

Interest rate comment

In a close call, MPC cuts by 25bps

As widely expected, the Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) reduced the repo policy interest rate by 25bps to 6.50% (prime rate at 10.00%). The decision was widely discounted in domestic financial markets, while a significant majority of economists (including the BER) polled before the decision also pencilled in a 25bps cut.

In the end, the decision was not as clear cut as generally expected with four MPC members voting in favour of a reduction, with three preferring to keep the policy rate unchanged. SARB Governor Kganyago confirmed that a 50bps cut was not discussed. Indeed, he emphasised that the MPC was locked in a heated debate about whether a 25bps interest rate reduction was appropriate. The following factors informed the decision to cut by 25bps:

- A mild improvement in the SARB's 2019 headline and core **CPI forecasts** to 5.2 (from 5.4%) and 4.9% (from 5.1%) respectively.
- The **risks to the inflation outlook** were judged to be more or less evenly balanced – in January the risks were still believed to be on the upside. In particular, **food prices** are no longer judged as a risk to inflation.
- The improved outlook was despite the higher VAT rate from April 1 and reflects the positive impact of the sustained strength in the **rand exchange rate**.
- Some of the key domestic risks and uncertainties for the currency (and by implication the inflation outlook) has dissipated. In particular, these refer to the 2018 Budget that was positively received and the subsequent decision by Moody's to keep SA's credit rating at investment grade, as well as the stable outlook for the rating.

A further development welcomed by the MPC was the notable improvement in **inflation expectations**. The BER's 2018Q1 survey revealed that average expectations declined by 0.5 and 0.6 percentage points to 5.2% and 5.3% respectively for 2018 and 2019. Five-year ahead expectations declined to 5.3%, the lowest level since these expectations were first surveyed in 2011. Despite the notable improvement, on two occasions the MPC statement emphasised that the MPC would prefer inflation expectations to be anchored closer to the midpoint (4.5%) of the inflation target range. This continues the trend in recent MPC statements where the MPC has (albeit subtly at times) signalled a desire to rather focus on the midpoint of the 3 to 6% target range.

Other observations worth noting in the MPC statement include the following:

- At current levels around R11.70-80/\$, the SARB's model suggest that the rand **exchange rate** is "somewhat overvalued". In line with this, the SARB sees limited scope for further rand appreciation. Because the interest rate cut was priced by markets, these comments most likely explain why the rand weakened by about 8c to the dollar through the reading of the MPC

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statement. *Both in terms of the current valuation and the scope for further rand gains, we are in agreement with the SARB.*

- The MPC was somewhat ambiguous about domestic **fiscal policy**, highlighting that the improved (relative to the October 2017 MTBPS) budget deficits outlined in the 2018 Budget were still higher than was projected in the 2017 Budget. Furthermore, the MPC mentioned a number of implementation risks, including the outcome of the current round of public sector wage negotiations, that could alter the fiscal numbers presented in February.
- The SARB's **real GDP growth** forecasts seem overly cautious. While the forecast for growth in 2018 was revised higher to 1.7% (in line with the latest Reuters consensus), for 2019 the forecast was actually cut slightly to 1.5% (from 1.6%). This compares to the latest consensus view of 1.9% for 2019. We are in the process of upgrading our numbers, but all indications are that we will end up around 2% for 2019. The SARB's growth forecast only reaches 2% in 2020. *It seems that the SARB is waiting for concrete evidence that improved business and consumer confidence is translating into increased private capex growth and consumer spending before upgrading the medium-term growth outlook.*
- With domestic risks alleviated, the SARB (somewhat) predictably shifted to the **global environment**. The statement focused on the adverse impact that faster-than-expected global monetary policy normalisation (especially in the US) could have on the rand.

Interest rate outlook

In our view, the scope for further interest rate relief is limited. Indeed, our baseline view is that we have now reached the end of the domestic rate cutting cycle. This is informed by:

- The MPC's increased focus on the **midpoint** of the inflation target range. While the SARB's inflation trajectory through 2020 is benign at just above 5%, it is some way above 4.5%. Indeed, although less so than previously, the SARB's core forecasting model (the QPM) continues to suggest policy interest rate hikes through 2020.
- The implementation risks on the **fiscal policy** front, which could still result in market volatility and credit rating concerns down the line.
- The potential spillovers from **global monetary policy tightening**.
- The likelihood that the SARB will upgrade their **domestic growth outlook** as the year progresses, which may reduce the need for further policy accommodation.

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