

Interest rate comment

A hawkish stay of execution on the repo rate

In a close decision, 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%). An unchanged decision was expected by the vast majority (16/19) of the analysts polled by Bloomberg before the time, while the domestic money market had virtually priced out the possibility of a hike following the release of much better-than-expected August consumer inflation data on Wednesday. Nevertheless, the fact that the key inflation risks (weaker rand and higher oil price) flagged by the MPC at the previous (July) interest rate meeting have materialised, meant that there was always the possibility that the MPC would feel pressured into a pre-emptive hike. While acknowledging that the decision could go either way, we had a 25bps hike pencilled in for this meeting.

In the end, concerns about the weak state of the real economy and (more importantly) the related lack of demand-side pressure on inflation was the overriding factor that swayed the decision. Put differently, the continued lack of visible second-round price effects of the weaker rand and higher oil price was key in the decision to keep the repo rate on hold. Furthermore, the SARB's inflation forecast was upwardly revised by less than we anticipated. Relative to the SARB's July outlook, the weaker rand and higher oil price assumptions were to an extent mitigated by a much wider negative output gap, i.e. the difference between actual and potential GDP, over the forecast period. The wider output gap is a function of the sharp downward revision to the SARB's real GDP growth forecast in 2018 (see below).

That the interest rate decision was a close call is borne out by the evenly split voting pattern of the MPC. Indeed, four members voted to keep the repo rate on hold, while three favoured a 25bps increase. The SARB made only minor upward adjustments to the inflation forecast. The SARB's updated forecast is for **headline CPI** to average 4.8% in 2018, unchanged from the July projection. Headline CPI is then expected to average at a higher rate of 5.7% in 2019, up 0.1 percentage point (% pt) from the 5.6% projected in July. The forecast for 2020 is unchanged at 5.4%. Excluding fuel and food prices from the headline measure, the SARB's forecast for core CPI was a mixed bag at 4.4% for 2018 (from 4.6%), 5.6% in 2019 (up from 5.5%) and 5.5% in 2020 (up from 5.3%).

Risks to the inflation forecast were judged to be on the upside, again largely from the currency, oil price and electricity prices. In addition to these, we thought that the SARB may also list food prices as an emerging risk factor as (albeit from low levels) domestic maize future's prices are up by more than 15% since the July MPC meeting.

Regarding the real **GDP growth** outlook, the SARB's forecast for 2018 was revised down sharply to 0.7% from 1.2% in July and 1.7% in May. The growth outlook for 2019 and 2020 remained unchanged at 1.9 and 2% respectively. The MPC noted that the growth risks were modestly on the downside.

20 September 2018

Please refer to the [glossary on the BER's website](#) for explanations of technical terms.

Interest rate outlook

From our perspective, the most important take-away from this MPC meeting is that three members voted for a hike despite the SARB's headline inflation forecast remaining below the 6% upper inflation target through the forecast period. This reinforces the argument we have often made of late that the MPC's shift to focus on the midpoint, or 4.5%, of the inflation target range implies that the trigger for a MPC policy rate hike is no longer a CPI forecast of above 6%. Rather, a forecast of between 5.5-6% will in future likely be sufficient for the MPC to increase the repo rate. This is especially the case if the risks to that forecast are assessed to be on the upside and/or if real GDP growth is on a firmer footing than now.

Given that demand-side pressures on inflation are likely to remain absent in the foreseeable future, the movement in the rand exchange rate and oil price is set to remain the key drivers of the SARB's inflation forecast. Besides international currency trends, between now and the next MPC decision on 22 November, a number of domestic events have the potential to influence the rand. These include:

- 21 September: President Ramaphosa announces his economic **stimulus plan**
- 27 September: Parliamentary committee set to announce decision on whether to amend **Section 25** of the Constitution regarding expropriation of land without compensation
- 12 October: Moody's sovereign **credit rating review**, although this may be delayed until after the October 24 Medium-Term Budget Policy Statement (MTBPS)
- 24 October: **MTBPS**, which is likely to reveal slippage in the **public debt metrics** compared to the February 2018 projections
- 26 October: Ramaphosa's **investment summit**

Especially the Section 25 decision and the MTBPS have the potential to weigh on the value of the rand exchange rate. Despite significant gains during the last two days, at the time of writing the rand was trading around R14.45/\$, i.e. somewhat weaker than the starting point of R14.20/\$ used in the latest SARB inflation forecast. This highlights the currency risk to the SARB's inflation forecast. If the rand is sustained at current levels, or even worse weakens back towards R15/\$, the SARB's inflation outlook will most likely deteriorate even further. Under such conditions, the MPC may decide to increase the repo rate in November. Alternatively, if the stronger rand trend of the last couple of days continues through November, there would be no need to increase the repo rate.

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