

Nedbank

Economic commentary

28 May 2009

MONETARY POLICY COMMITTEE MEETING

The MPC continues aggressive cuts on persistent weakness

Latest

Repo rate: 7,5%, effective 29 May 2009 (previously 8,5%, effective from 4 May 2009)

Prime rate: 11,0%, effective 29 May 2009 (previously 12,0%, effective from 4 May)

Comment

The Monetary Policy Committee (MPC) has continued on its path of aggressive interest-rate easing. This is despite the Governor's earlier warnings that more regular meetings would not automatically translate into more rate cuts and despite evidence of inflation remaining sticky. Evidence of the worse than expected decline in economic activity therefore swayed the MPC to continue frontloading the rate cuts.

The MPC indicated that economic prospects for both the global and domestic economies remain bleak, with the weakness likely to remain for most of the remainder of this year. There are, however, tentative signs that the rate of decline is moderating. The recovery is likely to be slow and prolonged.

The Reserve Bank's short-term inflation forecasts have remained unchanged since the last MPC meeting. At that meeting, the Bank projected CPI for all urban areas to drop to 6,4% in the third quarter of 2009 and 6,2% in the fourth quarter, before reaching 5,4% in the final quarter of 2010. Inflation is therefore still expected to remain sticky in the short term, but the Bank expects that the wider output gap, combined with the stronger exchange rate of the rand will ensure that it falls rapidly in the medium term. The risk to inflation remains cost-push factors, mainly the expected large increase in electricity tariffs.

Other key developments highlighted by the MPC were:

- ❑ There are tentative signs that the global downturn is slowing, with financial market conditions appearing to be less restrictive.
- ❑ A plunge in manufacturing activity was the main driver of the sharp fall in domestic economic activity in the first quarter of this year. Capacity utilisation has dropped, resulting in a significant widening of the output gap.
- ❑ The Reuters consensus forecast indicates that private analysts expect inflation to average 6,9% in 2009 and 5,7% in 2010.
- ❑ Food price inflation has remained sticky at high levels despite rapidly falling producer inflation and lower commodity prices.
- ❑ The rand has firmed by 13% on a trade-weighted basis since the beginning of this year, but it remains vulnerable to further possible bouts of risk aversion.

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Implications

The poor prognosis for the domestic economy, extremely uncertain global conditions and the moderately improved medium-term inflation outlook prompted the MPC to deliver yet another rate cut. The committee continues to look beyond the next few months of inflation figures and to focus on the medium-term inflation outlook as well as the weak domestic economy.

The Governor did indicate in question time that there might be a case for pausing the easing cycle until the impact of rate cuts already made could be assessed. In our view, economic news will remain negative, leading to a further 100 basis point reduction by September. This will probably come in the form of a 50 basis point cut in June to be followed by another 50 basis points in August (there is no scheduled July meeting).

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