

Economics

South Africa: Monetary policy alert

Stable interest rates



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What is the latest? The Monetary Policy Committee (MPC) delivered its decision on the appropriateness of the current level of the repo rate today. At the second meeting under the chairmanship of governor Gill Marcus, the MPC decided to keep the repo rate unchanged. The task of the MPC is to weigh the balance of risks of a relatively poorly performing economy (and especially the outlook 12 months hence), against the prospects for inflation over the next 12 to 18 months. The Bank concluded that risks are finely balanced and do not warrant a change in the repo rate. This conclusion of the MPC is in line with the consensus view of economists and analysts.

Our view: Some factors that will discourage future rate cuts are that the oil price is at relatively elevated levels given the generally poor health of the global economy – thus implying that the price may increase rapidly when the growth performance of the global economy improves; and that cost push factors, such as high electricity prices and rather generous wage settlements in 2009, could cause upside risks for inflation in the medium term. Also, the comparatively low inflation rate is a function of the strong, but volatile, rand. Furthermore, inflation may be outside the target range over the next couple of months, even if only marginally, before declining again to within the target range. The inflation rate is expected by the SARB to be 5.4% by the end of the forecast period. We concur with this view but highlight that the inflation profile is not expected to remain below the target band over the period. We anticipate above 6.1% readings between July 2010 and March next year.

The recent announcement regarding suggested electricity tariffs over the next three years will most likely not have a huge direct impact on inflation given the low weight electricity has in the consumer inflation basket. Further second round effects may be substantial and could add around half a percent to inflation, while GDP growth could be lower. The danger of higher inflation is that the increases could lead to higher inflation expectations and become part of the cost structures of companies. The outcome of the current discussion around the electricity price will be known towards the end of February.

A further argument is that the interpretation of data is complicated by lags of various duration and intensity. The last interest cut was in August last year and have not fully filtered through the economy. This is important since inflation targeting is a forward looking exercise. Nonetheless, the Reserve Bank's leading economic indicator has been climbing for eight months in a row in November, thus improving the prospects of the economy.

There could have been a discussion by the MPC regarding arguments that favoured a rate cut. Lower rates will benefit companies that are currently under severe pressure due to the recession and could reduce the serious loss of jobs. Another argument is that business confidence has hovering near a ten-year low and that lower rates will improve business sentiment, investment prospects as well as an improved labour market outlook. The latest data from the global economy, do not point to vibrant growth, especially in the developed world. Locally, despite the fact that the country has emerged from the recession, economic growth is hesitant and is likely to remain so over the short- to medium-term. Growth in credit extension to the private sector is in the red while retail sales remain deeply in the doldrums. A final potential argument is that lower interest rates could lead to lower capital inflows and thus a somewhat weaker currency, which will support exports and thus economic growth. This outcome, though, is not a foregone conclusion.

Given the above uncertainties, it came as no surprise that the MPC decided to keep the repo rate on hold. This has the advantage that February will see the release of data which will provide a clearer picture of the economy. In February GDP growth for the fourth quarter of 2009 will become available, the National Budget will be tabled and the decision of the National Energy Regulator regarding electricity tariffs will be known.

Conclusion: The Reserve Bank decided to keep the repo rate unchanged at 7%, expressing greater confidence about the economy's growth rate and the robustness of the current positive inflation outlook. The Bank's view that the downside risks related to weak demand is

currently offset by higher electricity price risks. We maintain the view that rates are likely to start heading higher by September 2010.

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