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Interest rate hike reflects the Reserve Bank's intolerance for inflation expectations at the top end of the target

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) hiked interest rates by 25 basis points, for the first time since March 2016, to 6.75%.
- The SARB emphasised the need to create more flexibility in monetary policy to deal with shocks. The SARB aims to do this by leading inflation expectations closer to the midpoint of the 3% to 6% inflation target band.
- The SARB's near-term growth outlook has been revised lower, but forecasts in the outer years were little changed. The output gap is expected to narrow in the medium term, but will remain negative into 2020.
- Although the SARB acknowledged near-term risks to the inflation outlook had subsided, it warned that tighter global financial conditions, higher wage growth, international oil prices and rising electricity and water tariffs continue to pose upside threats in the long run.
- The interest rate decision was preceded by a very robust debate as evidenced by the even split in preferences on the MPC between no interest rate hike and a hike of 25 basis points.
- Tighter global financial conditions and SA's relatively poor macro fundamentals highlight the need to maintain an attractive real interest rate profile, but a muted growth outlook prevents a sharper acceleration in interest rates.
- Momentum Investments expects a shallow interest rate hiking cycle and forecasts two further interest rate hikes during 2019 and 2020.

Interest rates raised to 6.75% following a robust debate

The MPC hiked interest rates by 25 basis points to 6.75% at the November 2018 interest-rate-setting meeting, but acknowledged that three out of the six MPC members had made arguments for interest rates to remain on hold at 6.5%. This was the first interest rate hike since March 2016, which was triggered by a continued breach of the inflation target and upside risks from food prices and the exchange rate, at the time.

The decision to keep interest rates unchanged was in line with the views of 11 out of 21 surveyed analysts, who participated in the Bloomberg consensus forecast. According to Absa, market pricing equally reflected the high level of uncertainty going into the meeting, with the forward-rate-agreement (FRA) curve signalling a 42% probability of an interest rate hike at the beginning of the week, which dropped to 24% before the meeting.

Despite headline inflation either meeting expectations or surprising the market consensus to the downside in three quarters of the time since January 2016, the expectation is for inflation to drift higher in upcoming quarters. Regardless of the downward revisions to the SARB's inflation projections, the SARB highlighted risks to the longer-term inflation outlook remain. It also strongly signalled its intention to lower inflation expectations, justifying the more hawkish stance adopted in the two recent meetings.

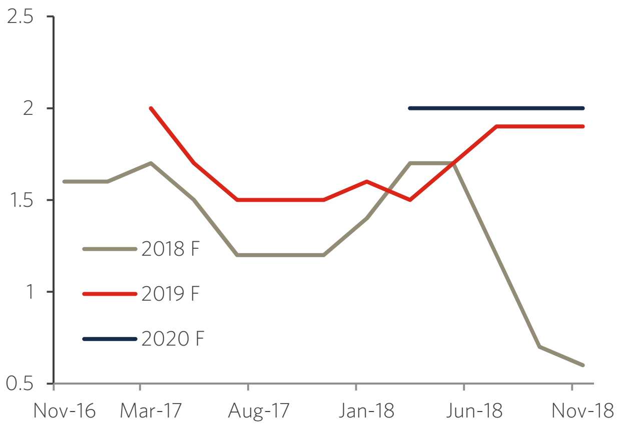
The output gap has once again been revised wider due to an additional downgrade to growth estimates for this year. Demand-pull inflation pressures are still largely absent, with the economy operating below its potential growth, but the SARB warned tighter global financial conditions, higher wage growth, international oil prices and rising electricity and water tariffs have contributed to the upward risks to the SARB's inflation forecasts in the longer term.

Short-term growth forecasts revised lower

Uninspiring data produced by Statistics SA for the retail, manufacturing and mining sectors for the third quarter of the year have contributed towards a further downgrade of 0.1% to the SARB's estimate for growth in gross domestic product (GDP) for 2018 (see chart 1). The SARB declined to reveal its estimate for growth for the third quarter of the year, but indicated the high-frequency data releases pointed to a positive print for overall growth in the economy.

Since the start of the year, the SARB has downwardly revised its full-year growth estimate for 2018 by 0.8% to 0.6%, while projections for 2019 and 2020 have remained relatively stable since the January 2018 interest-rate-setting meeting. The SARB kept its 2019 and 2020 GDP growth forecasts at 1.9% and 2%, respectively, in line with its projections outlined in the September 2018 meeting. The SARB noted the risks to the growth outlook were assessed to be moderately to the downside.

Chart 1: The SARB's real GDP growth forecasts (% y/y)

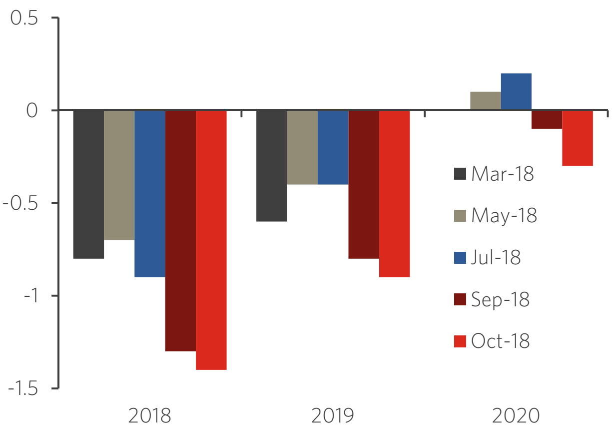


Source: SARB, Momentum Investments

In Momentum Investments' view, growth is likely to disappoint the SARB's growth forecast for 2019. While growth of 2% could likely be achieved in 2020, the firm acknowledges the necessary contribution from an upturn in fixed investment spend, which is only likely to materialise if policy uncertainty lifts and if the outlook for demand improves. The Reuters Econometer poll for November 2018, which surveyed 28 economists, suggested growth is likely to average 0.7% in 2018, 1.5% in 2019 and 2.1% in 2020.

The SARB's estimate of the output gap (the difference between actual and potential growth) has widened for the medium term, in response to the downward revision in growth projections for 2018. A recovery in the output gap is still expected, but is seen to remain negative in 2020 (see chart 2).

Chart 2: The SARB's output gap expectations (%)



Source: SARB, Momentum Investments

Long-term inflation risks remain to the upside

Notwithstanding the recent string of positive downside surprises in the headline inflation print, the SARB's forecasts on inflation were little changed. The SARB lowered its forecast for 2018 by 0.1% to 4.7% (see chart 3), which was in line with the view of 26 economists polled for inflation in the November 2018 Reuters Econometer. This is marginally higher than Momentum Investments' forecast of 4.6%.

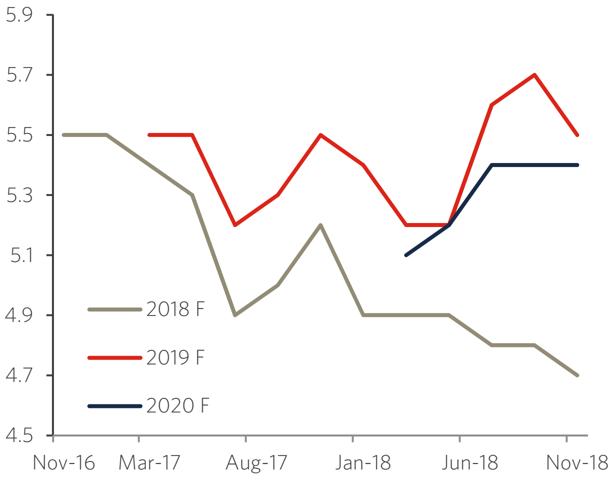
The SARB downwardly revised its 2019 estimate by 0.2% to 5.5%, once again in line with the Reuters consensus, but higher than Momentum Investments' expectation of 5.2%. The SARB's forecast for 2020 remained unchanged at 5.4%, which is marginally higher than the consensus estimate, but lower than Momentum Investments' forecast.

Notwithstanding the recent plunge in international oil prices from a peak of US$85/bbl at the start of October 2018 to US$64/bbl, at the time of writing, the SARB upwardly revised its oil price forecast by US$3/bbl to US$73/bbl in 2019 and 2020. These updated forecasts are more or less in line with Momentum Investments' view on international oil prices of US$73/bbl for 2019 and US$75/bbl for 2020.

Upward adjustments were made to the MPC's electricity tariff assumptions. Electricity prices are anticipated to increase by 9.7% in 2018, relative to the 7.6% assumption made at the September 2018 meeting. This is lower than Momentum Investments' estimate of around 12%.

The MPC admitted the near-term outlook for inflation had improved, but warned against upside risks in the longer term. Tightening global financial conditions, volatility in financial markets and negative sentiment towards EMs were noted as the major risks to the currency outlook, while higher wage growth, international oil prices and electricity and water tariffs were seen to pose additional threats to the inflation outlook.

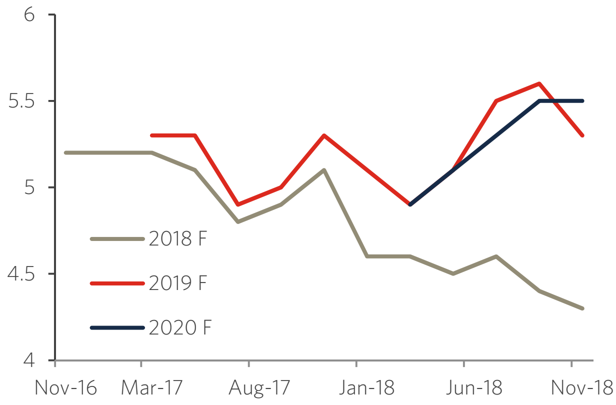
Chart 3: The SARB's headline inflation forecasts (% y/y)



Source: SARB, Momentum Investments

The SARB's core or underlying inflation projections (excluding food and fuel prices) based on the Quarterly Projection Model, were downwardly revised by 0.1% and 0.3% to 4.3% and 5.3% for 2018 and 2019, respectively (see chart 4). The SARB's forecast for 2020 remained steady at 5.5%. These forecasts broadly reflect Momentum Investments' expectations of 4.3%, 5.1% and 5.3% for 2018, 2019 and 2020, respectively.

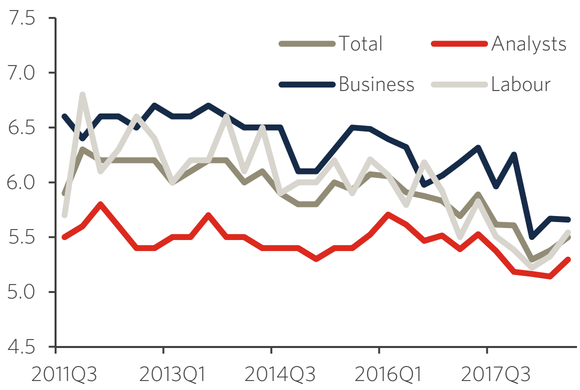
Chart 4: The SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

Fourth-quarter data for inflation expectations (calibrated by the Bureau of Economic Research (BER)) had not been released at the time of the November 2018 MPC meeting. The third-quarter results showed inflation expectations had inched higher for 2018. The average five-year-ahead inflation expectation shifted marginally higher to 5.5%, from a low of 5.3% in the first quarter of the year (see chart 5).

Chart 5: The average expected inflation for the next five years (%)



Source: BER, Momentum Investments, data up to Q3 2018

A decision was arrived at after a "very robust debate"

The interest rate decision was a close call, as evidenced by the even split in views on the MPC. The SARB acknowledged there were three members who preferred an unchanged stance on interest rates, whereas three members made arguments for an interest rate hike of 25 basis points (see table 1). The November 2018 meeting captured the preferences of six MPC members, in comparison to seven at the September 2018 meeting, owing to the retirement of one of its members. After the reading of the statement, the MPC stated it would replace the seventh member in due course.

In the question-and-answer session, it was noted that at the turning points in monetary policy, interest rate decisions become a very finely balanced act. The MPC admitted a decision was arrived at "after a very robust debate". The SARB had to balance acting too soon (which disallows it from reassessing unfolding developments) and being behind the curve, which could lead to an even stronger response in monetary policy in the future if inflation expectations (anchored to the top end of the target band) were to contribute to second-round inflation effects.

Table 1: A split preference on the MPC for the November 2018 meeting

Number of committee members	Favoured no move	Favoured a 25 basis point hike	Favoured a 50 basis point hike	Favoured a 25 basis point cut
24 January 2017	6	-	-	-
30 March 2017	5	-	-	1
25 May 2017	5	-	-	1
20 July 2017	2	-	-	4
21 September 2017	3	-	-	3
23 November 2017	6	-	-	-
18 January 2018	5	-	-	1
28 March 2018	3	-	-	4
24 May 2018	7	-	-	-
19 July 2018	7	-	-	-
20 September 2018	4	3	-	-
22 November 2018	3	3	-	-

Source: SARB, Momentum Investments, the March, May, July and September meetings for 2018 reflected the views of seven members

Shallow interest rate hiking cycle anticipated

The SARB's decision to hike interest rates, in spite of headline inflation projected to remain below the upper end of the inflation target band, reflects its preference to anchor inflation expectations closer to the midpoint of the target. This will allow the SARB to have more flexibility to deal with potential shocks and allow it to manage inflation within the inflation target range of between 3% and 6%.

The SARB reiterated the difficulty in making interest rate decisions at the turning points in the monetary policy cycle. It had to balance the risk of acting too soon (with less confirmation of a materialisation in inflation risks) and acting too late, where elevated inflation expectations could result in higher inflation, which could solicit a much stronger response in monetary policy.

With the SARB acting early, it is likely that a shallow interest rate cycle will follow. Lower growth and in-target inflation should prevent a more aggressive cycle in the absence of a faster-than-anticipated normalisation of monetary policy in developed markets or broad-based negative sentiment towards EMs.

A number of EM economies have started to increase interest rates either in response to a recovery in growth, to combat rising inflationary pressures, or to steady their currencies (see table 2). In its October 2018 Monetary Policy Review, the SARB noted that, although it has alluded to raising interest rates in the past, it is "not contemplating emergency hikes of hundreds of basis points, like those recently implemented elsewhere", given that monetary policy is seen to be credible in SA and the country is not suffering from double-digit inflation.

Momentum Investments expects another two staggered interest rate hikes during 2019 and 2020.

Table 2: EMs that have raised interest rates in the last six months

Country	Latest inflation print*	Latest interest rate move	Current interest rate	Reason
Argentina	45.5%	+15%	60%	Forced to raise interest rates to stem inflation pressure arising from a sharp depreciation in the peso.
Chile	2.9%	+0.25%	2.75%	Surprised the market by hiking interest rates. The decision to hike earlier was made in fear of falling behind the curve in a rising inflation cycle.
Czech Republic	2.2%	+0.25%	1.75%	Raised interest rates to combat fast-rising wages and inflationary pressures.
India	3.3%	+0.25%	6.5%	Interest rates increased to counter inflation pressures. Growing risks from global trade and currency tensions were noted.
Indonesia	3.2%	+0.25%	5.75%	Interest rates were hiked in an attempt to curb a further sell-off in the rupiah and to strengthen the stability of the economy.
Mexico	4.9%	+0.25%	8%	The outlook for inflation had deteriorated significantly. Inflation risks are associated with the possible adoption of policies that could structurally affect the economy's price formation process.
Russia	3.5%	+0.25%	7.5%	Interest rates were increased in response to mounting inflation risks, currency depreciation and the rising threat of US sanctions.
Saudi Arabia	2.1%	+0.25%	2.75%	Interest rates hiked to prevent money market rates from falling too far below US rates, which could trigger capital outflows.
Turkey	25.2%	+6.25%	24%	Strong monetary policy tightening was triggered to support price stability and stem currency depreciation.

*Source: global-rates.com, cbrates.com, Reuters, Mexico News Daily, Momentum Investments, * below or within target = blue, above target = red*