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### In a nutshell

#### Focus article:

#### Fixed versus variable mortgage interest rates

- ▶ The primary objective of a fixed rate is to cap the interest rate on a mortgage loan at a certain level for a limited period. This helps households to cope with the negative effect of rapidly rising interest rates, making it possible for them to keep up with mortgage repayments and preventing banks from having to repossess properties.
- ▶ The decision to fix or not to fix rests entirely with consumers, which will depend on their personal financial position, trends and developments regarding various macroeconomic and other external factors which may impact on interest rates and, ultimately, consumers' view of the timing, magnitude and frequency of future interest rate adjustments. The decision will also be influenced by expectations regarding the duration of any upward or downward adjustment in interest rates.
- ▶ At the time of sharply higher interest rates in 1998, South African commercial banks' mortgage rates peaked at 23,5%, whereas the prime rate was hiked to an all-time high of 25,5%. It was during this period of extremely high interest rates that fixed rates became more popular with home-owners in South Africa.
- ▶ Inflationary pressures currently present in the economy, high growth in credit extension and household debt, as well as a deteriorating current account on the balance of payments, prompted the South African Reserve Bank to lift the repo rate by 50 basis points in June 2006. As a result, commercial banks increased their prime lending and mortgage rates by the same margin, while their fixed rates were also increased.
- ▶ When interest rates are hiked, many consumers, in view of their debt commitments, become uncertain about the future trend and level of rates and consider reverting to a fixed rate on their mortgage loans in an attempt to minimise the risk of sharply higher interest rates.

#### Recent house price trends

- ▶ House prices in the affordable segment of the market increased by 6,8% year-on-year in nominal terms in the second quarter of 2006. This represents price growth of 3% in real terms.
- ▶ Nominal house price growth of 14,3% year-on-year was recorded in the middle segment in the second quarter of 2006. In real terms, house price growth came to 10,2% year-on-year in the second quarter of the year.
- ▶ In the luxury segment of the market, house prices increased by a nominal 7,7% year-on-year in the second quarter of 2006. In real terms, house prices in this segment of the market increased by a real 3,9% in the second quarter of the year.

#### Outlook

- ▶ In view of an expected higher CPIX inflation rate towards the end of 2006, interest rates are forecast to rise by 50 basis points at each of the remaining Monetary Policy Committee meetings in August, October and December this year. This will bring the variable mortgage interest rate to a level of 12,5% by year-end.
- ▶ Nominal growth in house prices of around 12% is projected for this year compared with an increase of 22,9% recorded in 2005.

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## Focus article: Fixed versus variable mortgage interest rates

### Introduction

Over the past six years, the housing sector in South Africa has been booming, driven by a wide range of economic, social, cyclical and structural factors.

Probably one of the most important cyclical economic factors impacting on the housing market during this period has been the sharp declining trend in interest rates since they peaked in 1998 owing to the contagion effect of the Asian financial crisis. Significantly lower inflation since late 2002 has also contributed to interest rates dropping to their lowest level in more than two decades.

At the time of sharply higher interest rates in 1998, commercial banks' mortgage rates peaked at 23,5%, whereas the prime rate was hiked to an all-time high of 25,5%. The 200 basis points difference between mortgage rates and the prime rate at the time were an attempt by the banks to accommodate clients experiencing difficulty in paying high mortgage instalments. It was during this period of extremely high interest rates that fixed rates became more popular with home-owners.

The primary objective of a fixed rate is to cap the interest rate on a mortgage loan at a certain level for a limited period. This helps households to cope with the negative effect of rapidly rising interest rates, making it possible for

them to keep up with mortgage repayments and preventing banks from having to repossess properties.

At a time when interest rates in South Africa appear to have reached a lower turning point, this article focuses on the issue of fixed versus variable mortgage interest rates.

The analysis starts by outlining the difference between a fixed and a variable mortgage rate. It then sets out the advantages and disadvantages of each of these two types of rates. The question of whether or not to fix a mortgage interest rate is then discussed, followed by an analysis of international and South African developments with regard to fixed and variable mortgage rates.

### The difference between fixed and variable mortgage rates

#### Fixed mortgage rate

A fixed mortgage rate agreement is a legally binding contract between a financial institution and a client that guarantees a fixed rate of interest over a pre-determined period. The agreement may not be terminated prior to the expiry of the contracted term of the agreement. The implication of withdrawing from the contract before the expiry date is the payment of a penalty fee, which is stipulated in the agreement.

<b>Nominal house prices</b> Year-on-year % change										
Country	2004				2005				2006	Total % change 1997-2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1 <sup>1</sup>	
Australia	17,9	12,7	8,2	0,2	0,1	-0,1	1,0	2,3	3,6	119
Britain	16,9	19,4	19,3	14,3	10,1	2,3	2,4	3,7	4,6	176
Canada	5,7	7,0	6,9	6,2	5,7	4,3	4,4	5,7	7,7	57
China	7,7	10,4	9,9	10,8	9,8	8,0	6,6	5,1	5,6	-
Denmark	6,0	7,9	9,7	11,8	13,2	12,2	14,3	17,7	21,3	92
France	14,7	14,9	15,5	15,9	15,7	14,5	14,2	14,7	14,2	115
Hong Kong	17,4	29,1	31,2	29,5	22,1	22,1	14,1	5,8	-3,2	-43
Ireland	13,2	11,9	11,5	9,7	7,9	6,2	7,2	10,2	13,2	231
Italy	10,8	10,8	9,7	9,7	8,5	8,5	7,3	7,3	7,3	81
Japan	-6,4	-6,4	-6,0	-6,0	-5,4	-5,4	-4,7	-4,7	-3,9	-31
Netherlands	5,5	3,9	2,9	2,4	1,6	4,2	5,6	6,0	5,4	86
New Zealand	21,3	22,3	16,4	12,2	13,4	14,2	14,5	16,8	14,8	93
Singapore	-1,5	-0,8	0,0	0,9	2,0	2,4	3,3	3,9	4,7	-
South Africa	28,2	31,2	34,7	34,3	29,3	25,2	20,7	17,8	16,4	322
Spain	17,2	17,4	16,8	17,2	15,7	13,7	13,4	12,8	12,0	165
Sweden	7,7	9,7	9,8	10,0	10,0	8,3	9,5	10,5	13,5	109
Switzerland	3,4	2,1	2,2	2,2	1,4	0,5	1,3	1,6	2,4	16
United States	8,2	9,9	12,9	12,0	13,2	14,1	12,7	13,3	12,5	95

<sup>1</sup>Or latest available at the time  
Sources: Absa, OFHEO, *The Economist*

Currently, South African commercial banks offer clients fixed mortgage rates for periods of 12, 18 or 24 months. The level of the fixed rate varies according to the period over which it is fixed, as well as the loan amount and the loan-to-value ratio.

### Variable mortgage rate

Commercial banks' variable lending rates to the public normally fluctuate in line with the central bank's key policy interest rate.

Adjustments to South African commercial banks' variable lending rates (the prime and mortgage rates) normally take place after the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) has announced a change to its key policy interest rate, the repurchase (repo) rate.

Although this has not always been the case in the past, the current convention among the South African commercial banks is to adjust their variable lending rates by the same margin as the adjustment in the repo rate. As a result, the margin between the repo rate and variable lending rates such as the prime and mortgage rates has remained stable at 3,5 percentage points since the late 1990s.

### The advantages and disadvantages of fixed and variable mortgage rates

#### Fixed mortgage rate

- ▶ **Advantages:** A fixed mortgage rate will not increase when other interest rates rise. This gives peace of mind with regard to future mortgage repayments. It allows the client to plan and budget more accurately and facilitates future cash flow management. Clients may revert to the variable rate after the fixed-rate contract has expired, or may decide on a new fixed-rate contract, depending on their personal financial circumstances and views of the future interest rate cycle.

- ▶ **Disadvantages:** A fixed mortgage rate may well be above the variable rate for the full term of the fixed-rate contract. The gap between fixed and variables rates may widen if variable rates fall during the term of a fixed-rate contract. Clients are locked in for the full term of a fixed-rate contract.

#### Variable mortgage rate

- ▶ **Advantages:** Clients get the immediate and full benefit of a cut in interest rates, while they may at any time switch to a fixed-rate contract in an attempt to hedge interest rate risk. Under certain conditions and terms, clients may gain a rate concession (negotiate a mortgage rate lower than the prevailing variable rate, depending on certain terms and conditions).
- ▶ **Disadvantages:** Clients feel the immediate and full impact of any increase in interest rates. Sharp increases in interest rates may affect clients' ability to repay mortgage loans to such an extent that the financial institution has no other option but to repossess the properties concerned because instalments are not being paid. However, this is normally the last option, as such actions benefit neither the client nor the financial institution.

The various options currently available with regard to fixed and variable mortgage rates have increased the flexibility of managing the repayments on a mortgage loan to a large extent. Clients can take market conditions and interest rate expectations into account in their choice of a mortgage rate.

#### Whether or not to fix a mortgage rate

The decision whether or not to fix the interest rate on a mortgage loan will depend on the following factors:

- ▶ **Macroeconomic conditions and their possible impact on the interest rate cycle.** Factors such as inflationary pressures, growth in credit extension, the level of household debt, currency movements, and the condition

Predominant type of mortgage interest rate and house price growth

Country	Mortgage interest rate	Standard deviation in house price growth 2004-2006	Country	Mortgage interest rate	Standard deviation in house price growth 2004-2006
Australia	Variable	6,5	Japan	Fixed	0,9
Austria	Fixed	-	Netherlands	Fixed	1,6
Belgium	Fixed	-	Norway	Variable	-
Canada	Fixed	1,1	Portugal	Variable	-
Denmark	Fixed	4,7	South Africa	Variable	6,8
Finland	Variable	-	Spain	Variable	5,4
France	Fixed	0,6	Sweden	Variable	1,6
Germany	Fixed	-	Switzerland	Variable	0,8
Ireland	Variable	2,6	United Kingdom	Variable	7,3
Italy	Fixed	1,4	United States	Fixed	1,9

Sources: Absa, BIS, OFHEO, *The Economist*

of the balance of payments (which will depend on the balance on the current account and capital flows) may influence the central bank's monetary policy stance (the direction of interest rates, as well as the magnitude and duration of interest rate adjustments).

- ▶ **Consumers' personal financial circumstances.** Interest rates may be at a historical low at any given point in time, but if consumers have the view that rates will increase for any reason in the near future, they may elect to switch to a fixed rate, especially if they have a fixed level of income and strict control over cash flow is important to them.
- ▶ **Timing.** The timing of the decision to fix a mortgage rate can be of great importance. The best time to fix an interest rate is as near as possible to the time when rates are expected to start increasing (the bottom of the interest rate cycle). If rates are expected to increase only in twelve months time, it may be expensive to fix the rate too early at a level that is above the variable rate at the time. However, if you wait too long before fixing your mortgage rate and interest rates increase, the eventual fixed rate may be higher than what you would have paid if you fixed the rate at a somewhat earlier stage.

The following example illustrates the impact of a fixed and a variable mortgage rate under changing interest rate conditions:

Based on expectations that the variable mortgage rate is to increase from its current level of 11% in the near future, a client decides to fix the rate on his mortgage loan at 12% over a period of 18 months. As a result, the repayment on his mortgage loan of R300 000 over a 20-year period will increase by R206 from R3 097 to R3 303 per month.

However, variable interest rates remain stable for another six months before increasing from 11% to 12%. The client pays an extra R1 236 as a result of having a fixed mortgage rate of 100 basis points above the prevailing variable rate during that period. For the remaining 12 months of the fixed-rate agreement, there is no saving or further loss.

Under the abovementioned interest rate scenario, had the client decided to stick to the variable rate during the 18-month period, he would have paid an extra R2 472 over the remaining twelve month period after the variable rate increased from 11% to 12%. Compared with the fixed-rate

scenario, his loss would have been an additional R1 236 over the 18-month period.

However, had the client decided to fix his mortgage rate at 12% for 18 months and the variable rate increased by only 50 basis points to 11,5% six months after he opted for the fixed-rate agreement, his total loss would have been R2 484. Had he decided to fix his mortgage rate at 12% while the variable rate was 11% and interest rates dropped instead of increasing, his loss would have been even bigger under the fixed-rate contract.

The abovementioned example illustrates the fact that the net result of a decision to fix or not to fix a mortgage rate may be significantly influenced by the view of the future direction of interest rates, the magnitude of interest rate adjustments, as well as the timing of the decision to fix or not to fix.

### International developments

The predominant type of interest rate applying to mortgage loans varies significantly across countries (see table p. 3). However, the distribution is 50-50 among those countries analysed, with ten having predominantly fixed mortgage rates and ten having predominantly variable rates.

The sensitivity of the housing market to adjustments in interest rates has proven to be lower in countries with predominantly fixed mortgage rates compared with those with predominantly variable rates. This is because the effect of unexpected and large interest rate hikes on households, and thus the housing market, is lessened in fixed-rate countries.

The higher the level of securitisation of mortgage loans, the lower the risk to financial institutions. In the US, a fixed-rate mortgage loan may have a term of up to 30 years, and is mostly financed through institutions such as Fannie Mae and Freddie Mac. These institutions securitise their mortgage loan books in an attempt to minimise the risk of interest rate fluctuations.

The difference between fixed-rate countries and variable-rate countries is illustrated in the table on p.3 by the standard deviation in house price growth between the first quarter of 2004 and the first quarter of 2006. In most fixed-rate countries, the standard deviation was relatively small.

Absa's fixed mortgage interest rates <sup>1</sup>						
Loan value R'000	12 months		18 months		24 months	
	LTV of <80%	LTV of ≥80%	LTV of <80%	LTV of ≥80%	LTV of <80%	LTV of ≥80%
R100-R199	12,55%	12,80%	12,65%	12,90%	12,80%	13,05%
R200-R350	12,25%	12,50%	12,30%	12,55%	12,45%	12,70%
R351-R500	12,00%	12,25%	12,15%	12,40%	12,25%	12,50%
R501+	11,70%	11,95%	11,85%	12,10%	11,95%	12,20%

<sup>1</sup>Rates as at 10 July 2006.  
LTV = Loan-to-value ratio  
Source: Absa

In the case of variable-rate countries, the standard deviation was significantly bigger.

However, in the case of Denmark and the US, both countries with predominantly fixed mortgage rates, the variation in house price growth, as measured by the standard deviation, was relatively big (respectively 4,7 and 1,9) compared with the rest of the fixed-rate countries mentioned in the table. This may be the result of refinancing costs in these two countries being relatively low compared with other fixed-rate countries, which may impact positively on the demand for housing, leading to higher levels of house price growth.

In recent years, many households in fixed-rate countries have taken advantage of lower interest rates to increase the size of their mortgage loans in an attempt to trade up to larger, more luxurious homes. These developments have supported the demand for housing and the growth in house prices in many countries.

### South African developments

Most mortgage loans in South Africa are of the variable-rate type. Over the years, the mortgage interest rate has shown substantial variations. At times in the past, it has deviated from the prime lending rate (see graph on interest rates, below).

Although the mortgage rate is not the only factor influencing the housing market, it is regarded as a very important variable impacting the performance of the market. In the past, there has largely been an inverse correlation between the mortgage rate and the growth in house prices (see graph on interest rates and nominal house price growth, p.6). However, since late 2004, the two variables have been moving in tandem. The sharp increase in house prices since 2000 has made housing much less affordable during the past few years. As a result, the market has slowed down, causing price growth to move to lower levels, while interest rates have remained low.

Because of the tough competition between the South African commercial banks for mortgage loan business, they

have constantly launched innovative products and marketing campaigns in an attempt to keep existing clients and attract new ones, many of whom have not previously had access to finance at banks.

As a result, many home-owners have been able to negotiate a home loan at a lower interest rate than the variable mortgage rate during the past number of years.

These developments have made a mortgage one of the most flexible banking products and also one of the cheapest forms of credit in recent times. It is now much easier for people to afford housing and repay a mortgage loan than it was a decade or two ago.

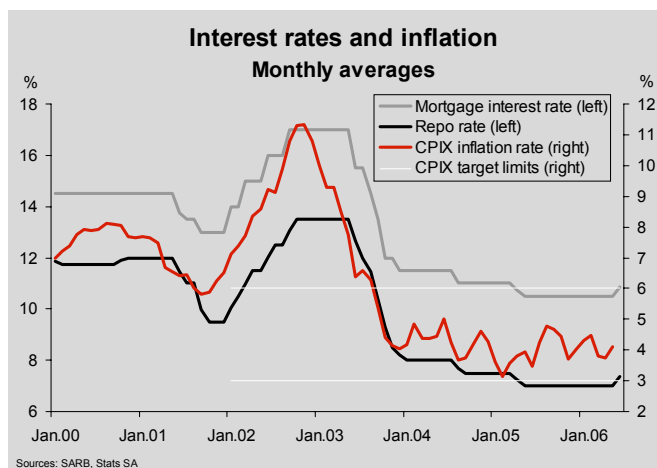
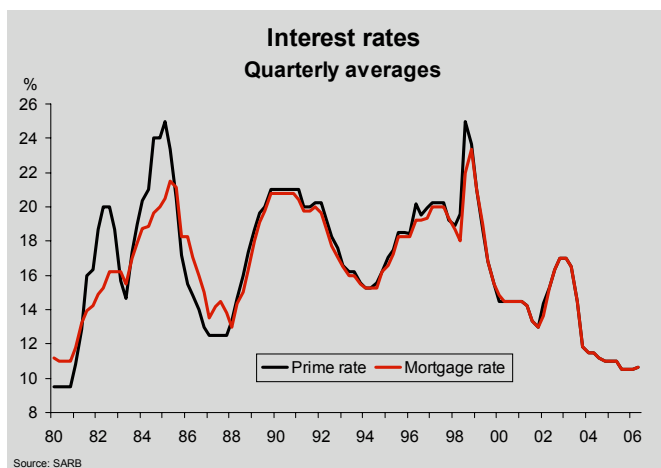
Mortgage rate movements over the years have also had a large impact on the affordability of mortgage debt (see graph on interest rates and the affordability of mortgage debt, p.6). Whereas house prices have risen sharply since 2000, the mortgage debt servicing cost has not shown a significant increase, mainly as a result of steadily declining interest rates over this period.

During 1998, when the prime interest rate was hiked to a record level of 25,5% and variable mortgage interest rates increased to 23,5%, fixed-rate mortgages became more common in South Africa. This development gave huge support to many households that were struggling with significantly higher debt repayments, helping them to survive the adverse effects of extremely high interest rates at the time.

Because financial institutions have to take most of the risk of fixed-rate mortgages, as well as the history with regard to interest rate fluctuations in South Africa, the maximum period over which a fixed rate on a mortgage loan is offered by South African commercial banks is 24 months.

However, households are also required to take on some of the risk by having to pay a higher fixed rate than the prevailing variable rate, depending on the loan amount, the loan-to-value ratio and the period of the fixed-rate contract. (The contract can be for a period of 12, 18 or 24 months. See table depicting Absa's fixed mortgage rates, p.4).

In recent years, the focus of monetary policy in South



Africa has been on keeping inflation within a certain target range. Currently, the SARB's mandate is to keep CPIX inflation (headline CPI inflation, excluding the effect of mortgage interest rates) within the target range of 3%-6%. CPIX inflation has declined sharply since late 2002 and has been within the inflation target range since September 2003. As a result, lending rates such as prime and mortgage rates dropped to their lowest level in decades (see graphs on the prime and mortgage rate, and interest rates and inflation, p.5).

Inflationary pressures currently present in the economy, high growth in credit extension and household debt, as well as a deteriorating current account on the balance of payments, prompted the SARB to lift the repo rate by 50 basis points in June this year. As a result, commercial banks increased their prime lending and mortgage rates by the same margin shortly afterwards.

It is at times like these that many consumers, in view of their debt commitments, become uncertain about the future

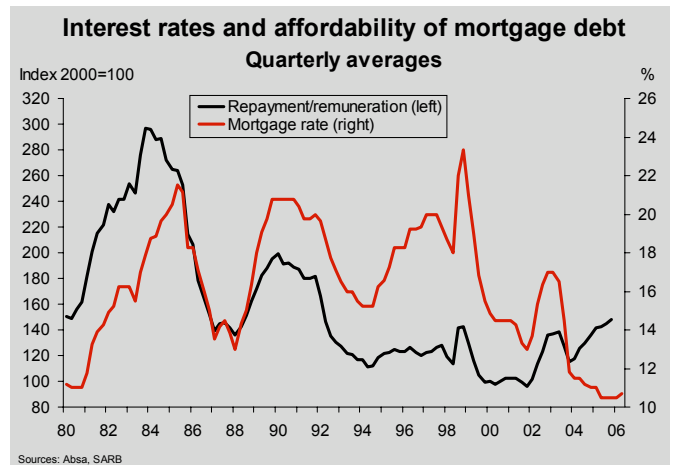
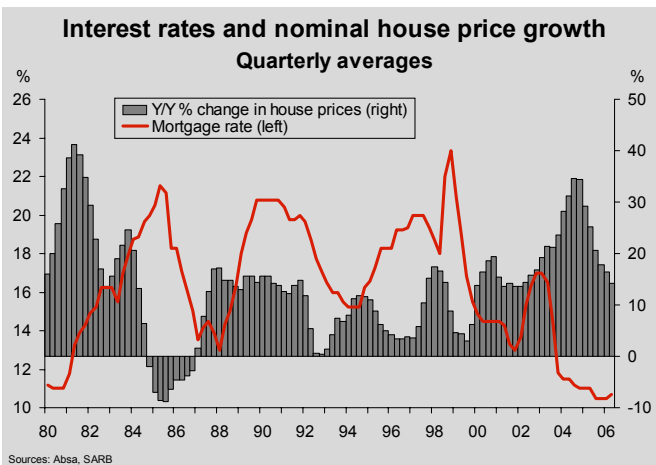
trend and level of interest rates and consider reverting to a fixed rate on their mortgage loans in an attempt to minimise the risk of sharply higher interest rates.

Current projections are for domestic interest rates to increase somewhat further over the next twelve months, but to remain low by historical standards.

### Conclusion

Fixed and variable mortgage interest rates have both advantages and disadvantages. The decision to fix or not to fix rests entirely with consumers.

This decision will depend on consumers' personal financial position, trends and developments regarding various macroeconomic and other external factors which may impact on interest rates and, ultimately, consumers' view of the timing, magnitude and frequency of future interest rate adjustments. Consumers' decisions will also be influenced by expectations regarding the duration of any upward or downward adjustment in interest rates.



## Residential property market

### Macroeconomic and household sector overview

Real economic growth accelerated to 4,2%, at a seasonally adjusted annualised rate in the first quarter of 2006 compared with 3,2% in the fourth quarter of 2005. The stronger growth in the first quarter was mainly the result of a significantly higher rate of expansion in the manufacturing sector – around 4,5%, compared with a decline of about 0,5% in the fourth quarter of last year.

In the first quarter of 2006, the ratio of household debt to disposable income increased further to an all-time high of 68,2% from 65,6% in the previous quarter. This was the result of continued high growth in private sector credit extension on the back of low interest rates and strong consumer demand. The cost of servicing household debt increased marginally from 7% in the final quarter of 2005 to 7,3% of household disposable income in the first quarter this year.

The ratio of household net saving to disposable income hit an all-time low of -0,1% in the first quarter of 2006. The low interest rates of the past two years, which offered no real incentive for households to increase deposit-type investments, together with high levels of geared consumer demand, were the main contributors to this low savings ratio. Growth of 20% per annum in nominal house prices in 2000-2005 and further price growth of 15,3% year-on-year in the first half of 2006 caused the consumption of fixed capital (depreciation write-offs on the value of fixed assets held by households) to increase significantly. This figure is subtracted from gross saving to arrive at net saving. These higher levels of depreciation also contributed to the net saving-to-income ratio turning negative in the first quarter this year.

Seasonally adjusted annualised growth in the real disposable income of households remained strong at 6,1% in the first quarter of 2006. This can be ascribed to further

personal tax relief, whereas CPI inflation remained stable at just below 4% in the first quarter.

The following macroeconomic and household sector related developments occurred in the second quarter of 2006:

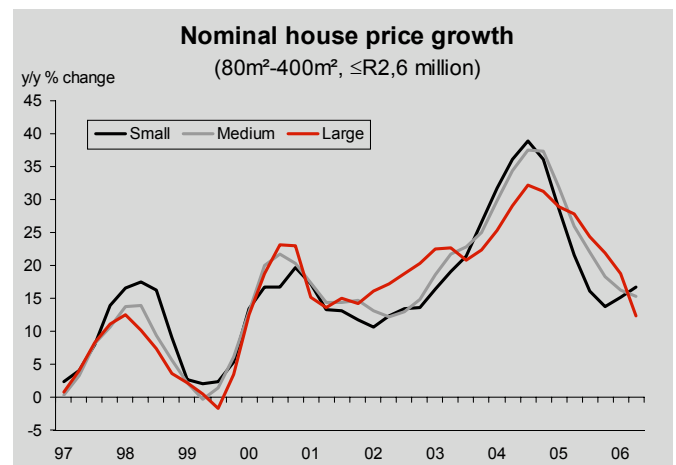
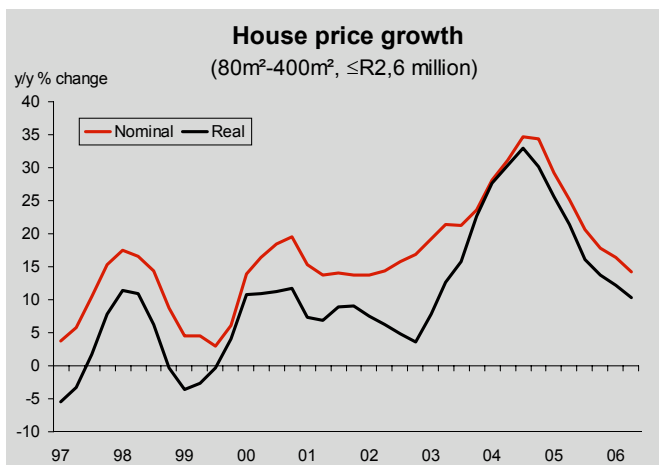
- ▶ Domestic fuel prices increased further in reaction to sustained high international oil prices and a weaker rand exchange rate.
- ▶ Both headline consumer price inflation and CPI inflation (headline CPI inflation, excluding the effect of mortgage interest rates) increased to higher levels.
- ▶ The Reserve Bank's Monetary Policy Committee hiked the key monetary policy interest rate, the repo rate, by 50 basis points in June. As a result, commercial banks' lending rates (the prime overdraft rate and the mortgage rate) were adjusted upwards by the same margin.
- ▶ Growth in domestic private sector credit extension, especially mortgage advances, remained high.

### Revisions of cut-off points in house prices

South African residential property prices increased by a massive 32,2% in nominal terms in 2004 and another 22,9% increase was recorded in 2005. In the first six months of 2006, nominal house price growth came to 15,3% year-on-year.

As a result of the continued increase in house prices, it was decided to adjust the cut-off prices for residential properties in the various segments of the market as defined by Absa. This decision was made because keeping the cut-off prices constant for too long will result in an increasing number of properties at the upper end of each of the market segments migrating to the next category, or being excluded, in the case of the upper end of the market.

Absa differentiates between three broad categories of housing. These categories are the affordable housing market (houses of between 40m<sup>2</sup> and 79m<sup>2</sup>, priced at up to R226 000 in 2006 – previously R193 000), the middle



segment of the market (houses of between 80m<sup>2</sup> and 400m<sup>2</sup>, priced at up to R2,6 million in 2006 – previously R2,2 million) and the luxury market (no size limits, but priced from above R2,6 million up to R9,5 million in 2006 – previously R2,2 million to R8,2 million).

## House prices in the second quarter of 2006

### Affordable housing

In the second quarter of 2006, nominal house prices in the affordable category increased by 6,8% y/y compared with an increase of 10,5% y/y in the preceding quarter. In real terms, house price growth in this category came to 3,0% y/y in the second quarter this year, whereas real y/y growth of 6,5% was recorded in the first quarter.

### Middle-segment housing

In the second quarter of 2006, nominal house prices in the middle segment of the market increased by an average 14,3% year-on-year (y/y) to about R792 600 (16,4% y/y growth recorded in the first quarter). The 14,3% y/y increase was the lowest nominal growth in any quarter since the first quarter of 2002, when a growth rate of 13,7% was recorded. In real terms, house price growth came to 10,2% y/y in the second quarter compared with 12,2% in the first quarter of the year.

In the three middle-segment categories, house price growth was as follows in the second quarter of 2006:

- ▶ Small houses (80m<sup>2</sup>-140m<sup>2</sup>): a nominal 16,7% and a real 12,2% higher.
- ▶ Medium houses (141m<sup>2</sup>-220m<sup>2</sup>): a nominal 15,3% and a real 10,8% higher.
- ▶ Large houses (221m<sup>2</sup>-400m<sup>2</sup>): a nominal 12,4% and a real 8,0% higher.

In the category for small houses, year-on-year nominal price growth bottomed at 13,8% in the fourth quarter of 2005 and has since increased to 15,2% and 16,7% respectively in the first and second quarters of 2006.

Nominal year-on-year growth in house prices in both the medium and large categories continued to trend downwards in the second quarter (see graph).

The rising trend in the price growth of smaller houses in the first half 2006 can be ascribed to the fact that housing, in general, has become less affordable in recent years, shifting the focus to smaller properties. This is regarded as one of the contributing factors to changing residential living trends away from big, single-stand properties to smaller, higher-density properties in security villages and complexes, especially in the major metropolitan areas around the country (also see the focus article in the *Residential Property Perspective* of the second quarter 2006).

### Luxury housing

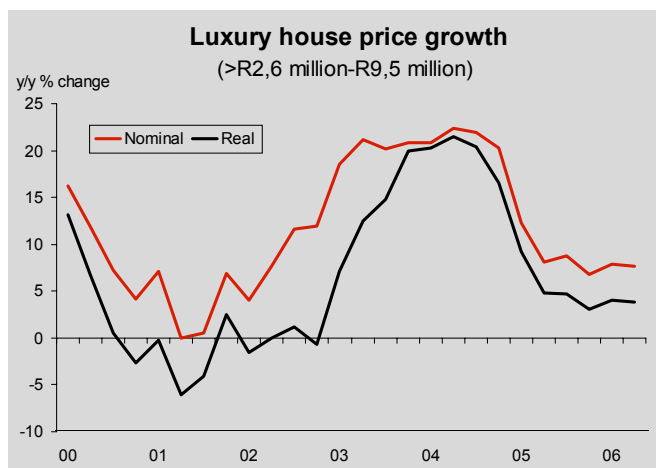
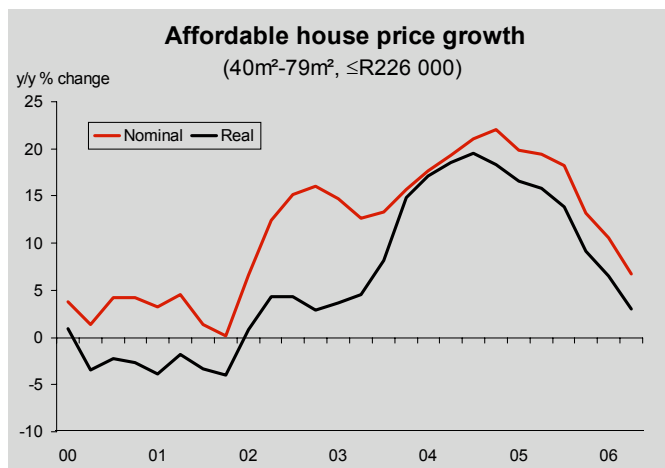
Nominal house prices in this segment of the market increased by an average 7,7% y/y in the second quarter of 2006 compared with an increase of 7,9% y/y in the first quarter. In real terms, house prices in the luxury category increased by 3,9% y/y in the second quarter of the year, following a real price increase of 4,0% y/y in the first quarter.

The continued low growth in house prices at the upper end of the market since the second quarter of 2005 is related to a strong supply of properties in this market segment during recent years, whereas demand started to taper off in late 2004 because of the high prices caused by strong price growth in 2003 and 2004.

### Regional house prices

On a provincial basis, growth in house prices in the middle segment of the market remained relatively strong in some provinces in the second quarter of 2006. Nominal house price growth varied from as high as 35,1% y/y in Limpopo to only 11,5% y/y in the Eastern Cape.

In the country's major metropolitan areas, nominal house price growth varied from 21,5% y/y in the central and southern parts of Johannesburg in the second quarter of 2006 to 4,9% y/y in the Port Elizabeth/Uitenhage area.



The low price growth in the Port Elizabeth/Uitenhage area and the Eastern Cape compared with the other metro regions and provinces in the country in the second quarter of the year can be ascribed to a growth rate of more than 30% y/y in house prices recorded in the Port Elizabeth/Uitenhage metro and the Eastern Cape in the second quarter of 2005, which created a high base of calculation twelve months later.

### Building costs and new and existing house price trends

The cost of building a new house increased by a nominal 10,3% y/y in the second quarter of 2006, compared with a growth rate of 11,2% y/y in the preceding quarter. This above-inflation increase in building costs reflected an active building and construction sector over the past twelve months. Factors such as a strong demand for building materials and skilled labour in view of the demand for new housing have contributed to this development.

However, the nominal y/y growth in building costs continued its downward trend, which commenced in the third quarter of 2003, into the second quarter of 2006. This can be ascribed to the large number of developers and building contractors active in the property market, which leads to greater competition.

The average price of a new house increased by a nominal 9,1 % y/y to about R801 200 in the second quarter of 2006, which meant an increase of 2,4% y/y in real terms. The average price of an existing house increased by a nominal 15,6% y/y to about R792 400 in the second quarter, which brought the real price increase to 11,1% y/y.

The nominal price difference between new and existing houses declined to only about R8 800, or 1,1%, in the second quarter of 2006. This is the smallest price difference since early 1989. The price difference between new and existing houses has declined sharply since the first quarter of 2003, when it reached an all-time high of R173 100, or 31,1%.

### Land prices

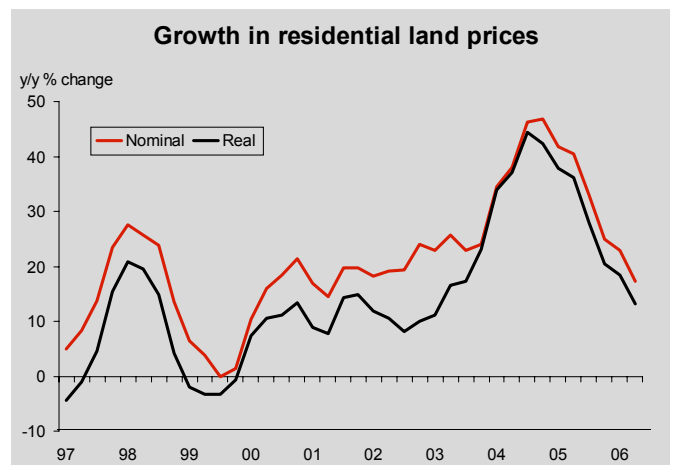
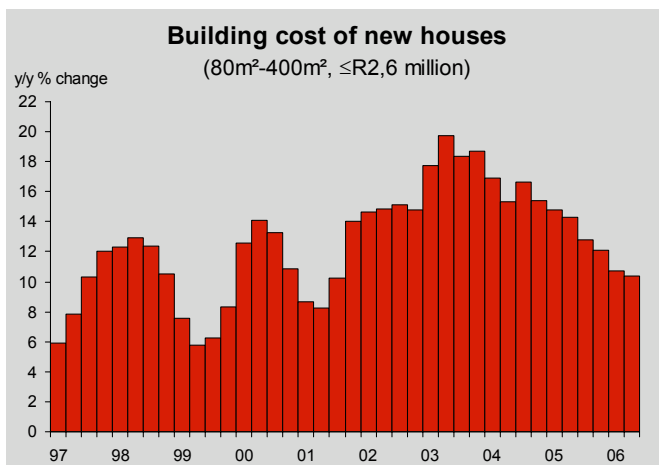
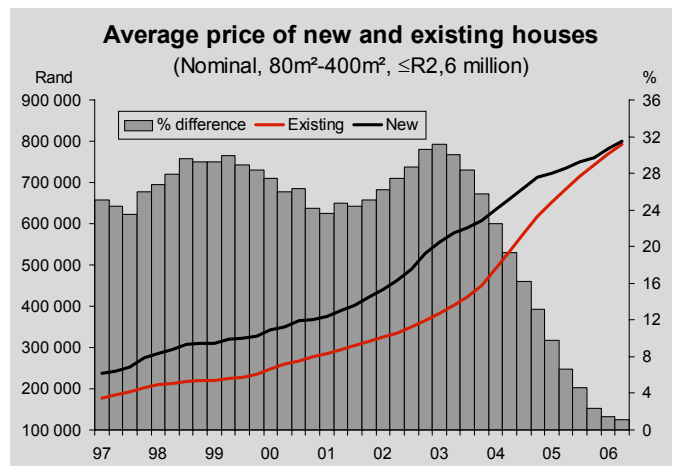
In the second quarter of 2006, nominal residential land prices increased by 17,3% y/y to about R280 200 on average, compared with growth of 22,9% y/y in the first quarter. Real growth in land prices of 13,1% y/y was recorded in the second quarter compared with 18,5% y/y in the previous quarter.

The scarcity of suitable and properly serviced land for residential development has been a problem for some time, especially in the rapidly growing urban areas of the country. These conditions are not expected to improve materially and will be reflected in vacant land prices in years to come. Along the coast, residential land with good views have also increased significantly in value over the past few years. As the supply of and demand for vacant land are, to a large extent, moving in opposite directions in these areas, prices are expected to escalate further in future.

### Mortgage finance

Commercial banks' variable mortgage interest rates increased by 50 basis points to 11% in June this year after the Reserve Bank's Monetary Policy Committee decided to hike the repo rate by the same margin to 7,5% at its June meeting.

Based on an average house price of R792 627 in the



middle segment of the market in the second quarter of 2006, the monthly repayment on a new mortgage (100% over a 20-year repayment period at a variable mortgage rate averaging 10,7%) amounted to R8 002. In the same quarter of last year, the comparable repayment was R6 956, calculated at an average house price of R693 603 and an average mortgage rate of 10,6% at the time. The difference of R1 046 between these monthly repayments can be ascribed to house prices being 14,3% higher in the past quarter than they were a year ago, whereas the mortgage rate was on average 10 basis higher than in the second quarter of 2005.

### Affordability of housing

Based on interest rate and house price trends in the second quarter of 2006, the average mortgage repayment and the qualifying gross income levels were 15,0% up on the same quarter last year. In the second quarter of 2005, this growth rate was still at 17,7%.

The house price-to-remuneration ratio increased somewhat further in the fourth quarter of 2005 (most recent remuneration data available). This was the net result of house prices increasing by 17,8% y/y at the time, whereas nominal growth in remuneration was 4,6% in the fourth quarter of 2005 compared with 8,4% in the third quarter.

The mortgage repayment-to-remuneration ratio, which can also be regarded as an indication of the affordability of mortgage debt, increased further in the fourth quarter of last year. Although the ratio of mortgage debt to the disposable income of households increased to an all-time high of almost 54% in the first quarter of 2006, the affordability ratio has displayed a more gradual rising trend since 2002

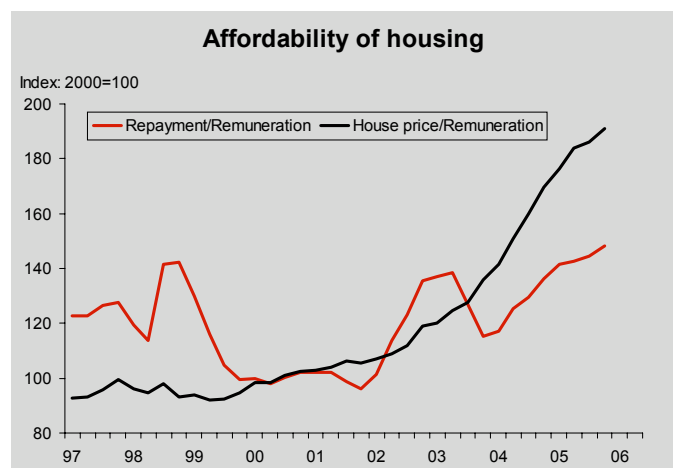
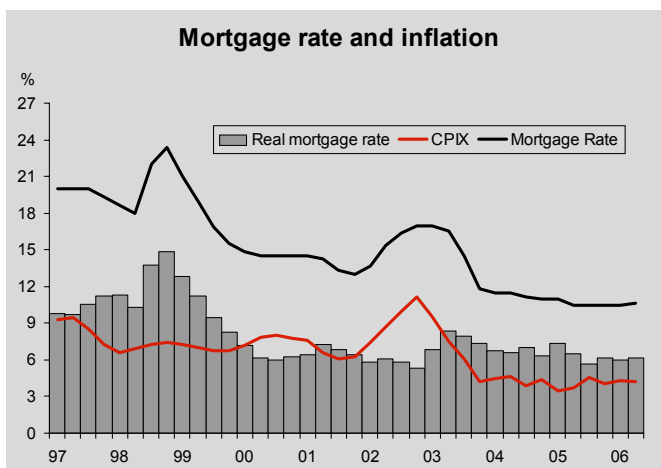
than in the case of the house price-to-remuneration ratio (see graph below). These developments in the mortgage repayment-to-remuneration ratio can be ascribed to slower-growing house prices and stable interest rates over the past twelve months, whereas growth in remuneration remained relatively strong.

An increase in the abovementioned two ratios implies that house prices and mortgage repayments are rising at a faster rate than remuneration. This means that housing is, in effect, becoming less affordable.

### Outlook

CPIX inflation increased in the second quarter of the year on the back of a weaker rand exchange rate, an international oil price that remained above the \$70/barrel level and higher food price inflation. CPIX inflation is projected to rise further to about 6% by year-end. The deficit on the current account of the balance of payments increased substantially to 6,4% of GDP in the first quarter of 2006, which contributed to the rand depreciating significantly against the major international currencies. Year-on-year private sector credit extension remained high, with mortgage advances growth still at around 30% compared with a year ago.

Against this background, interest rates are forecast to rise further, by 50 basis points at each of the remaining Monetary Policy Committee meetings in August, October and December this year. This will bring the prime interest rate and the variable mortgage interest rate to 12,5% at year-end. As a result of these expectations, house prices are projected to increase by around 12% y/y in nominal terms this year.



## Statistics and projections

Average nominal house prices											
	2002 Rand	2003 Rand	2004 Rand	2005 Rand	2005			2006			
					Q2 Rand	Q3 Rand	Q4 Rand	Q1 Rand	Q2		
									Rand	q/q % Δ	y/y % Δ
<b>National</b>											
<b>Middle segment (80m<sup>2</sup>-400m<sup>2</sup>, ≤R2,6m)</b>	357 828	434 520	574 498	706 130	693 603	719 332	747 263	773 225	792 627	2,5	14,3
Small (80m <sup>2</sup> -140m <sup>2</sup> , ≤R2,6m)	255 248	308 838	419 558	501 574	492 752	507 950	527 132	551 288	575 159	4,3	16,7
Medium (141m <sup>2</sup> -220m <sup>2</sup> , ≤R2,6m)	325 969	398 079	537 039	666 523	652 495	681 149	706 002	727 955	752 577	3,4	15,3
Large (221m <sup>2</sup> -400m <sup>2</sup> , ≤R2,6m)	492 951	601 713	779 711	978 773	964 897	1 004 710	1 040 859	1 074 298	1 084 426	0,9	12,4
New (80m <sup>2</sup> -400m <sup>2</sup> , ≤R2,6m)	479 630	582 797	673 647	741 935	734 442	749 157	760 564	781 544	801 179	2,5	9,1
Existing (80m <sup>2</sup> -400m <sup>2</sup> , ≤R2,6m)	343 554	415 103	554 728	698 691	685 446	714 368	742 497	769 693	792 402	3,0	15,6
<b>Affordable (40m<sup>2</sup>-79m<sup>2</sup>, ≤R226 000)</b>	89 472	102 538	122 697	144 803	142 514	147 927	149 129	151 017	152 185	0,8	6,8
<b>Luxury (&gt;R2,6m-R9,5m)</b>	2 157 438	2 602 187	3 150 143	3 422 798	3 342 581	3 474 051	3 545 717	3 572 733	3 599 097	0,7	7,7
<b>Provinces</b>											
<b>Eastern Cape</b>	288 878	361 118	527 483	667 421	664 485	680 875	689 937	711 793	740 679	4,1	11,5
<b>Free State</b>	236 808	287 317	391 037	489 021	481 263	498 839	515 553	539 345	555 914	3,1	15,5
<b>Gauteng</b>	402 651	479 878	613 488	740 247	726 926	754 759	772 811	796 252	826 801	3,8	13,7
<b>KwaZulu-Natal</b>	289 609	407 442	551 655	682 198	663 622	693 080	741 425	784 527	791 159	0,8	19,2
<b>Limpopo</b>	252 234	287 887	375 338	527 283	506 901	546 501	588 394	636 126	684 972	7,7	35,1
<b>Mpumalanga</b>	256 852	304 538	407 542	530 206	521 364	539 925	562 121	596 292	635 944	6,6	22,0
<b>North West</b>	287 957	334 170	427 013	518 237	509 817	525 691	553 355	567 583	574 441	1,2	12,7
<b>Northern Cape</b>	224 549	273 950	367 673	441 893	436 940	436 670	459 559	497 525	528 347	6,2	20,9
<b>Western Cape</b>	404 722	489 630	655 865	838 666	821 130	865 295	897 610	922 065	935 545	1,5	13,9
<b>Metropolitan regions</b>											
<b>PE/Uitenhage (Eastern Cape)</b>	299 203	364 838	540 219	667 248	673 371	668 907	668 549	684 175	706 180	3,2	4,9
<b>Bloemfontein (Free State)</b>	278 145	340 917	480 747	613 276	608 566	630 004	641 823	674 541	713 575	5,8	17,3
<b>Greater Johannesburg (Gauteng)</b>	405 556	482 995	620 207	744 975	729 696	760 903	783 304	815 999	846 287	3,7	16,0
Johannesburg Central & South	378 465	429 189	596 676	697 794	678 931	686 784	722 559	758 238	824 843	8,8	21,5
Johannesburg North & West	508 016	633 493	773 868	946 683	939 019	974 375	990 835	1 023 700	1 037 872	1,4	10,5
East Rand	336 624	387 788	503 509	635 783	618 820	660 044	681 304	699 634	729 614	4,3	17,9
<b>Pretoria (Gauteng)</b>	446 367	533 785	664 533	801 914	796 207	810 949	827 095	848 313	870 291	2,6	9,3
<b>Durban/Pinetown (KwaZulu-Natal)</b>	328 437	469 078	623 432	746 914	732 454	747 049	802 140	843 950	819 985	-2,8	12,0
<b>Cape Town (Western Cape)</b>	417 095	497 808	662 378	841 442	820 121	870 645	908 849	935 495	948 717	1,4	15,7

House prices are based on the total smoothed purchase price of houses (including all improvements) in respect of which loan applications were approved by Absa Bank. House prices for the provinces and metropolitan regions are smoothed for all houses between 80m<sup>2</sup> and 400m<sup>2</sup>, up to R2,6 million.

Average nominal house prices by middle-segment category in the second quarter 2006									
	Small: 80m <sup>2</sup> – 140m <sup>2</sup>			Medium: 141m <sup>2</sup> – 220m <sup>2</sup>			Large: 221m <sup>2</sup> – 400m <sup>2</sup>		
	Price Rand	q/q % Δ	y/y % Δ	Price Rand	q/q % Δ	y/y % Δ	Price Rand	q/q % Δ	y/y % Δ
<b>National and Provinces</b>									
<b>South Africa</b>	575 159	4,3	16,7	752 577	3,4	15,3	1 084 426	0,9	12,4
<b>Eastern Cape</b>	523 807	3,8	21,3	734 201	6,0	17,6	995 878	-1,1	4,1
<b>Free State</b>	403 284	8,7	19,1	517 541	8,8	25,9	663 903	-4,2	6,8
<b>Gauteng</b>	516 023	2,8	15,4	747 307	3,8	14,5	1 154 223	2,8	11,4
<b>KwaZulu-Natal</b>	534 655	2,8	20,5	786 944	1,3	22,2	1 098 392	-1,6	17,1
<b>Mpumalanga</b>	481 154	6,4	17,2	617 120	3,0	25,2	843 090	7,6	23,6
<b>North West</b>	474 829	5,6	21,4	519 365	2,5	8,2	790 379	2,5	17,2
<b>Northern Cape</b>	472 124	9,9	47,1	490 601	5,1	19,4	670 046	4,1	20,0
<b>Limpopo</b>	464 850	10,5	31,9	655 647	4,1	30,6	907 336	6,8	33,2
<b>Western Cape</b>	723 813	3,3	16,1	963 445	2,9	14,4	1 338 282	0,3	11,5
<b>Metropolitan regions</b>									
<b>PE/Uitenhage (Eastern Cape)</b>	511 015	6,5	14,8	696 524	7,8	11,7	951 837	-4,9	-4,6
<b>Bloemfontein (Free State)</b>	426 013	8,1	22,7	722 209	11,3	23,9	932 964	2,9	9,1
<b>Greater Johannesburg (Gauteng)</b>	537 258	4,4	22,5	775 608	3,3	15,9	1 153 508	2,5	9,2
Johannesburg Central & South	471 757	7,1	21,2	772 729	9,4	24,8	1 196 582	6,2	12,6
Johannesburg North & West	633 071	-1,0	9,9	912 004	0,9	9,3	1 390 891	3,3	11,6
East Rand	515 166	5,9	23,3	692 412	4,3	18,2	945 530	0,6	8,7
<b>Pretoria</b>	522 838	0,0	6,7	797 236	2,4	10,5	1 235 701	1,6	12,9
<b>Durban/Pinetown (KwaZulu-Natal)</b>	432 103	-5,4	-4,4	849 055	1,5	20,2	1 223 024	-7,0	10,7
<b>Cape Town (Western Cape)</b>	733 636	3,2	15,2	986 504	2,3	16,6	1 416 864	1,6	13,8

House prices are based on the total smoothed purchase price of houses (including all improvements) between 80m<sup>2</sup> and 400m<sup>2</sup>, up to R2,6 million, in respect of which loan applications were approved by Absa Bank.

### Affordability of housing taking into account house price and interest rate trends

Quarter	Nominal house prices <sup>1</sup>		Average mortgage interest rate	Monthly repayment over 20 years (100% mortgage)	Gross monthly qualifying income <sup>2</sup> (100% mortgage)	q/q % change in repayment & income (100% mortgage)	y/y % change in repayment & income (100% mortgage)
	Price	y/y % change					
1q2003	R 400 895	19,3	17,0%	R 5 880	R 19 601	4,9	38,0
2q2003	R 422 407	21,4	16,5%	R 6 036	R 20 119	2,6	29,3
3q2003	R 442 626	21,2	14,5%	R 5 666	R 18 885	-6,1	9,5
4q2003	R 472 151	23,6	11,8%	R 5 144	R 17 147	-9,2	-8,2
1q2004	R 513 802	28,2	11,5%	R 5 479	R 18 264	6,5	-6,8
2q2004	R 554 019	31,2	11,5%	R 5 908	R 19 694	7,8	-2,1
3q2004	R 596 026	34,7	11,2%	R 6 220	R 20 733	5,3	9,8
4q2004	R 634 146	34,3	11,0%	R 6 546	R 21 818	5,2	27,2
1q2005	R 664 322	29,3	11,0%	R 6 857	R 22 857	4,8	25,1
2q2005	R 693 603	25,2	10,6%	R 6 956	R 23 186	1,4	17,7
3q2005	R 719 332	20,7	10,5%	R 7 182	R 23 939	3,2	15,5
4q2005	R 747 263	17,8	10,5%	R 7 461	R 24 868	3,9	14,0
1q2006	R 773 225	16,4	10,5%	R 7 720	R 25 732	3,5	12,6
2q2006	R 792 627	14,3	10,7%	R 8 002	R 26 674	3,7	15,0

<sup>1</sup> Smoothed purchase price of houses in the 80m<sup>2</sup>-400m<sup>2</sup> size category (including all improvements), valued at R2,6 million or less, in respect of which loan applications were approved by Absa.

<sup>2</sup> Gross monthly income required to qualify for a mortgage bond if assumed that the monthly repayment does not exceed 30% of income.

#### Monthly mortgage repayment (rand, calculated over a period of 20 years)

Mortgage amount	Repayment at different mortgage rates				
	10,5%	11,0%	11,5%	12,0%	12,5%
100 000	998	1 032	1 066	1 101	1 136
200 000	1 997	2 064	2 133	2 202	2 272
300 000	2 995	3 097	3 199	3 303	3 408
400 000	3 994	4 129	4 266	4 404	4 545
500 000	4 992	5 161	5 332	5 505	5 681
600 000	5 990	6 193	6 399	6 607	6 817
700 000	6 989	7 225	7 465	7 708	7 953
800 000	7 987	8 258	8 531	8 809	9 089
900 000	8 985	9 290	9 598	9 910	10 225
1 000 000	9 984	10 322	10 664	11 011	11 361
1 500 000	14 976	15 483	15 996	16 516	17 042
2 000 000	19 968	20 644	21 329	22 022	22 723

#### Mortgage amount at fixed monthly repayment (rand, calculated over a period of 20 years)

Mortgage repayment	Mortgage amount at different mortgage rates				
	10,5%	11,0%	11,5%	12,0%	12,5%
1 000	100 162	96 882	93 771	90 819	88 017
2 000	200 325	193 763	187 542	181 639	176 035
3 000	300 487	290 645	281 313	272 458	264 052
4 000	400 649	387 526	375 083	363 278	352 069
5 000	500 811	484 408	468 854	454 097	440 086
6 000	600 974	581 289	562 625	544 916	528 104
7 000	701 136	678 171	656 396	635 736	616 121
8 000	801 298	775 052	750 167	726 555	704 138
9 000	901 460	871 934	843 938	817 375	792 156
10 000	1 001 623	968 815	937 708	908 194	880 173
15 000	1 502 434	1 453 223	1 406 563	1 362 291	1 320 259
20 000	2 003 245	1 937 631	1 875 417	1 816 388	1 760 346

#### Transfer duty on property in 2006/07

Value of property	Transfer duty payable
R0-R500 000	0%
R500 001-R1 000 000	5% on the value above R500 000
R1 000 001 and above	R25 000 plus 8% on the value above R1 000 000

Source: National Treasury

#### Key variables and projections Annual averages

		2000	2001	2002	2003	2004	2005	2006	2007
\$/R exchange rate	Rand per US\$	6,94	8,60	10,52	7,56	6,45	6,36	6,50	6,93
CPI headline inflation rate	%	5,3	5,7	9,2	5,9	1,4	3,4	4,6	6,1
CPIX inflation rate	%	7,7	6,6	9,3	6,8	4,3	3,9	4,7	6,0
Mortgage rate	%	14,5	13,8	15,8	15,0	11,3	10,6	11,2	12,5
Household disposable income	Real % Δ	4,0	3,2	3,0	4,0	5,7	6,6	5,9	4,4
Final consumption by households	Real % Δ	4,1	3,5	3,2	3,5	6,5	6,9	6,1	4,5
Household saving to disposable income	%	1,2	0,9	0,7	1,2	0,5	0,2	-0,1	-0,2
Private sector credit extension	Nominal % Δ	7,9	10,6	10,3	11,7	13,1	20,9	19,6	12,4
Mortgage advances	Nominal % Δ	8,3	15,7	12,1	13,7	20,4	27,7	20,7	10,6
Household debt to disposable income	%	53,3	52,6	50,3	51,8	55,9	62,4	69,5	68,4
Gross domestic product	Real % Δ	4,2	2,7	3,7	3,0	4,5	4,9	4,1	4,1
House prices (80m <sup>2</sup> -400m <sup>2</sup> , ≤R2,6m)	Nominal % Δ	17,1	14,2	15,2	21,4	32,2	22,9	12,2	7,6
House prices (80m <sup>2</sup> -400m <sup>2</sup> , ≤R2,6m)	Real % Δ	11,2	8,0	5,6	14,7	30,4	18,9	7,3	1,3