

Interest rate comment

MPC highlights self-inflicted currency risk

This week's sharp reversal of the strengthening trend for the rand exchange rate dominated the latest interest rate statement from the SA Reserve Bank's (SARB) Monetary Policy Committee (MPC). In line with our and the financial market expectation, the MPC decided to keep the repo rate unchanged at 7% (prime rate at 10.5%). Unlike in January when the unchanged repo rate verdict was unanimous, SARB Governor Kganyago revealed that one MPC member voted for a 25bps interest rate reduction at the March meeting.

Of more significance than the interest rate decision was the MPC's latest inflation forecast and the committee's judgement about the most important risks to the inflation outlook. In line with our expectation, the SARB presented an improved inflation outlook. Although the extent of the improvement was less than expected, considering the sudden rise in domestic political risk over the past week, a more cautious approach was warranted. An important factor that limited the downward adjustment to the central bank's forecast is that they are now even less optimistic about **food prices**. This is mainly on account of an expected acceleration in poultry prices. At first glance, this may seem strange in light of the dramatic decline in domestic feed costs (maize), but it likely reflects the impact of reduced (cheaper) imports amid an import ban from Europe because of bird flu. The SARB expects food prices to rise by 7.4% in 2017, up from the 7% forecast in January. Additional reasons why the SARB's forecast was not adjusted further are outlined below when the inflation risk factors are unpacked.

Headline CPI is now forecast to fall to below 6% in 2017Q2 vs. only in 2017Q4 in the SARB's January 2017 forecast. CPI is expected to average 5.9% in 2017, down from the 6.2% projected in January. We were always of the opinion that the SARB's January CPI forecast was overly conservative. Looking forward, the SARB expects CPI to ease further to 5.4% in 2018 vs. 5.5% expected in January. The central bank's forecast horizon has been extended to 2019 – CPI is forecast at 5.5% in the outer year of the forecast period.

The MPC judges the risks to the inflation outlook to be moderately on the upside. This is despite the following:

- The SARB's forecast assumptions were completed three weeks ago. The result is that even after this week's weakening of the **rand exchange rate**, the SARB's outlook incorporates a somewhat weaker currency than current levels of around R13/\$. The MPC statement highlights the risk of a currency overshoot to weaker levels should the domestic political environment deteriorate further. *It is hard to argue against this risk, although it may not be as symmetric as implied by the MPC statement. In other words, given a favourable global environment, the currency could move stronger should domestic politics stabilise again. However, we do acknowledge that the political risks are biased on the downside, i.e. for a weaker rand.*

- The SARB's **oil price assumption** does not incorporate the recent declining trend. From current levels of around \$52/bbl, the SARB expects the oil price to average \$56/bbl and \$60/bbl in 2017 and 2018 respectively. *While this is more or less in line with our view, if anything, the risk is that the oil price could be lower than expected amid ample global supplies.*
- The SARB still incorporates an **electricity tariff hike** of 8% for 2017 in the forecast. This is done on the basis that the energy regulator still needs to determine the price hike. *We find this reasoning puzzling as even on Eskom's website, it is stated the increase for 2017 will be 2.2%.* The statement does acknowledge that the electricity price hike could turn out to be lower than the SARB assumes.

Besides being uncomfortable about still elevated longer-term inflation expectations, concern about the prospects for the rand is the only reason why the SARB judges the inflation risks to be on the upside. There is no question that a cabinet reshuffle that involves the firing of Finance Minister Pravin Gordhan will be accompanied by a dramatically weaker rand exchange rate. Partly, this will be driven by the reality that SA is very likely to lose our investment grade credit rating status in such a scenario.

We would just note that in the absence of a worse-case scenario of a cabinet-reshuffle, in our view there is the potential for headline inflation to come in materially lower in 2017 (and potentially also 2018) than the SARB's latest forecast. Again, we understand the SARB's preference to err on the side of caution in current conditions.

Interest rate outlook

It is clear from the statement that an interest rate reduction is extremely unlikely in the foreseeable future. This is despite one MPC member voting for a 25bps rate cut in March. Indeed, the statement argues that a more sustained improvement in the inflation outlook is required before the MPC will consider reducing the repo rate. In all likelihood, this implies that the SARB's forecast for headline CPI in 2018/19 would need to decline further towards 5% or perhaps even lower. The inflation threshold for a rate cut may depend on the strength of domestic demand and GDP growth. In a continued weak SA growth environment, an inflation forecast of nearer to 5% should in our view be sufficient to induce a rate cut(s).

The uncertain political outlook makes any forecast subject to a number of caveats. Suffice to say that in the event of a cabinet reshuffle, the MPC may even be forced into resuming the interest rate tightening cycle as it tries to prevent a currency-induced inflation spiral. On the other hand, in a more 'favourable' scenario where the status quo of a muddle-through political environment is sustained through at least the ANC elective conference in December 2017, more supportive global forces may return as the key currency driver. This may open up the possibility for an interest rate reduction towards the latter stages of the year.

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