Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

The Macro Research Desk

Interest rates steady at 6.5%, but the balance of sentiment is shifting towards tighter monetary policy

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) warned a materialisation of inflation risks may warrant a tighter monetary policy stance.
- Sustained currency weakness, international oil prices and higher-than-expected electricity tariffs continue to pose an upside threat to the SARB's headline inflation forecast.
- The SARB's near-term growth outlook has been revised lower and its risk assessment has deteriorated moderately from being broadly balanced at the previous (July 2018) MPC meeting.
- Lower growth projections left the SARB's estimated output gap wider in the near term, but it still anticipates the gap to narrow into 2020.
- Four members of the MPC preferred interest rates to remain unchanged, while three argued for an interest rate increase of 25 basis points.
- Tighter global financial conditions and SA's relatively poor macro fundamentals highlight the need to maintain an attractive real interest rate profile.
- Momentum Investments expects a shallow interest rate hiking cycle to commence early in 2019, but an earlier hike at the November 2018 interest rate-setting meeting cannot be ruled out, given the balance of sentiment on the MPC, which has shifted towards a tighter monetary policy stance.

Interest rates left at 6.5%, but a more hawkish stance adopted

The MPC left interest rates unchanged at 6.5% at the September 2018 interest rate-setting meeting, but noted three out of the seven MPC members had made arguments for an interest rate increase of 25 basis points. The decision to keep interest rates unchanged was in line with the expectation of 16 out of the 19 surveyed analysts, who participated in the Bloomberg consensus forecast in September 2018.

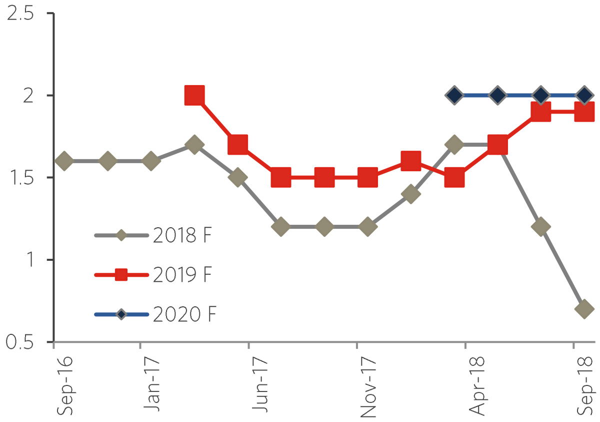
Despite headline inflation surprising to the downside in ten out of the past 12 months, the expectation is for inflation to drift higher in upcoming quarters towards the top end of the 3% to 6% inflation target band. Moreover, the SARB highlighted risks to the inflation outlook have continued to materialise, justifying the more hawkish stance adopted relative to the July 2018 meeting.

With the SARB's 2018 growth forecasts being downgraded to a new low of 0.7%, the output gap is expected to be wider than previously forecasted in the near term. Demand-pull inflation pressures are still largely absent, with the economy operating below its potential growth, but rising supply-side pressures, including the rand, international oil prices, electricity tariffs and the potential for a further escalation in global trade wars, have contributed to the upward risks to the SARB's inflation forecasts.

SARB's 2018 growth estimate slashed by a further 0.5%

Paltry growth in the first half of the year has contributed to a second consecutive downward revision in the MPC's growth forecasts. The SARB downwardly revised its estimate for real growth in gross domestic product (GDP) for 2018 from 1.7% to 1.2% in July 2018 and shaved off a further 0.5%, to 0.7% in September 2018 (see chart 1). This is lower than the August 2018 consensus print in the Reuters Econometer Survey of 1.4%, which unlikely factored in the weaker-than-expected second-quarter growth figures. The estimate is a touch lower than Momentum Investments' projection of 0.8% for 2018.

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



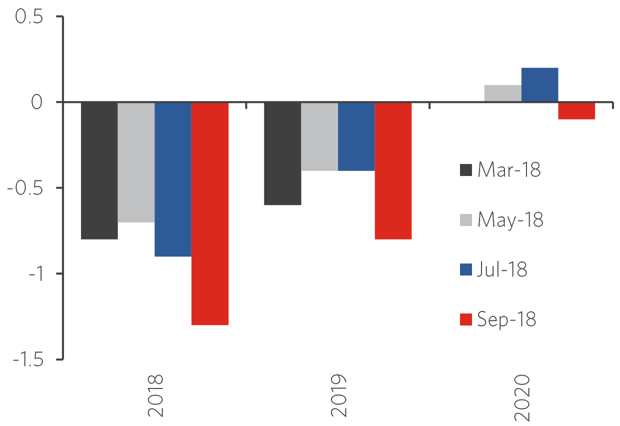
Source: SARB, Momentum Investments

The SARB left its 2019 and 2020 growth forecasts unchanged at 1.9% and 2.0%, respectively, but suggested its risk assessment had deteriorated moderately to the downside from the previous meeting, in which it saw risks to the growth outlook as being broadly balanced.

Comparatively, Momentum Investments expects a recovery to 1.8% in 2019 (Reuters consensus: 1.9%) and 2.3% (Reuters consensus: 2.2%) in 2020. The anticipated uptick to 1.8% in 2019 is likely to be driven by a reversal in inventory decumulation, steady growth in household consumption due to an increase in disposable income and a slight lift in fixed investment growth in the second half of the year, following the national elections. A sharper recovery is anticipated in 2020, where the fixed investment cycle is expected to gain more traction in an environment of increased certainty around policy and regulatory factors.

The SARB's estimate of the output gap (the difference between actual and potential growth) has widened in the near term, in response to the downward revision in growth projections for 2018. Nevertheless, the output gap is still expected to recover by 2020 (see chart 2).

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



Source: SARB, Momentum Investments

Inflation expected to move further away from the mid-point of the target

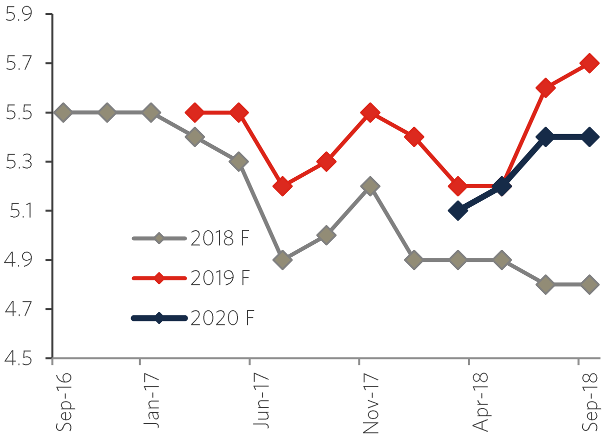
Despite a 0.3% positive surprise (to the downside) on the 4.9% headline inflation print for August 2018, the MPC's headline inflation forecast for 2018 remained unchanged at 4.8%. This projection is marginally higher than Momentum Investments' expectation for a 4.7% increase in price pressures relative to 2017, which is line with the August 2018 Reuters Econometer Survey.

The SARB's 2019 forecast inched higher to 5.7% from 5.6% previously (owing to higher international oil prices and a weaker exchange rate), but remained at 5.4% in 2020.

Momentum Investments sees upside risks to the 2020 print, but is broadly in agreement with the SARB's 2019 forecast for headline inflation.

The MPC continues to view risks to the inflation outlook as being to the upside. Persistently high wage settlements (above the top end of the inflation target), the risk of a higher-than-expected electricity tariff in 2019, international oil prices and sustained rand weakness were all highlighted as key threats to the SARB's inflation view.

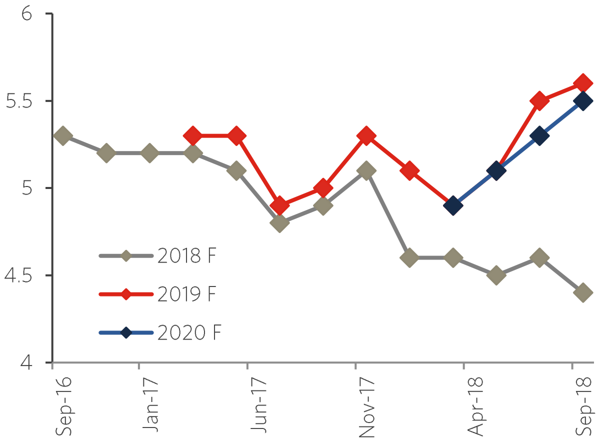
Chart 3: The SARB's headline inflation forecasts (% y/y)



Source: SARB, Momentum Investments

The SARB maintained its average oil price expectation at US$70/bbl for 2018 and 2019, which is slightly lower than Momentum Investments' own expectation of US$73/bbl in both years.

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



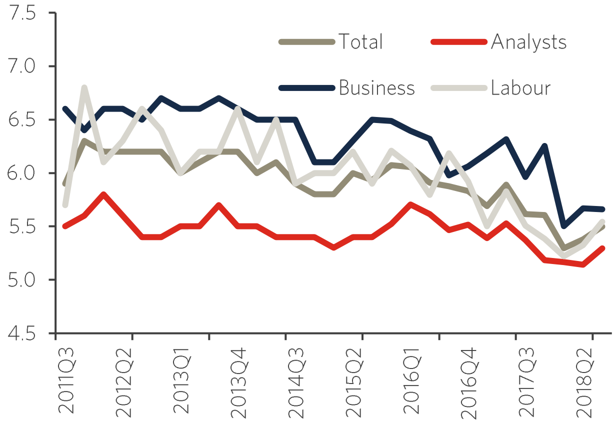
Source: SARB, Momentum Investments

Momentum Investments has factored in a higher prediction for adjustments in the electricity tariff of around 12% for 2019, relative to the SARB's upwardly revised projection of 7.6% (previously 7.3%). In the July 2018 question and answer session, the MPC clarified its inflation forecast captured the second-round effect of the expected increase in the electricity tariff.

The SARB downwardly adjusted its 2018 estimate for underlying or core inflation from 4.6% in July 2018 to 4.4% in September 2018, but raised its 2019 estimate from 5.5% to 5.6% and its 2020 forecast from 5.3% to 5.5%.
In Momentum Investments' view, core inflation could average 2018 at a slightly lower rate of 4.3%, rising to 4.9% in 2019 and 5.3% in 2020.

Longer-dated inflation expectations, as calibrated by the Bureau of Economic Research (BER) inched higher in the third quarter survey for 2018. The average five-year ahead inflation expectation shifted marginally higher to 5.5%, from a low of 5.3% in the first quarter of the year (see chart 5).

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



Source: BER, Momentum Investments, data up to Q3 2018

The SARB voiced its concerns over upside risks to the inflation outlook. Firstly, the SARB highlighted ongoing risks to the local currency, including the potential for an escalation in global trade wars, negative sentiment towards emerging markets and a faster-than-signalled pace of interest rate tightening in developed markets. Secondly, the SARB remarked elevated international oil prices could pose an additional upside threat to the inflation forecast.
Thirdly, average wage settlements are expected to average 7%, which remains above the upper end of the inflation target and, lastly, administered price inflation, which accounts for nearly 15% of the inflation basket, ticked up to 12.1% in the August 2018 inflation release. The SARB warned water, electricity and rates and taxes in major metros could increase at levels above the upper end of the inflation target range, most likely as a consequence of the pressure on municipal finances.

Unanimous decision to keep interest rates unchanged

The SARB announced there were four members who preferred an unchanged stance on interest rates, whereas three members made arguments for an interest rate hike of 25 basis points (see table 1). In the question and answer session, it was revealed there was no debate of any interest rate cuts.

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
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	-	-

Source: SARB, Momentum Investments, six members views reflected prior to March 2018 meeting

Balance in sentiment among the MPC members shifting to a tighter monetary policy stance

Headline inflation is expected to rise, but should remain within the target band in the medium term. Although low food inflation and a dulled rate of currency pass-through have kept inflation outcomes surprising to the downside, negative emerging market sentiment (either as a result of an escalation in global trade wars or a faster-than-anticipated rate of interest rate tightening in developed markets), the rand, international oil prices and electricity tariffs are still viewed as the major upside threats to the inflation outlook.

Although the SARB views moderate downside risks to its downwardly-revised growth forecast, it warned a realisation of the upside threats to inflation could trigger an increase in interest rates, particularly if there are second-round inflation effects.

While weaker-than-anticipated growth outcomes could delay the first interest rate hike to the beginning of 2019, it will remain necessary to maintain a healthy real interest rate level in an environment where global liquidity additions are shrinking.

A shallow interest rate hiking cycle is anticipated, as the SARB continues to urge inflation expectations closer to the midpoint of the target band.

Relative to the July 2018 interest rate-setting meeting, three members have swung their preference from keeping interest rates steady to preferring an interest rate hike of 25 basis points, painting a more hawkish stance on monetary policy and an effort to shift inflation expectations away from the top end of the inflation target range and closer to the mid-point of the 3% to 6% band. Though Momentum Investments expects the first interest rate hike in January 2019, the balance in sentiment among the MPC members shifting to a tighter monetary policy stance is likely to make the November 2018 interest rate decision a close call.