

Interest rate comment

MPC cuts by 25bps, Governor firm on mandate

Against the overwhelming financial market consensus - and our expectation - for an unchanged repo rate, the Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) reduced the policy interest rate by 25bps to 6.75% (prime rate down to 10.25%).

The statement that accompanied the decision revealed that four MPC members voted for an interest rate reduction with two preferring to keep the rate on hold. This marks a significant shift from the previous (May) meeting when only one member opted for a cut. As outlined in our 2017Q2 *Economic Prospects* publication, the decision was always going to be close. We argued that purely based on the macroeconomic environment, a reduction could be justified. This environment is characterised by more moderate price pressures and expectations for future inflation, as well as sustained weaker than expected GDP outcomes. Indeed, the SARB's **headline CPI forecast** was reduced by 0.4 percentage points (% pts) for 2017 and 2018 to 5.3% and 4.9% respectively. The forecast for 2019 was downscaled by 0.3% pts to 5.2%. Over the same periods, the **core** (headline excluding food, petrol and energy) **CPI** projection was reduced by 0.2, 0.3 and a fairly large 0.4% pts. The inflation risks were characterised as balanced.

On the growth front, the statement outlined at length the current weakness in domestic demand. In terms of the forecast, real **GDP growth** is now expected to be 0.5, 0.3 and 0.2% pts lower during 2017, 2018 and 2019 than was previously pencilled in. The latest SARB growth projections are 0.5, 1.2 and 1.5% for the three years. These revisions did not come as a surprise.

Before the meeting, our sense was that, even considering notable revisions to the inflation and growth outlook, the MPC would be cautious to reduce the policy rate in an environment of heightened uncertainty. This relates both to the path of global monetary policy and the potential for a subsequent negative shift in investor sentiment towards emerging markets, as well as the domestic political environment. Both of these have the potential to push the rand exchange rate to much weaker levels. In the end, the MPC took a more sanguine view on the risks to the currency. This was based on global and domestic developments. First, notwithstanding extreme volatility, the MPC took comfort from the relative calm that has persisted through emerging markets despite the recent ebb and flow of developed country monetary policy expectations. Second, it was noteworthy that the MPC is now projecting a sustained narrowing in the SA **current account deficit**. As recently as the March MPC statement, the improvement in the current account shortfall was expected to be temporary.

Given that the rand exchange rate has long been highlighted as posing the major risk to the inflation outlook, less concern about foreign capital flows, the current account and by extension the currency must have played an important role in the MPC's decision to cut. Furthermore, the MPC would also have

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welcomed the marginal improvement of inflation expectations in the latest BER survey. However, expectations remained at the upper end of the inflation target range. The latest BER inflation survey results can be found [here](#).

Governor firm on SARB mandate and independence

In a lively Q&A session following the interest rate announcement, SARB Governor Lesetja Kganyago gave a passionate response to questions about potential political interference in MPC decisions and threats to the SARB mandate. In a nutshell, the Governor argued that the credibility of the SARB had been hard earned and that it would not be compromised. Furthermore, he refuted concerns about the nationalisation of the bank, at length explaining that the shareholders of the bank (whether private or government) have no influence on policy matters. In terms of the SARB mandate, the Governor made it clear that a change is highly unlikely as any such attempts would need to adhere to the constitutional principles that brought about the current mandate. It was a powerful performance from the Governor, which should allay any lingering concerns about the SARB's independence in the wake of recent pronouncements from the ruling ANC and the Public Protector.

Interest rate outlook

A response to the rate cut may be to say that a solitary reduction will make no real difference to the growth outlook, implying that a further cut(s) may be in the offing. However, the MPC statement again emphasised that a lower policy rate is not the solution to SA's structural growth constraints and that the MPC would not "...hesitate to reverse this decision should the inflation outlook and risks deteriorate".

One is left with the sense that the inflation outlook may need to improve further and / or the growth prospects continue to deteriorate for the MPC to reduce the repo rate again over the short term. Considering our forecast that the rand will weaken through the rest of 2017 as the extent of the fiscal difficulties become clear and the domestic political / policy environment remains constrained, we are hesitant to pencil in a further rate cut at this stage. *However, if the rand can hold onto current levels around R13/\$ and the expected further actual inflation easing is reflected in lower surveyed inflation expectations, at least another 25bps repo rate reduction before the end of the year would very much be on the cards.*

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