

Nedbank

Economic commentary

25 March 2010

MONETARY POLICY COMMITTEE MEETING

Rates taken to their lowest level in almost three decades

- Improving domestic economy no threat to inflation
- The inflation outlook is favourable in the next two years, although administered prices remain a threat
- There is still a downside risk, but we expect rates to remain on hold until the third quarter of 2011
- There is unlikely to be any lasting effect on the rand

Latest

Repo rate: 6,5% effective 26 March (previously 7%, effective 14 August 2009)

Prime rate: 10% effective 26 March (previously 10,5%, effective 14 August 2009)

Comment

The Monetary Policy Committee (MPC) reduced the repo rate by 50 basis points, taking the prime rate to 10%, its lowest level since January 1981. Data released since the last meeting in January 2010 pointed towards a moderate improvement in economic activity, inflation has dropped to within the target band and is projected to remain within the target band until the end of 2011, and inflation expectations have moderated.

The MPC's inflation outlook has improved somewhat mainly due to the certainty relating to electricity tariffs. Although Eskom has been granted increases of around 25% per annum for the next three years, municipalities have been granted lower increases. The Bank's model therefore assumes tariff increases of 20% during each of the third quarters of 2010 and 2011. CPI is therefore projected to remain within the target band until the end of 2011 after falling below 6% in February. The Bank projects CPI to average 5,3% this year and 5,4% in 2011, touching a low point of 4,9% in the third quarter of this year.

The Bureau for Economic Research's first quarter *Inflation Expectations Survey* indicates that inflation expectations have moderated slightly, although inflation is still expected to remain outside the target band. Inflation is now expected to average 6,5% in 2010, 6,7% in 2011 and 6,8% in 2012, with the figures for 2010 and 2011 slightly down on the 7,5% and 7,7% expected in the previous survey. Analysts remained the most optimistic about the inflation trajectory, expecting CPI to average 5,5%, 5,9% and 6,0% in 2010, 2011 and 2012, respectively. Business people were the more pessimistic as they expect CPI to remain well above the 6% level over the period, averaging 7,1%, 7,2% and 7,3%.

Other key developments highlighted by the MPC were:

- Domestic demand is recovering, albeit at a modest pace, with credit demand still subdued

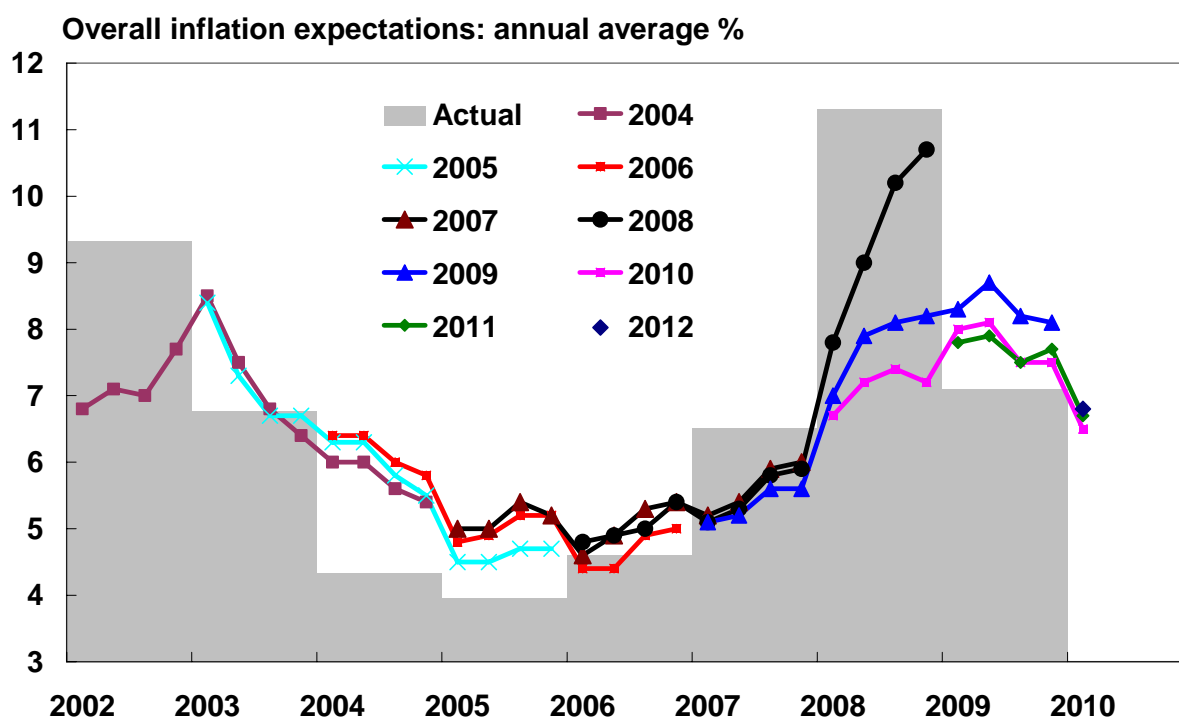
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- The high level of household indebtedness, equivalent to 79,8% of household income, high unemployment, and strict credit criteria are likely to inhibit a strong recovery in household demand
- There is no risk of demand inflation, with the main threat to the inflation outlook posed by high increases in administered prices
- The government's expansionary stance does not pose a significant threat to macroeconomic stability
- The global environment of a moderate rebound and a benign inflation environment is supportive of the domestic inflation trajectory
- Other contributors to the improved inflation outlook were food prices and lower-than-expected inflation outcomes
- Market inflation expectations, as indicated by both the Reuters survey and the break-even inflation rate, show an improvement in inflation expectations since the previous MPC meeting
- Wage settlements remain concerning, with nominal unit labour costs rising significantly in the fourth quarter, although this was partly because of once-off public sector adjustments
- The rand has firmed noticeably since the January meeting, gaining 6% on a trade-weighted basis; this is positive for inflation, but poses a risk to the recovery of export and import-substituting sectors



Implications

The MPC's decision was in our view always going to be tricky. Although we thought that the committee would hold interest rates unchanged given recent decisions under similar circumstances, we thought that there was still a significant risk of a last cut in this cycle (of around 45%). Ultimately the MPC's decision was probably taken on the basis of a cut doing no harm in the current depressed credit environment. However, there will also be considerable speculation as to how much the finance minister's clarification of mandate letter played a part in the MPC's decision.

In our view this is the right decision at the wrong time. There was plenty of scope for further cuts in interest rates in the second half of last year but, despite severe economic conditions, the MPC was guided by concerns about cost-push inflation. The risk is that further easing now could hurt credibility in the medium term leading to higher inflation expectations. This is probably unlikely but future signals will be closely watched by the markets.

The question is whether the committee will be tempted to cut once more in this cycle and whether the current change will influence the timing of the turning point in the cycle. Inflation is likely to dip towards the 5% level by the time of the May meeting, but the economy will have probably gained further momentum by then, helped by the approaching 2010 FIFA World Cup. On balance, we think that the Reserve Bank will keep interest rates unchanged until well into 2011, raising rates in the third quarter.

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