momentum

investments

The Macro Research Desk

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Interest rates unchanged amid elevated uncertainty

Highlights

- **Highly uncertain environment and balance of risks keep interest rates unchanged at 6.75%**
- **Mild growth recovery expected, but risks remain firmly to the downside**
- **Currency, oil and wage price developments are driving upside risks to the inflation forecasts**
- **SARB's Quarterly Projection Model is not seen as prescriptive**
- **Unanimous view from the MPC**
- **Fiscal deterioration and vulnerability to additional rating downgrades reduce chances of further easing for now**

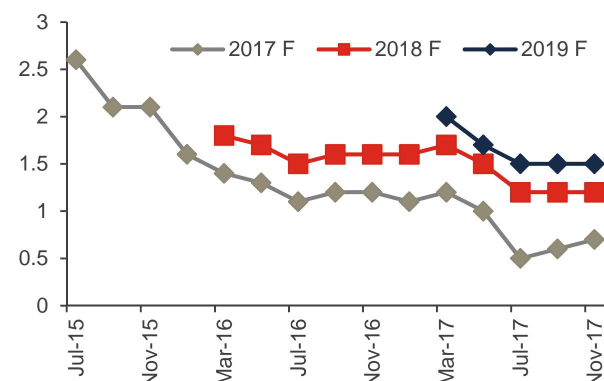
Highly uncertain environment and balance of risks keep interest rates unchanged at 6.75%

The South African Reserve Bank (SARB) exercised caution at its November 2017 Monetary Policy Committee (MPC) meeting, noting the high degree of political and economic uncertainty left the committee with a unanimous vote to leave interest rates unchanged at 6.75%. Although the SARB's interest rate decisions made at the July and September 2017 meetings took the market by surprise, the decision to stay on hold in November 2017 was in line with the market's view. All 19 economists surveyed by Bloomberg were anticipating no move in interest rates.

The SARB mentioned that the balance of risks remained an important factor in its final decision to leave interest rates at 6.75%. Although the MPC's forecasts on growth were largely unchanged relative to those presented at the September 2017 meeting (see chart 1), risks to the projections remained firmly to the downside.

Despite marginal upward revisions to the MPC's headline and core inflation expectations, risks to the projections are still tilted to the upside.

Chart 1: SARB's real growth forecasts (%)



Source: SARB, Momentum Investments

Mild growth recovery expected, but risks remain firmly to the downside

The SARB's real gross domestic product (GDP) growth forecast for 2017 inched higher to 0.7%, from 0.6% at the September 2017 interest rate-setting meeting. However, projections for 2018 and 2019 remained unchanged at 1.2% and 1.5%, respectively. These growth forecasts are in line with the latest October 2017 Reuters Econometer Poll median forecast. Momentum Investments expects a similar growth outcome in 2017 and 2018, with marginal upside risks to the outer year (2019).

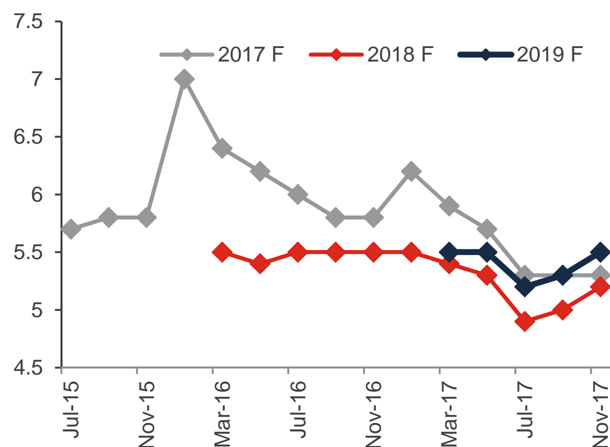
While these growth forecasts outline the expectation of a mild recovery in SA, the SARB noted depressed consumer and business confidence as the key detractors to a higher growth assumption in the medium term.

Weak growth forecasts imply that SA's output gap (trend relative to actual growth levels) will remain in negative territory for the foreseeable future. The SARB estimates potential growth at an unchanged 1.0% in 2017, increasing to 1.3% by 2019. In Momentum Investments' view, the negative output gap to date has suppressed demand-pull inflation pressures, as retailers limit pass-through from rising input costs, in an effort to maintain sales volumes.

Currency, oil and wage price developments are driving upside risks to the inflation forecasts

The MPC adjusted its headline inflation forecasts higher from 5.0% to 5.2% in 2018 and from 5.3% to 5.5% in 2019, while keeping its 2017 forecast unchanged at 5.3% (see chart 2). Once again, these are in broadly in line with the median forecast of the Reuters Econometer Poll for October 2017.

Chart 2: SARB's headline inflation forecasts (%)



Source: SARB, Momentum Investments

International oil prices have risen steadily since the middle of the year. An agreement by the Organisation of the Petroleum Exporting Countries (OPEC), nearly a year ago, to cut production will be reviewed shortly to decide whether or not the agreement will be extended beyond the current March 2018 date. Trouble in the Middle East has further spurred the rise in international oil prices more recently. Nevertheless, Momentum Investments agrees with the SARB's view, which suggests that, although oil prices may linger at these levels, further upward pressure will be limited by other producers' output, including shale gas in the United States. The SARB upwardly revised its assumption on international oil prices from US$55/bbl in 2018 to US$57/bbl and from US$56/bbl to US$58/bbl in 2019.

Aside from oil prices, the MPC warned wage pressures and adverse currency movements pose an upside risk to its upwardly revised inflation forecast. The Andrew Levy Employment Publication showed average wages, in collective bargaining, settling at 7.6% for the first three quarters of 2017, which translates into an average 2.2% real increase relative to a year ago. In Momentum Investments' opinion, the renegotiation of the civil servant multi-year wage agreement, expiring at the end of the first quarter of 2018, could pose an additional upside risk to overall wage inflation pressures.

Lastly, the SARB noted two key risks to the outlook for the domestic currency. In the first instance, the SARB warned that the upcoming rating agency reviews were likely to dominate currency movements in the short term, even though there might be some retracement further down the line. Secondly, the SARB suggested economic implications of the ruling party's electoral conference in December 2017 could cause further adjustments in the currency.

In addition to these risk factors, the SARB highlighted the uncertainty around future electricity tariffs. Currently, the SARB's model incorporates a 5% increase in 2018 and an 8% increase in 2019. It confirmed there will be more certainty on electricity prices at the time of the January 2018 MPC meeting.

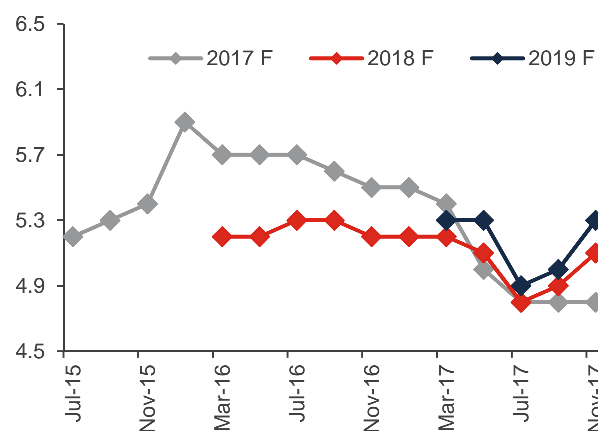
The SARB alluded to improved trade balance prints, partly offsetting these risks to the currency. Relative to the Reuters consensus, it is more optimistic on the outlook for SA's current account deficit.

The SARB sees the current account deficit narrowing to 2.2% (Reuters median: 2.5%) in 2017 and only mildly increasing to 2.9% (3.2%) and 3.2% (3.4%) in 2018 and 2019, respectively.

Moreover, the SARB's revised forecasts on food inflation have also contributed towards partly offsetting higher inflation risks. The SARB's forecast on food inflation is now expected to bottom at 3.8% in 2018, relative to its prior forecast of 4.7% in the September 2017 MPC economic projections.

The MPC dismissed the recent muted core inflation print, which registered at a five-year low in October 2017. It pointed out that core inflation was likely near the bottom and an upturn in inflation measures should occur next year. The MPC's forecast on core or underlying inflation (headline less the effect of food and fuel) rose by 0.2% to 5.1% in 2018 and 5.3% in 2019 (see chart 3).

Chart 3: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

SARB's Quarterly Projection Model is not seen as prescriptive

The SARB released the interest rate results of its Quarterly Projection Model, which suggested interest rate increases of up to 75 basis points by the end of 2019. The SARB emphasised "that this does not mean an unconditional commitment to change policy rates in line with this path". The MPC reiterated in its question-and-answer session that the Committee may diverge from this path, depending on its judgement of prevailing economic conditions at the time and, as such, an alternative path could be generated.

The nominal interest rate increases proposed by the Quarterly Projection Model further indicated that the neutral rate of interest would increase from 1.7% in 2017 to 2.2% in 2019.

Unanimous view from the MPC

The SARB confirmed the decision, to leave interest rates unchanged at 6.75% based on the balance of risks and the level of prevailing uncertainty, was unanimous. Previously, at the September 2017 meeting, three MPC members preferred to leave rates unchanged, while an equal number of members favoured a 25 basis point cut in interest rates (see table 1).

Table 1: Committee members' views in recent meetings

No. of committee members	Favoured no move	Favoured 25 basis point hike	Favoured 50 basis point hike	Favoured a 25 basis point cut
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-
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	-	-	-

Source: SARB, Momentum Investments

Fiscal deterioration and vulnerability to further rating downgrades reduce chances of further easing for now

Headline and core inflation prints continued to moderate in October 2017. However, the SARB cautioned that inflation was likely to reverse course early next year after bottoming in the first quarter of 2017. Although the SARB expects inflation to remain within the 3% to 6% inflation target band over the forecast horizon, it warned potential adverse movements in the currency, wage settlement pressures and international oil price shocks posed upside risks to the inflation trajectory in the medium term.

In Momentum Investments' view, the current environment has created additional challenges for monetary policy. The Medium Term Budget Policy Statement in October 2017, showed a significantly wider fiscal deficit ratio and a marked rise in the country's expected debt profile, highlighting a shift towards an easier fiscal stance in the medium-term horizon.

Fitch rating agency was displeased by the shift away from fiscal consolidation. This was followed by a response from Moody's, which suggested that debt sustainability would be at risk, unless a more credible fiscal consolidation plan was revealed at the time of the February 2018 national budget. Recent comments by Finance Minister Malusi Gigaba have, however, revealed a plan to implement R25 billion in spending cuts and proposals to increase tax revenues by an additional R15 billion (together amounting to 0.8% of GDP) to prevent SA's public debt ratio from rising beyond 60% by 2022.

In Momentum Investments' view, the detail outlined in the October Medium Term Budget Policy Statement raised the risk of further sovereign rating downgrades.
The SARB admitted the imminent rating agency reviews could weigh negatively on the currency, should downgrades materialise, but qualified its comment by noting that the degree to which the currency had priced in an additional downgrade was still highly uncertain.
As such, Momentum Investments believes the chances of further interest rate easing have been reduced in the near term. Further out, however, a possible positive outcome at the ruling party's electoral conference in December 2017 and a potential implementation of further revenue options and expenditure cuts (at the upcoming February 2017 national budget) prevent the firm from ruling out the possibility of marginally lower interest rates in the medium term, should the currency remain well behaved and inflation forecasts stay well within the target band.

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