



SARB SIGNALS AN END TO THE MONETARY POLICY TIGHTENING CYCLE

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Introduction

In line with market expectations, the SA Reserve Bank's (SARB) Monetary Policy Committee (MPC) yesterday kept the repo rate unchanged at 12%. Only seven out of 26 analysts polled by Reuters expected another 50bps rate rise with the rest all of the view that the repo rate would remain unchanged. Of further interest is that (bar one) all the analysts polled expected the next rate move to be down.

This is also the BER's view and is important in light of table 1, which indicates that the monetary tightening cycle that commenced in June 2006 was paused twice (February and June '07 as well as January '08) before the repo rate was increased further. In our view, yesterday's decision is more than a pause and signals the end of the tightening cycle, which saw rates rise by a cumulative 500bps, i.e. 100bps more than the previous upward rate cycle during 2002. This view is primarily based on the forecast that inflation is close to reaching a peak from where price pressures should start to moderate towards the end of 2008. The slowdown is set to accelerate from January 2009 when the new consumer inflation weights¹ will be introduced.

Table 1: Changes in the repo rate since June '06

	Repo rate (%)	Change
June '06	7.5	+50bps
August '06	8.0	+50bps
October '06	8.5	+50bps
December '06	9.0	+50bps
February '07	9.0	-
April '07	9.0	-
June '07	9.5	+50bps
August '07	10.0	+50bps
October '07	10.5	+50bps
December '07	11.0	+50bps
January '08	11.0	-
April '08	11.5	+50bps
June '08	12.0	+50bps
August '08	12.0	-

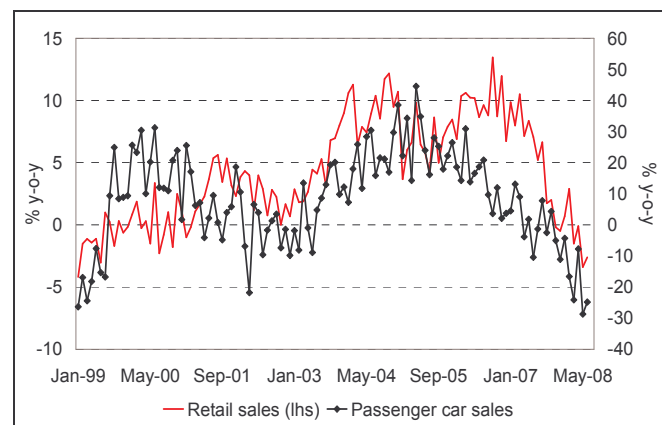
Source: SARB

The recent sharp fall in the oil price has further brightened the consumer price outlook, although it has to be seen whether crude oil can sustain the current lower levels. The current over

¹ As outlined in the BER's 2008Q3 *Economic Prospects* publication, the new consumer inflation weights give a smaller weighting to the main drivers (food, petrol and electricity) of inflation in recent times. The new weights will be introduced from January 2009 and the impact is likely to be that CPIX inflation moderates sharply during the month.

recovery for petrol and diesel amounts to 114c/l and 167c/l respectively, hinting that fuel prices could decline sharply in the beginning of September. The significant easing of consumer spending (see figure 1) is the other factor that should prevent another rate hike.

Figure 1: The impact of 500bps worth of rate hikes has been severe



Source: Stats SA/ Naamsa

SARB gives a brighter inflation outlook

The MPC statement that accompanied yesterday's decision indicates that the SARB may also be thinking along these lines. Despite having to make provision for the additional 13.3% Eskom electricity tariff hike announced after the previous (June) MPC meeting and indications that tariffs will rise by 20 to 25% for the next three years, the MPC presented (as expected) an improved inflation forecast, albeit somewhat less optimistic than the BER's latest inflation projection.

In June the SARB expected its targeted inflation measure (CPIX) to peak at an average around 12% in 2008Q3, while CPIX was only forecast to moderate to below 6% in the third quarter of 2010. The current (central) SARB forecast is for a slightly higher CPIX peak (13% in Q3), but importantly the outlook from 2009 onwards has improved. The central bank mentioned that provision has been made for a sharp moderation in CPIX during 2009Q1 because of the impact of the new weights. The SARB now sees CPIX falling below 6% during 2010Q2. This is less optimistic than the BER's view that CPIX may already be below 6% at the end of 2009.

In a change from previous statements, the MPC also provided an average CPIX forecast for 2009 and 2010. Despite the timing difference of the dip below 6%, the SARB expects CPIX to average 7.2% during 2009, which is in line with our forecast (see table 2 on next page). The central bank projects CPIX to average 5.9% in 2010, marginally above the BER's forecast of 5.7%. The SARB also pointed out that financial market inflation expectations, as measured by the so-called break-even inflation rate, has improved significantly (from 9% to 7%) since the previous MPC meeting.

On a more negative note, the MPC highlighted an increase in wage settlements in reaction to the higher inflation. According to the Wage Settlement Survey of Andrew Levy Employment Publications, the average level of wage settlements for the first half of 2008 was 8.3%, compared with 6.8% in the same period during 2007. Unit labour costs increased by a worrying 10.2% y/y during 2008Q1.

As was the case in the June statement, the MPC again indicated that the economy is reacting to the previous rate hikes. Besides mentioning the sharp moderation in retail and vehicle sales, the SARB emphasised the easing (although still at high levels) in private sector credit extension, weak leading indicators for the economy, the decline in domestic asset (JSE stocks and the housing market) prices and the soft global economy.

GDP growth implications and interest rate outlook

Although the August rate decision will come as a relief to especially the domestic consumption related sectors of the economy, the consumer is expected to remain under pressure in the foreseeable future. The lagged (adverse) impact of the most recent (April and June '08) rate hikes holds the risk that consumer spending (after an expected sharp slowdown in 2008) may show even weaker growth in 2009. The same is likely to be true for private sector investment with the result that GDP growth in 2009 is unlikely to recover from the projected moderation to 3.0-3.5% in 2008.

Next week's 2008Q2 GDP growth figures are likely to show a significant improvement from the 2.1% q-o-q (saar) recorded during Q1 as manufacturing and mining production recovered robustly amid improved electricity supply. However, growth in the second half of 2008 may turn out to be weaker than previously thought, especially in light of the latest BER survey results (the FNB/BER consumer confidence index plunged by a cumulative 28 index points during the first half of 2008, while the Investec PMI reached a record low in July). The global economy also remains fragile - data released this week showed that both the Japanese and eurozone economies contracted during 2008Q2.

The external as well as domestic environment is thus not conducive to SA growth. As mentioned above, the projected growth softness is an important reason why we expect that the next rate move could be down, starting in mid-2009. At this stage, interest rates are likely to be cut by 150bps in the second half of 2009.

It is worth mentioning that SARB Governor Tito Mboweni, in reply to a question after he read the MPC statement, said that "we are not out of the woods yet" in terms of inflation. He also acknowledged that a lot of uncertainty surrounds the SARB's inflation forecast as, for example, it is unclear whether the lower oil price can be sustained. Furthermore, the impact of the new CPIX weights/rebasing will only really be known once the January 2009 inflation figures are released at the end of February next year. For these reasons interest rate cuts should not be expected anytime soon.

Hugo Pienaar
15 August 2008

Table 2: Forecast of key economic variables: 2008/9

	2007	2008	2009
Real GDP growth (y-o-y %)			
Final household consumption exp	7.0	2.4	1.6
Government consumption expenditure	5.0	4.7	4.5
Gross fixed capital formation	14.8	8.1	1.8
Real GDE	6.0	3.8	2.0
Total exports	8.3	0.8	6.7
Total imports	10.4	3.2	2.7
Real GDP	5.1	3.2	3.0
CPI-X	6.5	11.4	7.2
PPI (all-items)	10.0	15.9	9.8
Prime overdraft rate (end of period)	14.50	15.50	14.00
R/\$ (Q4)	6.77	8.05	8.50
R/€ (Q4)	9.81	12.42	12.33

Source: BER forecast