

Easing real interest rates another notch

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The Rex Column



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The argument for further SARB interest rate easing should not be of the mindless variety, simply advocating deep nominal easing in support of populist 'easy' money.

That's the way to ruin as other countries have shown before and our own history not devoid of such policies.

But that doesn't mean there is no longer any scope for a judicious easing of real interest rates, even if fairly late into this particular cycle.

Taking care of the last point first. Globally, this is a very extended interest rate cycle, less so for countries that did not experience much of a recession and remain near potential growth, but certainly for countries that experienced deep recession accompanied by much resource slack and still far removed from potential.

Israel and Aussie, as representatives of the former, may have started to raise rates already last year. But the US, Europe, Japan and probably the UK may only start raising rates sometime next year (and some later than others), being representatives of the latter.

Measured against that background, South Africa is probably a 'low for long' candidate, too. But were we too late into the cutting cycle, and didn't we proceed far enough? If so, does there remain potential for still cutting shortly or has that space been fully taken?

Purely going by recent inflation realities (above the target zone), wage trends (averaging over 9% last year), unit labour costs (5.7% in 3Q2009) and multiplying signs that the economy is coming out of recession these past six months, there are excellent grounds for not cutting interest rates any further, but to simply outwait the economy's gradual revival with inflation re-entering the target zone this week and comfortably remaining within it for a long time to come.

There are, however, at least three grounds for still cutting interest rates in South Africa.

Firstly, inflation forecasts for this year and next vary widely, some observers seeing it below 5% shortly but thereafter rebounding back towards 5.5%-6.5%, with others more inclined in seeing 4%-4.5%. That makes for quite a gap, some of it potentially below the target midpoint.

With Eskom coming in at 25% (and 18% for households once we allow for municipal charging as suggested), with low food inflation, a firming Rand, global core inflation still easing below 1% and other inflation risks mostly neutral), the surprise potential for our inflation may well remain on the downside rather than the upside.

Are inflation expectations also this low? Labour and business expectations are still elevated (6%-8%), but do these allow enough for jobless and cost-cutting recovery, and a more impressive falloff in unit costs below 4% as productivity improves, and for its repressive impact on the inflation trajectory besides the other disinflation forces already mentioned?

When CPI inflation this year falls well below 5%, watch inflation expectations follow in due course, as already foreshadowed by bond market discounting.

That could be a reason in its own right (purely inflation oriented) for allowing nominal interest rates to ease some more.

Secondly, there is the more comprehensive mandate for a flexible inflation targeter. Even if one buys the easier inflation outlook, there is still the added complication of the growth outlook. Private forecasts of GDP growth this year and next may range from 2.5%-4.5%, but SARB and Treasury populate the 2%-3.2% range.

Are the public sector forecasts too low, and the private forecasts more realistic?

We may have a nice inventory and export rebound at present, and windfall effects from agriculture and even soccer later this year, but we still have important drag anchors on growth as well.

Government spending is set to slow (from 7% real to 2% these next three years). Private fixed investment will decline this year and recover only modestly from next year as company managements remain wary about conditions and constraints. Also, public infrastructure has incurred new project delays (going by contractor announcements) and a project pipeline deficit is building up (going by municipal conditions).

Even if consumer disposable incomes rise this year and next, under the impact of real wage increases and higher activity levels in the economy, these will be partially drained by higher public sector tariff charging (electricity, roads, municipalities, airports), eroding available disposable income for 'normal' household expenditures. Though banks will be increasingly willing to lend to 'good' credit risks, the borrowing cost will be higher than before (relative to prime).

This could mean that the lower growth forecasts probably carry greater credibility despite normalization and windfall effects boosting initial growth revival.

With slow growth being mostly jobless and below potential through 2012 (though allow for skilled labour, electricity and other supply constraints restraining that potential) there is a case here for easing (real) rates some more, given both inflation and growth prospects.

Thirdly, there is the structural argument. Cost of capital has gone up, and banks on average charge some 1% more (relative to prime). Also, the 'new' credit discipline means less easy access, probably equivalent to another 1%-2% of interest cost. This suggests that structurally credit demand and spending will be less than before for a given interest rate level.

One could argue that real interest rates were too low in bygone years, given the stupendous credit growth then, therefore warranting current interest rate levels.

Still, current conditions may well offer reason for allowing slightly lower real interest rates now, even if later in the cycle this can be undone if warranted.

This makes for three reasons to cut interest rates by another 0.5% this week, prime reaching 10%, and the state of the global interest rate cycle for the time being no reason to hold us back.

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