

By Cees Bruggemans, Chief Economist FNB – 29 June 2009

With the SARB going on hold last week, the prime interest rate remaining at 11%, the question is; what next. Will there be another cut of 0.5% in August, prime falling to 10.5%? Or have we reached a bottom, through to next year, with the speculation shifting as to when the first tightening move will occur (2010-2012?).

I feel that we have reached an abrupt bottom at 11%, which isn't warranted by the current CPI inflation forecast or the recessionary condition of the economy. The reasons lie elsewhere, in the risks to the inflation forecast (which may change but will probably not improve) and especially the global picture (where the strength of industrial recovery is probably going to surprise many).

In terms of a simple Taylor Rule, the bedrock assumption is for our prime interest rate to incorporate a stable real premium longer term (in our case 5.5%) and to match the CPI inflation rate towards the end of the forecast period (here taken as 5% in 4Q2010). That gives us a basic prime interest target today of 10.5% before corrections aimed at addressing deviations such as an inflation gap and an output gap.

By August 2009, the positive inflation gap should have shrunk some more, with CPI inflation nearer 6.9% and the gap narrowing to 2.4% (being 6.9% minus 4.5%, the midpoint of the 3%-6% target range). That drop in CPI will for many observers be a reason to still give a 0.5% interest rate cut, and the MPC may well oblige such sentiment by cutting rates one more time.

The negative output gap, the difference between rising potential GDP and depressed actual GDP is currently estimated at between 4% and 5%. By August this picture won't yet have improved. If anything, it may have deteriorated if, as expected, 2Q2009 shows another GDP decline, with 3Q2009 also still suspect.

If SARB interest rate policy tries to address both this positive inflation gap and negative output gap simultaneously, the basic targeted prime interest rate of 10.5% is further lowered by $0.5(+2.4\%)+0.5(-4.4\%)$, that is by -1%. Thus according to Taylor, SARB should really be gunning for a 9.5% prime rate. This provides yet more ammunition for favouring a rate cut from the present prime 11%.

However, we must take into account asset prices (which isn't yet the fashion at the SARB) and especially risks to the inflation forecast (already beloved of the SARB, and a throwback to Greenspan's risk management at the Fed, which of course in the end didn't come close to saving him for he ignored asset prices for far too long, leaving the subsequent mess to Bernanke and the US government to clean up).

By August our main asset price picture shouldn't be materially different. House price indices should still be falling gradually. Equity prices could be a little higher, anticipating recovery, following the global fashion. Bond prices could be lower and yields higher, anticipating the end of inflation decline and a new cycle shaping sometime, aside of government funding needs and central banks on hold.

There is not much in this soup that may influence our SARB in the short term. That leaves risks to the inflation forecast. And may I add the shaping global recovery and how it's going to change expectations worldwide, in markets, at central banks, with presumably implications for us.

The first question, with Taylor's targeted prime rate actually dropping from an estimated 10% today to closer to 9.5% by August, is whether the SARB will have need to revise its risks to the inflation forecast. If no change to the risks, with Taylor's floor lowered, the case cements for another 0.5% cut, prime being lowered to 10.5%.

With wage and salary settlements backward-looking and CPI inflation likely steadily falling, the wage trend should also erode, if with a lag. With economic recovery at some point taking off even as job shedding still continues, productivity growth should accelerate and unit costs decelerate, even dramatically.

More job losses may have tempered union demands somewhat but it may also have inflamed their rhetoric, especially as the falling CPI inflation will be lowering the floor under their wage demands monthly. That won't be fun.

The real threat lies external. Here we have the setoff of a firming Rand as the global picture improves, risk appetite with it, and more capital flooding in even as our current account deficit contracts (net of unexplained transactions).

But the firming Rand may not be enough. The global industrial revival could be robust in coming quarters, as final global demand is already showing signs of recovering while the inventory destocking and capex cutbacks since 4Q2008 were probably overdone in response to credit fears and beyond.

We know by now electricity will be adding to our pricing woes. But so will probably oil, though this isn't guaranteed in the short term. As to the current food price decline build into the CPI inflation play out through 2010, it presumably will eventually start a new up cycle as well, but oil (the entire energy complex) is the main suspect.

So far I haven't touched anything that wasn't touched upon by SARB Governor Mboweni in his recent commentary. So two questions then. Will the actual CPI inflation reality keep declining as forecast, through August and beyond? And will the SARB keep its sense of risk as expressed last week unchanged? A qualified 'yes' to both questions could still yield an 0.5% rate cut in August, prime falling to 10.5%, but you will really be mining gut feel to get there.

More likely, the global reality will keep erring towards strength (a flood of flowering green shoots) and especially the commodity universe eventually flexing its muscle, with central banks worldwide slipping into defensive mode anew (ending rate cutting but not as yet monetary accommodation, yet likely becoming more 'vigilant' as they prepare to welcome the new cycle).

With SARB Governor Mboweni presumably reappointed for a third term shortly, SARB's inflation-fighting credibility and independence once again confirmed, with global peace (recovery) at hand, with our own recession ending and recovery in sight, and with inflation gradually trundling towards a cyclical bottom in 2010 high within the target zone, why would we want to resume cutting rates during 3Q2009?

Does that mean prime will stay unchanged at 11% through 2012? Not necessarily, because the world will keep on changing, probably fast. Watch commodity inflation starting to surge again. More importantly, at what point will the SARB lift its risk ceiling (and less sure at what point will it discover asset prices?). That comes on top Taylor's revised base prime target of 11% through 2010-2012, to which we must still add any lift in our CPI (nearly immediately threatening to leave the targeting reservation, something that won't be kindly welcomed).

So sooner rather than later our next interest rate cycle may make its appearance, the more is the pity. But this is in the nature of dynamic global growth and financial cycles and the inflation disturbances following in their wake and central banks trying to keep on top of their game throughout.

We would be so lucky not to encounter our first rate increase from prime 11% in the course of 2010.