17 May 2011

Economic Commentary

Monthly Insight

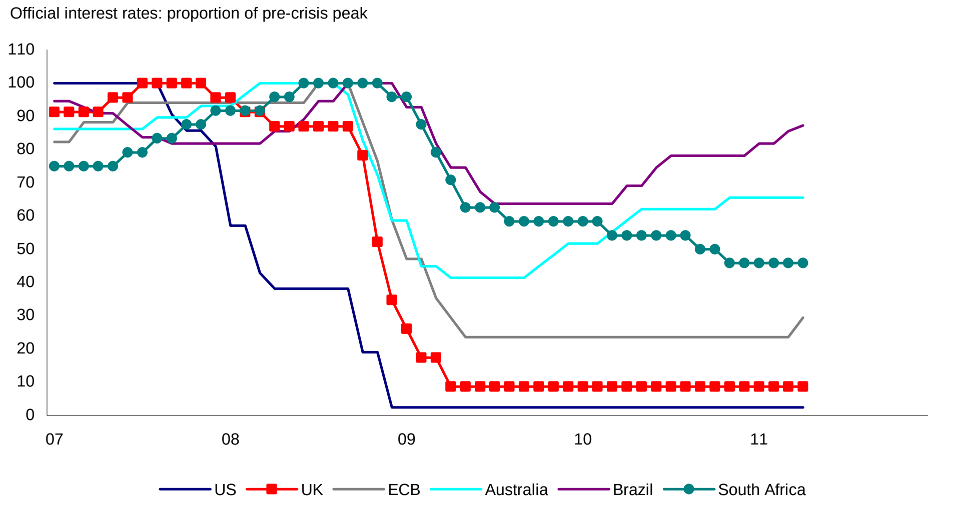
Interest rates on hold for now, but upside risks are mounting

- Interest rates will probably remain on hold until early 2012.
- The Reserve Bank's Monetary Policy Committee (MPC) continues to face contradictory signals, with inflation rising but growth still anaemic.
- The current cycle is unusual given the background of the global financial crisis and the country's positioning during and after the turmoil
- This has meant that the Reserve Bank has not had to act as quickly as it otherwise would have in the cycle.
- At the same time, Inflation is being driven by cost-push rather than demand-pull factors

Comment

The MPC left the repo rate unchanged at its 24 March meeting, stating that although inflation risks had increased most of the threats were of a cost-push nature. The strong rises in energy and food prices have increased the risk that inflation could breach the upper target limit of 6% before the end of the year. This prospect has prompted some in the market to suggest that the MPC is 'soft on inflation' or 'once again behind the curve'. With even the European Central Bank (ECB) now starting to tighten policy there has also been criticism that the Reserve Bank is out of step with other central banks. A major rating agency has even suggested that the current account deficit may be difficult to finance unless rates rise and attract foreign capital.

Chart 1: Varying central bank strategies



Source: Central banks

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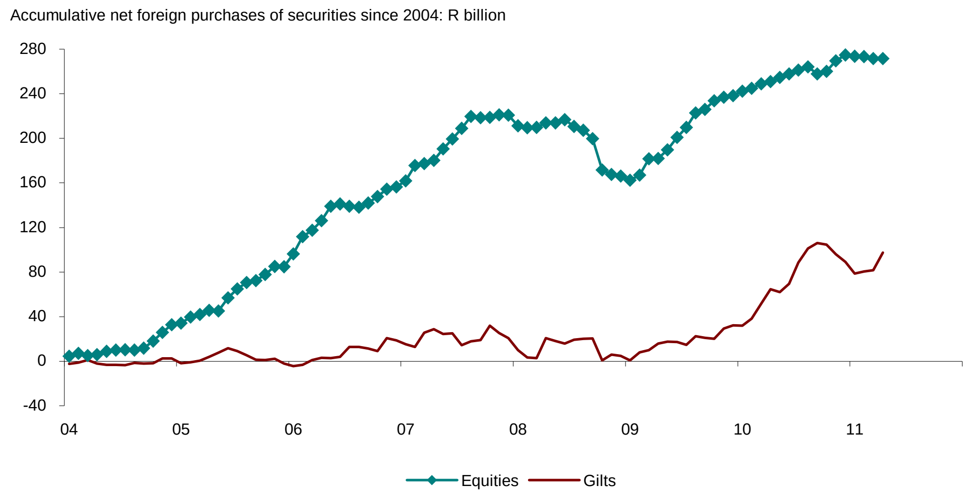
Many of these arguments confuse the direction of interest rates with the actual level, however. For example, the recent rise in the ECB's repo rate from 1% to 1,25% leaves rates at such low levels that it hardly presents any tightening at all. Others, such as the US and the UK, have kept rates on hold despite inflation greatly exceeding official interest rates, which are in any case still at historically low levels. Where there have been strong increases, such as in Brazil for example, these have normally been in response to vigorous credit growth and clear signs of overheating. Even under similar overheating conditions, some (for example, Turkey) have taken a wait-and-see attitude. If anything, interest rates in South Africa remain high and positive in real terms, simply because they were already very high going into the downturn and were not cut nearly as aggressively as was the case in many other countries. Chart 1 illustrates the various paths chosen by central banks in the wake of the crisis. It shows target interest rates as a proportion of the pre-crisis peak. South Africa initially followed a similar path to Brazil, cutting rates only gradually. However, in contrast to South Africa, Brazil's economic slowdown was mild and shortlived, necessitating an early tightening in policy as domestic demand bounced back. The South African economy was affected more adversely and, in retrospect, deeper and earlier cuts similar to those in Australia might have helped to reduce some of the damage caused by the global downturn. Admittedly, this strategy might have been difficult to follow initially given rand weakness, but once financial markets started to calm down in early 2009 a faster path to current - or even lower - interest rate levels should have been taken. Had this been the case the recovery would probably have now been more vigorous and rates would have started rising earlier off a lower base. However, given the economy's average performance it is not surprising to see South African interest rates following a middle course.

Chart 2: Foreign interest in the bond market has revived



Source: Inet

Importantly too, there is very little evidence therefore that foreign capital flows into South Africa are starting to falter on perceptions of easy policy. In fact, bond purchases have recently strengthened (see chart 2) and pushed the rand higher against the trade-weighted basket of currencies. After some weakness earlier in the year, the currency has performed in line with emerging market and commodity currency peers. It remains in overvalued territory from a purchasing power parity point of view and the authorities are unlikely to panic about financing unless global circumstances change drastically for the worse (in which case high interest rates would also do very little to remedy the situation).

The Reserve Bank's current stance therefore seems quite reasonable in the global context, is in step with many others, and actual investor behaviour is supportive.

The more important determinant of whether the MPC is getting it wrong is how the domestic economy has been responding. In a normal cycle, interest rates would be very close to rising. Real credit growth has been rising for nearly 18 months, normally a trigger for some tightening, and the economy has been expanding since the second quarter of 2009. Inflation is also on the rise and inflation expectations are worsening.

However, we continue to believe that this is not a normal upswing. Bank behaviour, both internationally and locally, has been and will continue to be different because of regulatory changes, the effect of recent poor debt experience on risk models, and existing high levels of debt. In many countries governments will also have to reduce debt over the medium term, hurting growth prospects further. Locally, infrastructure constraints – particularly in electricity and transport – as well as regulatory uncertainty are hampering investment and employment prospects.

Recent statistics provide a mixed picture, with better than expected manufacturing production, car sales and retail sales in the first quarter suggesting good growth in the first quarter of the year. However, employment contracted in the first quarter and credit growth has been very modest. Our base case is that momentum will falter rather than improve, with modest domestic demand keeping retail pricing power under control.

Rising inflation is more problematic. The proximate cause is beyond the Reserve Bank's control. Rising commodity prices and particularly energy and food prices are more linked to lax monetary policy in the US and in other developed countries. Some normalisation of interest rates in these countries and the gradual withdrawal of quantitative easing in the US in particular should ease some of the upward pressure in the second half of the year and in 2012, although the rand itself could also depreciate moderately on the same factors. Our base case would see oil moving back into the $90 to $110 a barrel range in the fourth quarter, allowing the MPC to concentrate more on underlying inflation and growth.

Conclusion

More moderate cuts off a higher base during the global recession mean that the Reserve Bank does not have to tighten as aggressively as some of its emerging market peers. The MPC is likely to continue with its wait-and-see policy until credit growth picks up more convincingly or if evidence of second-round inflation becomes compelling. This is not likely in the short term and we maintain our forecast of unchanged rates until early 2012.

Table 1 : SARB checklist

Factor	SARB's most recent interpretation (MPC March)	Recent tendency
International economy		
Growth	'The domestic growth prognosis has improved, and the recovery is expected to be sustained, although not at rates sufficient to make appreciable inroads into the unemployment situation in South Africa"	Global growth prospects for 2011 have recently been revised upwards, but significant risk remains particularly from peripheral Eurozone countries.
Inflation and interest rates	' The global inflation outlook has also deteriorated somewhat in the face of higher oil and food prices	Rising on higher food and fuel inflation, has forced breaches in targets in both the UK and EU.
Oil	'Brent crude oil prices have increased by almost US$20 per barrel. Domestic petrol prices have increased by just under R1 per litre since January 2011, and a further upward adjustmeant is expected in April in addition to the increased fuel levy.'	The price of Brent crude oil has remained above $120 per barrel
Food	'.Food price pressures remained relatively subdued in January despite marked increases in global food prices.'	Food inflation at consumer level has begun to edge higher
Domestic economy		
Balance of Payments	Current account deficit narrowed to 0,6% of gdp in the fourth quarter, from 2,5% of gdp in third quarter of 2010.	A trade surplus of R970,6 million was recorded in March.
Exchange rate (rand)	'The rand exchange rate is relatively unchanged since the previous meeting of the MPC, but has fluctuated between R6,80 and R7,33 per US dollar during this period. Part of the recent strength of the rand can be ascribed to US dollar weakness'	The rand has strengthened against the weak dollar and is in sync with other emerging market currencies.
Labour markets (unit labour costs)	'In Q2 2010, unit labour costs have eased to 9,1% y-o-y. Wage expectations also remain elevated'	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 3,7 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 is recovering but fixed investment remains weak. A more favourable outlook for the global economy should support domestic manufacturing.
Monetary conditions	'Underlying credit extension remains weak but there has been some improvement in the past months.'	Households continue to drive the modest recovery in credit extension, while lending by corporates remains subdued.
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	'Average inflation expectations for both 2011 and 2012 have increased with inflation expected to average 4,7% in 2011 and 6% in 2012'	Rising headline inflation will push expectations up higher

Source: Nedbank

Regular economic analysis is available on the Nedbank Group's internet site, http://www.nedbankgroup.co.za