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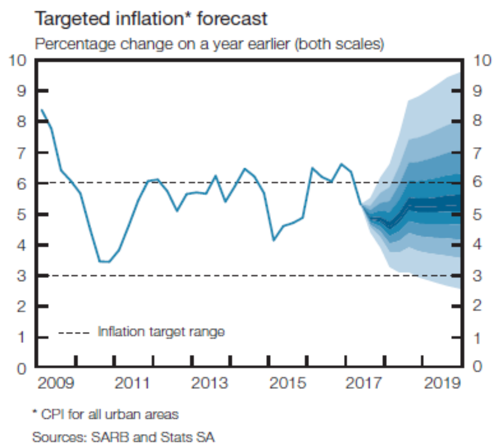
SARB monetary policy review notes (MPF held on 04 October 2017)

Inflation and Monetary policy

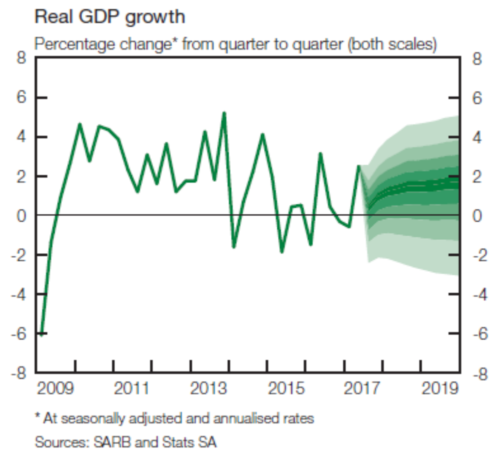
- The SARB is exploring the possibility of pushing interest rates permanently low/lower if inflation stays low. However this depends on the robustness of the Bank's inflation forecast, which currently indicates that low inflation is likely a temporary phenomenon.
- The main reasons for beginning a loosening cycle are well known. Lower food/electricity prices, base effects and a stable rand, as well as import prices falling by more than 10% yoy are some of the factors which prompted a 25bps rate cut in July 2017. In this (July) meeting, risks to the inflation outlook were broadly balanced.
- Subsequently however, inflation risks have risen. Furthermore, talks of a 20% electricity tariff hike by Eskom, a volatile political climate which may place pressure on the rand, as well as food inflation forecasts which were raised because meat price inflation have exceeded SARB estimates. As a result, the SARB deemed it prudent to keep rates unchanged in September. The SARB was at pains to stress that the MPC can make any one of three decisions at every meeting – raising, holding or cutting interest rates (hence keeping rates unchanged in September was still a monetary policy decision).
- A few sensitivity scenarios were provided for the uncertain electricity tariff: should Eskom provide a 20% electricity tariff hike, the SARB's CPI forecast will rise by 20bps in 2018 and 30bps in 2019 (from current estimates), to 5.2% and 5.6% respectively. Consequently, the GDP growth forecast will be lowered by 10bps in 2019 to 1.4% if this were the case, because of the substitution effect that the higher electricity costs will have on consumer behaviour.
- Nonetheless, the SARB is currently working off its baseline assumptions until certainty can be provided about the electricity tariff hike and tax implications or changes (MTBPS and February budget speech). As a result of this, the SARB's central range for inflation until 2019 stays mostly between 5% and 5.5% (see below).

The SARB's central inflation forecast estimates remain close to 5% over the medium-term



Source: SARB

Growth is expected to pick up in 2018 and 2019, closing the output gap



Source: SARB

Growth

- The MPC members expressed deep concern for subdued growth rates in the local economy, at a time when global growth has picked up markedly. The SARB views the SA economy as stagnant despite strong global growth and easy financing conditions. South Africans have become poorer on a per capita basis over the last two years, while confidence levels have been significantly lowered.
- When pressed for a reason for this move away from the global rhetoric, members admitted that they cannot put a finger on exactly what the root cause is of this stagnant economic activity, but that the volatile political climate and policy uncertainty may have contributed significantly to the confidence recession the country currently finds itself in.
- There was much debate about the reasons why monetary policy has no, or a minimal, impact on economic growth. Members indicated that a pro-growth mind-set needs to come from all government departments, that there needs to be policy cohesion and policy certainty, and that monetary policy in and of itself will have little bearing on economic activity.
- Overall, the outlook on growth remains sombre, while the SARB remains cautious about its inflation outlook.

Other

- Other issues discussed were the structural weakness of SA relative to its EM peers, in that SA has a higher inflation rate and a higher inflation target. The SARB admitted that this was an issue because higher inflation by default lowers real rates.
- The MPC was scathing in its comments around the government's failure to act on corruption, admitting that this is severely affecting confidence and brings into question the effectiveness of the rule of law in the country.
- Questions regarding the ownership of the SARB were quashed with the MPC members highlighting that the SARB is governed by the Constitution of SA, and it does not matter whether it is nationalised or privatised (ie this will have no effect on monetary policy).
- Concerns around elevated inflation expectations remain – the SARB has said that this lies "more on the trade union and business side rather than with analysts". Even though people are noticing lower inflation, they keep their projections high because elevated inflation seems to be their most recent memory – the SARB is yet to find a way to influence this meaningfully.

On our radar:

- While the MTBPS will be the underpin for credit ratings reviews in the final quarter of the year, the ANC leadership conference in December 2017 will be the key underpin to the longer term economic policy and prosperity of the country. We anticipate further credit ratings downgrades by 1H18 no matter the outcome of the leadership contest, as we believe that there has been enough fiscal slippage and fraying of the institutional framework to warrant a worsening credit outlook.
- There has been a shift in the rhetoric of global central banks recently – the Fed has persisted with its monetary policy tightening, while up until last month the ECB seemed set on its path of loose monetary policy. This has changed, with the ECB now discussing tapering of its QE programme in 2018. The BOE has also changed its tune dramatically in the last month. It stated that it was getting increasingly uncomfortable with the prolonged breach of the inflation target, and might even consider raising interest rates and/or tapering its asset purchase programme to combat inflation. As a result, we view tighter monetary policy as a key risk to emerging market economies over the medium term, particularly capital flows into EMs and SA in particular.
- Other forms of event risks over the horizon take the form of exogenous factors like geopolitical tensions between North Korea and the US, and global tensions in general, as well as policy uncertainty in the US, deleveraging in China, oil market dynamics and international terrorism, among others.

Outlook:

- Inflation has surprised to the downside in the last six out of eight months mainly as a result of strong base effects from last year. While we are not alarmed by the recent petrol price hikes, we believe that there are upside risks to the inflation trajectory in 2018. An added layer of risk is the inflation expectations in the economy, which remain too close to the 6% upper target band. This combined with the possibility of above-inflation public sector wage demands will probably keep expectations elevated. While we still believe the current environment of low growth and low inflation warrants further interest rate cuts, we remain of the view that the current loosening cycle will remain shallow and short-lived and therefore unlikely to boost growth meaningfully. Much depends on the trajectory of the rand exchange rate, local political headlines, foreign investor sentiment and exogenous factors like the oil price and weather conditions locally. Our view is therefore for two to three more rate cuts before mid-2018, assuming no sustained and significant rand weakness until then.
- The SARB caution at the MPF strikes us as a concern – we believe the SARB may hold out through the turbulence of the last quarter of this year and resume a shallow cutting cycle in January 2018. However, here again credit ratings risks in June 2018 may pose a risk to the loosening monetary policy trend.

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