

**SARB HIKE BY 50BPS AS INFLATION EXPECTATIONS SURGE**

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Introduction

After a pause at the January interest rate meeting, the MPC increased the repo rate by another 50bps to 11.5% yesterday, bringing the total rate rise to 450bps since mid-2006. The SARB has thus now tightened monetary policy by 50bps more than the 400bps in hikes we saw during the previous upward rate cycle in 2002. This in itself may indicate that the current inflation problem is more severe than was the case in 2002 when rand weakness fuelled local price pressures.

Although the analyst community was split down the middle on the outcome of the second MPC meeting of the year, there was widespread consensus that the decision would be the most difficult to make in many a year. However, if one reads the statement accompanying the decision, it (in our view) becomes clear that the SARB in actual fact had very little room to manoeuvre on rates.

CPIX set to be significantly higher

Not only was the SARB's central CPIX inflation forecast revised up significantly, but inflation expectations also surged in 2008Q1. The SARB now sees CPIX peaking at an average around 9.3% (previous 8.5%) in 2008Q1. Furthermore, CPIX is now only forecast to moderate to below 6% in the final quarter of 2009 (in January inflation was forecast to already be below 6% in 2008Q4). According to the BER's latest (2008Q1) inflation expectations survey, average CPIX inflation is expected to remain above 6% through 2010. Expectations for 2008 increased sharply from 5.9% expected in 2007Q4 to 7.8%, and for 2009 from 5.6% to 7.0%. CPIX is expected to average 6.7% in 2010. Combined with the higher expectations, the SARB mentioned that there is evidence of higher wage settlements - according to Andrew Levy Employment Publications, wage settlements in 2008Q1 averaged 7.8% compared to 7.3% in 2007 and 6.5% in 2006.

It is important to also emphasise that the central bank's forecast (as is the case with the BER's current inflation forecast) does not factor in electricity price increases in excess of that already granted to Eskom. The energy utility has asked that the 14.2% hike already approved by Nersa for 2008 be revised to 60%. Should this request become a reality, CPIX is set to be significantly higher than current forecasts. One could then have a situation where actual CPIX inflation is not that far removed from (and perhaps even higher than) the figures quoted in the BER inflation expectations survey.

Should we expect further rate hikes?

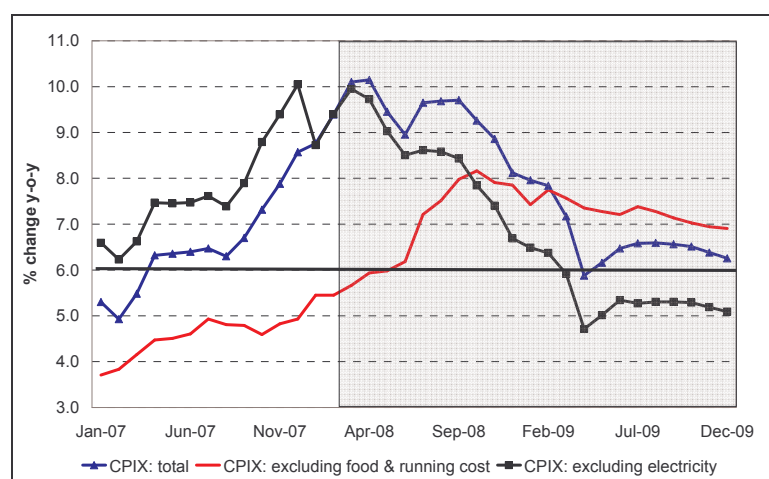
The significant inflation risks beg the question whether the April hike will be the last in the current monetary tightening cycle? It is worth noting that the MPC statement (on more than one occasion) mentions that recent survey data point to GDP growth being below potential in the upcoming quarters. This output gap should alleviate some of the capacity problems in the economy and is likely to have a moderating impact on inflation.

The statement goes into some detail to highlight the slowdown already witnessed in household consumption, the demand for credit and house price growth. These comments highlight (as was the case in January) that the MPC is clearly aware (perhaps concerned is a better word) of the more challenging growth outlook. The problem is that the SARB's main mandate is to keep CPIX inflation below 6% and (perhaps of most importance) to ensure that inflation expectations do not become dislodged. Given the spike in expectations for inflation since January, it could be argued that the central bank would have suffered a big credibility knock had they not raised rates further in April.

However, it is questionable whether this line of thinking can continue to warrant further rate hikes if factors (read oil, food and crucially electricity) which are not responsive to interest rates continue to be the main inflation drivers. For this reason it is somewhat disappointing that the MPC statement made no mention of the possibility of making use of the so-called explanation clause. The clause is part of the inflation targeting framework and is meant to be used to prevent excessive rate hikes (which are negative for growth) when inflation is being driven higher by a supply shock which cannot be prevented through higher interest rates.

If Eskom is granted the 60% tariff increase or oil/food prices continue to rise at the current rates, CPIX could remain above 6% well into 2010. Given the weak growth outlook, a case can be made that the SARB should not raise interest rates further, which in any event will do nothing to prevent the higher electricity tariffs/food and oil prices from being reflected in rising inflation.

Figure 1: Excluding electricity, inflation much less of a concern¹



Source: BER forecast

While the argument could be made that excluding food and oil prices from the CPIX basket may not be the best option as it is a global phenomenon with all (especially inflation targeting) central banks under pressure, the same does not apply to electricity. SA is in a fairly unique situation in that the country is set for a huge increase in a relative price which is going to have a significant impact on the overall inflation basket. Our forecast indicates that if one excludes the electricity component from the CPIX basket, CPIX is likely to fall below 6% in 2009Q1 and remain below the upper band of the inflation target until the end of the year.

Given the weakness seen in consumer demand, the central bank could opt to, for example, target CPIX excluding electricity for the next number of years in order to prevent having to raise rates in an environment where the economy is already cooling. If this policy is communicated to the public and financial markets in a transparent manner, it need not have a negative impact on the SARB's credibility.

¹ These inflation projections allowed for average annual electricity tariff increases of around 20% during 2008/9, i.e. less than half Eskom's latest application for a (cumulative) doubling in tariffs this year and next. Nersa will make a decision on Eskom's application after public consultation on the 6th of June 2008.

In our view such a scenario could be a way in which further rate hikes are prevented with the SARB's credibility also remaining in tact. The alternative is that, although not our baseline view, there is a significant risk of a further rate hike when the MPC meets again in June.

General remarks

We are busy updating the 2008/9 quarterly forecast for the SA economy. In the forecast we already built in another 50bps rate hike so yesterday's decision will not impact the forecast. Combined with a weaker than previously anticipated global outlook, the implication of the further hike (which was not expected at our previous forecast run in January) is that GDP growth for 2009 is now expected to be weaker (below 4.0%) than previously thought. The detailed forecast numbers and overview of the SA economy will be released in due course in our *Economic Prospects* publication for 2008Q2.

Hugo Pienaar
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