

02 March 2011

# Economic Commentary

## Monthly insight

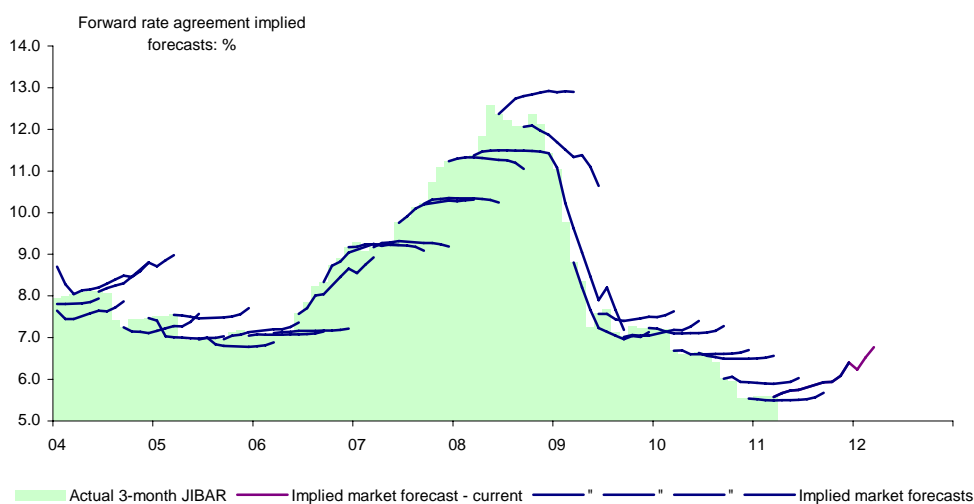
### Hiking rates too early could do more harm than good

- Hiking interest rates prematurely could do more harm than good to the economy and risks repeating the mistakes of 2008.
- Although the prospects for 2011 appear a little brighter - we expect growth of 3,2% for 2011 – growth will remain below potential. Internationally forecasts have generally been revised upwards. However, significant uncertainties remain.
- As a result, demand-driven inflation is unlikely to play a role. Rather, exogenous factors – higher food and fuel prices – pose the greatest risk to the inflation outlook. Hiking interest rates will have no impact on curbing these exogenous price increases directly.
- The Bank may opt to react pre-emptively, hiking rates in the third quarter. However, we believe that this would do little to contain inflation and risks curbing the economic recovery.

### Comment

In February's Monthly Insight we highlighted the risk posed by higher food and fuel prices to our favourable inflation outlook, a risk which has intensified over the past month. The surge in global commodity prices combined with the rand's recent round of weakness has prompted some economists and the market to revise their interest rate forecasts. The forward rate curve is currently pricing in a hike as soon as the third quarter of 2011.

**Chart 1 : Forward rates curves suggest a hike later this year**



Source: Inet

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Important disclosures can be found in the Disclosures Appendix.

In our view a hike this early would likely do the economy more harm than good and risks repeating the mistakes of 2008.

Throughout 2008 we consistently argued that the Reserve Bank needed to talk tough, but act cautiously. This was because the rise in inflation was not a demand-driven phenomenon, but a function of rising global food and energy prices magnified by a relatively weak rand. We suggested that to tighten monetary policy further would be disproportionate and unnecessary, as the household sector had already been under stress for some time. Growth in consumer spending had stalled and credit growth, while still high, was slowing substantially. Despite these signs that the economic growth was softening quickly, the SARB responded by hiking rates a further 100 basis points to 15,5% during the course of 2008

**Demand remains soft**

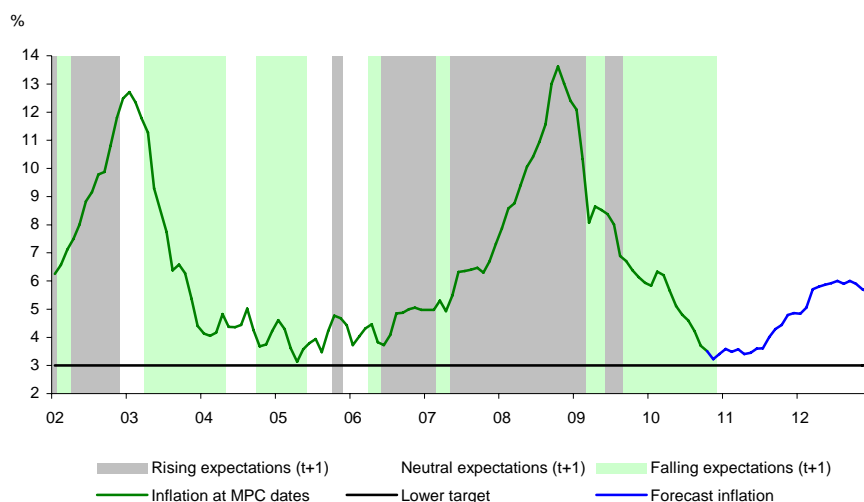
Economic growth remains below potential, while capacity utilisation is well off the highs seen in 2007. Consumer spending has recovered, but much of the recovery has been driven by a sharp rebound in spending on durable goods off a very low base. A useful gauge for the health of the consumer is credit growth, which is anaemic and even lost some momentum in the final quarter of last year. The recovery in the manufacturing sector has not been particularly striking, with output still 14% below its pre-crisis peak. Although there was a small rise in employment in the final quarter of 2010, levels remain very weak with 118 000 jobs lost last year.

Although the prospects for 2011 appear a little brighter - we expect growth of 3,2% for 2011 – growth will remain below potential. Internationally forecasts have generally been revised upwards. However, significant uncertainties remain. The sharp spike in the oil price to over \$110 a barrel due to conflict in the oil-producing Middle East and North Africa, could dent the global recovery, by eroding consumers’ spending power. Continuous murmurings about the sustainability of some of Europe’s peripheral country’s debt could also erupt and derail Europe’s growth.

**Exogenous shocks will be main source of inflation this year**

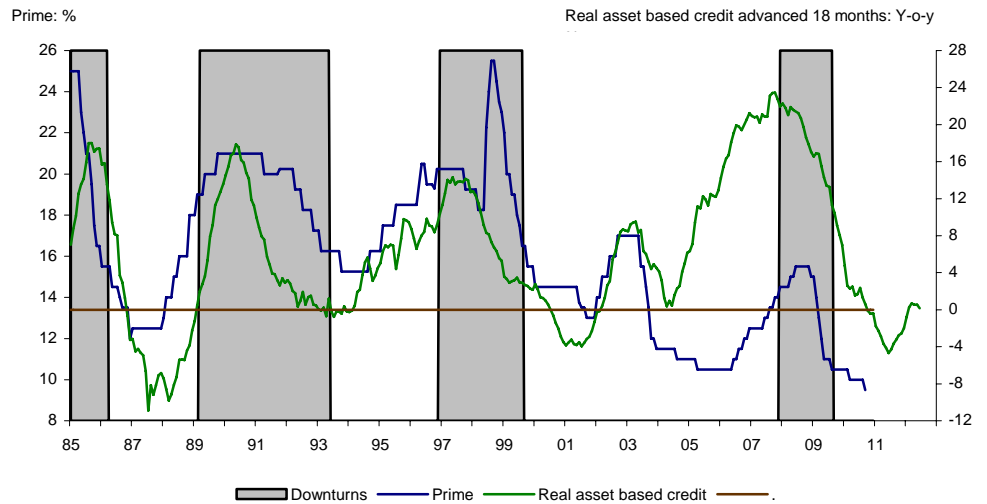
As a result, demand-driven inflation is unlikely to play a role. Rather, exogenous factors – higher food and fuel prices – pose the greatest risk to the inflation outlook. Hiking interest rates will have no impact on curbing these exogenous price increases directly. Two arguments in favour of hiking rates in this situation are usually put forward. First, second-round effects need to be brought under control. And second, inflation expectations need to be curtailed. Both these arguments have merit when demand is strong and inflation risks getting out of control more quickly. However, in an environment where demand is subdued and consumers are anything but exuberant, hiking rates would only compound the impact of higher prices and do little to curb inflation expectations, which tend to move in line with current inflation.

**Chart 2 : Inflation expectations move in line with current inflation**



Source: SBER and StatsSA

**Chart 3 : The credit cycle and interest rates**



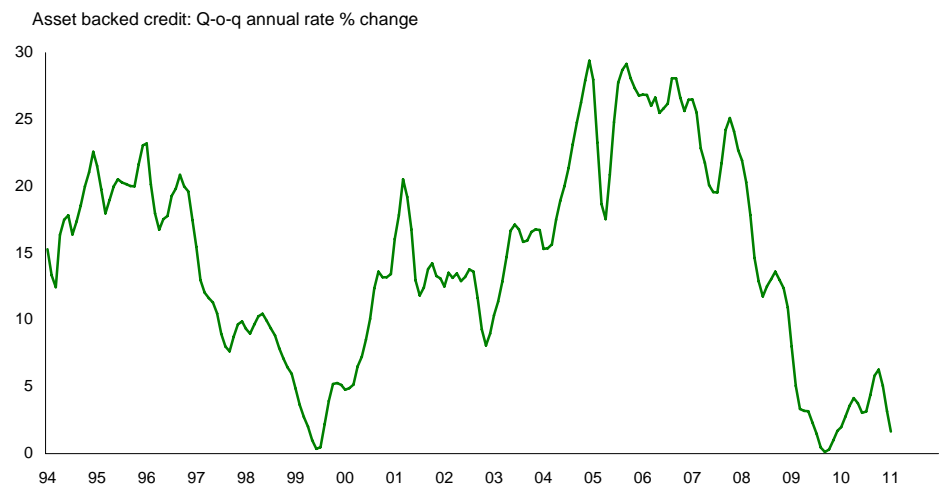
Source: StatsSA

**Looking for Early Warning Signals**

With exogenous factors expected to distort inflationary signals in the economy this year, when should the Reserve Bank start to hike interest rates? Past cycles tend to suggest that the SARB should start hiking or cutting interest rates 18 months after a convincing turn in real asset-based credit growth (see chart). The fact that interest rates only started increasing well into the upward phase of the credit cycle during 2004, and were cut only once credit growth had slowed sharply, perhaps provide some insight into why the last cycle was so dramatic.

A hike could arguably be appropriate in the second half of the year as the credit cycle would have turned 18 months prior to this. However, credit growth is barely back in positive territory and any acceleration is likely to be modest given tighter regulatory constraints and continued caution by banks. The graph below shows that credit has yet to build any momentum.

**Chart 4 : Growth in asset backed credit remains anaemic**



Source: StatsSA

### **What are other central banks doing?**

Most central banks in both emerging and advanced economies are taking a cautious approach.

Although inflation is double the Bank of England's (BoE) target rate and well above the European Central Bank's 2% target, both Banks are openly reluctant to raise interest rates. The BoE's governor, Mervyn King, has argued that increasing interest rates would be ineffective at combating inflation, which is largely due to exogenous factors like higher commodity prices and increases in the VAT rate. Equally the Eurozone – barring Germany and perhaps France – is still in a vulnerable state and could ill afford higher interest rates.

In emerging markets the picture is slightly different. In Brazil for example, with inflation at nearly 6% and credit expanding by 20% y-o-y, has responded to an over heating economy by hiking rates by 250 basis points. In contrast, in Indonesia, where inflation is 7% and credit growth is running at 30%, interest rates have been raised by only 25 basis points. Elsewhere, although inflation has picked up slightly the inclination to hike rates has been slow, suggesting that unless there are marked signs of overheating authorities will probably be inclined to tolerate slightly higher inflation. Somewhat bizarrely, the Turkish central bank recently cut interest rates despite rising inflation threats and credit growth of over 40%, largely because of exchange rate considerations.

### **Conclusion**

The risk of a rate hike earlier than what we are currently anticipating have increased over the past month, with food, oil and other commodity prices continuing to rise. The Bank may opt to react pre-emptively, hiking rates in the second half of the year. However, we believe that this would do little to contain inflation and risks curbing the economic recovery.

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