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Interest rates still on hold, but the MPC became more hawkish

Highlights

- The Monetary Policy Committee (MPC) of the South African Reserve Bank (Sarb) kept the repo rate unchanged at 3.5%.
- The Sarb raised its year on year (y/y) headline consumer price inflation (CPI) estimate for 2021 to 4,3% (from 4% in January), but lowered that of 2022 to 4,4% (from 4,5%). The forecast for 2023 is 4,5% (down from 4,6%).
- Core CPI estimates for 2021, 2022 and 2023 respectively are 3,3%, 4% and 4,3%.
- Although the Sarb's Quarterly Projection Model (QPM) forecasts an increase of 25 basis points in each of the second and fourth quarters of 2021, our analysis suggests no change in the repo rate in 2021.
- All the members of the MPC were in favour of no change in the repo rate. In January, two members still favoured a reduction in the repo rate.
- The Sarb's economic growth estimate for 2021 is 3,8%, up from 3,6% in January. The forecasts for 2022 and 2023 are unchanged at 2,4% and 2,5% respectively.
- The Sarb expects the negative output gap to shrink over time.
- Interestingly, the MPC made no mention of South Africa's high unemployment rate in its statement.

Sarb raises its near-term CPI estimates, QPM suggests an earlier repo rate increase

The MPC decided to keep the repo rate unchanged at 3,5%.

The MPC's decision was informed by, among other factors, economic growth and CPI-projections (see table 1) of the Sarb's QPM. The MPC uses the Sarb projections as a guide, but base their interest rate decisions on members' own individual views and other information.

It is noteworthy, though, that the Sarb's QPM in January estimated two increases in the repo rate in 2021, one in the third quarter and one in the fourth quarter. The estimates changed in March, with repo rate increases now projected in the second and fourth quarters.

The Sarb estimates an economic growth rate of 3,8% in 2021 (up from 3,6% In January). This is projected to decelerate to 2,4% in 2022 and then increase marginally to 2,5% in 2023. The output gap is projected to shrink due to actual economic growth increasing faster than potential economic growth. The output gap for 2021 is now -3.5% (-3,9% in January), narrowing to -0.5% in 2023.

The Sarb raised its estimate for headline CPI to 4,3% in 2021 from 4% estimated in January. The projections for 2022 and 2023 are however marginally lower. The core CPI estimate for 2021 was lowered, while that of 2022 and 2023 remained unchanged.

The MPC views the overall risks to the inflation outlook to be balanced.

The five MPC-members were unanimous in voting for no change in the repo rate. This differed from the January meeting when two members still voted for a reduction in the repo rate.

Table 1: Forecasts of the Sarb's Quarterly Projection Model

	2021		2022		2023	
	Previous	New	Previous	New	Previous	New
Headline CPI (y/y %)	4,0	4,3	4,5	4,4	4,6	4,5
Core CPI (y/y %)	3,4	3,3	4,0	4,0	4,3	4,3
GDP growth (y/y %)	3,6	3,8	2,4	2,4	2,5	2,5
Output gap (% change)	-3,9	-3,5	-2,3	-2,0	-0,7	-0,5
Current Account: % of GDP	0.0	1,3	-1,6	-0,8	-1,6	-1,3

Source: South African Reserve Bank

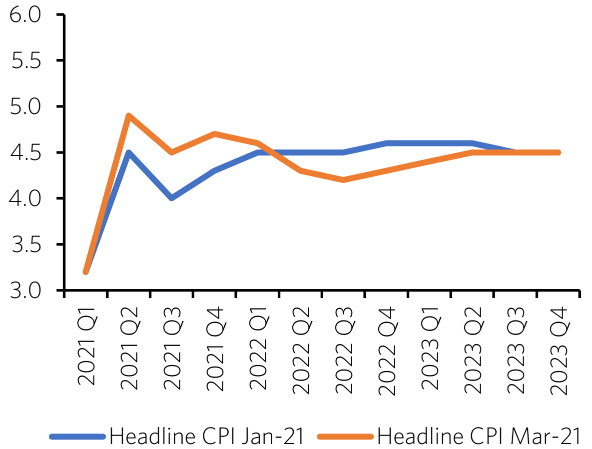
Weight of evidence suggests unchanged repo rate in at least 2021

The Sarb noted a better international and local economic growth outlook. It raised South Africa's main trading partners' economic growth estimate for 2021 to 5,8% from 5% previously. However, South Africa's economic growth estimate is much lower at 3,8% due to, among other factors, structural problems such as a lack of sufficient electricity. It, however, is stronger than the previous estimate of 3,6%.

The MPC does not foresee such stronger economic growth to pose a risk to their CPI-outlook, though. The majority of the economic growth estimated for 2021 will in any case result from the low base registered last year. At the same time, the output gap remains negative, adding no pressure from this source on CPI. The MPC also does not view the rand exchange rate as an inflationary risk. The Sarb expects the real effective exchange rate to be 4,9% stronger in 2021 compared to 2020. In any event, research done by the Sarb revealed a muted pass-through from a weaker rand to higher consumer prices.

The MPC view the risks to the Sarb's CPI-outlook to accrue from higher energy and other administered prices. The low base registered last year, higher international food prices, a steep increase in the international oil price and levies on the fuel price, as well as above-target increases in electricity and municipal rates are perceived to put upward pressure on y/y CPI in the near term. Figure 1 shows how the quarterly CPI outlook changed from that of January.

Figure 1: Sarb now expects headline CPI to be higher in 2021, but lower in 2022 up to mid-2023



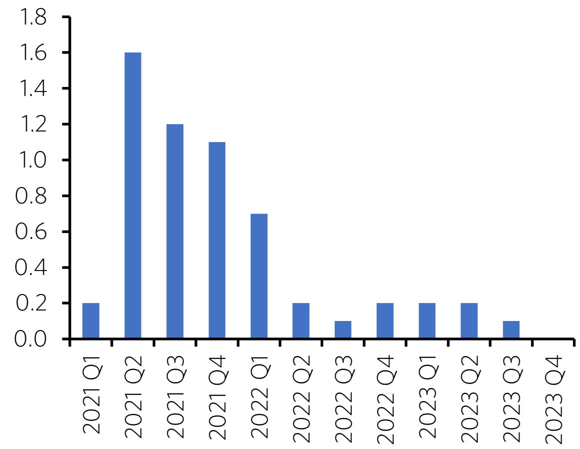
Source: Sarb, Momentum Investments

However, the MPC in the past emphasised that they are exercising flexible inflation targeting. Although they want to see CPI close to the 4,5% mark, they will tolerate higher CPI accruing from shocks such as fuel price increases, provided that they are temporary.

One way of evaluating whether price increases emanating from shocks are temporary, is to assess the core CPI-rate over time as it excludes the effect of food, fuel and energy prices.

Figure 2 shows the difference between headline and core CPI and reveals that most of the near-term increases in headline CPI will emanate from fuel, energy and administered prices. The gap narrows over time, implying less pressure from these items on headline CPI.

Figure 2: Headline CPI minus core CPI: Effect of higher fuel and energy prices subsides over time



Source: Sarb, Momentum Investments

The MPC should therefore view the near-term increases in the headline CPI as transitory.

However, as core CPI is on an increasing path, there is no doubt that consumer prices are on an increasing path. As such, it is not surprising that the MPC decision to leave the repo rate unchanged was unanimous. It can't be expected that MPC-members will keep on voting for the repo rate to be reduced if CPI is on an increasing trend.

The question, however, is whether the MPC will follow the QPM-projections and increase the repo rate by 25 basis points in the second quarter and fourth quarters of 2021 – and for that matter, by another 95 basis points in 2022.

In our view, the repo rate should remain unchanged in 2021, especially as the increase in near-term CPI will be transitory. And while there might be further upward pressure on CPI in 2022, the economy can, in the midst of a pandemic with a bleak vaccination outlook, ill afford fast and strong repo rate increases. More so if CPI is still within the target band of 3% to 6% and close to the midpoint of 4,5%. In any event, the MPC framework states that CPI should be close to the 4,5%-mark and not exactly 4,5%, as it is a flexible inflation targeting framework.

In addition, it is noteworthy that the MPC made no mention of South Africa's high and increasing unemployment rate. This does not mean that the MPC did not consider the impact of the labour market on CPI, or the financial stability risks that may emanate from high unemployment. However, it will be difficult for the MPC to justify increases in the repo rate if the repo rate increases to for instance 4,9%, but the expanded unemployment rate approaches 45%.

In our opinion the MPC is well aware of this risk and will continue to apply flexible inflation targeting and not rigidly apply the QPM-suggestions.

Table 2: Monetary Policy Committee member views over time

	Monetary Policy Committee member votes				
	Favoured no change	Favoured 25 basis point cut	Favoured 50 basis point cut	Favoured 100 basis point cut.	Favoured 25 basis point increase
17 Jan 2019	5	-	-	-	-
28 March 2019	5	-	-	-	-
23 May 2019	3	2	-	-	-
18 July 2019	-	5	-	-	-
19 September 2019	5	-	-	-	-
21 November 2019	3	2	-	-	-
16 January 2020	-	5	-	-	-
19 March 2020	-	-	-	5	-
14 April 2020	-	-	-	5	-
21 May 2020	-	2	3	-	-
23 July 2020	2	3	-	-	-
17 September 2020	3	2	-	-	-
19 November 2020	3	2	-	-	-
21 January 2021	3	2	-	-	-
25 March 2021	5	-	-	-	-