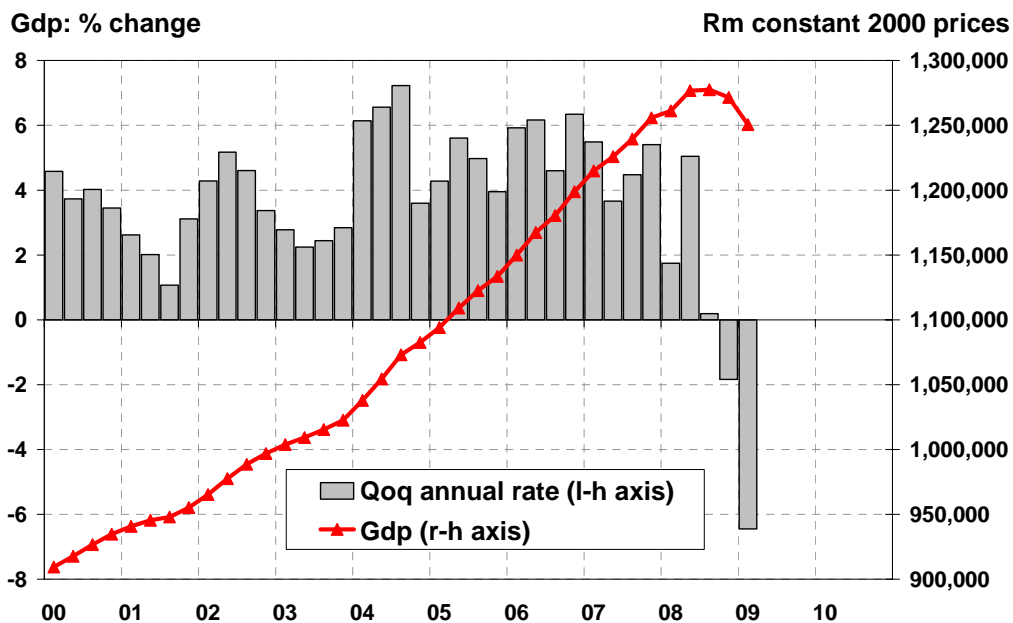


Interest rate cuts: are we at the bottom?

The Reserve Bank's Monetary Policy Committee (MPC) cut the repo rate by a further 100 basis points to 7,5% after its 28 May meeting, bringing the cumulative decline since early December to 450 basis points. The move was widely expected, although there was a noticeable minority of analysts calling for just a 50 basis point cut. Most of the interest following the decision centred on the Governor's comments after the meeting, where he indicated that further significant rate cuts were unlikely and that 'monetary policy has done as much as it can'. Forward rate agreements reflect this as well, with perhaps potential for a 50 basis point cut over the next few months before the cycle begins to turn in early 2010.

The clear concern of the MPC, as well as the market, is the disappointing inflation outlook. Despite a collapse in commodity prices, the recent firming of the rand, and a depressed local and global climate, prices continue to be 'sticky'. Perversely, in some sectors where demand is weakest, producers and retailers have tried to improve revenue by raising prices. The continual climb in services inflation and the sharp rises in administered prices have also been major contributors to the problem. The MPC is worried that further cuts could accommodate unwarranted price rises leading to a persistently high inflation rate.

Graph 1: Gdp has contracted sharply



Even so, the committee has still felt reasonably comfortable in cutting rates so far, underlying its sense that the domestic economy is still weak and vulnerable. The May decision came just a few days after the release of the horrible first quarter gdp figures (off an annualised 6,4% from the fourth quarter, the largest decline in the past 25 years), which both confirmed that the economy is in a severe recession and that the downturn has become more widespread. The extent of the contractions in mining (off 32,8%) and manufacturing (22,1%) and the turn for the worse in previously strong sectors such as transport and communications, finance and real estate, and even agriculture, suggest that domestic demand is slowing rapidly. Most recent indicators suggest that, at best, the rate of deterioration is starting to slow (for example, the May motor vehicle sales figures and the May purchasing managers index (PMI)). However, other indicators point to a further worsening. Employment losses are likely to mount while activity remains at the lower levels, house prices are still falling and the growth in credit extension is slowing significantly. Excluding the

volatile investments and bills discounted category, private sector credit extension rose by just 6,6% year-on-year in April. Over the past three months annualised growth in this category has been 0,4% only. The weakness extends over both the household and the corporate sector.

The MPC's decision in the 24 to 25 June 2009 meeting will therefore be based on an assessment of whether the current economic weakness will persist – or possibly get worse – and whether this will ultimately keep consumer prices in check. In some ways it will be an assessment of the nature of this downturn. If this is a normal cycle then further monetary easing is unlikely. However, if this is more structural in nature, both locally and internationally, then further easing is likely to take place as the year progresses. In our view, the economic recovery will be weak and faltering and further, albeit more modest, cuts in interest rates are likely.

Conclusion

The MPC is likely to continue easing policy, but the period of aggressive easing is probably over. June will probably have seen a pause, but there is no meeting in July and the committee may decide to cut by 50 basis points as a compromise. An expected resumption of economic weakness later in the year should lead to another cut, bringing prime to 10% by year end.

SARB's 'checklist'

Factor	SARB's most recent interpretation (MPC 4 May 2009 and other)	Recent tendency
International economy		
Growth	'There are tentative signs that the global economy may have seen the worst of the downturn, but the recovery is expected to be slow and protracted.'	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\$60 per barrel', but still well off last year's highs.	Oil prices have moved off the lower levels due to mainly to dollar weakness.
Food	Prices off at producer level and increases starting to moderate slowly at consumer level.	Food price inflation easing internationally. Will take time to reflect fully at consumer level in South Africa.
Domestic economy		
Balance of Payments	Current account deficit narrowed in the fourth quarter to 5,8% of gdp from 7,8% in the third, but may not sustain these lower levels.	February, March and April trade figures showed significant improvement 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 and a short-term recovery in some commodity prices.
Labour markets (unit labour costs)	...edged up slightly. Wages increased by 10,2% 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.
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 between a real 20% and 25% per annum over the next 3 years.
Domestic demand and supply	'Domestic demand conditions remain subdued'.	Household spending under pressure and fixed investment plans being postponed, with growing evidence of a general economic downturn.
Monetary conditions	Credit growth moderating due to stricter lending criteria and weak economy.	Downward trend in overall credit well established.
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	Slightly 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 Reuters suggests 6,9% and 5,7% in 2009 and 2010.	Forecasts showing inflation difficult to push through the 6% upper limit in 2009.
SARB's forecast of inflation	Similar to previous MPC meeting and to analysts.	Expectation very similar to the SARB's.