momentum investments

The Macro Research Desk

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SARB pauses to reflect on previous interest rate tightening

Highly uncertain environment for conducting monetary policy

In a recent speech the South African Reserve Bank (SARB) noted that heightened uncertainty had complicated the conduct of monetary policy. In their assessment of the global economic backdrop, they mentioned a number of key economic risks threatening the outlook for global economic activity. With SA perceived as being a globalised emerging market, these international influences (including falling commodity prices, uncertainty in financial markets, volatility in portfolio flows, muted trade activity and negative geopolitical episodes) are likely to shape SA's growth outlook negatively this year and next.

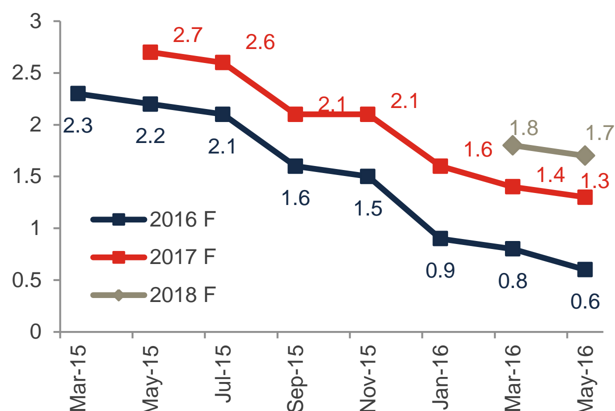
Today's interest rate decision was in line with our and the market's expectation. Only six of the 25 respondents to the Bloomberg survey expected a rate increase at the May 2016 Monetary Policy Committee (MPC) meeting, with the remainder predicting no move in the repo rate.

Worsening growth outlook

The Bank admitted that global growth remains "hesitant" and cut their real GDP growth estimates for SA's main trading partners further from 2.8% in 2016 to 2.7% and from 3.2% in 2017 to 3.1%. The SARB also downgraded their expectations on real GDP growth in SA from 0.8% in 2016 to 0.6% and from 1.4% to 1.3% in 2017 (see chart 1), broadly in line with our own forecasts. The range of GDP estimates as captured by Bloomberg for 1Q16 has widened once again to levels last seen in mid-2009. This further demonstrates the extent of disagreement amongst economic forecasters, proxying a high level of uncertainty in markets. The median Bloomberg consensus forecast pitches real growth expectations for SA at 0.6% in 2016 and 1.3% in 2017. Given the high degree of risk in global economic growth and financial market conditions, the SARB assesses risks to the domestic growth outlook to be on the downside notwithstanding a non-trivial downgrade to their growth forecasts since the start of the year.

In our opinion, poor domestic macro fundamentals, elevated uncertainty around the direction of economic policy and a stagnating reform agenda are, in addition to global headwinds, likely to curb local growth this year and next. Growth in household consumption is likely to buckle under pressure in the near term given lower growth in real wages and grim employment prospects. While upper-income household have de-levered significantly since the global financial crisis, a rising interest rate environment points to a rising debt-servicing burden. In addition, volatile financial markets and slow house price growth further point to a slowdown in the growth rate of household net wealth, highlighting fading support for upper-income earners. Anaemic jobs growth, rising levels of indebtedness and increasing food prices are expected to leave low-income consumers in a vulnerable position this year, particularly given their low level of savings. Moreover, conditions for higher (private) fixed investment remain unfavourable due to falling corporate profitability, muted domestic demand prospects and lingering policy uncertainty in SA.

Chart 1: SARB real GDP forecast revisions (% y/y)



Source: SARB, Momentum Investments

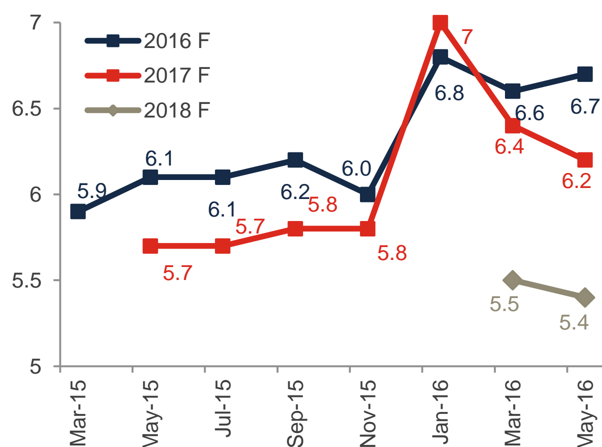
The SARB's assessment of the output gap (the difference between actual and trend/potential growth) shows the measure remaining negative (and likely widening from current levels) over their forecasted horizon. While this is indicative of limited demand-pull inflationary pressures, a recent working paper released by the SARB suggests that changes in the output gap have a relatively small effect on inflation. The paper did however find that a reduction in the size of a negative gap tends to push up inflation by more than an increase in the gap reduces it. As such, the risk of broader-based price pressures emerging likely poses a non-negligible risk in spite of a still negative output gap, particularly as the Bank's assessment of potential growth has dwindled to 1.5% in 2016, rising only marginally to 1.8% in 2018.

Near-term deterioration in inflation outlook with risks remaining to the upside

Favourable base effects in relation to food prices (based on the expectation of more favourable weather conditions later this year), a higher interest rate assumption (taking account of the move in March) and a wider output gap are the main reasons underlying an improvement in the medium-term inflation outlook. Meanwhile, international oil price assumptions were revised higher, following news of supply disruptions, from USD37/bbl to USD42/bbl in 2016 and from USD45/bbl to USD52/bbl in 2017. Though a high level of oil inventories have prevented the SARB from raising these assumptions more aggressively, the Bank warned against further upside risk to these figures.

The MPC raised their assumption on the headline measure of inflation to 6.7% (from 6.6%) in 2016, relative to our internal forecast of 6.6%. They marked down their 2017 projection from 6.4% to 6.2%, largely in line with our own figures (see chart 2). The expected peak in inflation remains unchanged at 7.3% in 4Q16 with the headline print expected to return to within the 3-6% target a quarter earlier in 3Q17. Though the MPC's inflation forecast has improved, they warn that the protracted breach in the headline print remains of key concern as any further possible exchange rate shocks and upside surprises in international oil and food prices could keep inflation outside of the target range for an even longer period of time.

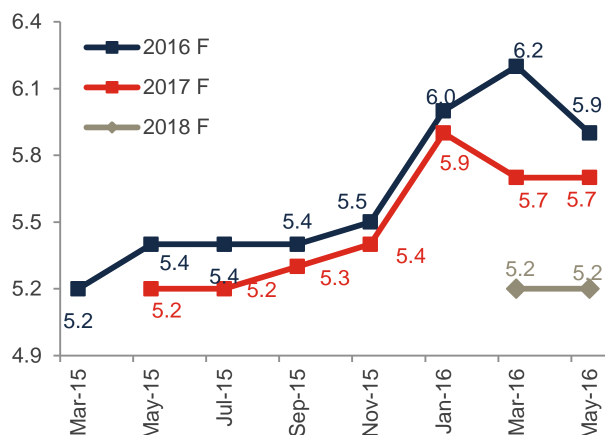
Chart 2: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

The MPC's forecasts on core inflation (headline inflation excluding the impact of food and fuel) have improved. Their latest forecast points to a slightly lower 5.9% forecast in 2016 (previously 6.2%), while their projections for 2017 and 2018 have remained intact at 5.7% and 5.2%, respectively (see chart 3).

Chart 3: SARB core inflation forecast revisions (%)



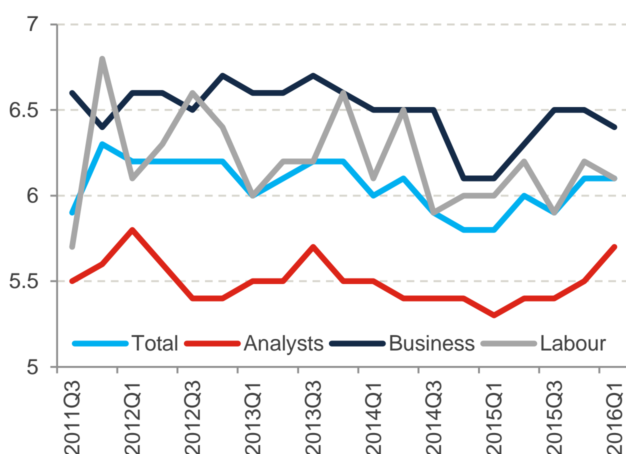
Source: SARB, Momentum Investments

Average inflation expectations remain undesirably close to the upper end of the inflation target

Despite the concerns over the finance ministry in December last year and the potential negative impact on inflation expectations following an abrupt move lower in the currency, the Bureau of Economic Research's (BER) survey on inflation showed mixed results in the near-term (2016 and 2017) outlook and remained unchanged on a five-year basis at 6.1% in the 1Q16 survey.

Although the overall measure remained at 6.1%, the expectation of analysts inched higher to 5.7% from 5.5%, while expectations by businesses and trade unions improved by 0.1% to 6.4% and 6.1% respectively (see chart 4). Although there was no clear evidence of a deterioration in longer-dated inflation expectations, the price-setters of the economy (namely businesses and trade unions) still expect headline inflation to trend above the 3-6% target on a five-year basis, which could fuel inflationary pressures further down the line and keep core measures of inflation elevated above the mid-point of the target band. The second quarter's survey results are expected to be released on the 21st of July.

Chart 4: Average five-year inflation expectations (%)



Source: SARB, Momentum Investments

Divergent views held by committee members

The varying opinions on the MPC as is evident in Table 1 underscore the high degree of uncertainty inherent in markets over recent months. While the committee was evenly split on their views between a 25 basis point interest rate hike and keeping rates on hold at the March 2016 meeting, more committee members favoured no rate change this time around, seeing the current time as appropriate to pause in the current tightening cycle. In the Q&A session, the Governor alluded to the weak state of the economy and the need for a protracted rise in interest rates in order to prevent an undue negative impact on economic activity.

Table 1: Committee members' views have been split over the past four meetings

No. of committee members	Favoured no hike	Favoured 25 basis point hike	Favoured 50 basis point hike
19 November 2015	2	4	-
28 January 2016	1	2	3
17 March 2016	3	3	-
19 May 2016	5	1	-

Source: SARB, Momentum Investments

SARB maintains hawkish stance

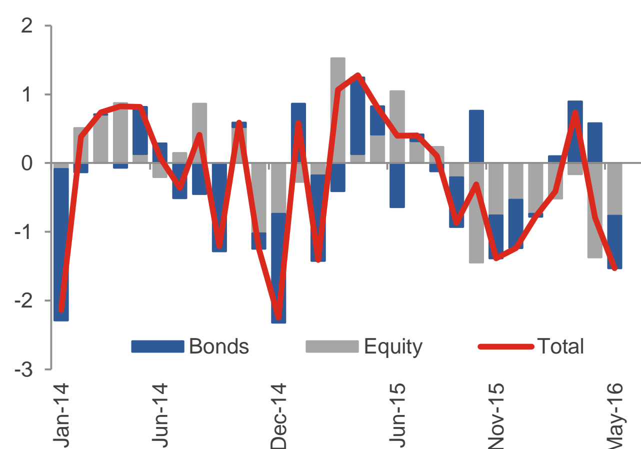
In a previous speech, the SARB noted that SA policymakers remain fully aware of the risk of becoming trapped in what the International Monetary Fund has referred to as the "new mediocre" or a cycle of persistently low growth. With low growth outcomes expected over the forecasted horizon, the SARB expects the output gap to remain in negative territory and expand from current levels.

Nevertheless, inflation is currently tracking outside of the target band and the SARB's latest forecasts suggest that it will only return to within the target range in the second half of 2017. Even though inflationary pressures have been underpinned by supply-side shocks (rising food prices and a sharp sell-off in the exchange rate), the bank remains mindful of potential second-round impacts which could lead to more generalised price pressures in the remainder of the consumer basket.

Notwithstanding an improvement in inflation expectations between 4Q15 and 1Q16, the SARB still expects headline inflation to breach the target for an extended period of time. While the Committee assessed risks to the inflation outlook as being relatively balanced at the time of the January 2016 MPC meeting, they now view risks (largely stemming from drought-inflicted food price rises and renewed anxiety about the prospects for the exchange rate) as being to the upside. They continue to warn against the potential impact of second-round effects of exogenous shocks to the inflation outlook, particularly as survey-based inflation expectations by the price-setters of the economy remain uncomfortably above the 3-6% inflation target band.

Global sentiment around potential rate increases by the US Federal Reserve (Fed) has once again shifted markedly on the back of the release of the Federal Open Market Committee meeting minutes. The probability of a June interest rate hike has moved from 4% at the start of the week to 32% after minutes were released. Contracts further out in the year have also observed a notable re-pricing. The probability of a July move is now up to 47% from 19% earlier this week, while a move by December has gone from 56% at the start of the week to 75% post the release of the meeting minutes. A rising rate environment in the US creates a challenging backdrop for the funding of SA's current account deficit. The MPC previously acknowledged the slow adjustment in the current account deficit despite a meaningful depreciation in the exchange rate over the past year and expressed concerns over the extent of net portfolio equity outflows over the last two months (see chart 5). The SARB intimated that SA's low growth outlook, concerns about a possible ratings downgrade and a re-emergence of political uncertainty likely led to SA not benefiting to the same degree from the recent improvement in the capital flow environment for emerging markets.

Chart 5: Net foreign portfolio inflows into SA (USD bn)



Source: INET BFA, Momentum Investments

The SARB's decision to hold rates steady at the recent MPC meeting was in line with previous comments that monetary policy tightening was expected to proceed at a moderate pace. However, we anticipate further modest tightening given the Reserve Bank's view that exploiting a short-term trade-off between growth and inflation (lower interest rates to accommodate growth in spite of rising inflationary pressures) will be less beneficial in the long run. The SARB has noted that the overall monetary policy stance in SA remains supportive of the weak economy and as such we expect a further two hikes of 25 basis points each in 2H16 which would leave real policy rates marginally above 1%.

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