

Interest rate comment

Repo rate on hold, inflation risks on the upside

As expected, the Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) kept the repo policy interest rate unchanged at 6.50% (prime rate at 10.00%). The decision was widely discounted in domestic financial markets, while all of the economists (including the BER) polled by Reuters before the decision also expected an unchanged verdict.

With the decision widely expected, attention was focused on the tone of the accompanying statement. Of particular interest was to what extent the combination of a higher oil price/weaker rand exchange rate since the previous MPC meeting in March would permeate through the statement and impact on the SARB's inflation forecast. Before going into the details, it is worth noting that the decision to keep the repo rate unchanged was unanimous, i.e. all seven members of the MPC agreed. Compared to March when the MPC reduced the repo rate by 25bps, the key change to the MPC statement is that the inflation risks are now judged to be on the upside. In March, the risks were seen as 'balanced'. The change in tone met our expectations and largely explains the decision to keep the policy rate at 6.5%.

Relative to March, the SARB's **headline inflation** (CPI) forecast was largely unchanged. This was despite the risks posed by a sustained softer rand exchange rate, the likelihood of a prolonged period of elevated oil prices and the potential for higher-than-expected **electricity price** increases. The SARB assumes an 8% rise in electricity tariffs for 2018 and 2019, but acknowledged a high degree of uncertainty surrounding this. The SARB's **oil price** assumption was revised upwards by \$7/bbl to \$70/bbl for 2018 and by \$5 to \$67 for 2019. In other words, the SARB expects the oil price to move lower over the next 12 to 18 months. This is in line with our expectation. For the rand, besides the potential for further gains in the US dollar/higher US interest rates, the MPC argued that the forecasted widening in SA's **current account deficit** has the potential to weigh on the currency in future. The SARB expects the current account shortfall to deteriorate from 2.5% of GDP in 2017 to 3.8% in 2020.

The impact of a higher oil price and weaker rand assumption was offset by a downward revision to the SARB's **food price** outlook and a lower starting point (i.e. lower than expected CPI outcomes for March and April). As a result, the headline CPI forecasts for 2018 and 2019 remained at an average of 4.9% year-on-year (y-o-y) and 5.2%, while the projection for 2020 was revised marginally higher to 5.2% (5.1% in March). A peak of 5.5% y-o-y is still expected in 2019Q1. At 4.5%, the forecast for **core CPI**, i.e. headline CPI excluding food and energy costs, is marginally lower for 2018. However, the outlook for the core measure in 2019 and 2020 deteriorated somewhat more than in the case of headline CPI. Core CPI is projected at 5.1% for both years (4.9% previously).

Regarding the **GDP growth** outlook, the SARB's forecast is unchanged at 1.7% for 2018, but has been revised marginally higher from 1.5% to 1.7% for 2019. In our view, the forecast for 2019 is still somewhat on the conservative side. The SARB acknowledges this by judging the growth risks to be marginally on the upside. We have 2019 growth pencilled in at 2%. For 2018, the statement mentions that a likely weak

24 May 2018

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2018Q1 GDP print should not derail the outlook for the rest of the year and 2019. We agree. Going forward, the SARB expects **household consumption expenditure** to be the key growth driver.

Interest rate outlook

Following the MPC's decision in March to reduce the repo rate by 25bps, we argued that the scope for further interest rate relief was limited. The global macro and financial market developments since March have increased this conviction. Therefore, our baseline view remains that we have reached the end of the domestic interest rate cutting cycle. While we expect the repo rate to be unchanged for the rest of 2018, the next move in the policy rate is likely to be higher. This view is informed by:

- The potential for sustained adverse spill overs from **global monetary policy tightening**.
- The MPC's increased focus on the **midpoint** of the inflation target range. The latter part of the statement says that the MPC will be vigilant to ensure that inflation remains well within the inflation target range. Furthermore, in response to a question about how the SARB aims to anchor inflation expectations at 4.5%, SARB Governor Kganyago replied that most importantly, this would require a monetary authority that demonstrates the commitment to 4.5%. *Our read of this response is that in the event that the SARB's 12-18 month ahead inflation forecast moves to 5.5% and higher, the MPC may well increase the repo rate. This would be a change from the post-crisis period when interest rate hikes typically occurred when the SARB's forecast was for a sustained period of inflation closer (or above) the 6% upper target band.* However, in the absence of an emerging market crisis, a domestic rate hike(s) is only likely once GDP growth is on a firmer footing.
- The SARB's core forecasting model (the **QPM**) continues to suggest policy interest rate hikes through 2020.

Hugo Pienaar



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