

06 October 2011

Economic Commentary

Monthly Insight

Downside risks to interest rate outlook have increased

- Global growth prospects have deteriorated in recent weeks and the risk of a double-dip recession in the US and Europe has increased. Locally the picture has also worsened, growth for this year is now forecast to be a meagre 3,1%, down from 3,8% just two months ago.
- This has prompted some calls for a cut in interest rates.
- The weaker rand has raised inflation risks, amidst weaker capital flows.
- Against this background the Reserve Bank is taking the cautious approach until there is greater clarity on what direction both the local and global economy will take.
- Although we believe that the risk of recession has increased, our central forecast remains one of sluggish growth both locally and abroad. As a result, we believe that the Reserve Bank will keep rates unchanged until the third quarter of 2012. .

Comment

August and September were exceptionally volatile and uncertain months, as policymakers and market participants struggled to digest a bevy of bad economic and financial news. Recent economic statistics paint a picture of economic stagnation in advanced economies and of a slowdown in emerging markets, including China. Against this backdrop of weakening growth and heightened risk of recession, officials in Europe are playing a dangerous game by continuously delaying the tough decisions needed to resolve the debt crisis. Sentiment has swung from one of despair, as it seemed improbable that Eurozone politicians would reach any agreement on expanding the European Financial Stability Fund (EFSF) to hope, as votes in favour of expanding the fund were slowly being passed in different countries, and back to uncertainty, on concerns that new measures would again be sufficient to quell the crisis.

In a highly volatile environment making any medium-term policy decisions becomes extremely difficult, as it is impossible to determine how events will unfold. These are the circumstances in which the Monetary Policy Committee currently operates. At the most recent meeting of the MPC the Committee opted for a cautious approach, while acknowledging the risks and reaffirming the Bank's willingness to react in the event that conditions change for the worse.

The latest statement of the Monetary Policy Committee painted an even more bearish picture of the global and local economy. The Governor noted that "since the previous meeting of the Monetary Policy Committee the downside risks to the global and domestic growth prospects have increased. Growth in some of the advanced economies has weakened against the backdrop of financial market turbulence, generated in large part by the unresolved European sovereign debt crisis."

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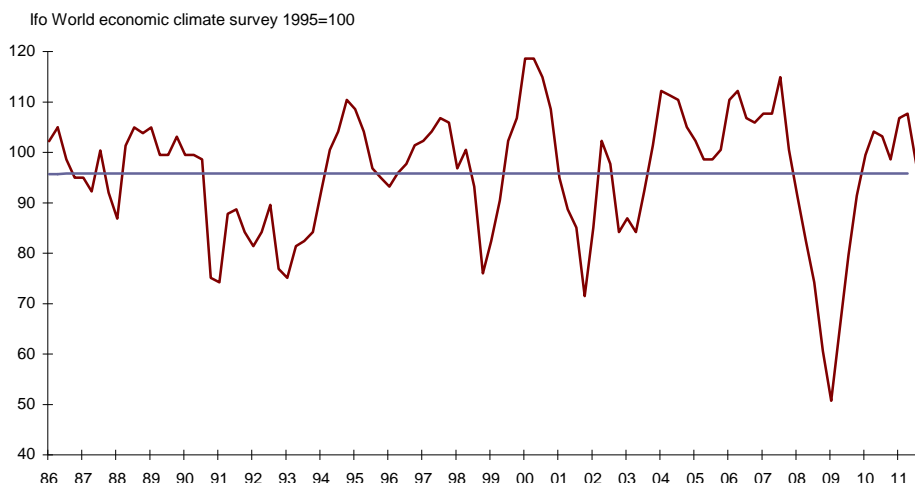
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Conditions locally have also deteriorated. The Committee noted that, "Recent data have confirmed the fragile and uneven nature of the domestic economic recovery, and unfavourable forward-looking indicators are consistent with a downward revision of the Bank's economic growth forecast." The Governor closed off the gloomier-than-usual statement by saying that "the MPC is however concerned at the potential impact of the current global turmoil on domestic economic prospects and stands ready to act appropriately should the need arise."

Chart 1 Global economic climate worsens



Source: BER

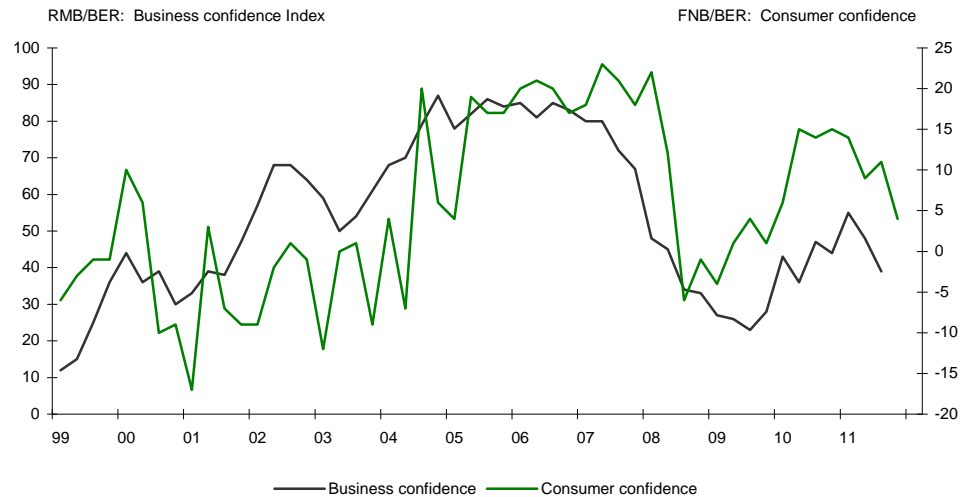
Much now depends on global economic and financial developments. In the recent IMF World Economic Outlook, the IMF highlights the fine balancing act that developing and developed countries need to walk between maintaining credibility and fighting inflation on the one side and facilitating growth on the other. The IMF looked at the G20 countries, assessing a number of factors to determine the degree of overheating and scope for further easing, including the output gap, credit growth, inflation, asset price growth as well as capital inflows. Based on these and other metrics, the IMF recommends that the Reserve Bank keep interest rates on hold in line with most emerging economies, with the exception of Brazil, which should raise interest rates. In contrast, most developed countries should consider cutting interest rates.

Brazil is an interesting case, showing how cutting interest rates too soon in a crisis can have undesired consequences. The Central Bank cut rates by 50 basis points to 12% in September, in a pre-emptive move against a weakening economy and the risk of growth slowing more sharply if the Europe's debt crisis worsens. However, markets reacted strongly with both the currency and equity prices falling precipitously. Inflation currently stands at 7,2% and many are concerned that inflation in Brazil will become a problem if the feared global slowdown does not materialise.

The Reserve Bank was therefore probably wise to keep interest rates on hold for now. However there is no doubt that downside risks to interest rates have increased.

The keys to a changed stance would be stronger evidence of a recession in trading partners as well as a pronounced slowdown globally. First, both the US and Europe would need to enter recession. Based on recent economic data the Eurozone appears to be on the brink of recession. The worse-than-expected deterioration in the Eurozone purchasing managers' indices points to some contraction over the month for the first time in two years and comes on top of sharp falls in consumer and business confidence. Added to this, new industrial orders fell by 2,1% m-o-m in July. For the moment, the US appears to be fairing slightly better. Recent PMI data is still tracking just above the 50 level, which marks a contraction from an expansion, while consumer confidence has edged up slightly.

Chart 2 :Consumer and business confidence is slumping



Source: BER

Locally economic news has been deteriorating. Confidence has been weak, manufacturing is under pressure (although the PMI showed some marginal improvement), consumer credit growth has eased and employment to has been static. Against this background, consumer spending has held up reasonably well and credit to the business sector has picked up. Overall, the position looks more vulnerable but so far most analysts are looking for lower growth rather than a renewed downturn. Inflation prospects have also become more uncertain, with the rand weakening but food and energy prices also falling in compensation. Inflation will probably flirt with the upper 6% band of the inflation target during 2012.

Conclusion

The Reserve Bank will be wary of reacting too pre-emptively in an environment where inflation is still rising at the risk of spooking international investors and prompting too strong a depreciation of the currency. Rather, the Bank is likely to maintain its cautious wait-and-see approach until the global and local economic environment becomes clearer. We maintain our view of unchanged interest rates until the third quarter of 2012, but acknowledge that the possibility of a rate cut in the short term has increased.

Factor	SARB's most recent interpretation (MPC September)	Recent tendency
International economy		
Growth	"Growth in some of the advanced economies has weakened against the backdrop of financial market turbulence, generated in large part by the unresolved European sovereign debt crisis."	Global growth has slowed over the past few months.
Inflation and interest rates	"Global headline inflation has increased, driven primarily by higher food and other commodity prices, particularly oil."	Rising on higher food and fuel inflation, has forced breaches in targets in both the UK and EU.
Oil	"Since the previous meeting of the MPC the price of Brent crude oil has fluctuated in a range of around US\$104 and US\$118 per barrel. The outlook for the oil price will be determined in part by global growth developments, and in particular by the extent to which China is affected by the slowdown."	The price of Brent crude oil has remained below \$120 per barrel.
Food	"Food inflation has been one of the main contributors to headline inflation."	Food inflation at consumer level continued to rise higher.
Domestic economy		
Balance of Payments	Current account deficit widened to 3,3% of gdp in the second quarter, from 3,1% of gdp in second quarter of 2011.	A trade deficit of R3,7 billion was recorded in August.
Exchange rate (rand)	"These recent outflows, together with increased risk aversion, have contributed to the high degree of volatility observed in the exchange rate of the rand. Since the previous meeting of the MPC, the rand has traded in a range against the US dollar of between R6.68 and R8,33 per US dollar, and has depreciated by around 15,6 per cent against the dollar."	The rand has weakened against a stronger dollar as risk aversion has increased.
Labour markets (unit labour costs)	"Nominal wage settlements have continued to moderate somewhat, and have been lower than many of the highly publicised initial demands. Nevertheless, wage increases have been well above the upper end of the inflation target range"	Wage demands have moderated slightly.
Administered prices	"The main risk to the inflation outlook remained administered prices, particularly electricity price increases."	Eskom proposal watered down to 25% pa over three years from original 45% pa.
Domestic demand and supply	"GDP growth now expected to average 3,6 per cent and 3,9 per cent in 2011 and 2012 respectively. These growth rates, while an improvement, are still too low to have a significant impact on the unemployment rate which measured 24,0 per cent in the fourth quarter of 2010."	Household spending has eased modestly, while fixed investment spending has risen modestly off a very low base.
Monetary conditions	"Underlying credit extension remains weak but there has been some improvement in the past months."	Household credit extension has begun to moderate, while corporate credit growth has picked up slightly.
Fiscal policy	"...the MPC does not foresee a possible conflict with monetary policy objectives."	Budget deficit is very large, but not an immediate threat to inflation unless public sector wages rise strongly again.
Indicators of inflationary expectations	"The inflation forecast of the Bank is more or less unchanged since the previous meeting of the MPC. Inflation is still expected to breach marginally the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6,2 per cent before returning to within the target range in the second quarter".	Rising headline inflation will push expectations up higher.

Source: Nedbank and SA Reserve Bank

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