Interest Rates: MPC

Efficient Group

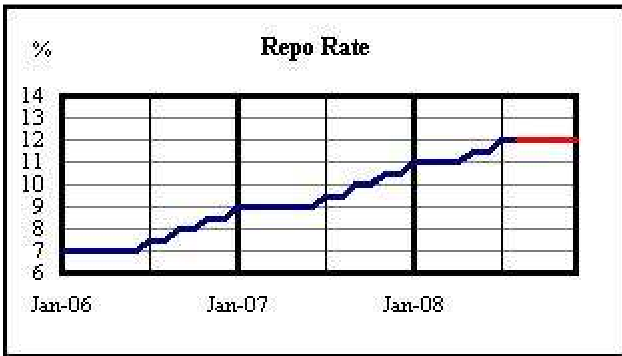
New CPI Basket Complicates Outlook

14 August 2008

The Monetary Policy Committee (MPC) of the South African Reserve Bank, decided this afternoon to leave the Repo rate unchanged on 12.0% per annum. The market (including ourselves) expected rates to be kept on hold. Despite the breather, consumers should remain cautious, as the Governor did mention that "we are not out of the woods yet", indicating that rates are likely to remain on the current high levels for a longer period of time.

	Aug '08	Jun '08	Aug '07	% m:m Change	% y:y Change
REPO	12.0%	12.0%	10.0%	0.0%	20.0%

The highlights of the MPC statement are…



The MPC mentioned that there are tentative signs that inflationary pressure (especially emanating from food and oil) seems to be moderating and that consumption expenditure remains subdued. Despite PPI accelerating to 16.8% y:y in June, the PPI sub-sector for agricultural food prices show some moderation and measured only 2.0% in June. Yellow maize and wheat prices have decreased recently but remains on high levels. Oil dropped to $112 per barrel compared to $145 at the previous MPC meeting and petrol prices dropped by 30 cents per litre for the first time in 11 months during August. The governor did mention that it is too early to say if this easing will continue as oil prices and exchange rates remain volatile.

Despite these moderations, there remain serious short term risks to the inflation outlook and CPIX excluding food and petrol prices measured 6.3% in June and service inflation continues to accelerate to 6.7% in June. The near term outlook for inflation deteriorated and CPIX is expected to peak at 13.0% in the third quarter of 2008 (up from the 12.0% peak expected previously). Inflation is now expected to return to below the upper inflation target range by the second quarter 2010 (third quarter 2010 previously) and to average 7.2% and 5.9% during 2009 and 2010 respectively (taking the additional Eskom price hikes into consideration). The statement mentions the additional uncertainty adds to complications in forecasting inflation due to the new CPI basket, but did not mention any specific detail.

Inflation expectations remain a serious concern and have had an impact on wage settlements. According to the Andrew Levy Employment Publication, average wage settlements during the first half of 2008 was 8.3%, compared to 6.8% in the same period last year. Unit labour costs also indicated strong increases.

Consumption expenditure remains subdued and the weak recent performance of both the retail and motor trade sectors of the economy was noted. Further, the FNB/BER Consumer Confidence Index experienced its largest decline in 24 years! Business confidence, as measured by the RMB/BER business confidence index also dropped sharply in the second quarter.

Growth in credit extension to the private sector is easing slightly, however it remains on high levels. The MPC did note that the part extended to households are on a downwards trend.

The SARB expects the second quarter GDP growth to outperform the first quarter's rise of 2.1%, but to be lower than the last few years. Slower growth is also evident in industrialised countries and the growth outlook for the US remains low in the wake of the weak housing market and continued financial market uncertainty.

The MPC noted high inflationary pressures in South Africa's Common Monetary Area (CMA) partners, including Lesotho, Namibia and Swaziland.

Despite leaving rates on hold, the Governor did give some strong cautionary statements over the deteriorating inflation outlook and that the MPC will not hesitate to act in future. The MPC is faced with some serious uncertainties currently, with the new CPI basket (and its effect on the level of inflation) to be implemented in January 2009, possibly causing most of the distress. This uncertainty, coupled with the large drop in oil prices, likely saved the consumer from a further interest rate blow. The MPC remains in the difficult position to anchor inflation expectations and bring the CPIX back to within the inflation target band, while also not grinding the consumer (and larger economy) to a halt. Given the unchanged stance, we do not expect any more rate hikes for the rest of 2008, but rather that rates could stay on this relative high level for some time. As for 2009, the effect of the new CPI basket in January will provide meaningful insights into further rate developments.

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