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Last Chance for MPC action

South Africa’s structural inflation problem is about to rear its head once more. The benign level of SA inflation in recent years has been aided by the Rand, which has strengthened significantly since early 2009, depressing goods inflation and therefore the headline number. Over the course of the current year inflation has moved strongly upward. Inflation is now expected to breach the 6% upper limit of the target band, a view held by market participants even before the Rand’s sharp depreciation in September 2011. The depreciated exchange rate increases the risk that inflation stays out of the band for an extended period over the course of next year. Notwithstanding these negative inflation expectations, there is a still good case for a 50bp cut at this weeks MPC meeting.

Global interest rates remain at extremely low levels, with much of the developed world running highly negative real interest rates (interest rates below the inflation rate). While central bankers usually signal to the market that future interest rate decisions will be determined by the progression of inflation and growth, Ben Bernanke has taken the highly unorthodox step of setting a time period for which the Fed Funds rate will remain low. He has promised to keep rates near zero until mid 2013. This hard cap on US rates will serve to suppress interest rates globally. Despite the low level of global interest rates, growth concerns have recently led to rate cuts in Europe, Brazil, and Australia. For South Africa to run a relatively high level of rates in this environment, risks provoking Rand strength and stalling the weak economic recovery.

The last MPC meeting contained a very dovish statement by the MPC, and it was clear from comments made by Governor Gill Marcus that, save for the extreme market volatility and Rand depreciation that was occurring throughout their deliberations, the MPC would have cut rates on growth concerns. While we haven’t seen the Reserve Bank’s updated inflation projections, they are no doubt aware that the Rand depreciation has increased the risks to the upside. While inflation is currently below the target at 5.7%, it is projected to breach the target when November’s inflation data is released next month. This means that when the MPC meets in 2012, inflation will in all likelihood be above the 6% target, with a deteriorated outlook. If the MPC cuts rates while inflation is above 6%, it would serve to damage some of the inflation fighting credibility that has been painstakingly built up over many years. While many have pushed their rate cut projections out to next year, we believe that developments in inflation will soon shut the door on
cuts. If the Reserve Bank does intend to cut rates to support the economic recovery, the November MPC meeting presents their last credible opportunity to do so.

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