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Sarb slices off another 50 basis points from the repo rate

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) reduced interest rates by an expected 50 basis points to 3.75% at the scheduled May 2020 interest rate-setting meeting.
- The Sarb downgraded its expectation of growth in SA's main trading partners due to the outbreak and spread of COVID-19 from negative 2.8% to negative 3.4% in 2020, but increased its growth assumption for 2021 from 4.0% to 4.3%.
- The Sarb's growth forecast for the local economy weakened further to negative 7.0% for 2020 from negative 6.1%, factoring in weaker demand for SA exports, as a consequence of disruptions to supply chains, suppressed global demand and decimated local confidence levels. The size of the forecasted negative output gap widened to 6.7% from 5.7% in 2020 and is expected to narrow to 2.5% in 2022, from 3.3% previously.
- Low food inflation, slower wage growth, modest services inflation, a muted pass-through from the local currency and lower international oil prices led to a downward revision in the Sarb's headline inflation forecast from 3.6% to 3.4% in 2020 and from 4.5% to 4.4% in 2021.
- Interest rate preferences by the MPC members were aligned in the previous three meetings. This time around, three members favoured a 50-basis point cut in interest rates, while two members preferred a smaller cut of 25 basis points.
- Unlike many developed market economies, higher interest rates in SA have provided the Sarb with the space for further monetary policy ammunition to shield the economy from the negative economic effects of COVID-19 and related financial market turbulence. In our view, the Sarb may be more inclined to temporarily cut real interest rates by more than usual to play its role in softening the blow of the virus shock on the local economy and as such we see further space for marginal easing to 3.25% by the end of the year.

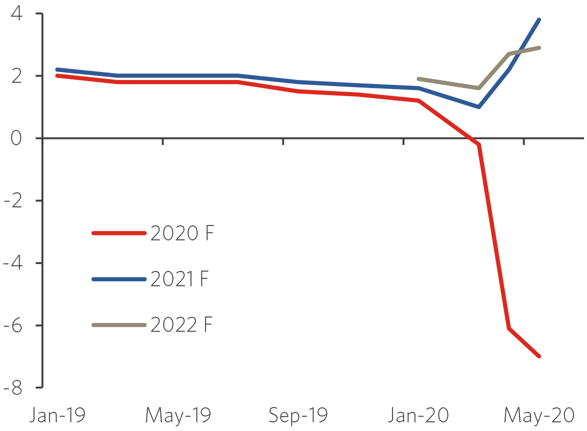
Sarb pares back its growth estimates

In its April 2020 World Economic Outlook, the International Monetary Fund projected global growth to fall by 3% in 2020 based on the assumption that the COVID-19 pandemic and required containment measures peak in the second quarter of 2020 for the majority of economies in the world, before receding in the second half of the year.

The Sarb's estimate of growth in SA's main trading partners moved lower to negative 3.4% from negative 2.8% for 2020, but increased from 4.0% to 4.3% for 2021. Lower estimated growth for 2020 will have negative consequences for SA's external trade.

Suppressed global demand, together with downbeat sentiment locally, led the Sarb to downwardly revise its growth forecast for the local economy for 2020 from negative 6.1% to negative 7%. The Sarb cited ongoing disruptions to global supply chains, suppressed global demand and downbeat confidence in the local economy as the major drivers behind the change in its growth forecast, as these elements were anticipated to weigh heavily on investment and exports. The Sarb expects the economy to recover by 3.8% in 2021, from a previous expectation of 2.2% (see chart 1).

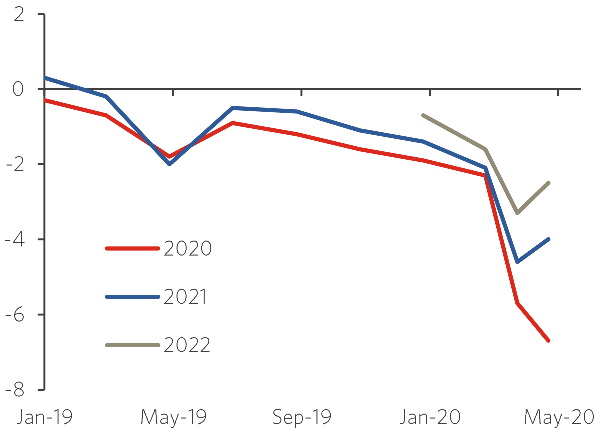
Chart 1: The Sarb's real growth revisions (%)



Source: Sarb, Momentum Investments

The expected gap between actual and potential growth is expected to widen from 5.7% to 6.7% in 2020, before declining to 2.5% (previously 3.3%), see chart 2.

Chart 2: The Sarb's output gap revisions (%)



Source: Sarb, Momentum Investments

The Sarb's growth forecast has shifted to a more bearish stance relative to the median consensus view appearing in the May 2020 Reuters Econometer, which pointed to an expected contraction in SA's economy of 6.5% in 2020, before resetting to positive growth of 2.5% in 2021. In the recent weeks, we lowered our growth projection to negative 7.2% for 2020 and expect a mild rise of only 2% in 2021.
Weak fundamentals, a rise in firm liquidations and insolvencies as well as significant job losses are likely to constrain the upturn, underlying our weaker growth assumption for 2021.

In a presentation to the Standing Committee and Select Committee on Finance and Appropriations on 30 April 2020, treasury sketched out three plausible economic scenarios following the COVID-19 crisis and the consequent lockdown measures. In the quick scenario, treasury assumes a speedy containment of the pandemic with a rapid bounce back in the economy. Growth contracts by 5.4% in this scenario. In its slow scenario, treasury expects it will take longer to contain the pandemic and sees the economy contracting by 12.1% in 2020. In its most bearish case, treasury expects the pandemic to endure into the fourth quarter of the year causing the economy to collapse by 16.1% in 2020.

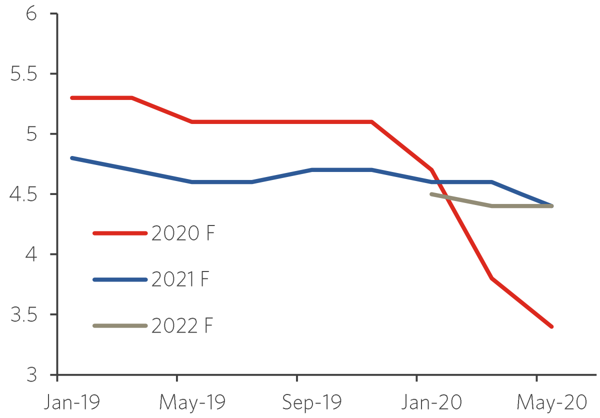
In the question and answer (Q&A) session, the Sarb governor refrained from assigning a shape to the expected economic recovery in SA, suggesting that shapes were not as useful as actual forecasts on growth and were likely emerging in the economic discourse given the elevated level of uncertainty associated with forecasting at present. The Sarb revealed its quarterly forecasts showed a steep growth contraction for the second quarter of the year, with a quick turn to positive growth in the third and fourth quarters of 2020. These forecasts were based on the assumption of a phasing out of the lockdown during 2020.

Downside risks to the Sarb's inflation forecast

Low international oil prices and continued downside surprises in food inflation continue to exert downward pressure on the forecast for headline inflation, while the Sarb warned that administered prices (which have averaged above 7% since 2009) pose upside pressures to the inflation rate. Nevertheless, the Sarb still assesses overall risks to its inflation outlook to be to the downside (albeit less so than in April 2020) after taking into account weaker global and local pricing power.

The Sarb trimmed its annual average oil price forecasts for 2020 from US$42/bbl to US$37/bbl, but kept its forecast for 2021 stable at US$45/bbl.
Overall, the Sarb expects headline inflation of 3.4% in 2020 from a previous 3.6% (compared with our forecast of 2.9% and the Reuters median consensus of 3.5%), 4.4% in 2021 from a prior estimate of 4.5% (relative to our expectation of 3.5% and the Reuters median consensus of 4.1%) and an unchanged rate of 4.4% for 2022 (relative to our projection of 4.9% and the Reuters median consensus of 4.5%), see chart 3.

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



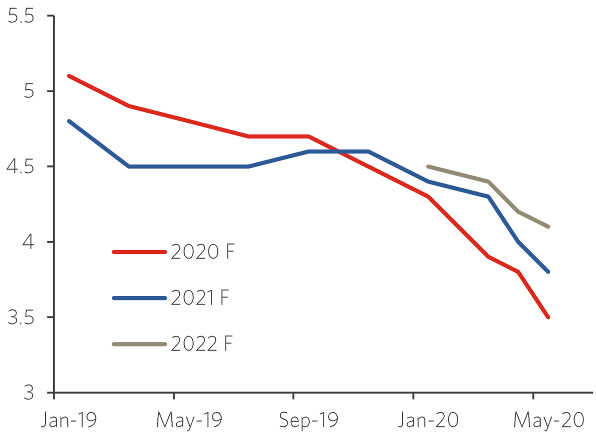
Source: Sarb, Momentum Investments

In the Q&A session, it was noted that the Sarb's inflation forecast for 2020 included two quarters (the second and third quarters of the year) in which inflation trends below the bottom end of the inflation target at 2.8% and 2.9%, respectively. The Sarb clarified this was largely owing to a sharp expected deceleration in petrol inflation. The governor noted that a temporary breach of the bottom end of the 3% to 6% inflation target would be treated the same as a temporary breach of the upper end of the target band. The Sarb would look through the shock and determine the existence of any second-round effects.

In our view, lower rental, services and wage inflation could drive the rate of inflation below 3% for 2020 as a whole.

The Sarb's core or underlying inflation projections (excluding food and fuel prices) were downwardly revised by 0.3% for 2020 to 3.5% (compared with our estimate of 2.9%) and by 0.2% to 3.8% for 2021, relative to our forecast of 2.8% (see chart 4).
Relative to its April 2020 projections, the Sarb expects core inflation to be 0.1% lower at 4.1% in 2022.

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



Source: Sarb, Momentum Investments

In response to a question around the validity of inflation figures coming from Statistics (Stats) SA in the coming months, the Sarb responded that an imputed method would be used, given that the lockdown restrictions should affect certain categories of the inflation basket. Nevertheless, these methods would be in line with the best methods used internationally, as many countries were facing the same problem of a reduced sample size. According to Stats SA, the inflation release for April will be published on 24 June 2020.

MPC preferences differed on the size of the interest rate cut

Three MPC members preferred an interest rate cut of 50 basis points, while two members favoured a cut of 25 basis points (see table 1).

Today's interest rate decision was in line with the Reuters consensus for May 2020, where nine out of 20 analysts (including ourselves) forecasted a cut of 50 basis points. One analyst estimated a cut of 100 basis points, three analysts looked for a cut of 75 basis points, four anticipated a cut of 25 basis points and three proposed the interest rate would remain unchanged.

According to the MPC, the Quarterly Projection Model (QPM) indicated two repo rate cuts of 25 basis points each in the next two quarters of 2020. Today's decision front loaded the QPM's indication, as the QPM is run before the interest rate decision is made.

In the Q&A session, the Sarb attributed the steepness of the yield curve to an increase in government issuance and higher credit risk. It noted that measures put in place to manage liquidity have worked and are not likely to stoke a rise in asset price inflation. Its purchases of government bonds varies day by day depending on which bonds are showing signs of stress, preventing a proper functioning of markets. The Sarb will announce the bond purchases it made for May on 7 June 2020.

The Sarb commented that defaults on household and commercial loans were not yet evident in the data available from the banking sector, but these were expected to rise between May and July 2020. Nonetheless, the Sarb views the SA banking sector as well provisioned and well capitalised for an increase in defaults. Moreover, regulatory relief measures will allow banks to absorb a higher level of defaults.

The Sarb also gave an update of the loan guarantee scheme in the Q&A session, pointing out that R90 billion of the first phase (R100 billion) had been taken up by the six-largest and three smaller banks. Drawdowns, however, remain low, as the scheme only started on 12 May 2020 and it is too early in the process to determine whether it has been a success or not.

Table 1: Differing MPC member views at the scheduled May 2020 meeting

Number of committee members	Favoured no move	Favoured a 25 basis point cut	Favoured a 50 basis point cut	Favoured a 100 basis point cut
17 January 2019	5	-	-	-
28 March 2019	5	-	-	-
23 May 2019	3	2	-	-
18 July 2019	-	5	-	-
19 September 2019	5	-	-	-
21 November 2019	3	2	-	-
16 January 2020	-	5	-	-
19 March 2020	-	-	-	5
14 April 2020	-	-	-	5
21 May 2020	-	2	3	-

Source: Sarb, Momentum Investments

Room exists to cut further if needed

Globally, governments have responded aggressively in an attempt to avoid a prolonged economic crisis from the COVID-19 pandemic. In many countries, particularly in the developed world, the fiscal responses unveiled to date have exceeded the stimulus triggered in the global financial crisis, with the latter being spread over three to four years.

Unfortunately, a number of emerging markets, including SA, had fewer resources going into the COVID-19 crisis, therefore limiting the magnitude of their respective fiscal stimulus responses to the virus. In SA, real interest rates were at significantly positive levels going into the crisis, allowing for considerable room to maneuver on the monetary policy side. As such, the Sarb has been able to provide a more aggressive monetary policy response to COVID-19, cutting interest rates by a combined 250 basis points so far since the end of January 2020.

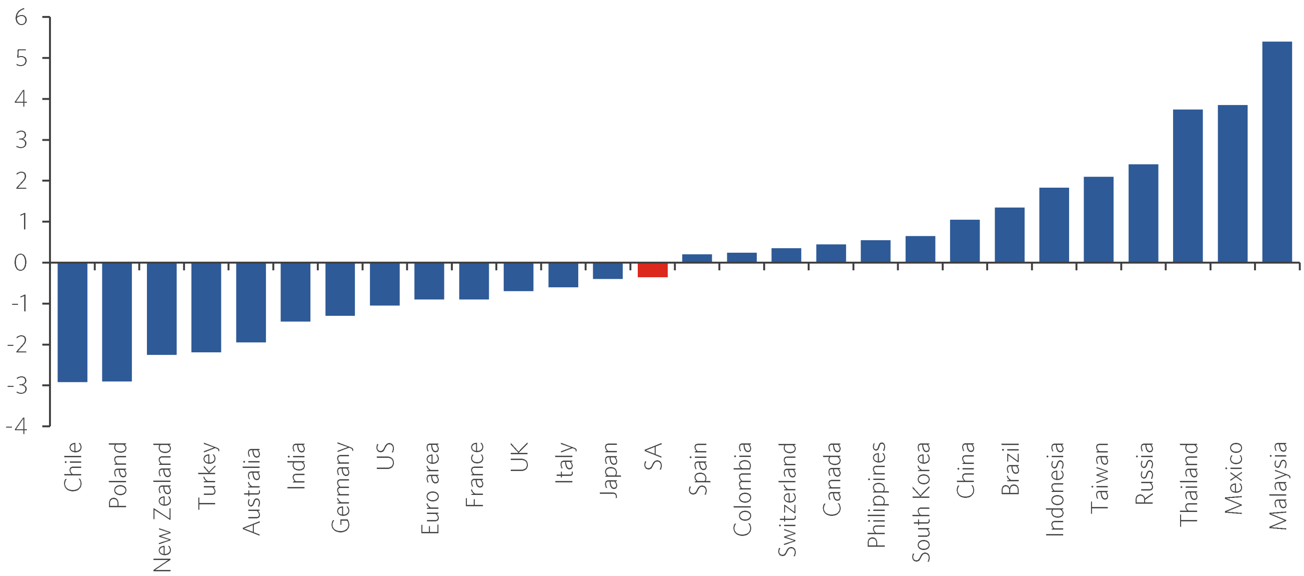
The governor previously noted the COVID-19 pandemic has led to a shock to demand and supply and policymakers are trying to deal with the demand shock. He noted the Sarb would use its entire range of tools in accordance with its mandate to cushion the SA economy from this shock.

While our growth contraction forecasted for 2020 is largely in line with the Sarb's, we are anticipating a milder recovery to take hold in 2021. Our inflation forecasts also point to further downside risks in the Sarb's numbers.

The Sarb noted that today's cut would take the real interest rate down to negative 0.6% if one-year ahead inflation forecasts are used. The Sarb uses a forward-looking inflation rate to reflect the range of the monetary policy transmission mechanism. The Sarb's neutral level of interest is deemed to be 2.1%, implying a large negative real neutral rate until the end of 2021.

In our view, the Sarb may be inclined to temporarily cut real interest rates by more than usual to play its role in softening the blow of the virus shock on the local economy and, as such, see further space for marginal easing to 3.25% by the end of 2020. The Sarb was clear that monetary policy has its limitations in trying to boost potential growth, but by cutting interest rates, it aims to help consumers and firms, with debt, to better manage their cash flows so a higher level of economic activity can resume once the lockdown restrictions are lifted.

Chart 5: Comparative real interest rates using the latest realised inflation figure (%)



Source: Bloomberg, Momentum Investments