Prospects for South Africa's policy rate

South Africa's economic recovery has gathered momentum against the backdrop of a buoyant global economy which is currently advancing at an estimated 4 per cent annualized.

The global recovery has supported a sharp increase in metals prices, which have bounced to a level last seen in the period leading up to the "Great Recession". As a result, South Africa's terms of trade index (calculated as export prices divided by import prices) has returned to its mid-1980s level, boosting domestic income growth. Concomitantly, the Rand has remained firm, keeping inflation low, supporting real income growth and allowing the Reserve Bank to cut interest rates to their lowest level in decades. This has created a favourable environment for domestic final demand, which has recovered led by an upswing in consumer spending.

In addition, the surge in the domestic equity market from its recession induced low in 2009 has helped underpin a bounce in household net wealth, thus further supporting the recovery in household consumption. Indeed, real consumer spending surprised consensus expectations to the upside through 2010, advancing, on average, at an annualized rate of between five and six per cent per quarter from 4Q09 to 3Q10.

As the business cycle upswing unfolds the rate of return on capital can be expected to improve, which should encourage a recovery in private sector fixed investment spending and job creation. Hence, the upswing in domestic final demand is set to maintain momentum through 2011 and into 2012.

Encouragingly, too, the 4.4 per cent annualized advance in real GDP in the final quarter of 2010 was accompanied by evidence of broadening of the recovery between industries.

Meanwhile, headline CPI appears to have bottomed and is expected to increase to close to the six per cent upper limit of the Reserve Bank's inflation target band by year-end.

Against the backdrop above one cannot be complacent about the prospects for interest rates. The expected increase in South African headline CPI over the next year mainly reflects the sharp increase in global agricultural product prices. However, the fading disinflationary impact of currency strength on goods price should lift core inflation too, while administered prices remain stubbornly high.

In addition, emerging market central banks have already begun to hike policy rates. Given rising inflation, including core inflation, market expectations of further interest rate hikes in emerging market economies continue to build. It is unlikely the South African Reserve Bank can buck this trend indefinitely.

Admittedly, we are unlikely to witness a robust recovery in domestic private sector credit extension. Given an elevated level of house prices to income per capita, a robust recovery in the residential housing market appears to be some way off. Household mortgages are the largest component of credit extension. Also, it appears as though lending standards may remain relatively tighter than during the years preceding the recession.

However, if the Reserve Bank leaves the repo rate unchanged, current inflation forecasts suggest the inflation adjusted policy rate will be zero by year-end 2011. In my view, such a stance would be too accommodative should the resurgence in the global and hence the domestic economy be sustained – especially if inflation expectations begin to increase.

Considering the above it is likely the next move in the domestic policy rate is up – possibly increasing between 50bp and 100bp by year end.

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