

Interest rate comment

MPC keeps powder dry as new QPM model suggests next rate move is up

At its final scheduled meeting of 2017, the Monetary Policy Committee (MPC) of the SA Reserve Bank (SARB) kept the repo policy interest rate unchanged at 6.75% (prime rate at 10.25%). This was in line with our and the financial market expectation. As expected, the decision was unanimous. This is in stark contrast to the situation in September when the MPC was split down the middle on whether to reduce the repo rate further or keep it on hold. In the end, the decision was to remain on hold.

Of interest is that, for the first time, the latest MPC decision was accompanied by guidance on the outlook for the policy interest rate. This is generated by the SARB's new **Quarterly Projection Model (QPM)**. The model uses a Taylor rule calculation. This mainly looks at the gap between targeted and forecasted inflation, as well as the difference between actual and potential GDP growth to forecast the interest rate path. Importantly, the inflation target used in the calculation is 4.5%, i.e. the midpoint of the 3 to 6% target range. Currently, the QPM suggests that the repo rate should be 25bps higher by the end of 2018 and another 50bps up by end 2019. In other words, the model indicates that the repo rate could increase by 75bps through 2019. However, the MPC statement was explicit that the model outcome does not indicate an unconditional commitment from the MPC. In other words, they are not bound to follow this path through actual policy changes. As always, an actual change in interest rate policy will depend on the MPC's judgement of the most appropriate action.

However, it does indicate that - at least in the foreseeable future - further interest rate reductions are most unlikely. On a technical note, the MPC's interest rate decisions of the last number of years does not suggest that they have been targeting inflation at 4.5%. Rather, policy implementation has been focused on keeping headline CPI below the 6% upper target band. As long as the real economy remains so weak (the SARB's own growth forecast is subdued), it is unlikely that actual policy will closely track what the Taylor rule (with a 4.5% inflation target) suggests. *Having said that, in a worst-case scenario of large and sustained foreign capital outflows amid local currency (LC) credit rating downgrades and subsequent exclusion from leading global bond indices, 75bps worth of hikes through 2019 would be quite benign.*

The latest MPC decision was informed by the SARB's assessment of upside risks to the inflation outlook. At the other end of the scale, the central bank judged the risks to real GDP growth to be on the downside, i.e. real growth may be weaker than the SARB's latest forecast. The SARB made a marginal upward revision to its **headline CPI** forecast for 2018 and 2019. At a projected 5.3%, the outlook for 2017 is unchanged. Excluding food and energy costs, **core CPI** is expected to stabilise at 5 to 5.3% in 2018 and 2019, somewhat higher than previously expected. In terms of the risks, the higher oil price and a number of uncertainties relating to the outlook for the rand exchange rate were flagged. The SARB now expects the trade weighted rand (against a basket of major currencies) to weaken by more than previously assumed in

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

2018. Furthermore, the oil price forecast was lifted somewhat. In terms of the impact on projected inflation, these revisions were to a degree offset by the impact of model-assumed interest rate hikes. The other key inflation risk is a higher than expected electricity tariff hike in 2018.

On real GDP growth, the forecast for 2017 (0.7%) was upped slightly, whereas for 2018 and 2019 the outlook has been downscaled somewhat to 1.2 and 1.5%.

Interest rate outlook

Besides the already mentioned inflation risk factors, the statement mentioned that the deterioration in the path of **fiscal consolidation** outlined in the October Medium-Term Budget Policy Statement (MTBPS) could reduce the scope for further interest rate accommodation. In our view, this is undoubtedly the case. The short-term interest rate outlook will to a large degree depend on the imminent decision by the leading credit rating agencies on SA's sovereign rating. Our baseline view is that at least one of Moody's or S&P Global will retain SA's LC rating at investment grade. If this proves to be correct, the MPC is likely to keep the repo rate on hold, at least until the next scheduled credit rating reviews in mid-2018.

LC rating downgrades by both Moody's and S&P Global will raise the risk of a repo rate hike when the MPC meets again in January 2018. However, the MPC will be guided by the (very uncertain) financial market reaction to further downgrades and index exclusion. Our take is that the MPC will need to be forced into hiking, i.e. they are only likely to act in the event of a significant and sustained weakening in the rand exchange rate.

Earlier, the SARB announced the following MPC meeting dates for 2018:

17-18 January

26-28 March

22-24 May

17-19 July

18-20 September

20-22 November

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