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SARB cuts inflation forecasts aggressively, but suggests risks remain moderately tilted to the upside

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) left interest rates unchanged at 6.75%.
- Key focus areas for the SARB remain guiding surveyed inflation expectations closer to the midpoint of the 3% to 6% inflation target band and creating more flexibility in monetary policy, to deal with external shocks..
- Downside risks to the SARB's downgraded economic growth outlook remain a function of concerns of electricity supply, low domestic confidence levels and weaker export prospects. The size of the forecasted output gap remained unchanged for the near term, but is expected to turn positive in 2021.
- Although the SARB lowered its inflation forecasts aggressively, it noted risks to the inflation outlook remained moderately to the upside. It warned that administered prices, rising domestic food prices, changing investor sentiment towards emerging markets (EMs), a moderation in global growth and volatile international oil prices were the key threats to forecast.
- Preferences on the MPC revealed unanimous support for leaving interest rates unchanged, this time around.
- Momentum Investments sees upside risks to the SARB's near-term inflation forecasts, which would warrant further monetary policy tightening if they were to materialise. However, if the SARB's forecasts for inflation are accurate, the current stance on interest rates would likely prevail.

Interest rates remained unchanged at 6.75% on a dip in inflation forecasts

The MPC left interest rates unchanged at 6.75% at the January 2019 interest-rate-setting meeting. The balance of sentiment had shifted from a more mixed view at the previous meeting (where three out of the six MPC members had made arguments for interest rates to remain on hold) to a stronger view to keep the repo rate unchanged.

The decision to keep interest rates unchanged was in line with the views of 27 surveyed analysts, who participated in the Reuters consensus poll. Heading into the interest-rate-setting meeting, Investec noted the forward-rate-agreement (FRA) curve had priced out an interest rate hike for 2019 and assigned a 50% probability of a 25 basis-point hike in 12 months' time. This was likely tied to a more benign inflation outlook and the expectation of a pause in the United States (US) Federal Reserve interest rate hiking cycle.

A recent dip in the international price of oil, a stronger exchange rate starting point and an expected delay in the rise in domestic food inflation led the SARB to notably downgrade its inflation projections, particularly those in the near term. Nevertheless, the SARB continued to caution against upside inflation risks. It warned that administered prices, rising domestic food prices, changing investor sentiment towards EMs, a moderation in global growth and volatile international oil prices were the key threats to its forecast.

Moreover, the MPC continued to signal its intention to lower surveyed inflation expectations (which remained elevated for businesses at 5.7% for 2019 and 5.8% for 2020) closer to the midpoint of the target band.

Low consumer and business confidence and the possibility of protracted constraints on energy supply have kept risks to the SARB's growth outlook tilted to the downside, despite a downgrade in its 2019 forecasts. With demand-pull inflation pressures still largely absent and the economy operating below its potential growth, the output gap remained unchanged at negative 0.9% and negative 0.3% for 2019 and 2020, respectively. However, the SARB anticipates a closing of the output gap in 2021.

Growth revised lower, but there is scope to disappoint further

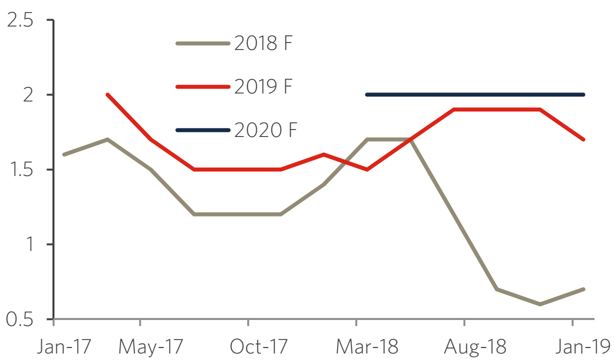
The SARB admitted global growth is likely to moderate in the medium term, but noted economic activity is expected to remain broadly favourable in the near term. Its forecast for growth in SA's main trading partners edged lower by 0.2% to 3.3% for 2019 and 2020.

Downside risks were highlighted in the local economy. The SARB pointed to the negative effects of electricity tariff increases on economic data. Uncertainty arising from negative trade developments remains a key threat to export growth, while a more meaningful slowdown in global growth in 2020 could dent export growth further in Momentum Investments' opinion. Subdued confidence levels have continued to hold investment prospects back, with the Bureau of Economic Research's manufacturing survey pinpointing a lack of sufficient demand and uncertainty on the outlook for policy as the main constraints to business investment.

The MPC's gross domestic product (GDP) growth forecasts were cut to 1.7% for 2019 (from 1.9%) previously. However, these remained below the January 2019 Reuters Econometer median forecast of 1.5% and is lower than Momentum Investments' internal forecast of 1.4%. Growth forecasts for 2020 were left unchanged at 2.0%, relative to the Reuters' forecast of 1.9% and Momentum Investments' forecast of 1.8%. The SARB introduced its 2021 forecasts, in which it expects growth to rise to 2.2%. This is a notch higher than the Reuters forecast for a rise to 2%, but in line with Momentum Investments' view.

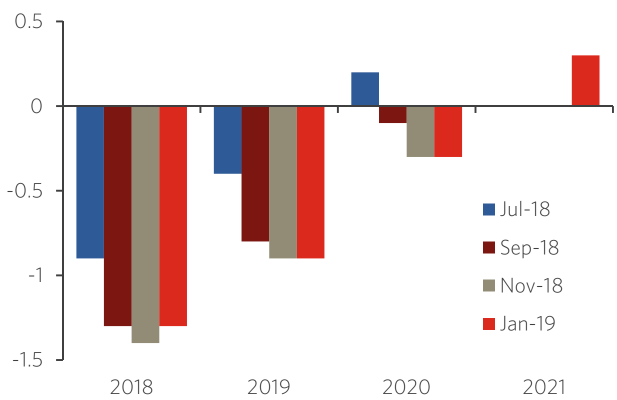
The SARB's estimate of the output gap (the difference between actual and potential growth) remained steady relative to its November 2018 estimates, but the 2021 forecast suggests an eventual closing of the output gap in the medium term (see chart 2).

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



Source: SARB, Momentum Investments

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



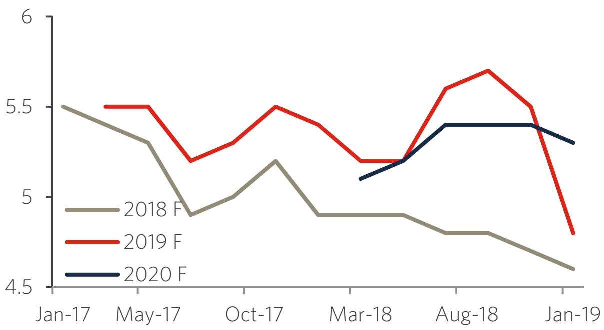
Source: SARB, Momentum Investments

Deep cut to inflation forecasts, but risks remain to the upside

A slide in the international price of oil since November 2018, a firmer starting point for the exchange rate relative to the previous interest-rate-setting meeting and an expected delay in the rise in domestic food inflation led the SARB to aggressively downgrade its inflation projections in the near term. The SARB revised its 2019 forecast sharply lower by 0.7% to 4.8% for 2019 (see chart 3), following on from a 0.2% downward revision at the November 2018 meeting. This is below the Reuter's consensus forecast for an increase from an estimated 4.7% for 2018 to 5.2% for 2019, which is in line with Momentum Investments' assumption.

The SARB's forecast for 2020 edged lower by 0.1% to 5.3%, matching the Reuters consensus estimate, but marginally lower than Momentum Investments' projection of 5.5%.

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



Source: SARB, Momentum Investments

Although the MPC admitted there is more forecast risk attached to its longer-dated inflation expectations, it revealed its 2021 forecast at 4.8%, which is lower than the Reuters consensus forecast of 5.2% and lower than Momentum Investments' expectation of 5.1%.

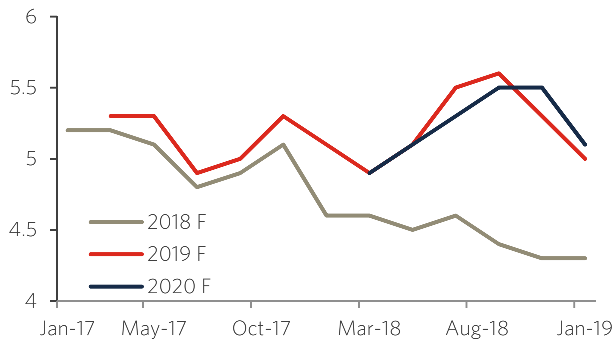
A downgrade to the SARB's forecast on the international price of oil was likely the largest driver behind its downward revision to its inflation forecast. The SARB lowered its oil price forecast from US$73/bbl to US$62/bbl for 2019 and from US$73/bbl to US$65/bbl for 2020. Its forecast for oil prices remains steady into 2021. Oil price futures hug the US$61/bbl level for the next three years, whereas the Bloomberg median consensus forecast estimates oil prices to average US$67/bbl in 2019 and US$70/bbl in 2020 and 2021.

In addition, there are upside risks to the SARB's electricity tariff assumptions. The SARB expects electricity prices to increase by 9.7% in 2019, whereas Momentum Investments' has pencilled in an increase of 12.5%. Eskom has requested a 15% tariff increase in its fourth multi-year price determination (MYPD4).

Despite a sharp downward adjustment to its inflation forecasts, the MPC admitted inflation risks remain moderately to the upside. It warned that potentially higher administered prices (electricity and water tariffs), rising domestic food prices, a negative shift in investor sentiment towards EMs, a faster slowdown in global growth and volatile international oil prices were the key threats to its inflation forecast.

The SARB's core or underlying inflation projections (excluding food and fuel prices) based on the Quarterly Projection Model, were downwardly revised by 0.3% and 0.4% to 5.0% and 5.1% for 2019 and 2020, respectively (see chart 4). The SARB's forecast for 2021 shows a further decrease in underlying price pressures to 4.8%. This compares with Momentum Investments' expectations of 5.0%, 4.7% and 5.2% for 2019, 2020 and 2021, respectively. This is suggestive of the oil price forecast (and potentially food prices) arising as the largest discrepancy between the projections of the SARB and Momentum Investments.

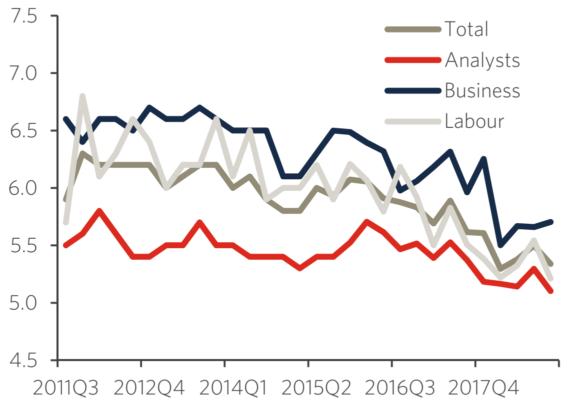
Chart 4: The SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

Fourth-quarter data for inflation expectations (surveyed by the Bureau of Economic Research (BER) between 30 October and 4 December 2018) showed a slight downward shift in the average five-year ahead inflation expectation from 5.5% to 5.3% (see chart 5). The downward revision was largely driven by a downward revision by analysts from 5.3% to 5.1% and a cut in forecasts from trade unions from 5.5% to 5.2%. It should, however, be noted that the expectations of the price-setters in the economy (i.e. businesses) kept their forecast unchanged at 5.7%. Similarly, near-term forecasts for 2019 and 2020 were revised lower by analysts and trade unions, but remained elevated for businesses at 5.7% for 2019 and 5.8% for 2020.

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



Source: BER, Momentum Investments, data up to Q4 2018

Unanimous decision to leave interest rates unchanged at 6.75%

The interest rate decision was unanimous with all five members preferring to leave interest rates unchanged at 6.75% (see table 1). With the departure of Deputy Governor Francois Groepe and MPC member Brian Kahn, there are two vacancies open on the MPC. It was not confirmed when these two vacancies would be filled.

Table 1: Unanimous preferences for the January 2019 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	-	-
17 January 2019**	5	-	-	-

Source: SARB, Momentum Investments

**The March, May, July and September meetings for 2018 reflected the views of seven members*

***The January meeting for 2019 reflected the views of five members*

In the question-and-answer session, the MPC reiterated the difference between private ownership of the SARB and the independence of monetary policy. It used Turkey, the US and Germany as examples, where private ownership in the respective central banks had no influence over the direction of monetary policy.

In response to the recent debate around the SARB's need to focus on growth, it defended its position by restating its commitment to its mandate to "achieve and maintain price stability in the interest of balanced and sustainable economic growth".

SARB may be too complacent on inflation risks

If the SARB's forecasts for a lower inflation outlook were to materialise, it is likely interest rates would remain steady from current levels. The SARB's updated inflation forecasts point to a peak in inflation in the first half of 2020, before moving lower once again.

In Momentum Investments' view, potential supply shortages in the international oil market, administered price pressures, geopolitical tensions, trade war risks, a negative shift in sentiment and unfavourable domestic political developments all pose an upside risk to the SARB's inflation forecasts. Moreover, the SARB reiterated its intention to guide inflation expectations lower towards the midpoint of the target band and business expectations have yet to lower meaningfully.

Should these upside risks materialise, a further tightening in monetary policy would be warranted.