

# Economics

## South Africa: Weekly preview

### Uncertainties bulldoze the case for a rate cut

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#### South Africa

##### A close call but MPC expected to sit tight

Figure 1: Prime interest rate



Source: SARB

The Monetary Policy Committee (MPC) of the Reserve Bank (SARB) will deliver its decision on the appropriateness of the current level of the repo rate next week. Given the forward-looking nature of inflation targeting, the task of the MPC is to weigh the balance of risks to the economic growth trajectory 12 months hence, against the prospects for inflation over the next 12 to 18 months.

The general view is that the interest rate decision is likely to be a difficult one and that keeping the rate constant or cutting the rate are

both possibilities that the MPC will consider. Those expecting a cut in the repo rate of 50 basis points to 6% will base their argument on the following points:

- The global economic environment has deteriorated somewhat since the last MPC meeting in May. The developed world's outlook has weakened in the intervening period and the possibility of a double dip in some countries, especially in Europe and the UK, cannot be ruled out with confidence. Policy announcement in these countries underline that reducing deficits and debt levels are priorities, implying lower government spending, which could seriously hamper local growth.
- Local economic growth in the first quarter of the year was to a large degree propelled along by external forces in the form of exports of commodities and manufacturing goods. These drivers of growth are likely to lose steam in the quarters to come as exports falter on the back of a more uncertain global environment and a slowdown in the build-up of inventories in many parts of the world. Notwithstanding the sharp acceleration in household consumption expenditure in Q1, domestic demand drivers, particularly capital formation, are relatively weak at this stage and may not be able to provide the necessary lift to the economy.
- The output gap, which is the difference between current production levels in the economy and what can potentially be produced when all economic resources are fully utilised, is substantial, implying a waste of resources. This is also confirmed by the relative low levels of capacity utilisation rates in industry and low credit appetite.
- The loss of more than one million jobs over the last five quarters is a potential time bomb: the creation of additional employment opportunities is urgently needed and may require, amongst others, sustainable and higher economic growth.
- Household finances remain fragile with the debt/disposable income ratio seemingly stuck at historically high levels. We

believe this reflects the backlog of debt in arrears, explaining why the stimulatory impact of rates has been suppressed up to now. A reduction in interest rates may be required to create some breathing space for consumers, while more vigorous growth will lead to higher disposable income and consequently pressure the ratio lower.

- Over the last few weeks many of the data and survey releases were somewhat worrying, indicating a loss of momentum in sections of the economy. The Bureau for Economic Research (BER), in its survey of manufacturing in Q1, indicated that softer exports, rising stocks relative to demand, and the strong rand are weighing on the sector. Domestic sales and orders continue to fall and the number of employed workers has declined in Q1. According to the Rand Merchant Bank (RMB) and BER Business Confidence Index (RMB/BER BCI), confidence fell to lower levels in Q2 and the latest BER/Kagiso Purchasing Managers Index (PMI) declined for the fourth consecutive month in June, and fell marginally below the key 50 mark for the first time since October 2009. The First National Bank (FNB) Building Confidence Index, which measures the business confidence of all major role players and suppliers involved in the building industry, took a knock in Q2 while the FNB/BER consumer confidence index remains virtually unchanged in Q2 compared to the first quarter. During the second quarter, fewer consumers expected an improvement in their finances a year from now, while only a small majority of consumers still rate the present time as inappropriate to buy durable goods.
- The inflation rate is well within the target band and is not expected to increase materially over the medium term. The relatively low inflation rate and lack of demand-side pressures may warrant a further loosening in monetary policy.
- The demand for credit from both corporates and households is anaemic and is not seen as a concern over the medium term.
- Finally, a recent speech by the Governor of the Reserve Bank was interpreted as dovish as far as her views on the state of both the local and global economies are concerned. She stated that “(T)he reality is that we probably never really emerged from the crisis, which is now entering its next phase. These developments have serious implications for the domestic growth outlook.” This signals official disillusionment with the state and outlook for the economy.

Those that expect the repo rate to remain on hold are likely to base their argument the following:

- Prospects for the globally economy are not quite as poor as being made out. The International Monetary Fund, in an update of their World Economic Outlook released on July 8, revised their forecast for global economic growth upwards from 4.2% in 2010 to 4.6%.

- The inflation rate (4.6% in May) is close to the midpoint of the target range and therefore not abnormally low. In fact we may only now be approaching what could be the unstated inflation target (the midpoint). However, the medium-term inflation trajectory is rising, and at risk from the substantial increases in wage pressure.
- The current recovery has seen GDP growth rebound to 4.6% (q/q and seasonally adjusted and annualised) in the first quarter of the year, following the 3.2% growth in the final quarter of last year. Furthermore, domestic drivers of growth will come to the fore as overall confidence improves throughout the year. Some improvement in the domestic drivers of the economy is visible in the gradual recovery in retail sales, which showed real growth of 4.6% in May, while durable and semi-durables have shown a strong rebound in the first quarter of the year, admittedly from a low base.
- That the impact of the sizable cuts in the interest rates over the last two years was rather disappointing, but it does not imply that a further cut now is required. The expected soft spot in global growth in the second half of the year and focus on restoring strength to balance sheets are two factors that may explain this phenomenon. As soon as confidence in the economy and global matters is restored, the economic growth trajectory may actually overshoot, and the SARB may sit with unwanted price pressure on hand.
- The SARB has previously signalled that interest rate smoothing is essential and it has the opportunity to do so by keeping rates constant over a longer time frame. Another rate cut may imply that rates will have to be reversed sooner than generally expected, thus adding to volatility in the markets.
- Although the recent thoughts expressed by the Governor on the prospects of the local and international economies can be interpreted as not very optimistic, the Governor two weeks prior to that said that the scope for further easing in interest rates is limited and that the repo rate is likely to remain stable for some time. It is not clear, though, whether the Governor had changed her mind in the intervening period between the two statements.
- Household savings as a percentage of GDP has turned negative again, with implications for gross savings in the economy and the financing of the deficit on the current account of the balance of payments. Lower interest rates will reduce the attractiveness of savings and may over stimulate the credit cycle.

These points are all relevant at least to some degree. Clearly, a strong case can be made for a 50 basis point reduction in the repo rate next week. This, however, may be based on a too negative and short-term view of the state of the economy. Crucially, though, will be the MPC's view of medium term risks beyond the normal 12 to 18 month in framing its view. Several uncertainties continue to linger at this stage. As such, it is not impossible that the September meeting may herald

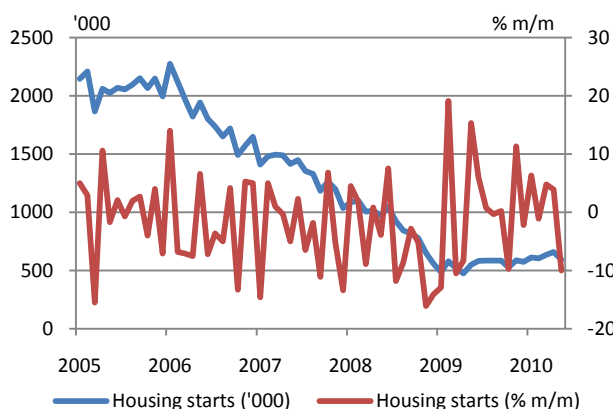
the opportunity to provide further relief in monetary policy, as several uncertainties may either have been confirmed or eradicated by then. For example, the magnitude of electricity price increases taking effect in July will only be available at the September meeting. Should this be lower than the SARB's current 20% assumption, the inflation trajectory may improve considerably over the medium term, as similar price increases should be sustained over the next three years. In addition, the aftermath of the World Cup will be more evident by the September meeting. Important data releases that will be available by September include Q2 GDP from both the production and expenditure side of the economy.

It is evident that the outcome of the interest rate decision next week is on a knife edge. Standard Bank is of the opinion that the MPC may choose to err on the side of caution and keep rates unchanged, but will closely monitor the relevant aspects of the local and global economies over the next couple of months.

## Global economy

### US housing starts halted by withdrawal of tax credits

Figure 2: Housing starts

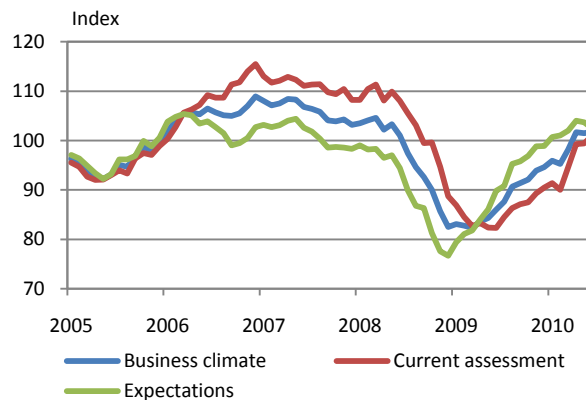


Source: Bloomberg

The housing market lacks the lustre required to help boost the economic recovery. Housing starts declined by 10% m/m to an annual rate of 593 000 in May and far worse than the 3.7% m/m decline envisaged. This was the lowest level since December last year. Housing construction took a substantial knock during the month after the government withdrew measures (i.e. tax credits were withdrawn) to support growth in the sector. The withdrawal of tax credits added a significant amount of caution to the recovery of the housing market. May's housing construction decline follows an increase of about 7.8% since May 2009, which came on the back of declining construction costs and the implementation of the first-time home buyer tax credits. A year later, in the absence of tax credits, tight credit conditions and an excess number of foreclosed properties are a significant drag on the outlook for the housing market. The housing market is unlikely to be a substantial source of economic revival. Housing starts are expected to have declined further in June, by -2.8% m/m.

## German IFO business climate reflecting optimism

Figure 3: Business climate

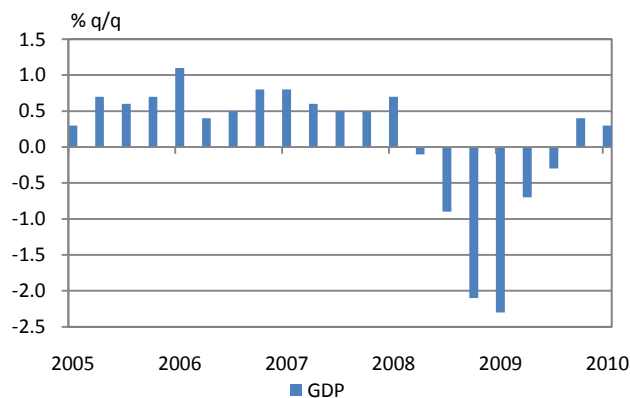


Source: Bloomberg

According to the IFO Institute, the German business climate improved in June as companies become more content and satisfied with their current business situation. Expectations regarding business conditions over the next six months, however, reflected a less optimistic outlook for the second consecutive month. Nonetheless, the expectations index overall continues on a confident path as the economic recovery continues. Homing in on the details, the manufacturing business climate continues to reflect brightened conditions. For the fourth consecutive month in June, survey participants assessed their current situations more favourably, with expectations over the next six months, however, marginally weaker as export growth is expected to ease. Supportive of conditions in six months' time, employment plans indicate that employee numbers are likely to remain at their current levels, at the least. Wholesalers are also reflecting a more positive business environment, although marked by a cautious optimism, while retailers' business outlook remains clouded. The business conditions index is due for release next week and is expected to still reflect optimism, albeit, expected to have declined to 101.5 in July from 101.8 in June.

## UK economy expected to have grown in Q2

Figure 4: UK economic growth



Source: Bloomberg

According to the Office for National Statistics, UK economic growth remained unchanged at 0.3% q/q in Q1 2010 from 0.4% q/q in Q4 2009. In addition and as part of the annual revision to the GDP, it was noted that the UK economy's recession was a little deeper than initially estimated. The UK economy contracted by 6.4% (compared to the previous estimate of 6.2%) between Q2 2008 and Q3 2009. This contraction wiped about GBP2bn from GDP. GDP growth in 2008 was revised down to show a fall of 0.1% compared with 2007, from an initial estimate of a 0.5% increase. This was the first back-to-back annual decline since 1980-1981. Minor revisions were made to household spending, which declined by 0.1% q/q from the previous estimate of having remained unchanged. Gross fixed capital formation also underwent a revision, but emerged higher at 4.5% q/q compared to the previous estimate of 1.5% q/q. Of concern was the lack of improvement in the export markets, especially at a time when the pound was still languishing. And had it not been for the public sector, it is likely that the UK economy could have slipped back into recession in Q1 2010. Next week sees the release of Q2 2010 economic growth data and these data are expected to be released without delay and to reflect an economy expanding by 0.6% q/q.

The week ahead: 19 - 23 July 2010

	Event	Time	Period	Unit	Forecast	Last
<b>Monday 19 July</b>						
Japan	Public Holiday – Marine Day					
<b>Tuesday 20 July</b>						
Japan	Leading economic index – final	07h00	May	Index	-	98.7
	Coincident economic index – final	07h00	May	Index	-	101.2
Germany	PPI	08h00	June	% y/y	1.2	0.9
United Kingdom	M4 money supply – estimate	10h30	June	% y/y	-	2.8
United States	Housing starts	14h30	June	% m/m	-2.8	-10.0
<b>Wednesday 21 July</b>						
South Africa	Building plans passed	13h00	May	% y/y	-	-33.4
South Africa	Start of two-day SARB Monetary Policy Committee meeting					
United Kingdom	Bank of England releases minutes of July meeting					
<b>Thursday 22 July</b>						
South Africa	Civil judgements recorded for debt	09h00	May	% y/y	-	11.6
	Civil summonses issued for debt	09h00	May	% y/y	-	13.0
EMU	PMI manufacturing – estimate	09h00	July	Index	55.1	55.6
	PMI services – estimate	09h00	July	Index	55.0	55.5
United Kingdom	Retail sales	10h30	June	% y/y	-	3.4
United States	Initial jobless claims	14h30	July 17	4wk, ma ('000)	-	455.3
	Leading indicators	16h00	June	% m/m	-0.3	0.4
	Existing home sales	16h00	June	Units, m	5.20	5.66
EMU	Consumer confidence – estimate	16h00	July	Index	-17	-17
South Africa	SARB monetary policy announcement & interest rate decision at 15h00 – no change expected					
	Department of Agriculture releases 6 <sup>th</sup> production forecast for summer & preliminary area planted for winter crops					
<b>Friday 23 July</b>						
Germany	IFO business climate	10h00	July	Index	101.5	101.8
United Kingdom	GDP – estimate	10h30	Q2 2010	% q/q	0.6	0.3

Sources: Bloomberg, CEC, SARB, Standard Bank Group, Stats SA

## This week's releases

Release	Period	Unit	Previous	Current
<b>South Africa</b>				
Retail sales	May	% y/y	2.9	4.6
<b>United States</b>				
Trade balance	May	USDbn	-40.3	-42.3
Advance retail sales	June	% m/m	-1.1	-0.5
Less: motor vehicles	June	% m/m	-1.2	-0.1
Business inventories	May	% m/m	0.4	0.1
PPI	June	% y/y	5.3	2.8
Initial jobless claims	July 10	4wk, ma ('000)	467.0	455.3
Empire State manufacturing	July	Index	19.57	5.08
Industrial production	June	% m/m	1.3	0.1
Capacity utilisation	June	%	74.1	74.1
<b>Japan</b>				
Industrial production – final	May	% y/y	20.2	20.4
Machine tool orders – final	June	% y/y	138.8	143.8
Interest rate decision	July	%	0.10	0.10
Tertiary activity index (industry)	May	% m/m	2.4	-0.9
<b>EMU</b>				
ZEW survey – economic sentiment	July	Index	18.8	10.7
CPI – final	June	% y/y	1.4	1.4
Industrial production	May	% y/y	9.6	9.4
Trade balance	May	EURbn	0.3	-3.4
<b>United Kingdom</b>				
GDP – final	Q1 2010	% q/q	0.3	0.3
CPI	June	% y/y	3.4	3.2
RPIX	June	% y/y	5.1	5.0
Average earnings (including bonus)	May	% y/y, 3mma	4.1	2.7
<b>China</b>				
PPI	June	% y/y	7.1	6.4
CPI	June	% y/y	3.1	2.9
Retail sales	June	% y/y	18.7	18.3
Industrial production	June	% y/y	16.5	13.7

Sources: Bloomberg, Standard Bank Group, Stats SA

## Update of the basic fuel price

	Date	Price
Petrol price	15 July	R8.27/l
R/\$ exchange rate	15 July	R7.57/\$
Brent crude oil price	15 July	\$76.19/bl
Over/(under) recovery	15 July	R0.03/l
Average over/(under) recovery	2 – 15 July	R0.16/l
Due to global oil price	2 – 15 July	R0.15/l
Due to exchange rate	2 – 15 July	R0.01/l

## Trading ranges

For the week 19 - 23 July	
<b>USD/ZAR</b>	7.4000 to 7.7500
<b>EUR/USD</b>	1.2600 to 1.3100
<b>GBP/USD</b>	1.5200 to 1.5550
<b>USD/JPY</b>	85.50 to 89.00

## Currencies

	8 July 10	15 July 10	Change
<b>EUR/USD</b>	1.2698	1.2950	2.0%
<b>GBP/USD</b>	1.5168	1.5462	1.9%
<b>USD/JPY</b>	88.36	87.40	-1.1%
<b>USD/ZAR</b>	7.5716	7.5500	-0.3%
<b>EUR/ZAR</b>	9.6139	9.7767	1.7%
<b>GBP/ZAR</b>	11.4840	11.6733	1.6%
<b>JPY/ZAR</b>	0.0857	0.0864	0.8%
<b>CHF/ZAR</b>	7.2168	7.2527	0.5%
<b>TWER</b>	74.14	74.27	0.2%

## Equity markets

	8 July 10	15 July 10	Change
<b>International</b>			
<b>DJIA</b>	10139	10359	2.2%
<b>S&amp;P500</b>	1070	1096	2.5%
<b>NASDAQ</b>	2175	2249	3.4%
<b>FTSE100</b>	5105	5211	2.1%
<b>Xetra Dax</b>	6036	6149	1.9%
<b>Nikkei225</b>	9536	9686	1.6%
<b>JSE securities exchange</b>			
<b>All share</b>	27061	27475	1.5%
<b>Industrials</b>	26537	27193	2.5%
<b>Financials</b>	20305	20515	1.0%
<b>Gold mining</b>	2412	2460	2.0%

## Bond markets

	8 July 10	15 July 10	Change
<b>US treasury curve</b>			
<b>2 Years</b>	0.62	0.60	-0.02
<b>10 Years</b>	3.03	3.00	-0.03
<b>30 Years</b>	4.01	3.99	-0.02
<b>Domestic</b>			
<b>R153 (Aug 2010)</b>	6.91	6.93	0.02
<b>R157 (Sep 2015)</b>	7.74	7.74	0.00

## South African sovereigns (yields)

Maturing	8 July 10	15 July 10	Change
<b>2012</b>	2.25	2.21	-0.04
<b>2019</b>	4.81	4.59	-0.22
<b>2022</b>	5.14	5.08	-0.06

## Central Bank interest rate changes\*

Country	Key targeted rate	Current rate (%)	Last change	Change (percentage points)	Inflation (%)	Real interest rate (%)
<b>US</b>	Fed funds	0.25	16/12/08	-0.75	2.00	-1.75
<b>Euro-zone</b>	Refinance rate	1.00	07/05/09	-0.25	1.40	-0.40
<b>UK</b>	Base rate	0.50	05/03/09	-0.50	3.20	-2.70
<b>Japan</b>	Target rate	0.10	18/12/08	-0.20	-0.90	1.00
<b>Australia</b>	Cash target rate	4.50	05/05/10	+0.25	2.90	1.60
<b>Canada</b>	Overnight rate	0.50	01/06/10	-0.25	1.40	-0.90
<b>South Africa</b>	Repo rate	6.50	26/03/10	-0.50	4.60	1.90
<b>China</b>	Lending rate	5.31	23/12/08	-0.27	2.90	2.41
<b>India</b>	Repo rate	5.50	05/07/10	+0.25	13.91	-8.41
<b>Argentina**</b>	Repo rate	9.19	n/a	n/a	8.37	0.82
<b>Hungary</b>	Base rate	5.25	26/04/10	-0.25	5.30	-0.05
<b>Turkey</b>	Interbank rate	6.50	20/11/09	-0.25	11.00	-4.50
<b>Russia</b>	Refinance rate	7.75	01/06/10	-0.25	5.80	1.95
<b>Brazil</b>	Selic rate	10.25	09/06/10	+0.75	4.84	5.41

\* As at 09h00 on this day

\*\* Argentina does not have a target benchmark rate; instead the Central Bank targets monetary aggregates.

Sources: Bloomberg, CEF, Standard Bank Group

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