

Nedbank

Guide to the Economy

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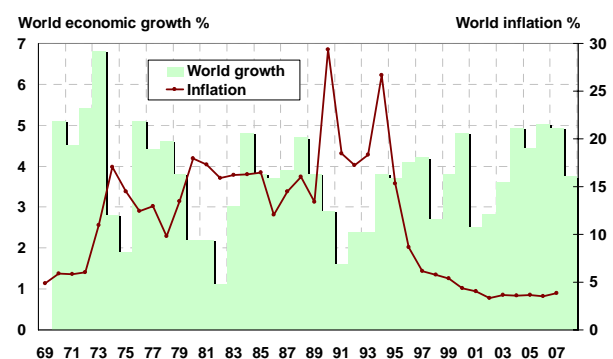
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IS INFLATION ALIVE AGAIN?

After a remarkable period of low inflation, the past year has seen inflation globally creeping upwards. The immediate causes are well-known – rising food and fuel prices. However, opinion is divided about whether the current upswing in inflation will be temporary or whether inflation will revive more dramatically as it did in the late 1960s and early 1970s. This article will consider both sides of the debate. The second article will look at how central banks are interpreting the threat and how they are choosing to respond.

Graph 1: Gdp growth and inflation



Source: IMF

The great moderation

Over the past 20 years or so the economies of most developed countries have experienced low inflation combined with relatively high and stable economic growth, a period that has been dubbed the 'great moderation'. This was preceded by last century's worst inflationary episode, where rampant inflation dogged many countries for over a decade. By the early 1980s, policymakers and politicians realised that, despite the short-term costs of raising interest rates, rising inflation posed a far greater threat to long-run economic stability. Between 1980 and 1983 central banks of developed countries began hiking interest rates aggressively to bring inflation back under control and restore credibility. The ensuing success helped to anchor inflation expectations, making the task of



MAKE THINGS HAPPEN

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keeping inflation under control that much easier and creating a favourable environment for stronger economic activity. In the mid 1990s this success was extended to developing countries, coinciding with the widespread introduction of inflation targeting as a monetary policy framework.

Low and stable inflation is a necessary ingredient for economic growth. It reduces interest rate volatility and helps firms to plan in a more stable environment, encouraging businesses to invest and therefore boosting economic potential. Low inflation also amplifies relative price movements, allowing the market system to work properly by sending clear signals. Lastly, low inflation is more desirable from an income and wealth distribution perspective, as high-inflation environments have more devastating impacts on the poor who are unable to protect themselves against falling real incomes.

The International Monetary Fund (IMF) noted in 2007 that the current global economic upswing has been one of the longest and most broadbased in the past century. In the past decade – post the 1997/98 emerging-market crisis – per capita gdp has grown at an annual rate of 7% in emerging market and developing countries. Low interest rates and a stable economic environment reduced risk aversion and fuelled an asset price boom, with equity and house prices rising by unprecedented amounts in real terms over the period.

Clearly, a more stable price environment has not been the only reason for the improvement in global fortunes. Liberalising economic regimes from Asia to Central and Eastern Europe and the massive opening up of economies to trade and capital flows were key ingredients.

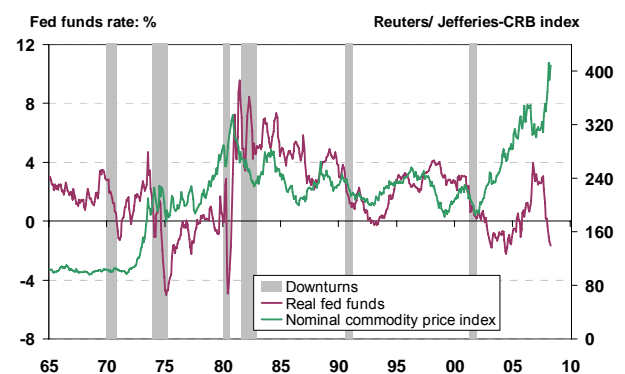
However, the recent strong rise in inflation and the threat of recession in the world’s largest economy, the US, have raised concerns that the great moderation may be coming to an end. The fear is that we may return to a 1970s-style inflation or even stagflation, where inflation is high, but growth is weak.

The great inflation of the late 1960s and 1970s

The commodity price shocks of the 1970s are most commonly blamed for causing the ‘great inflation’. In early 1971 the Organisation of Petroleum Exporting Countries (OPEC) asserted its muscle for the first time and drove oil prices up by nearly 40%. This was followed by a series of further increases. By 1974 the price had risen by almost 500% from the start of the decade. The second oil shock occurred in 1978 and 1979, when prices rose by a further 190% over the two-year period. With other input costs increasing as well, inflation rose to unprecedented levels in the developed world, where there was still a strong manufacturing bias. Inflation in industrialised countries increased to an average of 14,3% in 1974 and to another peak of 13% in 1980.

A closer look suggests that a strong buildup of liquidity prior to the rise in commodity prices was more to blame for the significant rise in inflation, however. During the 1960s monetary policies in industrialised countries became more lax as memories of high inflation started to fade. It was also the era of the Philips curve and central bankers wrongly believed that there was a long-term tradeoff between inflation and growth, which made policymakers reluctant to tighten monetary policy. Finally – at least in the US – the Federal Reserve played an important role in financing the fiscal deficit, which had ballooned due to the spiralling costs of the Vietnam War, in the process boosting the supply of dollars in the global economy. This buildup of liquidity also helped fuel an economic boom that further fed into stronger demand conditions in commodity markets and therefore higher prices.

Graph 2: Commodity prices and interest rates



Sources: Reuters; US Federal Reserve

This suggests that higher commodity prices and inflation were caused – or at least accommodated – by excess money creation, which kept real interest rates low and boosted economic growth to above potential levels. In fact, inflation started rising in the late 1960s, well before the first oil price shock in January 1974. Even once economic growth started to slow, commodities may have provided investors with some alternative to other investments, given low interest rates and a depreciating dollar. Between 1970 and 1973 the number of commodity futures contracts increased from 14 million to 33 million.

When the oil price spiked in 1974, this added significantly to inflation that was already in the economy and set the scene for the inflationary spiral that ensued. Over the next two decades inflation became entrenched, as rising inflation expectations quickly filtered into wage increases and the price-setting behaviour of retailers and manufacturers.

Is a repeat likely?

While a return to 1970s-style inflation may seem unlikely, there are some striking similarities between the early 1970s and the past few years. Surging commodity prices are again threatening to feed through into a more general

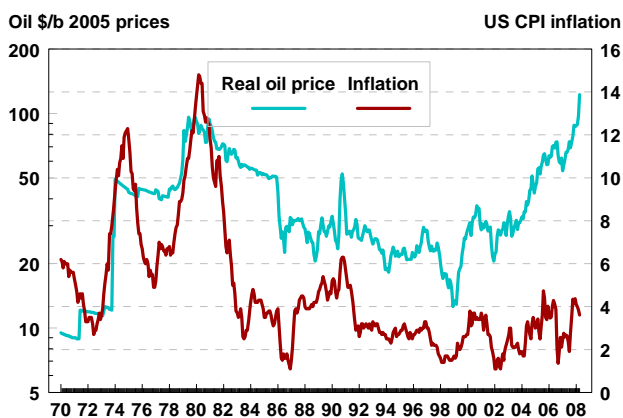
increase in inflation. The oil price, in particular, has risen by 138% since early 2007 and has now increased by nearly 1 080% since its lows in early 1999. While impressive, this still does not measure up to the cumulative 2 180% increase seen over the 1970s up until the peak in late 1980. Put differently, the current price would still have to rise to around \$440 a barrel to represent a repeat of this earlier period. However, the real oil price (deflated by US inflation) has increased by a very similar amount, suggesting that the relative increase in the oil price has performed similarly over the two periods. It is also quite astounding that such a dramatic increase has had such a limited effect on inflation so far, at least in developed economies.

One reason for this may be that these economies are more services-oriented and therefore less dependent on oil than they were in the 1970s, but this was also the case in the early 1990s, when the Gulf War oil spike had an immediate effect on inflation. Another is that the prices of manufactured goods have been held in check by employment-maximising Asian countries (principally China) that have absorbed cost increases.

General inflation has also been held in check by structural changes since the 1970s. Globalisation has increased competition and the productivity benefits of large-scale production. Escalating technological improvements have meant that new products have become less resource-intensive and also less costly to produce. The decline of trade union power following the turbulent 1970s also meant more flexible labour markets.

Finally, central banks are quick to take much of the credit, suggesting that the credibility established over the past two decades of keeping inflation low continues to pay dividends by keeping expectations and pricing behaviour under control.

Graph 3: The real oil price and US inflation



Some suggest that that credibility may be wearing thin, however. A number of studies, including those by Stephen Cecchetti et al (2007) and Jeffrey Frankel (2006),

suggest that overly loose monetary policy over the past few years has much in common with the late 1960s period, when it facilitated a buildup in liquidity and above-trend economic growth, at various points pushed asset and commodity prices higher and, ultimately, was the source of the great inflation. Frankel argues that low real interest rates and easy money make investing in commodities an attractive option, rather than low-yielding treasury bills. In addition to this, low real interest rates decrease the incentive to extract resources and increase the incentive to hold inventories. All these factors put upward pressure on commodity prices.

Disturbingly, the 'great inflation' period shows that many commodity prices took considerable time to adjust to slower economic conditions and that, once the inflation genie was out of the bottle, it took massive effort and draconian monetary policies to get the cork back on [see for example, Agénor and Montiel (1999) and Ben Bernanke (2004), the chairman of the US Federal Reserve].

The current episode may eventually turn out to be similar as commodity prices are showing little tendency to correct despite their elevated levels. Certain commodities have attracted considerable investment or speculative interest, a fact highlighted in the IMF's April World Economic Outlook, whose authors argue that low interest rates and rising inflation will keep financial demand for commodities high, as investors look to hedge against inflation and seek alternatives to equities and low-yielding treasuries.

What is different to the 1970s, however, is that the emergence of China and other emerging economies has fundamentally increased demand for both agricultural and non-agricultural commodities. There is unlikely to be a sufficient supply or demand response to higher prices in the short to medium term to change this. There are also other complications, with protectionist tendencies surfacing in response to shortages, particularly of food, where some agriculture-exporting countries have already constrained exports. If these practices escalate, prices are more likely to continue rising than fall as the necessary supply responses will not be forthcoming.

The danger is that the longer basic prices continue to rise the more likely it is that it will spill over into general inflation. Core inflation in most developed countries has so far also remained relatively subdued in comparison with the 1970s, despite the fact that headline inflation has been on an upward trend over the past year. This is less the case in emerging economies, where core inflation has been drifting higher, although not nearly as fast as headline inflation. However, there are signs that second-round inflation is starting to emerge, with companies globally suggesting that increased costs will have to be passed on to consumers despite weaker demand conditions. Inflation expectations are also starting to rise,

ticking up in both the UK and Europe and heading steadily upwards in most emerging economies.

Conclusion

Many central banks are betting that the current surge in commodity prices will be temporary rather than permanent. Central banks, particularly in emerging economies, have been reluctant to raise interest rates (see article below), despite rising inflation and robust domestic demand. If they are correct and the current inflation shocks are temporary, then they are preventing unnecessary economic discomfort. The danger is that, if they are not, and commodity prices continue to rise as some are now predicting, central banks will see significantly higher inflation in the future. Should this spill over into heightened inflation expectations, as was the case in the 1970s, they will instead face an even tougher challenge of restraining the inflation genie over the medium term, with negative consequences for economic growth and asset prices.

Carmen Altenkirch

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CENTRAL BANK BEHAVIOUR IN A RISING PRICE ENVIRONMENT

The reaction of different central banks to the renewed inflation threat has been varied. At the one extreme, the US Federal has slashed interest rates despite a material rise in inflation. The South African Reserve Bank is probably at the other end of the spectrum, continuing to tighten policy significantly in response to rising inflation. Between these two extremes, the majority of central banks have generally adopted a light-handed approach, emphasising the risks to the inflation outlook, but not adjusting interest rates by too much. There are many reasons for the differing approaches, ranging from broader mandates to interpretations of the business cycle, as well as hopes of how long the present rise in food and energy prices will last. This article briefly looks at some of these differing approaches and interpretations.

What central banks have done so far

Table 1 outlines what has happened to official interest rates since early 2007, when inflation first started to rise in

response to rising oil prices. It also details the rise in inflation at headline level over the same period. Lastly, it gives a crude measure of real interest rates (rates minus current inflation – although more properly this should be rates minus inflation over the term of the interest rate). On this basis, and also taking into account where each country is in the economic cycle, countries can crudely be divided into three categories – those who have cut interest rates or held them at very low levels despite rising prices (the doves); those who have raised rates, but only marginally and well below the increase in inflation (neutral); and those who have hiked relatively aggressively (hawks).

Table 1: Monetary policy stances by selected central banks

Countries	Basis point change since January 2007 in:		Real interest rate %
	Official interest rate	Inflation	
Thailand	-175	225	-2.1
Indonesia	-225	194	0.3
Hong Kong	-325	213	-0.6
Russia	-25	517	-2.7
India	0	118	-1.9
USA	-325	192	-2.0
Chile	100	570	-2.3
Hungary	50	-97	1.8
Brazil	-125	171	7.8
Israel	-225	364	-0.5
Czech Republic	125	579	-3.4
South Korea	50	230	1.0
China	135	610	-0.8
UK	25	-29	2.6
Taiwan	88	365	-0.5
Denmark	75	129	0.9
Euro area	50	161	0.6
Turkey	-175	-73	6.6
Poland	175	269	1.5
Australia	125	176	3.1
Sweden	175	146	0.9
Mexico	50	22	3.3
New Zealand	100	86	4.9
South Africa	250	462	0.9

Notes:			
Colour codes:	Doves	Neutral	Hawks
Countries ranked according to degree of tightening in response to rising inflation, level of real interest rates and stage of economic cycle			

The first group includes the US and is mainly influenced by its policies. In the wake of the subprime crisis the US Federal Reserve has been completely focused on trying to prevent a systemic banking crisis and a full-blown recession rather than worrying too much over rising inflation. Many other central banks are following similar monetary paths, simply because their currencies are US-dollar trackers. This means that large parts of the developing world have interest rates that are inappropriately low relative to their own burgeoning domestic demand. This, in turn, has been feeding into the global inflation cycle.

Certain countries in this category have chosen to keep interest rates unchanged and instead have imposed price

controls on basic foodstuffs. These include Thailand, Malaysia, Russia, Indonesia and Argentina. Unfortunately such policies are rarely successful and do not address the underlying reasons for prices rising in the first place, often leading to shortages as the desired supply response does not materialise.

The second category consists of central banks that have taken a softer approach to rising headline inflation, but for different reasons. The most common explanation for this approach is that core inflation has, so far, risen only modestly. Policymakers feel that so-called second-round effects – where rising energy prices in particular start feeding into more general inflation and inflationary expectations – have been muted and are therefore not reacting too aggressively to the rise in headline inflation. The implicit, underlying assumption is that the rise in food and energy prices is temporary and that inflation will ease over the next two years.

The Czech National Bank (CNB)'s actions are an example of this line of thought. Although the authorities have raised interest rates by 125 basis points since early 2007, inflation has dramatically overshoot the 2% to 4% target, leaving real interest rates in negative territory. Interestingly, core inflation has also risen significantly and at 6% is similar to that of South Africa's, and also well out of the target range. Despite this, the CNB declined to raise interest rates any further in its 7 May decision, preferring to leave the repurchase rate at around half the current inflation rate. The rationale behind this decision was that its forecast projected that inflation would fall back into the target zone over the 12- to 18-month time horizon, which it considers to be the monetary policy horizon.

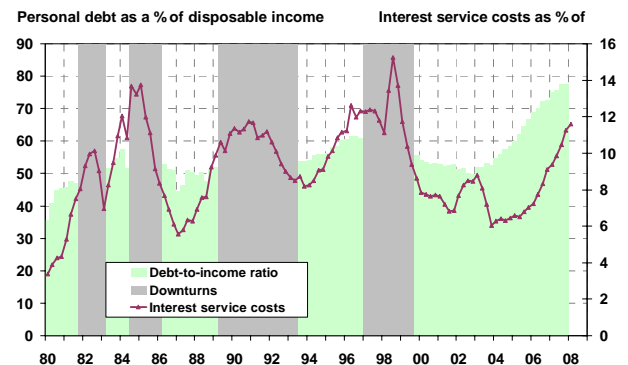
The final category – those who have been relatively tough – includes central banks such as those of Australia, New Zealand and South Africa. Here some attempt has been made to keep current real interest rates positive and to bring domestic demand under control. Even so there are nuances. For example, the Australian Reserve Bank has been cautious in raising interest rates by too much given evidence of slower economic growth. It is also helped by an inflation target that is over a full economic cycle, and therefore allows inflation to persist at higher levels in an upswing, without necessitating too severe a response.

The case of South Africa

In South Africa's case interest rates have been raised aggressively since June 2006. Interest rate rises have not quite matched the rise in headline inflation since early 2007, but they have risen by more than the increase in core inflation and they remain positive in real terms by both measures. More importantly, the higher level of household debt now, combined with the 450 basis point increase in interest rates over the cycle, has pushed interest service costs up to levels that have been associated with recessions in the past. What makes

South Africa different to most other countries? There are probably three interlinked factors.

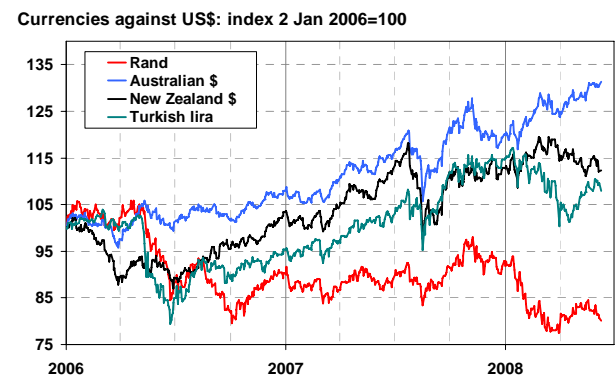
Graph 4: Household debt and debt servicing



Source: SARB

The first is that interest rates were too stimulatory prior to 2006. We were critics of the last two cuts in the down cycle simply because there was clear evidence that consumer credit and spending were already getting overheated. Growth in asset-based credit had been accelerating for over 18 months at the time of the August 2004 cut and had moved to 23% (or 16,3% in real terms) in April 2005 when the last cut occurred. When the Reserve Bank eventually raised interest rates in June 2006, credit was rising at a rate of around 27% off an already high base and debt had risen considerably. The reason why this seemingly reckless policy action occurred was that inflation was low, helped by a strong rand, low administered prices and moderate global inflation. The MPC was reacting to an apparent threat that CPI-X inflation would go below the 3% lower target. In doing so, it was concentrating too much on past inflation.

Graph 5: Rand performs poorly against US dollar and peers

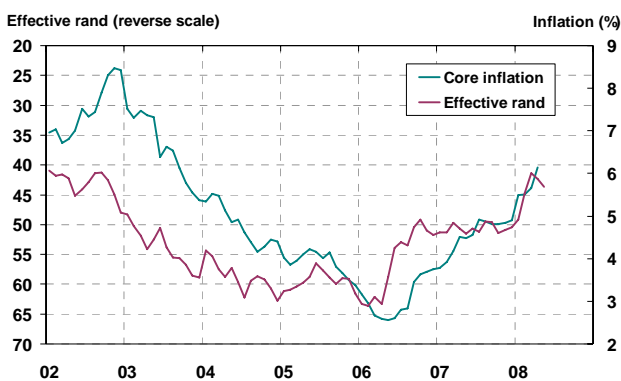


The second factor making South Africa a special case has been the weak rand – a complete reversal of the earlier dilemma. Since 2006 the trade-weighted rand has fallen at an annual rate of over 15%, adding considerably to the pain caused by higher global food and energy prices. The currency has even fallen against the US dollar, itself weakened by falling growth and a very unfavourable current account deficit. The reasons for this unusually

poor performance are varied, but would include an overheated domestic economy that manifested itself in a widening current account deficit and growing capacity constraints. These in turn were linked to the first factor.

Finally, South Africa has been unusual in that core inflation has risen fairly significantly while other countries have seen only small increases. The MPC seems to read into this that second-round effects of higher energy prices are feeding into more general inflation. While there may be some evidence of this, the overwhelming reason for the rise in core has been the exchange rate, where officials have since early 2006 shown an attitude of benign neglect (as well as actively siphoning dollars out of the market to add to official reserves, irrespective of market conditions), following a period of cheering excessive rand appreciation. Through statements and active dollar accumulation to build up reserves (regardless of market conditions), the message to the market has been that a weaker rand is more desirable, and so it has obliged.

Graph 6: Core inflation and the rand



Sources: SARB, StatsSA, own calculations

The Reserve Bank's dilemma is that the medicine applied so far seems to be having little effect on inflation, which is not surprising given the source. The medicine is, however, starting to have a severe effect on economic growth and a continuation of the chosen strategy would almost surely push the economy into a downturn. Consumer spending is already contracting and house prices are starting to slide, a major warning bell for most central bankers and one of the key reasons that interest rates have been cut elsewhere. So what should have been done and still must be done?

Firstly, interest rates had to rise and would have risen under any monetary regime. The issue is more the extent of the increase. Most central banks have sent the message that they are being tough about inflation without killing the patient at the same time. For this reason the 50 basis point increases at a time have been appropriate, although probably too frequent. We would also differ from some analysts calling for a stronger response (100 basis points, and more often). If the nature of the inflation threat were demand-led, then an early significant counter would have been appropriate. It is not, and therefore the

transmission mechanism is more about curbing expectations than reducing demand. More than enough has already been done on the demand front, although the authorities appear to believe that the economy will continue powering on, helped by infrastructural spending. This belief is likely to be dented, because if the current malaise in household spending persists it must ultimately affect private investment plans.

Secondly, this is no time to get rid of inflation targeting or start adjusting the targets radically. The framework has been remarkably successful so far and cannot be judged fairly in the current global turmoil. Rather, the explanation clause could have been used to help explain the significant deviation to the public and to explain more effectively that inflation will return to the range over the medium term, which after all is the only period that the Reserve Bank can influence anyway and should therefore concentrate on. Just as monetary policy became too lax in the face of unexpectedly low current inflation four years ago it has become too tight due to unexpectedly high inflation. Raising the target range now would raise inflation expectations and wage demands by a similar amount and result in higher – not lower – interest rates over time.

Thirdly, the rand needs to become more of a two-way currency again, with bouts of strength as likely as bouts of weakness. The plunge earlier this year to levels well below reasonable measures of purchasing power parity has greatly added to inflation and exacerbated the current interest rate dilemma. Encouraging a more neutral currency does not require intervention on its behalf but at least not intervention against it. Again, just as official encouragement of an overvalued currency led to overstimulated domestic demand four year's ago, so the recent apparent sanctioning (intentional or not) is contributing to an overly tight monetary stance.

Conclusion

Central banks have generally taken a soft approach to rising headline inflation, preferring to adopt a wait-and-see approach to food and energy prices. Collectively, this may turn out to be dangerous, as the resulting liquidity could continue to support price rises in these sensitive areas and allow overall inflation to move out of the comfort zone, particularly in countries where demand remains strong. South Africa has followed a more aggressive approach, which has been, and will continue to be, unsuccessful until global inflation is brought under control. Part of the reason for the harsh application is that the authorities continue to believe that the underlying strength of the South African economy remains intact. This assumption is likely to be severely tested in the months ahead.

Dennis Dykes and Carmen Altenkirch

Economic review and forecast

International background

Global growth continues to lose momentum. Forecasts have been revised down as the banking crisis and weak consumer confidence in developed economies continue to weigh on prospects. Financial markets remain distressed, with financial institutions having already reporting subprime-related losses of \$379 billion and additional writedowns still likely to emerge. The prospect of slowing growth coupled with rising inflation is a key challenge facing most developed and some developing countries. Over the past few months central banks have applied different medicine, with the US Federal Reserve cutting rates aggressively in an attempt to avoid a recession, while the European Central Bank has taken a slightly tougher stance against inflation. How central banks decide to deal with this twin challenge could be central to what happens to global growth in the medium term. Among other risks in developing countries are concerns that rising food prices may spark more food-related riots in poor and politically vulnerable countries. A further concern is significantly weaker consumer spending in the US, Europe and Japan, as consumers face rising prices, falling asset prices and tougher borrowing conditions.

The **US economy** continues to lose momentum, with many now fearing that the US has already entered a recession. Households are under pressure as energy and other costs have risen sharply, eroding disposable income. Conditions in the labour market have deteriorated noticeably, with the economy shedding jobs in the first four months of the year. As a result, consumer confidence has weakened to a 16-year low. While a \$120 billion fiscal stimulus package is currently being disbursed to boost consumption, people will be reluctant to spend their rebates, making the package less effective. Still robust demand for exports has helped to limit the extent of the contraction in the manufacturing sector. Good news is yet to emerge from the housing market, with new data suggesting that an end to the current crisis is not yet in sight. The financial system remains in distress. The collapse of Bear Stearns, a major US investment bank, and the Federal Reserve's willingness to add billions of dollars of liquidity into the system, are manifestations of the gravity of the crisis. In a bid to limit the repercussions of the credit crunch the Federal Reserve has cut rates by 325 basis points since August. The fear of falling into a recession is currently overriding concerns of rising inflation and inflation expectations. A recovery in the US will probably take longer than anticipated as financial institutions battle to adjust to the fallout from the credit crisis, and the housing market seems unlikely to stabilise this year.

Growth in the **Eurozone** has begun to show signs of faltering, while leading indicators suggest an even gloomier outlook. However, there are marked differences

across the region, with growth accelerating in Germany, easing in France and contracting in Spain. European consumers, who were less inclined to spend in the boom years than their US and UK counterparts, have had to reduce spending as rising prices and high borrowing costs have eroded disposable income. The manufacturing sector has held up well, despite a much stronger euro. The trade of most European countries is intra-Europe, making it relatively insensitive to developments in the exchange rate. High-tech manufactured goods, which make up a significant portion of exports to Asia and elsewhere, are also less price-sensitive. Although problems in the banking sector and sluggish consumer demand are starting to take their toll on the Eurozone economy, the European Central Bank (ECB) is maintaining its hawkish tone in the face of high inflation, which reached a 14-year high of 3.3% in April. Capacity constraints, above-inflation wage demands and robust money growth add significantly to upside risks and will make the ECB reluctant to cut rates in the short term.

UK economic growth is likely to weaken further over the next year as a drop in industrial production and waning consumer demand impact negatively on the economy. Consumers have remained remarkably resilient in the face of higher borrowing costs and soaring food and fuel prices. However, with debt-to-disposable income at a record 175%, consumers will have to reign in spending soon. A marked deterioration in the housing market and tighter credit conditions have also put a dent in consumer confidence. Growth in the services sector, which includes financial services, has begun to falter, as conditions in the banking sector have deteriorated significantly since the start of the credit crisis in August last year. Inflation remains above the Bank of England (BoE)'s 2% target level, but with producer prices rising and little indication that both food and fuel prices will come down in the short term, inflation is expected to remain above the target range until the end of next year. The BoE has cut rates three times since August, but only by 25 basis points each time. The bank faces the difficult task of balancing the risks of a slowing economy against inflation, which remained above the target range for much of last year. The BoE is not expected to cut rates again until late next year, as inflation is expected to remain above the target range until 2010.

Japan's economy gained momentum in the fourth quarter of last year, but early indications are that this is unlikely to be maintained during 2008. The economic recovery has been built on exports and business investment needed to expand production. Persistent financial market turmoil has increased borrowing costs for companies, left the yen firmer and weakened external demand. These factors combined will hamper export growth over the coming year. Despite record corporate profits, companies have not increased wages and as a result domestic demand remains depressed. Falling

equity prices combined with rising food and fuel prices have eroded consumer confidence, making a recovery in domestic demand less likely. As a result the economy is particularly vulnerable to a recession in the US, its major trading partner. Inflation has risen to a decade high, due to rising food and fuel prices. However, with the economy showing signs of strain, the Bank of Japan has changed its stance slightly and may even consider cutting rates.

Emerging markets have experienced several years of remarkably strong growth. Growth should moderate this year, albeit by not as much as in developed countries. The key question is whether the US will sink into recession and, if so, how deep and protracted the contraction will be. A mild slowdown only implies continued strong expansion in Asia and firm commodity prices. However, a deep contraction could impact more severely and lead to a significant correction in commodity prices over time. The **Chinese economy** will continue to expand at a robust pace. However, growth may be constrained by weaker demand in key export markets. Inflation has risen sharply, fuelled by spiralling pork and rice prices. The government has chosen to implement price controls, which may distort economic activity further. The prospects for growth in other **Asian** economies have deteriorated slightly on weaker demand for exports and a slowdown in capital inflows. However, domestic demand remains robust and should help to support economic growth. Rising inflation will be the most pressing domestic policy challenge.

High commodity prices and foreign direct investment is expected to boost growth in **Sub-Saharan Africa**, with growth only expected to slow very modestly this year. The election fiascos in Zimbabwe and Kenya may have undermined investor confidence in the region. **Latin America** may not escape last year's turmoil unaffected, given its close trade and financial linkages with the US. However, high commodity prices and still robust domestic demand is expected to support economic growth. Relaxed fiscal policy and robust domestic demand have exacerbated inflation in the region. Modest tightening of domestic interest rates in Chile, Columbia, Peru and Mexico should contain growth during 2009. Growth in **Eastern Europe** is expected to slow this year, as growth in Western Europe eases over the coming months. Over the past few years growth has been boosted by construction and consumer booms, which have been fuelled by cheap credit from abroad. This makes these economies particularly susceptible to changes in investor sentiment. Tighter credit conditions are making it more difficult to refinance loans on the concessional terms available prior to the credit squeeze and may constrain economic activity.

Commodity prices continued to break new records over the past three months. The price of Brent crude oil reached a record \$139 per barrel in early June. The oil price was driven by renewed unrest in Nigeria's oil-

producing Niger Delta, a strike at a Scottish oil refinery, robust demand from China, continued dollar weakness as well as speculative activity. Gold peaked very briefly above \$1 000 per ounce in mid-March on safe-haven buying and rising inflation expectations. However, profit taking and some dollar strength then saw gold relinquish much of its gains. The price of platinum has been supported by concerns about disruptions at South African platinum mines, due to electricity shortages. Supply disruptions have caused some base metals to remain at elevated levels, despite prospects of weaker global growth. Prices of agricultural goods, particularly, wheat, corn and rice, continued to climb higher. In the past prices have been driven higher by poor weather conditions, increased demand from the biofuels industry and emerging economies. More recently increased speculative activity, as well as some agriculture-exporting countries imposing bans on exports of key commodities, has put additional upward pressure on prices. Commodity prices are expected to ease off their current high levels in the coming months, as demand slows on weaker global growth.

Global equity markets remain under pressure on concerns of recessionary conditions in the US and fears about the health of the global financial system. Equities began to rally slightly in mid-March, as interest rate cuts by both the US Federal Reserve and the BoE improved growth prospects. Low and negative real interest rates also make equities an attractive option, despite weak economic fundamentals. Better-than-expected corporate earnings, particularly in the US, and bargain hunting have also buoyed equities. Markets will remain jittery as new economic data shows the extent to which global growth will slow as a result of the credit crunch.

On **exchange rate markets** the dollar continued to come under pressure. The dollar weakened for much of the period, as the Fed aggressively loosened monetary policy. More bad news on the economy and the financial system also weighed on the dollar. The US unit rebounded on speculation that the Fed will pause before deciding on what direction monetary policy will take. A deteriorating outlook for the Eurozone is also helping to support the dollar. Currencies are likely to remain volatile as the markets grapple with the possibilities of recovery in various regions.

Domestic prospects

The **economy** lost significant momentum in the first quarter of 2008, with real gdp growing by 2,1% on a seasonally adjusted annualised basis, down from over 5% in the final quarter of 2007. Severe disruptions to power supply were mainly to blame, but rising inflation and higher interest rates contained growth in most sectors. The worst affected industries were mining, power and water as well

as manufacturing, where output declined sharply. Activity levels in the domestic trade and accommodation as well as finance and real estate industries were also subdued as household spending slowed in response to tough financial conditions. However, agricultural output rose sharply on the back of a good field harvest, while construction activity remained strong due to robust infrastructure investment.

Table 2: Industry breakdown of gdp

Industry	Growth (q-o-q seasonally adjusted annualised rates %)						% of Total
	2005	2006	Q3'07	Q4'07	2007	Q1'08	
Agriculture	5.4	-7.9	5.8	10.4	0.3	12.5	2.2
Mining	2.2	-0.1	4.0	-1.7	-0.6	-22.1	5.5
Manufacturing	4.6	5.2	-2.5	8.2	3.9	-1.0	16.1
Power & Water	1.7	3.0	3.0	-1.8	3.2	-6.2	2.1
Construction	12.4	14.7	14.7	14.2	18.1	14.9	3.4
Trade	7.3	7.0	4.5	2.1	5.0	3.6	14.1
Transport & comm	5.3	5.0	4.4	3.6	5.2	3.5	9.7
Finance	5.2	8.6	12.3	8.5	8.3	4.9	20.2
General government	3.4	3.1	3.3	4.4	3.4	4.6	12.4
Personal services	4.4	4.5	5.1	4.3	4.1	3.9	5.3
Value Added	5.0	5.3	5.1	5.5	5.2	1.9	
GDP	5.0	5.4	4.8	5.3	5.1	2.1	

Signs of coming weakness were already evident in the expenditure figures of the fourth quarter. **Domestic demand** moderated significantly, mainly due to a sharp decline in inventories and slower growth in household and government consumption expenditure. In contrast, fixed investment activity remained robust. Households increasingly felt the effects of rising prices, softer income growth, high debt levels and stricter lending conditions, following the implementation of the new National Credit Act (NCA). Consumers also finally became wary of taking on more debt. As a result, the ratio of household debt to disposable income was almost unchanged at 77,6% in the last quarter of 2007 from 77,5% in the third quarter. However, higher interest rates pushed the ratio of debt service costs to disposable income up to just over 11% from 10,5% previously.

Fixed capital formation remained exceptionally strong. Capital spending by public corporations provided the main momentum, with significant progress recorded in the massive capacity expansion programmes of Eskom and Transnet. Private sector investment also remained robust, supported by large capital projects in mining and manufacturing sectors aimed at relieving growing capacity constraints and taking better advantage of good export opportunities for commodities in the fast growing Asian economies. Finally, capital spending by general government was relatively subdued, but spending on preparations for hosting the 2010 FIFA World Cup and general improvements in service delivery continued.

The country's external position remained a drain on growth, but at least the trade deficit narrowed somewhat towards the end of 2007. Export volumes picked up and export prices improved significantly, boosted by surging global commodity prices as demand from China and other fast-growing emerging markets remained strong. Imports

were little changed from the levels recorded in the third quarter and were mainly driven by rising international oil and food prices. As a result, the **current account deficit** narrowed to 7,5% of gdp in the fourth quarter of 2007 from 8,1% in the third quarter. In 2007 as a whole, the current account deficit totalled R145 billion or 7,3% of gdp, up sharply from R112,3 billion or 6,5% of gdp in 2006.

The current account deficit was again comfortably financed by foreign capital inflows, which remained healthy at R54,1 billion in the fourth quarter. The bulk of capital inflows came from foreign direct investment mainly due to a foreign purchase of a South African platinum mine, while portfolio investment, usually the mainstay of capital flows, dropped sharply to only R2,9 billion. Severe turmoil in global financial markets resulted in rising risk aversion, while dramatic changes to the ANC leadership at the end of 2007 also contributed. In 2007 as a whole net portfolio investments still amounted to R107,4 billion, and remained largely responsible for net capital inflows of R192,6 billion for the year. As a result the buildup of reserves continued, although at a slower pace. The months of import covered by reserves rose from 4,7 in January 2007 to 4,9 in December 2007 and 5,3 in April 2008.

Unfortunately, many of these balance of payments trends did not persist into the first quarter of 2008. The trade deficit widened again following a massive rise in energy-related imports. At the same time capital inflows slowed and became more volatile following the outbreak of the electricity crises and the sudden economic slowdown.

The economic outlook has deteriorated in recent months. Rapidly rising inflation prompted a further interest rate hike in April, taking the cumulative increase since June 2006 to 450 basis points. With household debt levels at record highs and much tighter credit conditions, most households are taking serious strain. Consumer confidence also continues to fade, increasingly tested by sharp price increases on necessities, growing expectations of further interest rates hikes, reports of falling house prices, continued political indecision and growing social discontent following a spate of xenophobic attacks. Household spending is likely to slow further, with significant downside risks. This will contain activity in most industries servicing the consumer market. However, other sectors should do better. Fixed investment activity will be buoyed by continued infrastructure spending. Eskom, Transnet and general government are likely to step up capital spending to alleviate capacity constraints and meet the 2010 World Cup deadlines. This should support construction activity and various manufacturing industries, while exporters in both the mining and manufacturing sectors should benefit from still strong demand from China and other emerging markets, record-high global commodity prices and a weaker rand. However, the ongoing power constraint and other capacity problems may continue to frustrate export efforts. The

economy is forecast to grow at a very modest 2,9% and 3,1% in 2008 and 2009 respectively.

Growth in **private sector credit extension** slowed to 19,6% y-o-y in April after unexpectedly rising to 22,6% in March from 20,8% in February. The credit figures have been distorted by the introduction of a new reporting system in January, which required changes in accounting practices and significant reclassifications between various categories. These technical factors partly explain the unexpected and counterintuitive rise in credit extension. However, corporate demand for credit remained robust, resulting in strong growth in the 'other loans and advances' category and mainly reflecting the ongoing fixed investment boom. In contrast, household demand for credit remained subdued, reflecting the effects of tighter monetary policy and access to credit.

Inflation continued to march higher. CPIX, which excludes interest cost on mortgage bonds, accelerated to 10,4% y-o-y in April – its highest level since December 2002. Persistent sharp increases in food and transport costs remained the main culprits, but signs of second-round inflation emerged in some categories of goods. Unfortunately, the outlook for inflation remains bleak over the short term. The main worries are still high global fuel and food prices. However, inflationary expectations also continue to deteriorate, wage demands are now well above the upper 6% limit, the rand is weaker and electricity costs are set to increase aggressively even if Eskom's proposed 53% tariff hike is not approved. Therefore CPIX inflation is expected to rise to a peak of around 11% in August before slowly easing to around 8% by year-end. CPIX is expected to approach the upper 6% limit only by end 2009 and is not likely to move back within the range before 2010.

The Reserve Bank's Monetary Policy Committee (MPC) responded by hiking **interest rates** by another 50 basis points in April. The tighter stance was mainly motivated by the poor inflation outlook and, more specifically, by worries over rising inflationary expectations. Although the monetary authorities acknowledged the weakness in the economy, the potential downside risks to growth were generally evaded or downplayed. Since then, Governor Mboweni's rhetoric has hardened alarmingly, with mention of 'drastic action for drastic times' and the possibility of a 200 basis point hike in June. Further rate hikes now seem a certainty. Interest rates are likely to rise by about 100 basis points in June, and the risk of another 50 basis point hike in August is very high. The rate cycle is likely to have peaked by October, with interest rates remaining steady at higher levels. Some monetary easing is expected in 2009 as a slowing economy limits retailers' pricing power and evidence of the turn in the inflation cycle becomes apparent.

Financial markets were volatile in the first five months of 2008. Local equities were initially dragged down by

volatile and weak global markets, which still struggled to come to terms with the collapse of the US subprime mortgage market and ensuing global credit crunch. In the process the FTSE/JSE all-share index fell to 25 135 on 23 January – its lowest level since 14 March 2007. However, as fears of a US recession spread, the US dollar plunged to new lows, pushing commodity prices to new highs, especially those of precious metals. As a result, prices of local resource shares rose sharply, taking the all-share index to a record high of 32 959 on 20 May 2008. For the year to date the all-share index gained 11%, with basic materials up by 32%. However, interest-sensitive stocks remained under pressure due to higher interest rates and heightened expectations for further hikes. Financials are down by 18% to date, while gains by industrials are limited to a modest 0,7%. The bleak short-term inflation and interest rate outlook kept the **bond market** under pressure, with yields on the R153 2010 and the R157 2015 rising to 11,05% and 9,81% on 28 May, from 9,41% and 8,57% at the beginning of the year.

The **rand** has been weaker since the start of the year, down 14% on a trade-weighted basis. The local unit initially depreciated as already risk-averse international investors adjusted their positions to reflect the uncertainty over the policy tendency of the new ANC leadership and growing concerns over domestic growth prospects following the unexpected and severe power outages. These worries pulled the rand down to R8,13 against a collapsing US dollar and R12,85 against a strong euro on 28 March. This was the rand's lowest level against the dollar since June 2003 and against the euro since December 2001. However, the rand recovered somewhat in mid April and early May, supported by higher commodity prices and expectations of further interest rate hikes. Since then, the recent xenophobic violence has limited gains. The rand is likely to remain volatile for much of 2008, but there is scope for consolidation and some recovery later this year as interest rates rise and international sentiment settles.

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FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

11 June 2008

	2003	2004	2005	2006	2007	2008	2009
Growth (real, % change)							
Gdp	3.1	4.9	5.0	5.4	5.1	2.9	2.8
Gde	5.2	7.9	5.7	9.2	6.0	3.9	5.2
Pce	3.5	6.7	6.9	8.2	7.0	2.6	2.6
Gdfi	9.1	8.9	8.9	13.8	14.8	8.5	13.9
Exports	0.1	2.9	8.0	5.6	8.3	4.6	4.9
Imports	8.1	14.5	10.3	18.8	10.4	7.5	11.5
Balance of payments (Rbn)							
Exports	291.4	310.5	352.2	434.5	535.7	760.7	923.2
Imports	264.8	311.8	358.5	476.5	576.0	789.1	919.3
Trade balance	26.7	-1.2	-6.4	-42.0	-40.2	-28.3	3.9
Net services	-40.3	-43.4	-55.8	-70.3	-104.8	-126.4	-143.3
Current account	-13.7	-44.6	-62.2	-112.3	-145.0	-154.7	-139.4
Capital account	8.8	82.2	96.4	142.1	192.8	148.6	176.6
Change net reserves	-4.9	37.5	34.3	29.8	47.8	-6.1	37.2
Gross reserves (eop)	52.9	82.8	130.5	178.3	221.2	256.0	295.7
Current account as a % of gdp	-1.1	-3.2	-4.0	-6.5	-7.3	-7.2	-6.0
Gold price (average per ounce)							
\$	363.5	410.4	445.7	605.1	699.0	859.8	796.5
Rand	2757	2652	2844	4103	4937	6870	6496
Exchange rates (average)							
\$-Rand	7.58	6.46	6.38	6.78	7.06	7.99	8.16
Euro-\$	1.13	1.24	1.24	1.26	1.38	1.54	1.54
\$-YEN	116.0	108.2	110.2	116.3	117.7	105.8	107.1
GPB-\$	1.63	1.83	1.82	1.84	2.00	1.98	1.94
Euro-Rand	8.56	8.03	7.93	8.51	9.71	12.28	12.60
Rand-YEN	15.3	16.7	17.3	17.2	16.7	13.2	13.1
GBP-Rand	12.39	11.83	11.60	12.48	14.13	15.79	15.85
Interest rates (end of period)							
Three-month JIBAR	7.73	7.47	7.05	9.18	11.25	13.13	11.03
Prime	11.50	11.00	10.50	12.50	14.50	16.50	14.50
Long bond	9.21	8.15	7.43	7.76	8.35	9.79	8.36
Inflation (average)							
Headline CPI	5.9	1.4	3.4	4.6	7.1	11.0	6.2
CPIX (metro and other urban)	6.8	4.3	3.9	4.6	6.5	10.1	6.3

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FACTS AND FORECASTS OF KEY ECONOMIC VARIABLES

11 June 2008

	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gdp (q-o-q annual %)	5.1	4.4	4.8	5.3	2.1	2.0	0.8	1.3	2.7	3.8	4.2	6.0
Interest rates												
Three-month JIBAR	9.18	9.78	10.21	11.25	11.38	13.03	13.33	13.13	13.00	11.99	11.51	11.03
Prime	12.50	13.00	13.50	14.50	14.50	16.00	16.50	16.50	16.50	15.50	15.00	14.50
Long bond (10 yr)	7.77	8.40	8.16	8.35	9.19	10.21	10.17	9.79	9.40	8.76	8.64	8.36
Inflation												
CPI	6.1	7.0	7.2	9.0	10.6	11.4	12.2	9.8	8.5	5.9	4.6	4.5
CPIX	5.5	6.4	6.7	8.6	10.1	10.3	10.8	8.8	7.3	6.2	5.6	5.8
Exchange rates												
\$-Rand	7.29	7.1	6.88	6.81	8.16	7.83	7.91	8.07	8.15	8.23	8.19	8.15
Euro-\$	1.33	1.34	1.42	1.47	1.58	1.56	1.55	1.53	1.53	1.54	1.55	1.57
\$-Yen	117.9	123.4	115.3	112.0	99.6	103.6	105.7	107.8	107.3	107.3	106.7	106.2
GBP-\$	1.96	2	2.02	2.00	1.99	1.99	1.97	1.95	1.93	1.93	1.95	1.97
Euro-Rand	9.73	9.55	9.75	10.04	12.86	12.23	12.23	12.35	12.47	12.66	12.72	12.79
Rand-Yen	16.17	17.4	16.75	16.45	12.22	13.23	13.36	13.36	13.17	13.04	13.04	13.04
GBP-Rand	14.30	14.2	13.92	13.60	16.20	15.55	15.55	15.71	15.71	15.86	15.94	16.03
Gold price per ounce												
\$	663	648	737	834	934	906	833	792	796	796	796	804
Rand	4834	4602	5074	5676	7618	7094	6592	6387	6483	6548	6515	6548

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