

## Rates on hold, but for how long?

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Although the decision last month was to keep interest rates steady, there were clear warnings that the Reserve Bank would not hesitate to increase rates if necessary. However continued weakness in economic growth remains a concern and may temper the decision to hike rates.

On 12 May the South African Reserve Bank (SARB)'s monetary policy committee (MPC) decided not to increase interest rates. The committee kept the repo rate at 5.5% and the prime overdraft rate at 9.0%.

These are some of the important developments the MPC noted in their decision:

### **Inflation will breach 6%**

The inflation outlook deteriorated significantly since the previous MPC meeting with the Bank forecasting that inflation will breach the upper 6% band of the target late in the year, peaking at 6.3% in early 2012 before reverting to being within target.

### **Waiting for second-round effects**

The main drivers of higher inflation were higher oil and food prices. These prices would not have been affected much by higher interest rates, so the MPC was correct in leaving rates unchanged. However, they will continue monitoring developments as there are other pressures on inflation, such as electricity prices.

### **Spending likely to fall**

During 2010, we saw an increase in household disposable income despite the number of jobs that were lost in 2009 and 2010. This is because consumers with jobs were able to get wage increases well above the upper 6% of the inflation target. Also, equities performed well, adding to disposable income and spending.

This might not be the case in 2011. While the performance of equities remains steady, wage increases are not likely to match those in 2010 because of the current low-inflation environment. In addition, the number of new jobs created this year is expected to be negligible so disposable income and spending will be under pressure. As household expenditure is over 60% of GDP, a drop in this spending category will affect GDP growth.

### **Growth remains slow**

Despite a minor downward revision on the GDP forecast to 3.6% for 2011, the South African economy is still on track to grow at around 3.9% in 2012. This was boosted by GDP figures for the first quarter of this year which came in at 4.8%. However, this growth is still below the country's potential output level.

### **Manufacturing fragile**

Indicators of manufacturing activity have rallied. The strong economic growth figures for the first quarter of 2011 were mostly a result of growth from the manufacturing sector. The Purchasing Managers Index (PMI) which is an indicator of future performance is around the 50 index point level which indicates expansion.

However, growth in this important sector is still fragile and performing below long-term potential. Capacity utilisation (how much of existing infrastructure is being used) is at around 80%, below the high of 85.8% in 2007 when annual economic growth was 5.6%. Manufactured exports remain low which negatively affects recovery in major manufacturing sub-sectors.

### **Retail reflects consumer pressure**

The monthly retail figures for the opening months on 2011 reflect the continued pressure on consumers. Retail sales for March grew at 5.1% compared to the same period last year which is good, but well below the rate of over 8% recorded during November and December 2010.

### **Unemployment remains a national crisis**

Government has job creation as a national priority because it's vital for the continued increase in retail and consumer spending, and right now future growth prospects don't look too promising. Stats SA employment data for Q1 2011 further underlines the importance of the job creation drive: unemployment increased from about 24.2% for Q4 2010 to 25% in Q1 2011.

This is discouraging because it indicates that the economy is not absorbing new entrants into the formal labour market. Also, the unemployment rate for youth is over 40% which does not bode well for social stability and this must be addressed as a matter of urgency. It's a vicious circle because job creation is not a matter of social engineering but depends on economic growth, and the South African economy is linked to international developments which are not too favourable right now.

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