

Nedbank

Economic commentary

25 June 2009

MONETARY POLICY COMMITTEE MEETING

The MPC pauses as conditions start to stabilise and risks to inflation rise

Latest

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

Prime rate: 11,0% (previously 11,0%, effective 29 May 2009)

Comment

The Monetary Policy Committee (MPC) kept the repo rate unchanged at its meeting today following five consecutive cuts totalling 450 basis points. This is not surprising as the Governor had warned at the previous meeting that the MPC could pause and assess the impact of previous cuts. We believe, however, that the stickiness of inflation and the risk posed by administered prices were behind the MPC's decision.

Despite weak conditions in domestic economic activity, there are increasing indications that economic activity, both globally and locally, is nearing its trough. The MPC, however, stressed that the recovery is expected to be slow and protracted.

The Reserve Bank's short-term outlook for inflation has deteriorated somewhat. Although the Bank still expects inflation to continue declining steadily, CPI is now projected to fall within the target range only in the second quarter of 2010 compared with the third quarter of this year at the time of the last meeting. CPI is then expected to remain within the target range until end 2011. The Bank indicated that cost-push factors, mainly electricity tariffs and nominal wage increases, posed the main upside risk to inflation. Eskom, the electricity utility, has been granted a 31,3% increase in tariffs for the current financial year. Electricity tariffs account for 1,68% of the CPI basket, indicating that the increase will contribute around 0,5 percentage points to CPI. On the other hand, nominal wage increases amounted to 11,2% year on year in the first quarter 2009.

The Bureau for Economic Research's second quarter *Inflation Expectations Survey* indicates that overall inflation expectations have continued to deteriorate, albeit at a moderate pace. Disconcertingly, inflation is still expected to remain outside the target band for the next three years, with CPI now expected to average 8,7% in 2009 (8,3% in the first quarter), 8,1% in 2010 (from 8,0%) and 7,9% in 2011 (from 7,8%). An increase in inflation expectations of financial analysts, which rose to 6,9% for 2010 (from 6,1%), 5,7% for 2010 (from 5,4%) and 5,6% for 2011 (from 5,5%) was mainly behind the rise in overall inflation expectations.

Other key developments highlighted by the MPC were:

- ❑ The break-even inflation rate, as indicated by the differential between conventional and inflation-linked bonds, increased marginally in recent

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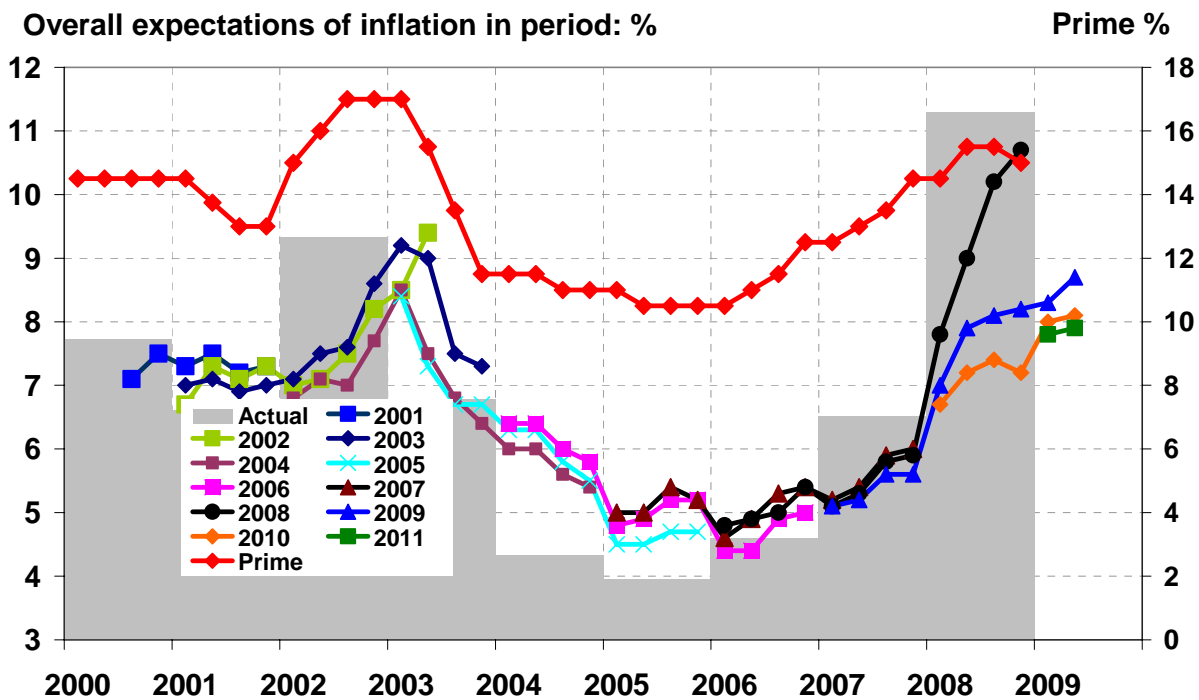
weeks but has remained within the target range in the short- to medium term

- The rand has appreciated by 15% on a trade-weighted basis since the beginning of the year, but its positive impact has been offset by higher commodity prices
- The output gap has widened over the past few quarters; growth prospects for the domestic economy remain a downside risk to inflation
- The Bank's leading indicator suggests that the trough for the domestic economy could be reached later this year
- Domestic growth prospects will depend largely on international developments; although there is cautious optimism about prospects for the global economy, the outlook remains uncertain

Implications

The decision to pause the interest-rate cutting cycle comes after some disappointing figures on consumer inflation and inflation expectations, hopes that the global recession is starting to abate and comments by the Governor after the previous meeting that interest rates were close to the bottom. Further cuts will now require evidence of some easing in inflationary pressures and expectations as well as evidence of deterioration in global and domestic prospects.

Our view is that there will be a relapse in the third quarter and that therefore some easing can be expected later in the year, probably in September and October (50 basis points each) or possibly in the form of one last 100 basis point cut in October. We still expect prime to end the year at 10%.



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