

Nedbank

Economic commentary

13 August 2009

MONETARY POLICY COMMITTEE MEETING

Adverse economic conditions prompt yet another interest-rate cut

Latest

Repo rate: 7,0%, effective 14 August 2009 (previously 7,5%, effective 29 May 2009)

Prime rate: 10,5%, effective 14 August 2009 (previously 11,0%, effective 29 May 2009)

Comment

The Monetary Policy Committee (MPC) reduced the repo rate by 50 basis points, taking it to exactly the same level before the last tightening cycle began in June 2006. Weak domestic growth conditions were the main reason for the cut, with the MPC statement highlighting that “notwithstanding upside cost pressures, the adverse economic conditions appear to tilt the balance of risks to the inflation outlook towards the downside over the medium term’. Domestic economic conditions still remain weak, and indications are that the economy contracted further in the second quarter.

The Reserve Bank’s short-term outlook for inflation has remained largely unchanged since the time of the last MPC meeting. CPI is projected to keep easing moderately, falling within the target range in the second quarter of 2010 and staying within the 3% to 6% range for the period to end 2011.

Other key developments highlighted by the MPC were:

- ❑ The outlook for the global economy has improved somewhat although economic growth will still be negative in 2009. The recovery in 2010 will be uneven, with emerging economies gaining momentum quicker than their developed counterparts
- ❑ Domestic economic activity has remained under pressure since the last MPC meeting, with household consumption, vehicle sales, as well as manufacturing activity contracting further in recent months
- ❑ Growth in demand for credit has fallen sharply on the back of weak demand conditions and stricter lending criteria
- ❑ The Bank’s composite leading indicator continues to indicate that the trough for the domestic economy could be reached later this year
- ❑ Market analysts also expect inflation to continue falling, with the Reuters consensus forecast for July indicating that analysts expect CPI to fall within the target range in the second quarter of 2010 and to average 5,8% and 5,6% in 2010 and 2011, respectively
- ❑ The break-even inflation rate, as indicated by the differential between conventional and inflation-linked bonds, has remained within the target range over the short- and medium-term maturities

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- ❑ The rand has appreciated by about 13% on a trade-weighted basis since the beginning of the year and this has contributed to the positive outlook for inflation
- ❑ Cost-push factors, particularly the rise in international oil price, pose a risk to the inflation outlook
- ❑ Other cost-push pressures include the rise in electricity tariffs as well as the recent above-inflation wage settlements

Implications

The Reserve Bank's decision to reduce interest rates further is welcome. The continual flow of poor economic data and the faster pace of easing in inflation ultimately tipped the scales in favour of another rate cut. More certainty on some of the inflation risks, especially the extent of the increase in Eskom's electricity tariffs, probably also helped.

The Governor described the move as a "tough decision", which is often the case near the end of the cycle. Decisions are not likely to become easier in the months ahead. History suggests that there are often longer pauses near the bottom of the cycle, as indicators send conflicting signals. As a result, we believe that the MPC is likely to pause in September, but will probably cut by another 50 basis points in October on negative growth and positive inflation surprises, with prime ending the year at 10%.

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