



A flagging economy

Local economic update: September 2011

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Our economy is far weaker than expected as we are dragged down by global economic turmoil. Exports are limited and consumer spending remains subdued. Interest rates will remain on hold for longer.

The upheaval in the global markets has revived talk of a double-dip recession as the dramatic fall in global markets has significantly increased the probability of that happening.

Weaker growth as exports decline

South Africa will not be immune to a global recession. Second-quarter GDP¹ came in at 1.3% which was far short of the 4.8% recorded during the first quarter of this year, mostly due to weaker manufacturing and retail trade.

Robust manufacturing performance depends on strong export performance and healthy domestic demand. The economic growth of our major trading partners remains weak, affecting the performance of our exports. Domestic demand is also weak and is set to remain so until employment levels improve.

Consumer wealth effect negated

In the past, consumer spending was financed by household wealth which includes equity from housing as well as portfolio investments. House prices are not increasing and owners cannot draw on the equity to finance expenditure. The significant fall in value of the JSE means that income from investments that finance consumer spending has been eroded.

As these two aggregates fall without an increase in employment, consumer spending and domestic demand will remain under pressure.

Inflation pressures increase

The weakness of both the global and domestic economy has put the Reserve Bank in a difficult position. Although inflation remains within the target band, it is increasing closer to the 6% level.

¹ Gross Domestic Product

The CPI² increased from 5% in June to 5.3% in July, slightly above what most analysts were expecting. CPI is expected to increase further in the coming months, mainly as a result of higher food and administered prices³.

In July, one of the significant increases was that of electricity prices. A few municipalities are still to implement their scheduled increases in August. More importantly, food inflation continued to increase compared to last month with further increases expected in the coming months.

On the positive side, global food prices have moderated so we can expect local food prices to come down next year.

All in all we expect inflation to breach the target (exceed 6%) late this year into early 2012.

Dilemma over interest rates

The upward trend in inflation on its own should be an argument for the Reserve Bank to start tightening its monetary policy and increase interest rates. However, under the current global uncertainties about recession and evidence of weak domestic economic prospects, normal rules don't apply. There has even been talk of the bank considering cutting rates to support growth. This would have been unthinkable a few months back when the discussion was about when, not if, interest rates would rise.

However the persistent upward trend in inflation has reduced the chances of an interest rate cut. Should there be a cut (not very likely now) the bank would still be within its expanded mandate to pursue prudent monetary policy without unduly sacrificing the country's growth prospects. Our view is that, in line with developed economies, the Reserve Bank will keep interest rates lower for a longer period to support the economy.

We need an economic plan

As Governor Marcus said, the bank cannot cure all economic ills by just changing interest rates: the education and transport systems, among others, must also change in order to put the economy on a sustainable growth path. Also, while low interest rates would be a perfect remedy to stimulate spending in an economy that is in a recession, these are not 'ordinary' cycles as we know them. Households are not in a position to spend as they have to rebuild their balance sheets which are plagued with high debt levels and poor employment prospects; it is difficult even with low interest rates to pay off high debts and still have a sizeable discretionary income to spend.

² Consumer Price Index

³ Municipal rates, electricity, water

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