Resilient Rand supports domestic demand recovery

The unfolding recovery in the global economy, the concomitant increase in South Africa's terms of trade over the past year and the marked decline in household debt servicing costs through 2009 are supportive of a recovery in economic growth in the year ahead.

Ironically, even though many role players in the domestic economy view the strength of the Rand as a hindrance to growth prospects, GDP forecasts are being revised higher. The latest Reuters Consensus forecast shows expected GDP growth of 2.4 per cent this year – a marked improvement on last year. This is a relatively buoyant growth forecast bearing in mind that following an estimated decline of close to 2 per cent in 2009, real GDP needs to grow by some 3 ½ per cent annualized per quarter in order to achieve the consensus forecast for 2010.

At stronger than USDZAR8.00 it is probably fair to argue the Rand, which has been supported by a material decline in the current account deficit in 2008 and 2009; a weak dollar; a marked fall in global risk aversion and robust capital inflows into emerging markets, is overvalued.

However, by maintaining downward pressure on inflation, the currency is contributing to an environment that is conducive to an upturn in domestic demand. South Africa is a small, open economy and the currency plays an important role in the inflation process.
Not surprisingly, the appreciation of the Rand against the US dollar from USDZAR 10.60 in early March 2009 to around USDZAR7.50, at the time of writing, has induced a sharp slowdown in goods price inflation in recent months. Meanwhile, services inflation should ease through the year, albeit with a lag.

Barring an unexpected Rand (or oil price) shock it is reasonable to expect CPI to slow to below 5 per cent by mid-year,. Thereafter, inflation may increase a bit towards the end of the year, but should remain within the Reserve Bank's current inflation target range, even as the favourable influence of lower commodity prices and Rand strength fade from the numbers and the second round impacts of electricity price increases take effect.

In turn, continued disinflation is expected to boost real income growth and keep interest rates low for an extended period, which should be supportive of a recovery in household spending – the largest component of domestic demand.

Admittedly, at - 6.1 per cent and – 6.6 per cent in October and November respectively, recent real retail sales releases have been decidedly disappointing. Also, credit extension data shows household credit extension remained palpably weak at just 1.8 per cent y-o-y in November. However, even though the household debt level is still high at 79 per cent of personal disposable income, debt servicing cost has declined to its lowest level since late 2006. In time, sustained low interest rates should help improve consumer confidence and prompt acceleration in household borrowing and spending - especially since the country's improved terms of trade can be expected to underpin income growth at the same time.

In contrast, private sector fixed investment spending may disappoint this year. Profits growth has slumped, the marginal rate of return on investment is in decline, capacity utilisation is low and business confidence is still far off its previous peak. Ultimately, a recovery in private sector fixed investment spending should follow the consumer upswing, but only with a lag – say in 2011.

Sluggish private sector investment implies muted, if any, growth in employment in the year ahead, which will constrain the strength of the upswing in household spending. However, since savings behaviour changes relatively slowly, the largest near term swings in the current account balance usually reflect changes in investment spending. Hence, weak private sector gross fixed capital formation in 2010 should prevent rapid deterioration in the current account balance.

Overall, although we are probably at or close to the bottom of the interest rate cycle, an environment characterized by a well behaved current account balance, low inflation and GDP growth below potential, should preclude the need for interest rate hikes for some time – even as a number of central banks around the world shift towards normalizing interest rates from extraordinarily low levels. That should help cement South Africa's fledgling business cycle upswing.

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