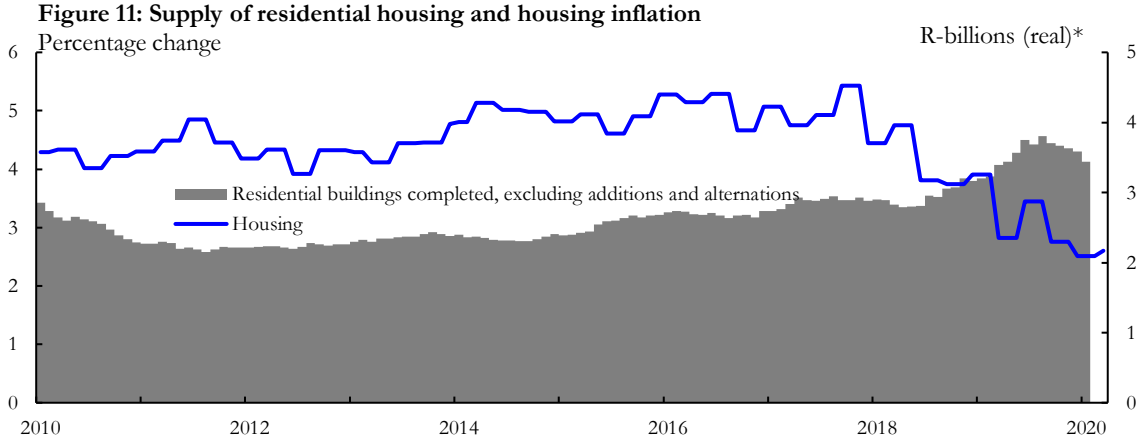
3.2 The supply side

Supply of residential buildings has continued to rise and is at a post-crisis high (Figure 11). This growth is nearly double that of GDP and the population.[15] We suspect that construction plans made when the economy was in a better state have taken time to come on-stream and are feeding into a currently oversupplied market. This is the major supply-side development but other factors such as emigration have also added to property supply. A leading indicator for how supply may expand going forward is the building plans passed for all housing, which averaged 2.3 thousand housing plans passed over the past 12 months, which is marginally below the post-crisis average of 2.6 thousand. Housing plans indicates that significant investment in the sector is still intended and should add to the current glut.

In addition, a lot of websites providing advice to home-sellers point to renting as a viable option when the property is not selling at the desired price or rate. The home-sellers who take this route would be adding more property to the rental market and this adds another layer to the relationship between the ownership and rental markets.

[15] See figure 23 in the Appendices.

Figure 11: Supply of residential housing and housing inflation



*12-month moving average
Sources: Stats SA and SARB

4. Still a soft market for now

In the second half of 2019, data showed a bit of positive news for consumers in the housing market. Confidence seemed to have somewhat returned and the number of registered mortgages was showing signs of improvement, albeit at a very slow pace. The other positive was that amid mortgage-lending competition, banks seem to be easing requests for deposits when property buyers request loans. But this was coming after a prolonged period of stringent borrowing conditions. Also, and probably more important from an inflation perspective, regional property prices were beginning to moderate in Western Cape and Gauteng.

Going into 2020, the economy is more fragile than ever and this will likely slow the recovery in the housing market. As we experience the COVID-19 outbreak, all sectors of the economy have become severely constrained. Under level 5 lockdown restrictions, people were not able to view, buy or move properties, and the deeds office was closed. Preliminary deeds office data show a 40% year-on-year decline in registration volumes, partly reflecting slowing activity amid COVID-19 concerns.[16] This is in addition to a drop in properties sold and registered in the first quarter, which includes the pre-lockdown period.[17] Moving to level 4 lockdown restrictions still limits the movement of people but the deeds office has opened, this should alleviate some of the strain in the market. However, the pandemic-induced recession, job losses and pay cuts are pressing concerns, especially if the recovery phase of the pandemic is stretched out.

Meanwhile, banks will be trying to assist existing clients struggling to repay mortgage bonds, never mind trying to attract new buyers. It is a tough climate that will cripple the economy for a few months at least, and potentially much longer. The residential construction market should slow on weak economic growth this year but this should not translate to higher housing inflation as the market remains oversupplied. However, there could be a silver lining for prospective property buyers. A combination of lower transfer

[16] Smith, C. (2020, April 16). *Property industry braces for 'deep, drawn out' recession to hit housing market*. Retrieved from fin24: https://www.fin24.com/Companies/Property/property-industry-braces-for-deep-drawn-out-recession-to-hit-housing-market-20200416

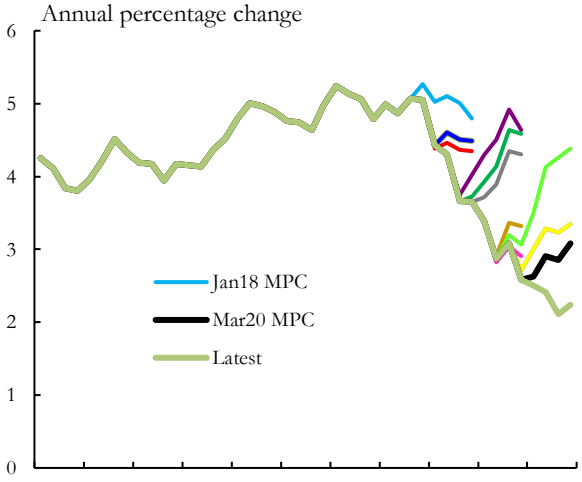
[17] Remax 2020Q1 national housing report: https://dl.airtable.com/.attachments/3f6d2ca45e1f45e2312f8346d22a751d/534ec755/HousingReportQ12020.jpg

duties for properties that cost less than R1 million, interest rate cuts of 225bp year-to-date, potentially eager sellers, and general oversupply of houses create favourable conditions for most buyers. Overall, the property market activity should remain fairly subdued as the world slowly recovers from the pandemic. In line with this, housing inflation can be expected to be muted.

The latest forecast shows housing inflation remaining below 3% for the remainder of 2020, posting 2.4% for the year, well below the midpoint. Given the historical upward forecast bias, risks remain to the downside in the near-term (Figures 12 and 13).

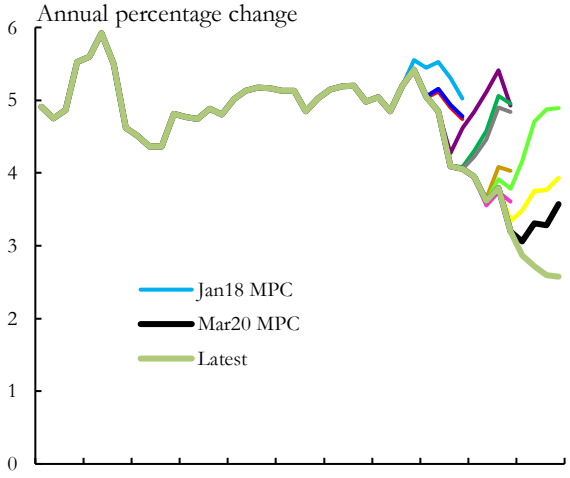
In the longer term, as construction moderates, so should the supply of housing, while population growth should support demand for residential property. But these are likely outside the forecast horizon.

Figure 12: OER forecast evolution
Annual percentage change



Source: SARB

Figure 13: Rental forecast evolution
Annual percentage change



Source: SARB

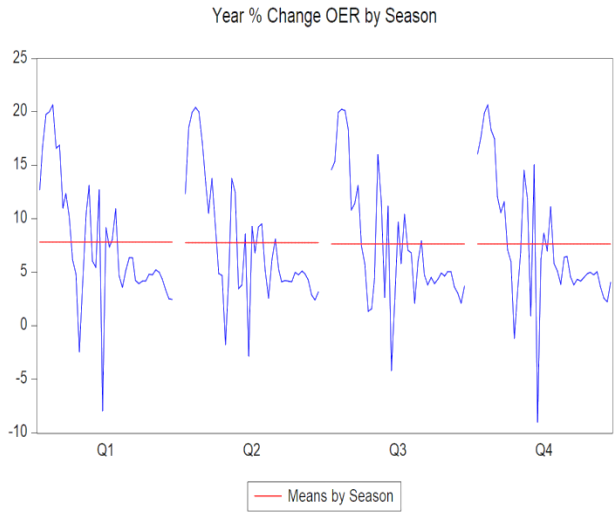
5. Conclusion

SA's residential property market remains under severe pressure from weak demand and oversupply, and house prices are declining in nominal and real terms. In addition to a rise in residential buildings supply, a prolonged period of tighter credit standards, weak employment growth, subdued economic growth, low levels of disposable income, and relatively high levels of household debt, are other factors that continue to put strain on the property market. The year-to-date 225 basis points cut by the SARB MPC will provide relief to consumers and ensure liquidity remains sufficient during the COVID-19 outbreak, but is unlikely to stimulate property demand. In addition, strict lockdown restrictions dampens any interest rate benefits to the property market since people have been limited in conducting the usual property market activities, like physical viewing of property and moving.

Given these fundamentals, the housing inflation forecast continues to be revised lower, and the latest expectation is for housing inflation to remain below 3% for the remainder of the year. This bodes well for services and headline inflation. Over the long-term, a moderation in residential property construction and population growth should support the housing market on condition that economic growth recovers.

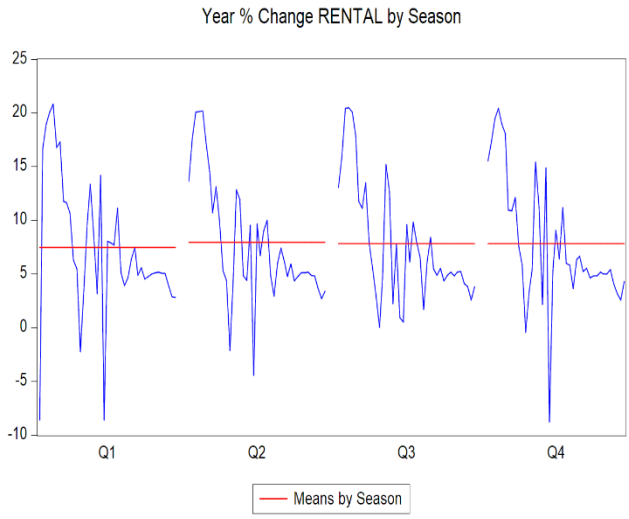
6. Appendices

Figure 14: OER seasonal chart



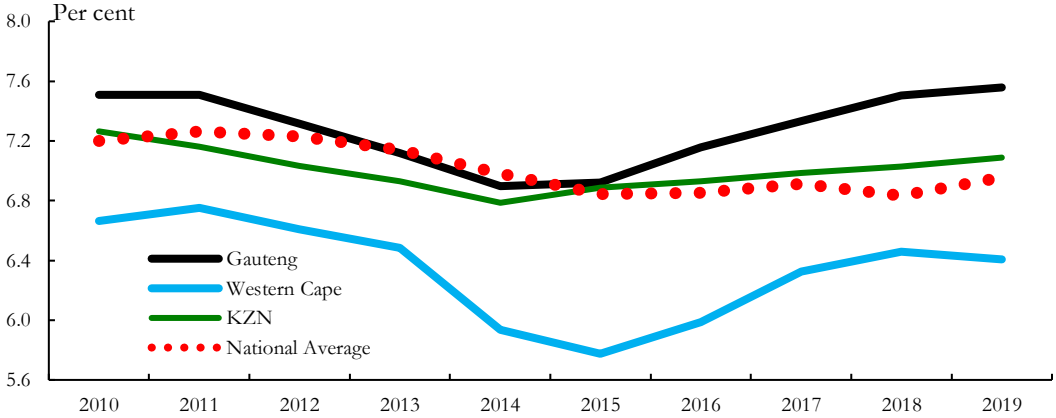
Source: Stats SA, SARB

Figure 15: Rentals seasonal chart



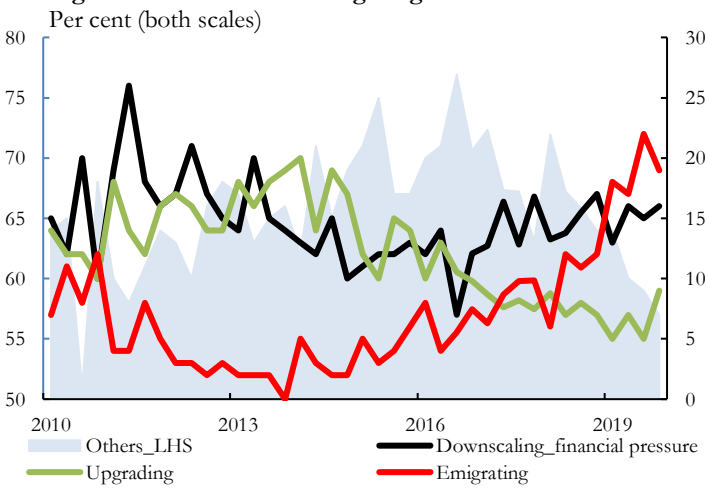
Source: Stats SA, SARB

Figure 16: Rental yields by province



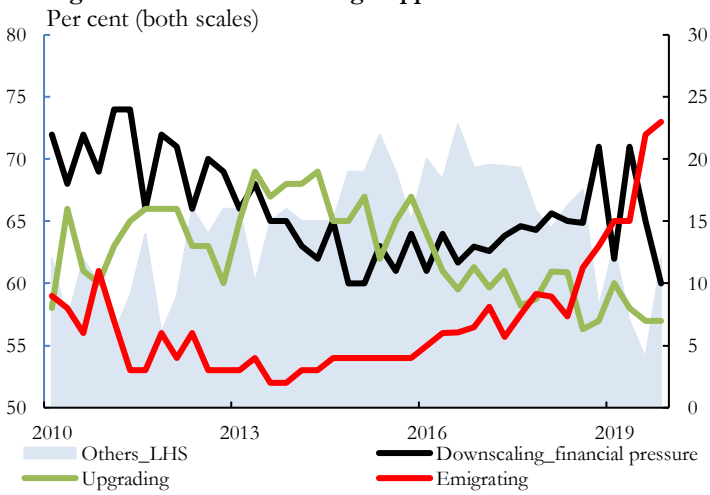
Sources: FNB and TPN

Figure 17: Reasons for selling - high net worth



Source: FNB

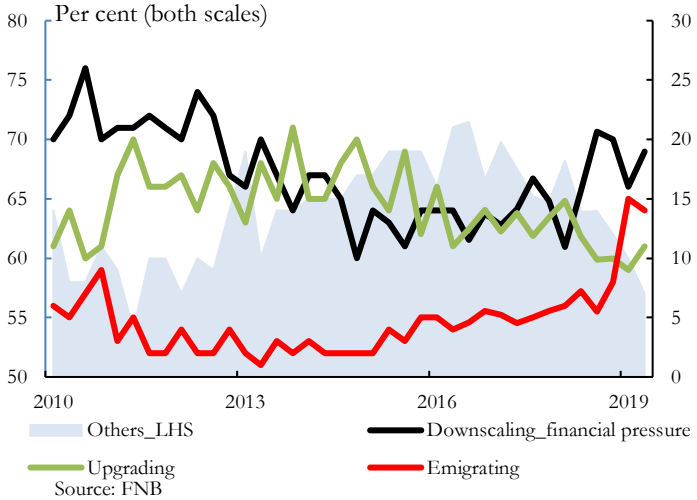
Figure 18: Reasons for selling - upper income



Source: FNB

Figure 19: Reasons for selling - middle income

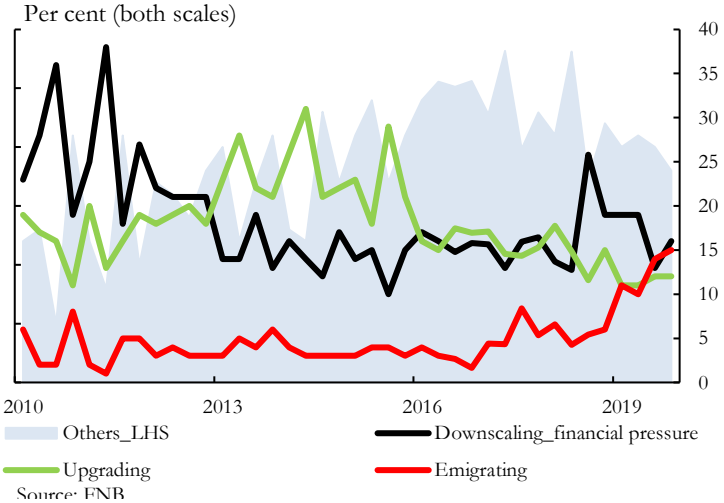
Per cent (both scales)



Source: FNB

Figure 20: Reasons for selling - lower income

Per cent (both scales)



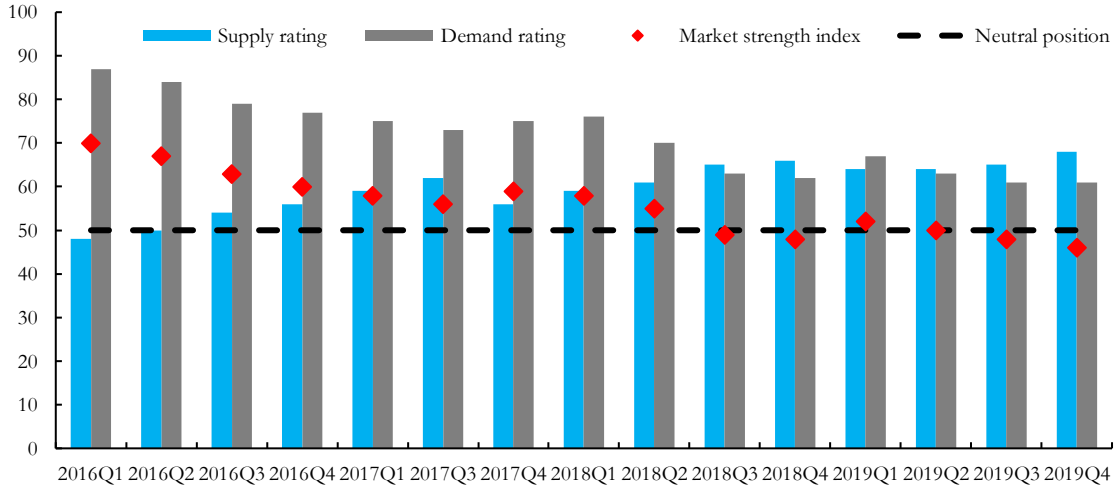
Source: FNB

Table 1: FNB survey results

Reasons for selling (% of Total Sales)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Downscaling for financial pressure	22.3	28.0	20.5	21.8	19.5	15.8	13.8	12.6	12.9	13.6	15.6	16.0
Downscaling with life stage	13.3	17.5	17.8	21.3	21.8	22.0	23.8	25.8	27.0	25.8	24.2	22.5
Emigrating	16.0	8.0	7.4	4.1	3.5	2.6	3.3	3.8	5.2	6.8	8.4	15.8
Relocating within SA	9.3	6.5	7.5	7.5	8.0	8.3	8.0	8.5	9.0	9.5	8.0	8.2
Upgrading	10.0	9.8	12.3	16.0	15.5	18.0	18.0	15.8	12.5	11.8	10.7	9.2
Moving for safety and security reasons	10.5	11.0	12.0	10.5	10.8	11.3	10.5	10.8	11.0	11.0	11.2	9.4
Change in family structure	12.3	13.8	14.5	11.8	13.5	13.0	13.5	14.5	15.5	14.3	15.1	12.4
Moving to be closer to work or amenities	6.3	5.8	8.5	7.0	7.5	9.0	9.0	8.0	7.3	6.5	6.4	6.4

Figure 21: Rental market strength

Index

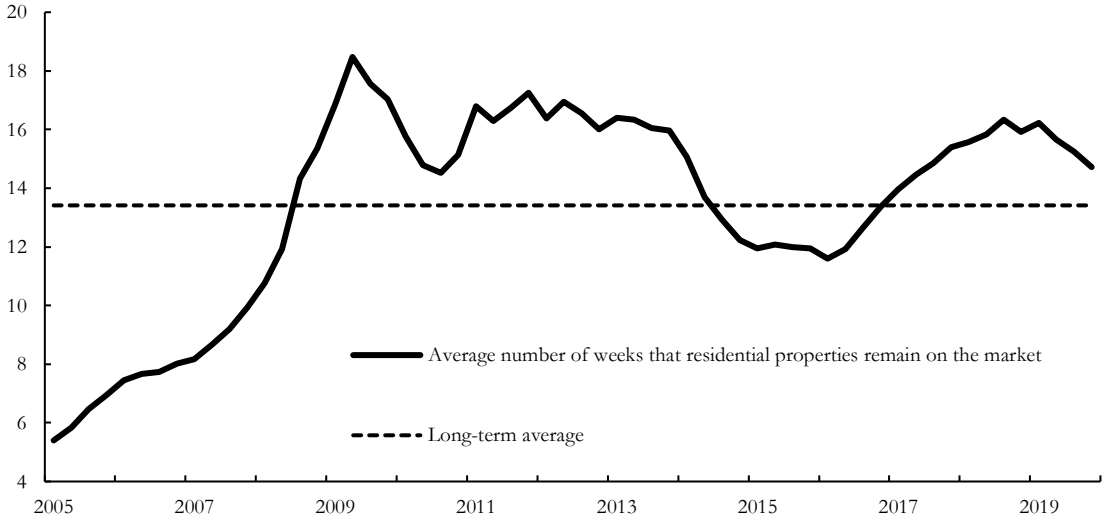


The rental market index is a sentiment index, surveying estate agents and landlords on whether they perceive demand and supply in their areas to be strong (100), weak (0) or average (50). The Market strength index is: (100+Demand rating-Supply rating)/2 and can be interpreted in the same way as the supply and demand ratings.

Source: TPN

Figure 22: Residential properties: weeks spent on the market

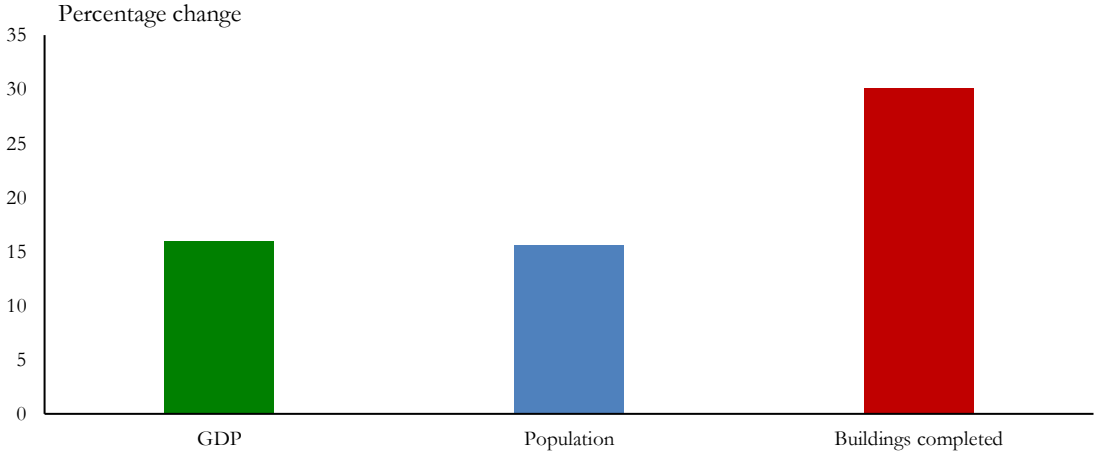
Weeks



Source: FNB

Figure 23: Growth (2010-2019)

Percentage change



Sources: Stats SA and SARB