What the hell was the Reserve Bank thinking?

Cees Bruggemans tells us why the Bank was right to cut rates.

The nice thing about an unpredictable central bank is that it should surprise you pleasantly at least sometimes.

In June, the Reserve Bank emphasised upside risks to the inflation forecast, disappointing many by not cutting interest rates further though the economy was weak and the output gap large.

Economic data has since perked up in some areas (mining, electricity, manufacturing) but disappointed in others (passenger cars relapsing and retail going nowhere in a hurry), in other words not much changed from June.

Similarly, the upside risk to the inflation forecast has not much changed (oil, electricity, unit labour costs, rigid sectors all remaining ‘worrisome').

However, Asia has been in recovery since 2Q2009, with the West entering recovery from 3Q2009, offering locomotive promise for us eventually.

On balance therefore not much of a new reason to act. Yet the Bank this time decided economic weakness warranted easing.

A rough Taylor Rule estimate of where prime interest rate currently should be, assuming neutral risks to the inflation forecast, suggests 9.5% as opposed to the 10.5% prime rate we now have. But that is before taking into account massive fiscal support, improving global conditions and much weakness being externally induced and being beyond our policy control.

The Bank seemingly still assumes some risk premium that the inflation forecast for 2010-2011 could be wrong. Yet mostly everyone keeps punting 5% inflation next year.

So if anything has changed, the Bank seems to accept a grimmer reading of the output gap, with lower inflation potential, and having only limited confidence in global recovery. Indeed, it seems to mirror the Fed, believing any global recovery so far to be a promise rather than a fact, given fragile consumer fundamentals and still ailing banking systems.

Is there on this basis scope for more interest rate cuts?

As events have shown, with our Bank anything is possible, as perceptions of economic weakness, inflation forecast risks and global recovery prospects are apparently moving feasts of collective committee uncertainties.

What applied on the way up during 2006-2008 (steady drip of ten serial interest rate increases of 0.5% apiece) apparently now also entertains us on the way down.

As to the interest rate cycle bottom, only events and the Monetary Policy Committee can tell us. The financial markets have started to discount the chance of yet another 0.5% rate cut soon, with a first rate increase pencilled in for 2H2009 (though both bets are subject to daily review and are worth monitoring).

Is the Bank responsible acting as it does?

Considering the Federal Reserve's apparent mission, best summarised as ‘full employment or bust!' our Bank appears less aggressive and more variable.

It remains difficult to correctly assess inflation risks ahead, the true weakness of the economy and how to address this, and not least the state of the greater world.

If a large part of our industrial weakness is due to external forces lowering our output (steel, car exports, mining), and if reduced global risk aversion is giving us another incoming capital inflow windfall firming the rand, cutting interest rates can't or won't necessarily undo this. Instead, we may like the Chinese be opting to domestically accelerate into global weakness.

That this invites resumption of the credit culture should apparently not bother anybody.

An unhelpful feature is the steady insistence by some on things weakening further, with especially manufacturing singled out.

Weakening further? Manufacturing output picked up in May and June, by all means in a very limited way. But it ROSE, it did not decline.

Mining is showing much more of a decided pick-up since February, along with electricity output.

This doesn't mean our economic recovery is vigorous. Unlike some other parts of the world we are still weak and late to start. But this may again have global reasons, such as international sourcing decisions opting to favour low-cost global operating units first.

The 2Q2009 GDP data out this week won't be helpful either in sharpening mindsets regarding recovery. For what we will get is the average output for April, May and June compared with the average of January, February and March.

That should still show decline, and the year-on-year comparison will be even more horrific because of the large step-down experienced in 4Q2008 output.

This may by now be historically irrelevant, but it is still powerful. In contrast, actual monthly data traces reality much more closely, but this is now so happily misrepresented at times its message simply doesn't penetrate.

Confidence got a useful boost from this latest Bank rate cut, as the stock market showed joyfully on the day and opinion surveys will probably reflect in September.

By 4Q2009 we should see GDP resuming expansion, considering the powerful policy stimulus, inventory destocking ending, replacement modestly firming and external trade perking up.

A year-long recession, dating from October 2008 (really from July 2008) should finally be ending. Viva!

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