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Sarb slashes interest rates by a larger-than-expected 100 basis points to shield economy against COVID-19 fallout

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) slashed interest rates by a larger-than-expected 100 basis points to 5.25% at the March 2020 interest rate-setting meeting.
- The Sarb acknowledged significant downgrades to expected global economic activity due to the outbreak and spread of COVID-19.
- Significant downside adjustments to the Sarb's economic growth outlook (1% weaker for 2020 and 0.6% lower for 2021 relative to projections made in January 2020) were a function of weaker demand for SA exports, disruptions to supply chains, subdued local confidence levels and ongoing electricity supply concerns. The size of the forecasted output gap has widened to negative 2.3% in 2020 and is expected to narrow to 1.6% in 2022.
- The Sarb's inflation forecasts were revised down since the January 2020 MPC meeting on low food inflation, slower wage growth, modest services inflation, a muted pass-through from the local currency and lower international oil prices. Taking these new projections into account, the Sarb continues to view risks to the inflation outlook as balanced. Meanwhile, the potential for higher electricity tariffs remains a concern.
- Inflation expectations for the first quarter of 2020 continued to drop closer towards the mid-point of the inflation target range. The Sarb noted today's decision was still in line with its intentions to structurally shift expectations towards 4.5% for broader macroeconomic stability.
- Interest rate preferences have been aligned at the recent two MPC meetings. This time around, there was unanimous support for a larger 100-basis point decrease in interest rates.
- In our view, a front-end loaded and strong monetary policy response, to shield the economy from the negative economic effects of COVID-19 and related financial market turbulence, give the Sarb an opportunity to implement a wait-and-see approach to assess the effects of today's move in interest rates on confidence and the broader economy. Unlike many developed market (DM) economies, interest rates in SA are not close to the zero-lower bound, leaving the Sarb with further monetary policy ammunition, if economic conditions deteriorate further. Should the Sarb perceive liquidity stress in financial markets as threatening to the stability of the financial system in the future, it has the option of using conventional and/or unconventional monetary policy tools if needed.

Interest rates cut to 5.25% amid economic and market turbulence

The MPC reacted strongly to the negative economic effects of the global outbreak of COVID-19 by reducing interest rates by 100bps. This is the largest interest rate cut since May 2009, when interest rates were lowered by 200 basis points. This is not the lowest interest rate the country has observed since the implementation of inflation targeting in February 2000. Interest rates reached a low of 5% between July 2012 and December 2013.

The decision to cut by 100 basis points was preferred by all five members of the MPC. Going into the interest-rate-setting meeting, 11 economists polled by Bloomberg were expecting a cut of 50 basis points, while 10 anticipated a shallower cut of 25 basis points.

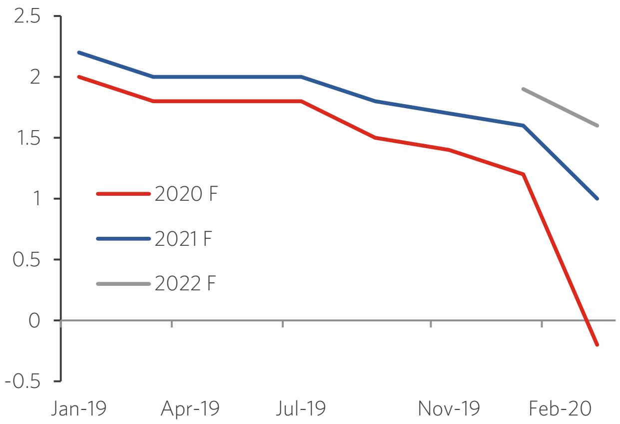
Heading into the MPC meeting, Absa noted the forward-rate-agreement (FRA) curve was pricing in 75 basis points worth of interest rate cuts in the next five months.

Negative growth expected for 2020 as a whole

The Sarb downgraded its global growth forecast from 2.7% for 2020 to 1.1% and from 3.1% to 2.8% in 2021. The Sarb anticipates growth will remain unchanged at 3.1% in 2022. Embedded in these forecasts is an expected 1% contraction in Chinese growth for the first half of 2020 and a contraction in growth in the United States (US) and Europe. However, an order of magnitude for the latter was not divulged.

The Sarb expects the first half of the year to bear the brunt of the negative growth effects of the spread of COVID-19, but also investigated a scenario under which the hit on growth persists for a prolonged period due to insufficient measures to limit the spread of the virus.

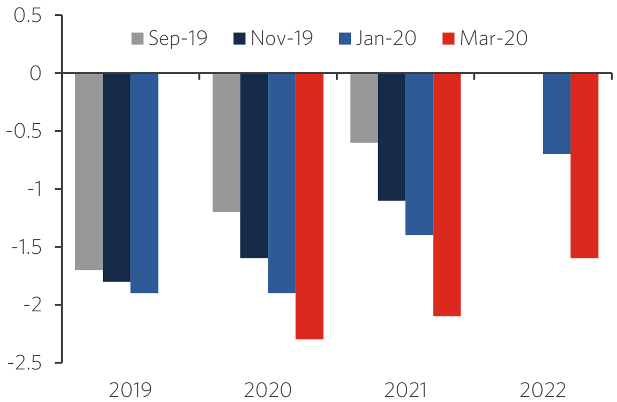
Chart 1: The Sarb's real growth revisions (%)



Source: Sarb, Momentum Investments, data up to March 2020

The Sarb axed its growth forecast for 2020 from 1.2% at the January 2020 MPC meeting to negative 0.2%, citing disruptions to global supply chains, weaker demand for SA's exports, downtrodden business and consumer sentiment and ongoing electricity supply constraints, as they key reasons underlying its downward revisions to growth. The Sarb expects growth to lift to 1% in 2021 (previously 1.6%) and to reach 1.6% (from January's estimate of 1.9%) in 2022. According to the latest Reuters Econometer for March 2020, the median economist forecast for growth in 2020 was recorded at 0.3% and is expected to climb to 1.2% in 2020, before dropping to 1.1%.

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



Source: Sarb, Momentum Investments

The Sarb's estimate of the output gap (actual growth relative to potential) has consequently widened considerably to negative 2.3% for 2020 from negative 1.9%. The output gap is expected to narrow to negative 1.6% by 2022 (previously negative 0.7%), see chart 2.

Risks to a lowered inflation forecast remain balanced

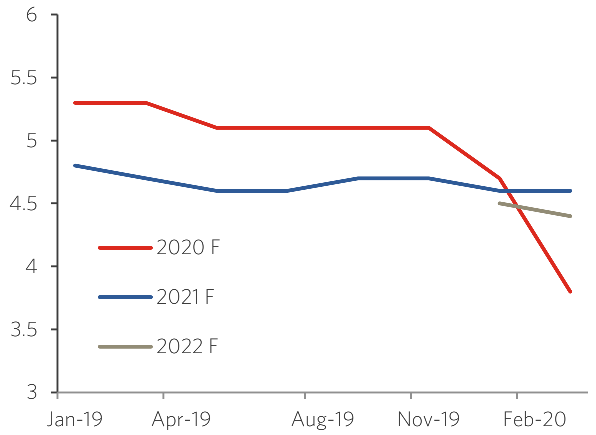
The Sarb remains of the view that subdued wage growth, muted services inflation, low food prices and a muffled exchange rate pass-through (as retailers attempt to preserve volumes in a moribund economy amid a wider negative output gap) will continue to keep inflation tracking well within the 3% to 6% inflation target band.

Moreover, weak global demand for oil and a price war between Saudi Arabia and Russia have caused international oil prices to plunge. The Sarb has lowered its annual average oil price forecasts for 2020 to US$40.4/bbl for 2020 from US$66.5/bbl and from US$66/bbl to US$44.5/bbl for 2021. The Sarb expects the price of Brent crude oil to remain suppressed at US$45/bbl in 2022, from a previously estimated US$66/bbl in January 2020.

Upside risks from electricity tariffs have not dissipated and the Sarb continued to cite these as the main source of upside pressure to its expected inflation trajectory. The Sarb has pencilled in electricity inflation of 10.4% for 2020, 7.4% for 2021 and 6.0% for 2021 (unchanged from January 2020).

Overall, the Sarb expects headline inflation of 3.8% in 2020 from a previous 4.7%, an unchanged 4.6% in 2021 and a marginally lower rate of 4.4% (previously 4.5%) for 2022 (see chart 3).

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



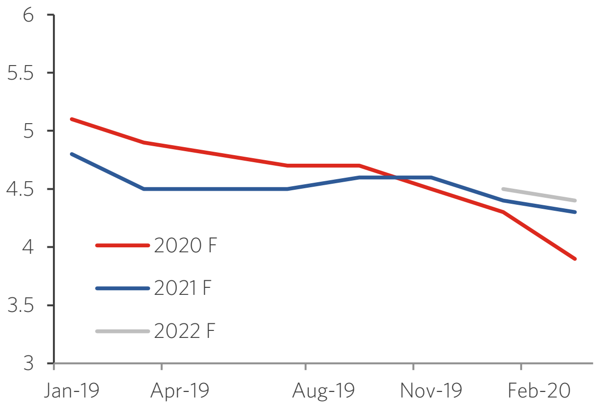
Source: Sarb, Momentum Investments, data up to March 2020

This compares to the Reuter's median economist forecast of 4.2% for 2020, 4.6% for 2021 and 4.5% for 2022. The Sarb believes it has factored in sufficient downside risks to the inflation forecast, particularly taking its latest oil price estimates into account.

The rand has depreciated sharply by more than 17% against the US dollar since the last meeting in January 2020 on negative global risk sentiment. The Sarb noted the starting point of the rand forecast had deteriorated to R15.30 to the US dollar from R14.90 at the previous meeting in January 2020. The Sarb expects the rand to strengthen over time to its long-run equilibrium.

The Sarb's core or underlying inflation projections (excluding food and fuel prices) were downwardly revised by 0.4% for 2020 and 0.1% for 2021 and 2022, to 3.9%, 4.3% and 4.4%, respectively (see chart 4).

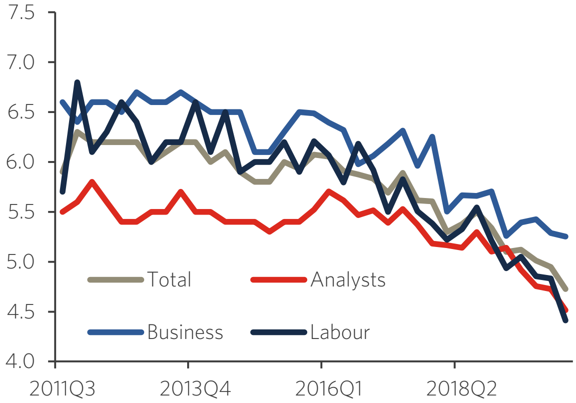
Chart 4: The Sarb's core inflation forecasts (%)



Source: Sarb, Momentum Investments, data up to March 2020

First-quarter data for inflation expectations (surveyed by the Bureau of Economic Research (BER) between 9 January and 20 February 2020) showed a further downward shift in the average five-year ahead inflation expectation from 4.9% to 4.7% (see chart 5). This is the lowest level on record, which started in 2011, and is consistent with the downward trend observed in services inflation.

Chart 5: Average five-year inflation expectations in five years' time (%)



Source: BER, Momentum Investments, data up to Q1 2020

Aligned committee preferences to cut interest rates to 5.25%

Table 1: Broad agreement at the March 2020 meeting

Number of committee members	Favoured no move	Favoured a 25 basis point hike	Favoured a 25 basis point cut	Favoured a 100 basis point cut
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	-	-	-
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

Source: Sarb, Momentum Investments
**The March, May, July and September meetings for 2018 reflected the views of seven members, **Meetings reflected the views of five members*

Preferences among the MPC were aligned with the decision to cut interest rates by 100 basis points (see table 1). Today's cut effectively brought forward the three interest rate cuts of 25 basis points each predicted by the Quarterly Projection Model (for the second quarter of 2020, the fourth quarter of 2020 and the first quarter of 2021, respectively), while the Sarb added an additional 25 basis points, bringing the total interest rate cut to 100 basis points. In the question-and-answer (Q&A) session, the MPC emphasised the cut in no way derails the Sarb's efforts to keep inflation at the mid-point of the inflation target range.

The MPC noted, at this stage, meetings would continue to be held every second month unlike during the global financial crisis (GFC). For a brief period following the GFC, meetings were conducted monthly. The governor explained this was owing to the GFC following a week or two after a meeting had just been conducted raising the need for another meeting at shorter notice. The MPC, nevertheless, acknowledged the fluidity of the situation and mentioned it had the option of convening an urgent meeting if the need arises.

Central banks globally are aggressively easing monetary policy

A number of emerging markets (EMs) have cut interest rates in the past year to alleviate slowing growth in a muted inflation environment. EM central banks have continued to ease monetary policy in light of the COVID-19 pandemic in spite of weaker currencies to support ailing growth (see table 2).

Table 2: EMs that have cut interest rates in 2020

Country	Latest inflation print*	Latest interest rate move	Current interest rate	Reason
Brazil	4.0%	-0.25%	4.25%	Fifth consecutive interest-rate reduction. Indications of a pause, but the threat of deteriorating growth may lead to a resumption of interest rate cuts.
Chile	3.9%	-0.75%	1.0%	The world-wide outbreak of COVID-19 and the associated global financial turbulence has led to a rapid and significant deterioration of the economy.
China	5.2%	-0.1%	4.05%	Monetary policy easing triggered by COVID-19-related damage.
Czech Republic	3.7%	-0.5%	1.75%	Reversal of a previous increase in February 2020 to counter the economic effect of COVID-19.
Mexico	3.7%	-0.25%	7.0%	Fifth consecutive interest-rate cut amid a stagnating economy and inflation, which is slightly above target.
Russia	2.3%	-0.25%	6.0%	Sixth consecutive decrease responding to lower-than-expected inflation and a downside threat to growth.
South Korea	0.5%	-0.5%	1.75%	Decrease triggered to ease economic effect of market volatility and to help pump money into the economy through the lowering of borrowing costs for companies.
Turkey	12.4%	-0.5%	10.75%	Sixth consecutive interest-rate decrease to boost the economy amid geopolitical worries and the negative economic effect of the spread of the virus.

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

Strong monetary policy response allows Sarb to adopt a wait-and-see approach

In the Q&A session, the governor acknowledged that, unlike DMs, which are either close to or at the zero-lower bound in interest rates, SA still has monetary policy space and the Sarb took advantage of this instead of considering unconventional tools.

At this stage, the Sarb remarked it is not concerned about financial stability risks and "would not play poker in the foreign exchange market". In the event of a realisation of financial stability risks, the Sarb would instead deploy a range of macro-prudential monetary policy tools.

In response to questions around market stress and liquidity issues, the Sarb advised it continues to monitor the healthy functioning of SA's financial markets closely, and indicated it can respond with a range of available tools if necessary. It added that monetary policy is about liquidity management and, if the need arises to inject liquidity, it would not hesitate.

In our view, a front-end loaded and strong monetary policy response, to shield the economy from the negative economic effects of COVID-19 and related financial market turbulence, gives the Sarb an opportunity to implement a wait-and-see approach to assess the effects of today's move in interest rates on confidence and the broader economy. Unlike central banks in many DMs, the Sarb has further monetary policy ammunition at its disposal should economic conditions deteriorate further.

Should the Sarb perceive liquidity stress in financial markets as threatening to the stability of the financial system in the future, it has the option of using conventional and/or unconventional monetary policy tools if needed.