


**Herman van Papendorp**
Head of Investment Research & Asset Allocation

**Sanisha Packirisamy**
Economist


# The Macro Research Desk

## A robust debate results in an interest rate cut to 6.5%

## Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) noted macro risks have abated since the January 2018 meeting, allowing for a 25 basis point cut in interest rates to 6.5%.
- SA's output gap is expected to close by 2020 on more robust economic growth activity in the medium term.
- Stronger exchange rate assumptions mitigated an increase in the value-added tax (VAT) rate.
- Risks to the inflation outlook have subsided somewhat.
- Longer-term inflation expectations, surveyed in the first quarter of 2018, dropped to a record low of 5.3%.
- A robust interest rate discussion was held at the SARB, where three members of the MPC preferred an unchanged stance on interest rates.
- In Momentum Investments' view, an additional interest rate cut cannot be ruled out should inflation expectations continue to trend lower in a stable rand environment.

## Lower inflation forecasts and a moderation in inflation risks allowed for a cut in interest rates

A downward shift in the SARB's inflation projections and a moderation in inflation risks triggered a decision to cut interest rates by an additional 25 basis points, to 6.5%, at the March 2018 interest rate-setting meeting. Interest rates were last cut in June 2017, on an improvement in the inflation outlook and a deterioration in economic growth prospects.

The March 2018 interest rate decision was in line with the Reuters consensus, where 15 forecasters expected a 25 basis point cut in interest rates. Two forecasters projected a 50 basis point cut in interest rates, while five expected interest rates to remain on hold. In the run up to the meeting, the forward rate agreement (FRA) market had priced in a 70% probability of an interest rate cut at the March 2018 meeting, with a 100% chance of an interest rate cut within a three-month horizon.

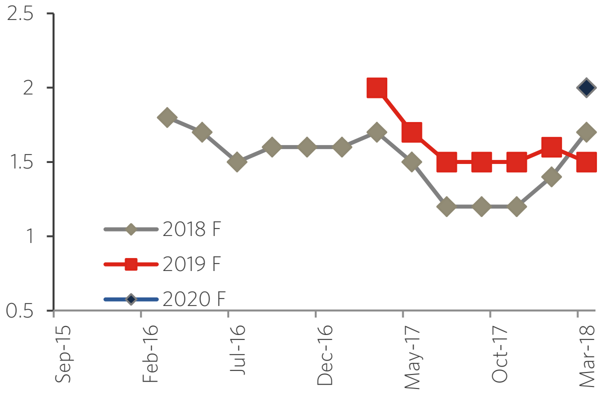
The MPC noted risks to its inflation projection were seen to be "more or less evenly balanced". In the MPC's view, key domestic risks and uncertainties mentioned at the previous (January 2018) interest rate-setting meeting have abated. It previously highlighted the potential for a sovereign credit rating downgrade by Moody's rating agency as a key risk to the local currency. Moody's recent favourable ratings review, which included an outlook shift from negative to stable, has seen the rand strengthen from levels reached earlier in March 2018, on heightened fears around how land expropriation without compensation would be accomplished in SA.

## Output gap expected to close by 2020

Statistics SA's (Stats SA) upward revisions to 2017 growth figures suggested the economy did not enter a technical recession. Revised growth figures suggest the economy fared much better in 2017 than the market and the SARB had initially anticipated. As such, the SARB's forecasts have been revised higher.

The SARB's real gross domestic product (GDP) growth forecast for 2018 rose to 1.7% in March 2018, from a 1.2% trough in November 2017 and a 1.4% expectation in January 2018. The projection for 2019, however, shifted a notch lower to 1.5% in 2018 from a previous estimate of 1.6% (see chart 1). The SARB has introduced forecasts for 2020, where it expects the economy to grow by 2%.

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




*Source: SARB, Momentum Investments*

Momentum Investments expects a similar growth outcome in 2018, with marginal upside risks to the outer years, potentially stemming from a faster acceleration in gross fixed capital formation, in reaction to greater certainty following the 2019 national elections.

The SARB mentioned its improved outlook on growth was also driven by an increase in business and consumer confidence, but clarified in its question and answer (Q&A) session sustained confidence is necessary for a revival in investment and consumption spend. In the near term, the MPC warned tax increases, a lack of compensation for fiscal drag, weak jobs growth and muted household credit growth are likely to constrain consumption spend. The MPC expects growth in consumption spend to increase in the forecasted horizon to 2.1% in 2020. This likely suggests the SARB's anticipated growth recovery depends on an acceleration in fixed investment spend and export growth, in line with an uptick in business confidence and a healthier global economy, respectively.

The SARB's projections for potential growth and expected growth for the next three years suggest the country's output gap is likely to close in 2020. No adjustments were made to the SARB's forecasts of trend growth, estimated at 1.3% in 2018 and 2019 and 1.4% in 2020. Although the SARB anticipates a closing of the output gap in the forecasted horizon, it noted demand-pull inflationary pressures are not of concern currently.

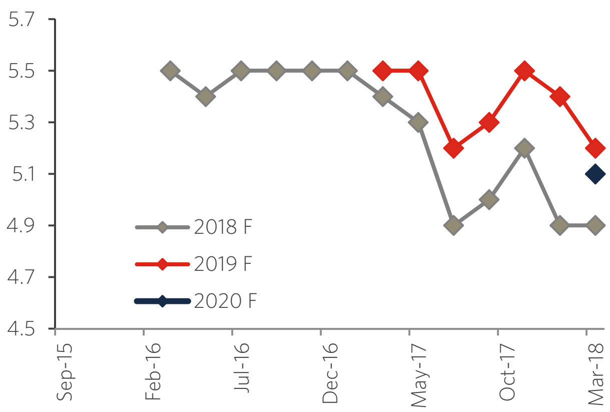
## Stronger exchange rate assumptions mitigated the inflation effect of an increase in taxes

The MPC's 2018 headline inflation forecast remained steady at 4.9% (see chart 2). It intimated the effect of the VAT increase from 14% to 15% added 0.6% to its inflation forecast, but this was offset by a more appreciated exchange rate outlook.

Forecasts for 2019 and 2020 are expected to remain within the target band at 5.2% in 2019 (from 5.4% previously) and 5.1% in 2020. Momentum Investments' inflation expectations are broadly in line for 2018, but are higher for 2019 and 2020.

The SARB explained the increase in the VAT rate would be applied for four quarters from the second quarter of 2018 and is expecting only marginal second-round effects in subsequent quarters.

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




*Source: SARB, Momentum Investments*

Although the SARB acknowledged some of the key risks to the outlook for the rand have dissipated, its currency model points to the rand being somewhat overvalued at current levels, limiting the potential for further strengthening.
A tighter-than-expected monetary policy stance by the United States (US) Federal Reserve (Fed) remains a key threat to the rand, in the SARB's opinion.

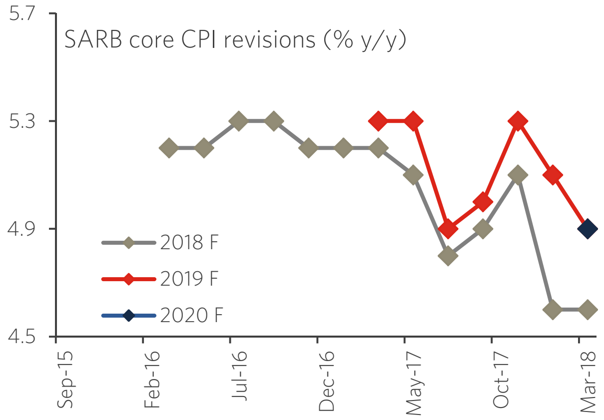
In the Q&A session, the MPC voiced its concerns over the current public sector wage negotiations, stating its importance for setting a bar for settlements in other sectors of the economy. Although the MPC stated it has not specifically forecasted an outcome for the current public sector wage negotiations, it shared its average wage settlement forecast for the economy, noting it is likely to decelerate from 7.6% in 2017 to 6.8% in 2020.

While previously the SARB warned about the upside risks to the international oil price, it left its forecasts relatively unchanged at US$63/bbl in 2018 and US$62/bbl in 2019 in the March 2018 meeting.

According to the SARB, the underlying or core measure of inflation (headline excluding the effect of food and fuel) is expected to remain below 5% for the majority of the forecasted horizon (see chart 3). The SARB was further comforted by the downward adjustment in inflation expectations.

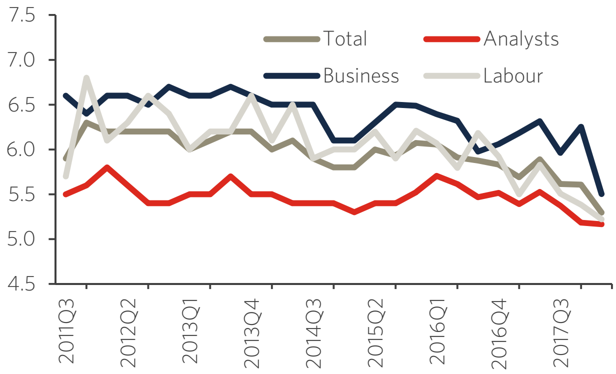
The Bureau of Economic Research's (BER) Inflation Expectation Survey suggested average inflation expectations for the next five years had dropped to its lowest level on record, to 5.3% (see chart 4).

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




*Source: SARB, Momentum Investments*

Chart 4: Average expected inflation for the next five years (%)




*Source: BER, Momentum Investments, data up to Q1 2018*

The SARB reiterated its intention to drive inflation expectations to the mid-point of the target (4.5%), but announced it did not expect the recent cut in interest rates to cause inflation expectations to deviate from its current downward trajectory.

## Heated interest rate discussion

In the Q&A session, the SARB admitted a heated discussion was held on whether to cut interest rates or not. Out of the seven MPC members, three preferred to keep interest rates unchanged, while four put forward arguments to cut interest rates to 6.5%. In the Q&A session, the MPC mentioned a 50 basis point cut was not discussed in its deliberations.

Table 1: Committee members' views in recent meetings

| No. of committee members | Favoured no move | Favoured a 25 basis point hike | Favoured a 50 basis point hike | Favoured a 25 basis point cut | Favoured a 50 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 | - | - | - | |
| 18 January 2018 | 5 | - | - | 1 | |
| 28 March 2018 | 3 | - | - | 4 | - |

*Source: SARB, Momentum Investments, 28 March 2018 reflects the view of seven members*

## Currency stability and a further drop in inflation expectations likely needed for an additional interest rate cut

In its March 2018 MPC statement, the SARB reiterated its preference for inflation expectations to be anchored closer to the mid-point of the inflation target band. The next BER Inflation Expectations Survey will only be released after the May 2018 interest rate-setting meeting, suggesting if there is scope to cut interest rates further, the timing is likely to be pushed out to the July 2018 MPC meeting.

In addition, currency stability is likely to play a key role in the MPC's future interest rate deliberations. While an uptick in commodity prices, a weaker dollar and more upbeat domestic sentiment remain in favour of a stronger rand, the local unit remains vulnerable to negative swings in global and local sentiment. A sharper-than-expected slowdown in China or a faster pace in developed market monetary policy tightening could trigger emerging market-wide currency weakness, whereas a perception of a shift to the left in SA policy (namely land reform), to appease a disgruntled electorate, could see the rand weakening in isolation.

While the possibility of another interest rate cut of 25 basis points by the second half of 2018 cannot be ruled out at this stage, more aggressive easing in monetary policy is unlikely given the medium-term outlook for inflation and political uncertainty, as the 2019 national elections draw near.