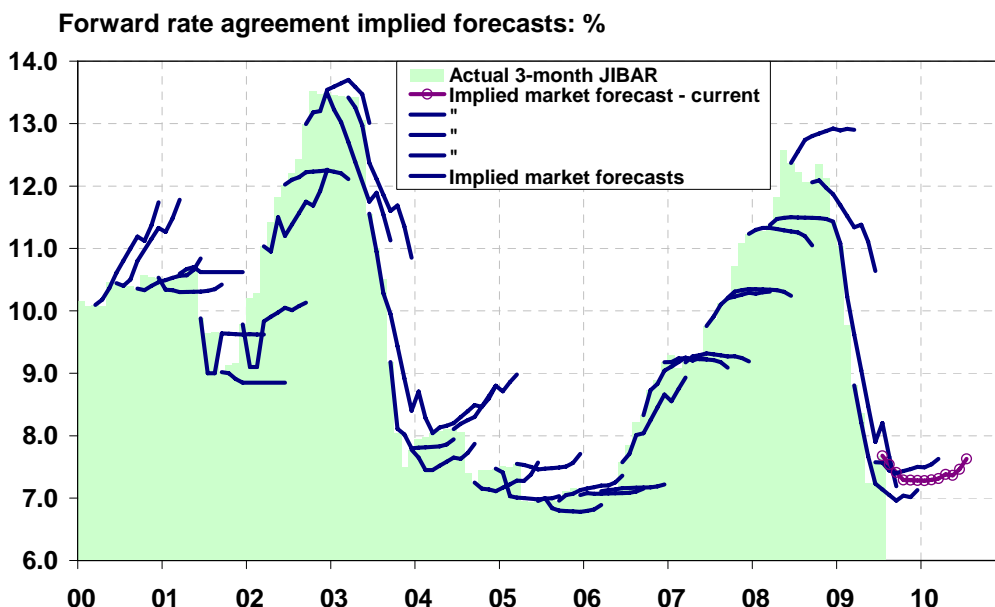


More cuts ahead?

The market has become more bearish over the prospects of further interest rate cuts following the Reserve Bank's Monetary Policy Committee's (MPC) decision to leave interest rates unchanged in June and the relatively tough rhetoric that accompanied the decision. The FRA curve (see graph 1) has flattened and is now starting to suggest some prospect of higher rates in the second half of next year. The market's view has also been influenced by increased optimism over economic prospects locally and globally. With 'green shoots' emerging and stock and commodity markets rising strongly over the past few months there is a feeling that - at the very least - the worst of the downturn is over and that therefore a key reason for the significant easing in monetary policy has been removed. The June MPC statement also took this view, with the emphasis more on growing inflation concerns than on the economy, where growing signs of economic consolidation and improved confidence levels were stressed.

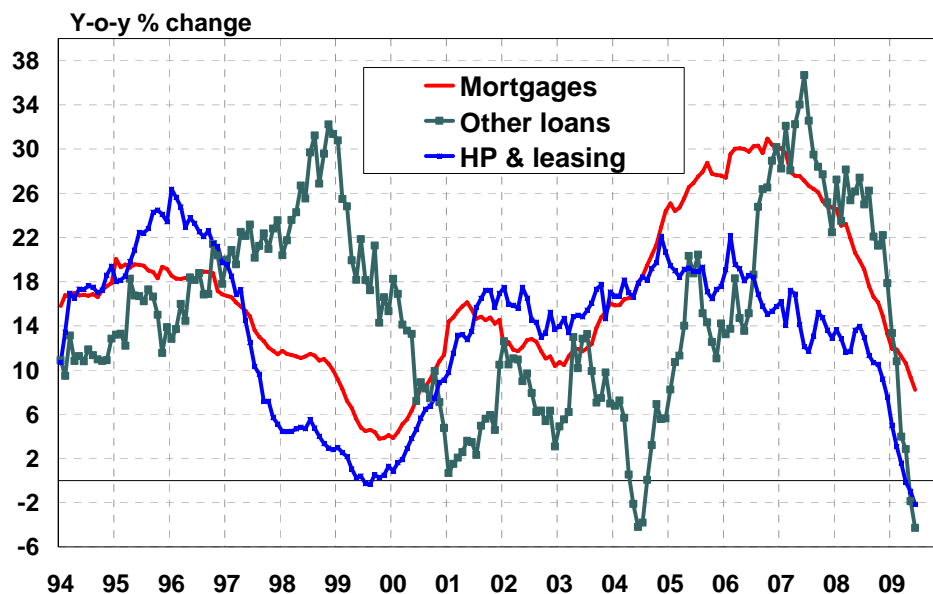
Graph 1: The market is signalling a small chance only of a further cut in rates



More recent evidence may create renewed doubt over this view, however. June's inflation statistics showed sharper-than-expected falls, with CPI inflation back below 7% and PPI showing deflation of 4,1%. This suggests that earlier 'stickiness' may have been only temporary and that prices could start responding more to economic realities over the next few months. Actual improvements to key economic statistics (as opposed to confidence surveys) are also fairly unconvincing so far. 'Green shoots', both domestically and internationally, are more about some stabilisation at very weak levels rather than a normal cyclical rebound. Some key statistics remain very concerning. In particular, employment losses continue to mount and credit advances have slowed dramatically. In South Africa's case, news that a further 267 000 jobs were lost in the second quarter (bringing the total jobs lost to 360 000 over the year) underlined how severe this recession has been so far. Credit figures for June were also sobering. The nominal growth in most categories is already as low as has been experienced in previous recessions and there is a real chance that credit extended to the private sector could contract on an annual basis later in the year. Instalment and leasing finance is already off on last year's levels and the rate of contraction is accelerating (with the category declining at an annual rate of 7% in the second quarter). Although mortgage finance has kept expanding (albeit at a slower rate), the 'other' category (which is dominated by term loans to

companies, but also includes overdraft and credit card debt) has contracted by over 4% over the past year and has fallen by a massive 13,1% over the past quarter.

Graph 2: Credit demand suggests that the economy will take some time to recuperate



The appointment of Gill Marcus as the new Reserve Bank Governor from November 2009 adds another element of uncertainty to the future stance of monetary policy. The market received her appointment well, happy with her obvious personal capabilities, her private sector banking experience as the Chair of ABSA as well as an earlier stint as Deputy Governor of the Reserve Bank. However, it is not clear what her views on issues such as inflation targeting are or whether she holds more dovish views generally than those of Governor Mboweni. This complicates the outlook, as it could imply at least three different avenues – no change, more dovish, and more dovish over the medium term but initially strict to establish market credentials. It also raises the question of whether the MPC will change course or emphasis between now and November. On balance our view is that little in terms of process and policy will change. The new Governor and the current MPC will continue to assess the facts on their merits and act accordingly, while any major changes to the monetary policy framework are unlikely in the short term.

Conclusion

Interest rate cuts will probably resume later in the year as the economy disappoints and inflation surprises on the downside. This is based on our view that the economy will not follow its usual cyclical path of recovery because of structural impediments in credit markets. Although there will probably not be sufficient evidence for a change in stance in August, lower inflation expectations and a relapse in local and global markets and economic conditions should still justify two 50 basis point cuts before the end of the year.

SARB's 'checklist'

Factor	SARB's most recent interpretation (MPC 25 June 2009 and other)	Recent tendency
International economy		
Growth	'The outlook for the global economy remains uncertain, but there is a general sense of cautious optimism.'	Some 'green shoots', but could prove to be short lived once stimulus programmes lose momentum.
Inflation and interest rates	'World inflation is expected to remain subdued'. Interest rates generally off.	Mostly neutral to easier. Many central banks in the developed world have now paused after cutting to close to zero.
Oil	'Oil has been trading at prices of around US\$70 per barrel', but still well off last year's highs.	Oil prices have moved off low levels due to dollar weakness as well as hopes of an economic rebound.
Food	Prices off at producer level and increases starting to moderate slowly at consumer level.	Food prices starting to move up again internationally, reduces the possibility that food prices will decline locally.
Domestic economy		
Balance of Payments	Current account deficit widened in the first quarter to 7% of gdp from 5,8% in the fourth quarter last year, should narrow further.	Recent trade figures showed significant improvements over the record January deficit.
Exchange rate (rand)	'...the risk to the inflation outlook has been reduced by the relative strength of the rand.'	Rand helped by dollar weakness, a short-term recovery in some commodity prices, and the MTN deal.
Labour markets (unit labour costs)	'...edged up slightly. Wages increased by 11,2% in Q1 2009. Nominal unit labour costs up 12,8% y-o-y in Q4 2008. Expected to moderate.'	Trend is up. However, threat of job losses will contain expectations in the private sector.
Administered prices	'...the MPC assesses the main risks to inflation to emanate from cost-push pressures, particularly administered prices, including electricity tariffs.'	Electricity tariffs set to rise. Rose by 27,5% in July 2008, and set to increase by 31% in July 2009.
Domestic demand and supply	'Domestic demand conditions remain subdued'.	Household spending under pressure and fixed investment plans being postponed. The economic downturn has become broad based.
Monetary conditions	Credit growth moderating due to stricter lending criteria and weak economy.	Credit demand is slowing significantly.
Asset price inflation	'...falling house prices and weak asset markets are also expected to restrain consumption expenditure'.	House prices starting to fall not only in real but also in nominal terms.
Fiscal policy	Deteriorating fiscal position due to weaker growth.	Will move more strongly into deficit because of weaker global and domestic conditions.
Indicators of inflationary expectations	A mixed picture with analysts and unions diverging. Latest BER inflation expectations survey suggests 8,7% for 2009 and 8,1 % in 2010	Forecasts showing inflation difficult to push through the 6% upper limit in 2009.
SARB's forecast of inflation	"Inflation is expected to enter the target range in the second quarter of 2010".	Expectations are similar to the SARB's.