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in the moment


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# SARB keeps repo rate at 8.25% but warns of inflation risks

## Highlights

- Synchronised global monetary policy tightening has been largely successful in reining in global inflation. However, as inflation has started to ease, global central banks are implementing varying policy decisions to suit their respective economic conditions.
- Despite monetary policy tightening nearing an end, we are of the view that global central banks will likely keep interest rates on pause for a while before we see a pivot to lower interest rates to keep inflation at bay.
- Electricity availability has surprised to the upside at the start of winter. This has, so far, prevented the materialisation of higher stages of loadshedding that the country was warned about going into winter. Nevertheless, the overall impact of lower loadshedding on growth may be muted because while certain industries could operate without interruptions, lower electricity demand is also partly due to large industrials who paused some of their operations due to higher winter tariffs.
- The South African Reserve Bank (SARB) assessed risks to the domestic growth outlook as balanced. The economic growth forecast for 2023 was revised up to 0.4% (previously 0.3%) but kept constant for 2024 (1%) and 2025 (1.1%).
- The average core (underlying) and headline (CPI) inflation for the second quarter of 2023 was lower than what the SARB had projected in the May Monetary Policy Committee (MPC) In the forecasts released today, headline inflation has been revised down marginally to 6% for 2023 (from 6.2% previously) and to 5% (from 5.1%) for 2024. Core inflation was revised lower by an average of 0.1% between 2023 and 2025.
- Notwithstanding the lower inflation forecast, the SARB still notes risks to the inflation outlook, namely elevated global food prices, tight global oil markets, the upcoming El Niño season, high administered costs, the energy crisis, logistic constraints and higher average salaries (despite a downward revision to wage growth assumptions).
- Risks to food and fuel prices remain given Russia's exit from the Black Sea Grain Initiative and oil production cuts announced by the Organisation of the Petroleum Exporting Countries Plus (OPEC +). The SARB expects food inflation to be lower at 10.3% from 10.8% for this year but the estimate for 2024 was revised up from 5% to 5.2%.
- Since the May 2023 MPC, the SA rand has strengthened and ranked as the second-best performer among emerging markets. Nevertheless, the rand remains volatile and the summits scheduled to be hosted in SA pose a risk to the exchange rate.
- The expected average inflation rate for 2023 published by the Bureau for Economic Research (BER) edged up from 6.3% is the first quarter survey to 6.5% in the second quarter of 2023. Expectations edged up across all surveyed respondents.

- The July MPC is the first interest rate meeting held on the back of the enhanced Quarterly Projection Model (QPM). While the Committee notes that it is difficult to compare results of the old model to the new one, one of the notable changes includes a lower exchange rate passthrough of 0.09 compared to 0.13 previously.
- The decision to keep interest rates constant was not widely anticipated by analysts (Reuters and Bloomberg polls). The Forward Rate Agreement (FRA) market nevertheless priced out a hike closer to the meeting in line with recent currency strength and a positive inflation surprise locally.
- The SARB noted additional inflation pressure from elevated inflation expectations, particularly arising from the business sector. In previous speeches, the SARB had also warned of rising fiscal risks underpinning elevated sovereign risk, leading to a higher real neutral rate of interest. Given that inflation risks are still viewed as being to the upside, we think that today's meeting leaves the door open to another hike, particularly if inflation takes longer than envisaged to reach the midpoint of the inflation target range.

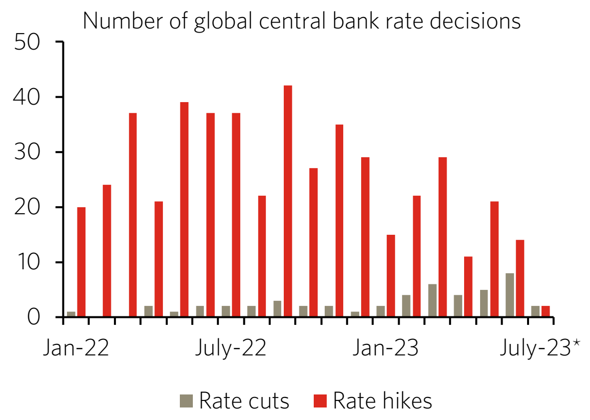
## Global monetary policy decisions are diverging

Global central banks are shifting from synchronised monetary tightening toward implementing varied monetary policy approaches. For the most part of 2022 and the first half of 2023, global central banks were implementing synchronised monetary tightening to arrest the sharp rise in inflation. According to the Bank for International Settlements (BIS), this was "the most synchronised and rapid monetary tightening in 50 years".

CBrates reports that the total number of rate hikes globally during 2022 were 367, significantly higher than 112 in 2021. In contrast, there were 17 rate cuts in 2022, up from 14 in 2021. However, chart 1 illustrates that the number of global central banks increasing interest rates is slowing down and the number of rate cuts are increasing. Year to date, the global economy has experienced 112 rate hikes and 31 cuts.

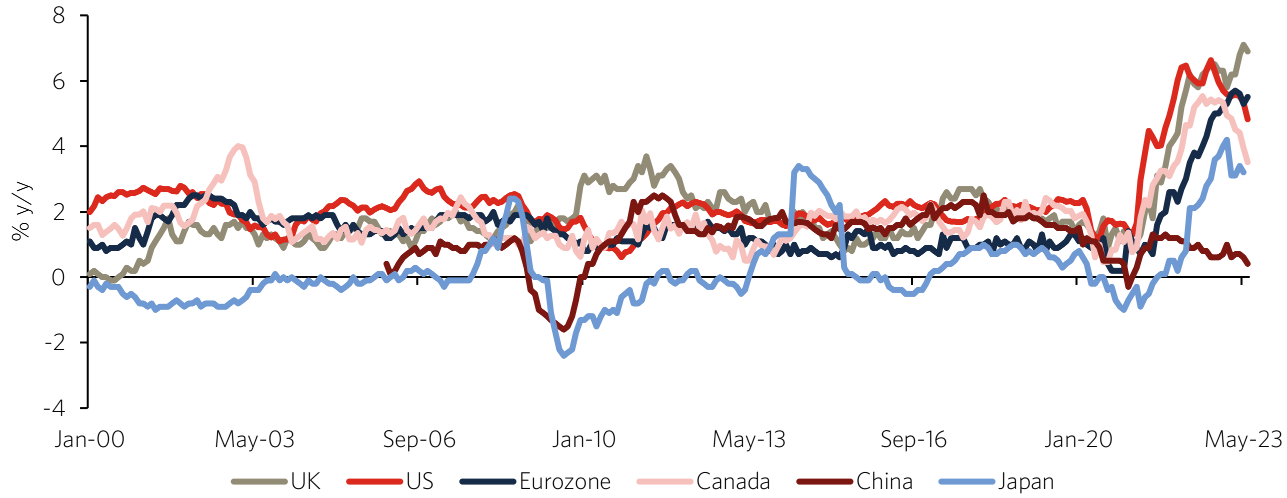
The gradual end to synchronised monetary tightening is largely due to inflation easing in most parts of the world. Despite a moderation in global inflation, interest rate decisions are varying between hikes, pauses and cuts given that country-specific inflation rates (including underlying inflation) are still well above the respective central bank targets in some jurisdictions (see chart 2). The rate of deceleration in inflation differs by country, nevertheless, and with central banks starting to place more emphasis on economic growth, some central banks have either paused or cut interest rates. The inflation rate in China has bucked the global trend and remained low due to the zero-Covid policy which resulted in extended lockdowns and lower demand. China's inflation rate remained muted even after the economy's re-opening because domestic demand has not picked up significantly on the back of smaller pandemic savings and suppressed confidence. As such, the spillover to the rest of the world has also been limited.

Chart 1: Global tightening cycle nearing a conclusion




*Source: cbrates.com, Momentum Investments*
**Month-to-date (1 July to 13 July)*

Chart 2: Headline inflation has retreated but core inflation remains sticky in the major economies




*Source: Bloomberg, Momentum Investments*
*Data until June 2023*

According to *Wall Street Journal*, the Bank of Canada (BoC) was the first major central bank to pause interest rates in January 2023, but this was short-lived. The BoC raised the policy rate to 4.75% in June due to stronger-than expected consumer spending and concerns over elevated inflation.

The United States (US) Federal Reserve (Fed) only paused rates in June 2023 (five months later than BoC), but they have communicated that they could continue hiking rates. This was also signalled by the upward shift in the dot plot (a chart that summarises the Federal Open Market Committee's outlook for the federal funds rate) median forecast to 5.6% for the end of 2023 in June from 5.1% in March, hinting at the possibility of two more hikes before the end of this year.

The European Central Bank (ECB) raised rates by 25 basis points in June noting that they expect inflation to remain high for longer. Furthermore, the ECB revised up its core inflation forecast for 2023 and stated that "key ECB rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation" to the target. This is a strong signal that they will likely increase rates again at the July meeting.

The People's Bank of China (PBoC) cut the one-year Loan Prime Rate to 3.55% in June for the first time since August 2022. The low inflation rate in China gives policymakers enough room to ease monetary policy to boost economic activity.

The SARB has revised their 2023 global growth forecast up from 2.4% to 2.5% but kept the forecast for 2024 and 2025 unchanged at 2.7% and 3.1%, respectively. They noted that near term growth prospects are stable, but the longer-term outlook is not clear due to the ongoing geopolitical tensions, effects of climate change and the inflation trajectory. However, they seem confident that global monetary policy will stay on course in the fight against inflation.

We expect global central banks to pause interest rates for a few quarters before looser monetary policy is carried out. While this will allow central banks to assess the impact of past decisions and limit the possibility of policy errors, keeping interest rates elevated will continue to cap economic growth prospects.

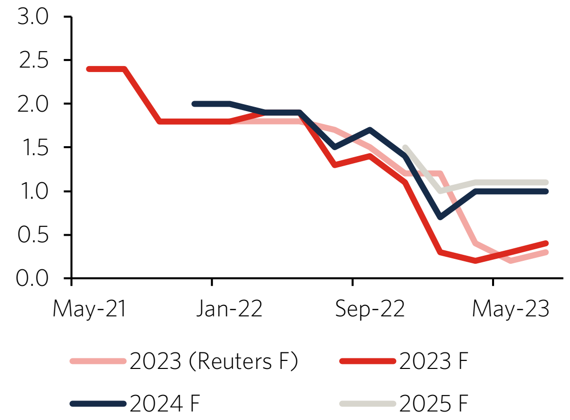
## Domestic growth prospects still weak despite upward revision

Prospects for economic growth in SA remain subdued due to loadshedding, logistic constraints and modest global growth.

The Reuters median consensus for July 2023 revised expected economic growth for 2023 up from 0.2% to 0.3%. This brought the forecast to the same level as the SARB's revision in the May MPC. In the July MPC, the SARB marginally revised domestic growth up to 0.4% for 2023 on account of less intense loadshedding experienced recently. The growth revisions for 2023 illustrated in chart 3 shows that the Reuters consensus has lagged SARB revisions. Growth forecasts for 2024 (1%) and 2025 (1.1%) were kept the same.

On a quarter-on-quarter (q/q) basis, the Reuters median consensus is projecting economic growth of 0.1% (seasonally adjusted) for the second quarter, lower than the SARB's forecast of 0.4% q/q. Estimates from Reuters and the SARB point to weaker economic activity in the third and fourth quarter of 2023.

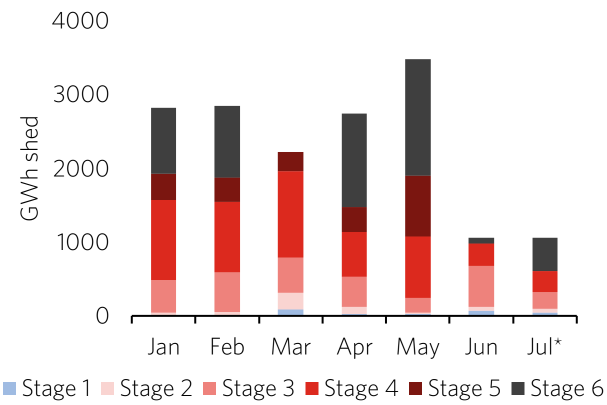
Chart 3: SARB's real growth revisions (%)




*Source: SARB, Reuters, Momentum Investments*
*Data until July 2023*

Growth in the second quarter of 2023 may garner support from the lower intensity and duration of loadshedding experienced in the second quarter as some sectors could operate with fewer interruptions. The total number of national loadshedding days were less in the second quarter thus making the first quarter the new peak for loadshedding so far. Furthermore, the total energy shed during the second quarter was also lower than in the first quarter and this was largely due to less loadshedding implemented in June as seen in chart 4.

Chart 4: SA experienced less intense loadshedding in June 2023




*Source: EskomSePush, Momentum Investments*
**Month-to-date (1 July 2023 to 18 July 2023)*

Eskom has attributed the lower stages of loadshedding in more recent weeks to higher generation capacity as units from various power stations were returned to service coupled with fewer breakdowns (an improvement of about 3 000MW); reduced planned maintenance and lower demand. *Daily Investor* notes that there is typically more generation capacity in winter because maintenance typically drops by 4 000MW and the air-cooled newer power stations are more efficient in cold weather. Additionally, the article states that the lower demand is due to the increase in rooftop solar installations and lower demand from energy-intensive industrial users who typically shut down some operations in winter. These large industries temporarily stop certain operations in winter (e.g. smelters) because those specific operations require more electricity during winter which could triple their energy costs. This could counter growth realised in other sectors. Better performance of wind farms has also contributed to improved energy supply.

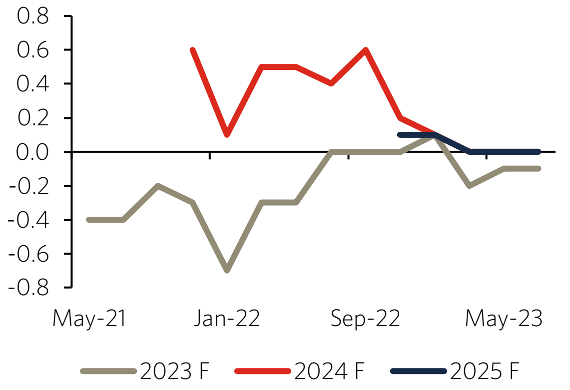
As we enter the second half of winter, the period of less loadshedding seems to be behind us. There has been an increased implementation of stage 6 loadshedding in

July, but the total energy shed is relatively contained. SA has so far dodged the worst-case scenario of stage 8 loadshedding that the minister of electricity warned of going into winter. However, this risk remains high as we enter the second half of winter.

The SARB's projection of potential growth in 2023 was revised up to negative 0.1% from negative 0.2%. However, given the upward revision in growth, the output gap was unchanged at negative 0.1% for 2023. It has been noted that a potential growth rate of 0% is a tough position for any central bank because a slight increase in economic activity may create the perception that the economy is overheating.

Potential growth is estimated to rise marginally to 1% in 2025 (unchanged) on the back of easing energy constraints. Consequently, the output gap is expected to narrow to 0% by 2025 (unchanged). An output gap of 0% means that there are no upside or downside risks to growth.

Chart 5: SARB's output gap revisions (%)

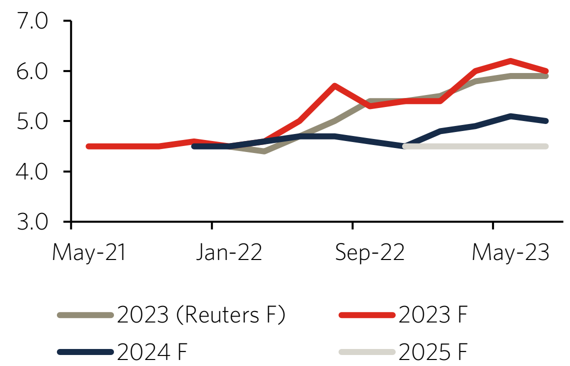



*Source: SARB, Momentum Investments*
*Data until July 2023*

## Domestic inflation is viewed to be on the glide path down to 4.5%

In line with global inflation trends, domestic headline inflation is moderating. Since the May MPC meeting, CPI eased back into the inflation target range from 6.8% y/y in April to 5.4% y/y in June. This resulted in an average inflation rate of 6.2% in the second quarter of 2023, a better outcome than the SARB's forecast of 6.4% from the May MPC. Given the better-than-expected monthly inflation prints, headline inflation was revised lower to 6% (previously 6.2%) for 2023, 5% (previously 5.1%) for 2024 and is still expected to stabilise at 4.5% in 2025.

Chart 6: SARB's headline inflation revisions (%)




*Source: SARB, Momentum Investments*
*Data until July 2023*

The SARB's average headline inflation forecast for 2023 through to 2025 remained higher than the median Reuters consensus. Respondents in the survey forecasted average inflation of 5.9% for 2023, moderating to 4.9% in 2024 before reaching 4.4% in 2025.

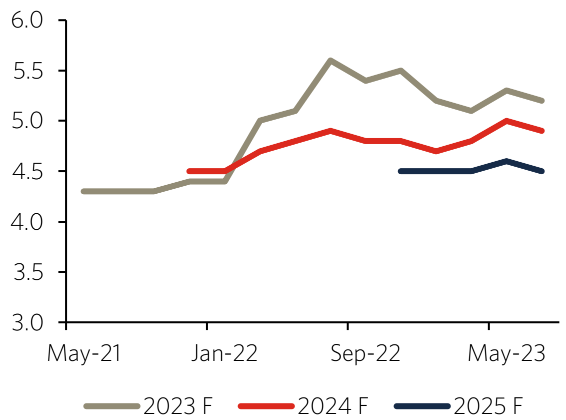
The deceleration in inflation over the second quarter was largely due to lower transport inflation (fuel fell into deflationary territory in June) and softer food inflation. Recent developments such as the oil production cuts announced by OPEC + and Russia's exit from the Black Sea Grain Initiative introduce upward pressure for international oil prices and global food prices. However, the SARB's estimates of Brent Crude oil are broadly in line with the recent forecasts from the Energy Information Administration (EIA), which means they have broadly factored the impact from higher oil prices. In the July Short-Term Energy Outlook, the EIA estimated Brent crude oil to average $79/bbl in 2023 and increase to $84/bbl in 2024 on the back of an expected decline in global oil inventories. The SARB expects crude oil prices to average US$81/bbl in 2023 (downward revision from US$85/bbl but higher than the EIA's forecast) and increase to US$82/bbl in 2024 (downward revision from US$85/bbl but lower than the EIA's forecast).

The forecast for food inflation was brought down to 10.3% in 2023 (previously 10.8%) but revised up from 5% to 5.2% for 2024. The upward revision reflects increased risks of drier weather conditions (El Niño).

Unlike globally, domestic core inflation has not de-anchored materially and is forecasted to remain within the inflation target band. Core inflation has largely been driven by core goods inflation and exchange rate-sensitive goods (alcoholic beverages and tobacco, vehicles, household contents, as well as spare parts and accessories). Lower-than-anticipated housing costs and health insurance is keeping a lid on services inflation and thus, core inflation.

The softer print for core inflation in June (5% y/y) surprised positively. This contributed to the lower-than-expected core inflation rate of 5.2% for the second quarter of 2023 (SARB's forecast: 5.3%). The SARB has revised core inflation lower across the medium term (see chart 7). Underlying inflation is expected to be 5.2% in 2023 (from 5.3%), 4.9% in 2024 (from 5%) and is anticipated to stabilise at 4.5% in 2025 (from 4.6%). Core goods inflation is expected to be lower at 6.2% this year (previously 6.3%).

Chart 7: SARB's core inflation revisions (%)

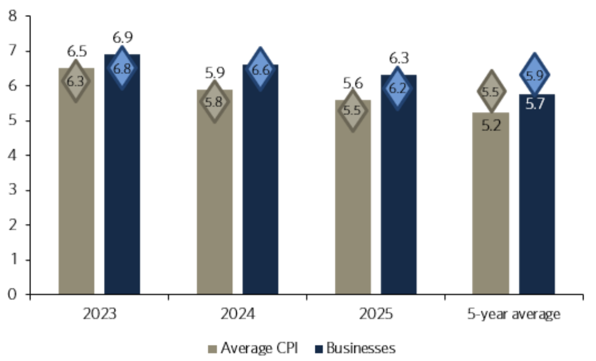



*Source: SARB, Momentum Investments*
*Data until July 2023*

Despite downward revisions made to core and headline inflation, risks to the inflation outlook are assessed to be to the upside. The risks cited included elevated global food prices, tight international oil markets, the upcoming El Niño season, high administered costs, the energy crisis, logistic constraints, and higher average salaries.

Inflation expectations published by the BER showed that short-dated expectations deteriorated in July (moving further away from the SARB's communicated forecast and midpoint of the target range). The average inflation rate expected for 2023 ticked up from 6.3% in the May survey to 6.5% in July (see chart 8). Elevated inflation expectations for 2023 were expressed by all the respondents (financial analysts, businesses and trade unions) but the rate of increase was higher among financial analysts. Nevertheless, businesses are recording the highest inflation expectation across the different forecast horizons and labour is not too far behind which is concerning as these two groups are the price setters in the economy. The SARB does, however, indicate that expected inflation among businesses could be higher because businesses may be pricing in the unknown costs of loadshedding, logistic costs and storage costs and they take solace from the fact that labour is not the frontrunner. Encouragingly, the deterioration in short-dated expectations was marginal (0.2% in 2023 and 0.1% for 2024 and 2025). Moreover, average five-year inflation expectations moderated from 5.5% to 5.2%.

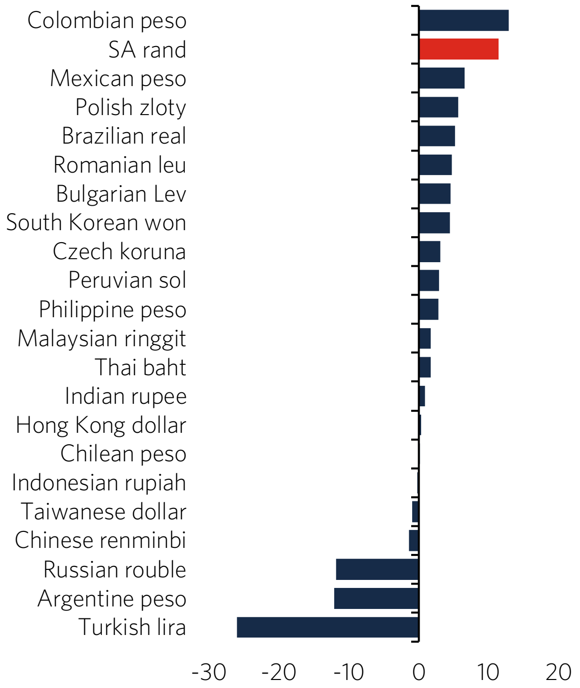
Chart 8: Businesses are driving elevated inflation expectations in the second quarter of 2023




*Source: BER, Momentum Investments*
*Diamond illustrates the Q1 2023 survey results*

Since the May 2023 MPC, the SA rand strengthened by 11.4% against the US dollar and ranked as the second-best performer among emerging markets (see chart 9). This is a notable improvement from being the second-worst performer at the May MPC (relative to the March meeting).

Chart 9: Rand strengthened since the May MPC* (%)

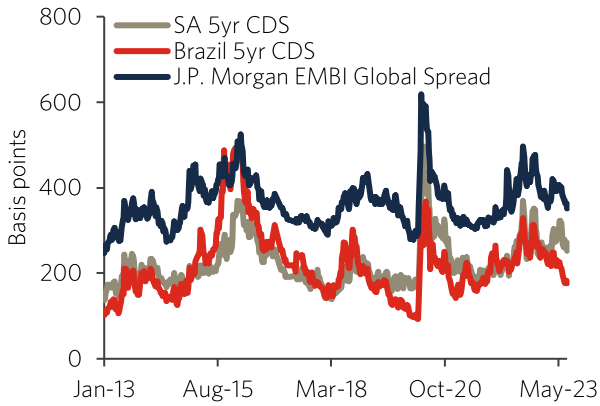



*Source: Bloomberg, Momentum Investments*
**25 May to 20 July 2023*
*Positive = appreciation, negative = depreciation*

Investec attributes recent rand strength to dollar weakness. The lower loadshedding experienced in June and July so far could also be a reason for the recovery in the domestic exchange rate. However, risks to the exchange rate remain. Despite the recent reduced loadshedding, the energy crisis is estimated to persist until late 2024 or early 2025. Secondly, the Fed and ECB have signalled further rate hikes this year which will have an impact on capital flows and exchange rate movements. Thirdly, SA is due to host the BRICS Summit in August and the African Growth and Opportunity Act (AGOA) Summit in November (both events carry risks). Lastly, rising country risk premium feeds into rand weakness.

The SA five-year credit default swap (CDS, proxy for country risk premium) spread has widened in recent months. The spread has decoupled from the Brazilian five-year spread (see chart 10) and moved closer to the J.P. Morgan EMBI Global Spread (an index which includes dollar-denominated debt of emerging market governments). The wider SA five-year spread reflects idiosyncratic factors such as loadshedding and concerns around fiscal slippage.

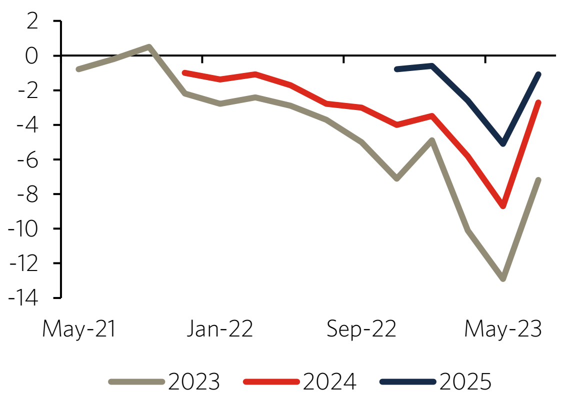
Chart 10: Idiosyncratic risk in SA




*Source: Bloomberg, Momentum Investments*
*Weekly data until 14 July 2023*

In the April Monetary Policy Review, the SARB projected that the elevated risk premium will stay above its equilibrium over the medium term. As a result, the real effective exchange rate is estimated to remain undervalued in the near term despite upward revisions (see chart 11) which means the exchange rate will remain an upside risk to inflation.

Chart 11: SARB's real effective exchange rate gap* revisions (%)




*Source: SARB, Momentum Investments*
**Values < 0 imply undervaluation*
*Data until July 2023*

The inflationary impact of unfavourable exchange rate shifts concerns the SARB. This is gauged through the passthrough rate into the consumer basket. The steady state passthrough is 0.13 but the enhanced QPM factors in a lower rate of 0.9 because the rising country risk premium limits benefits from a weaker currency. Given the high inflation environment, the SARB notes that the passthrough may currently be tracking closer to 0.15.

## MPC pauses rate but declares that interest rate hikes could resume

The SARB's decision to keep the repo rate constant at 8.25% was a positive surprise against the Bloomberg median consensus and our projection for a 25-basis point hike but it was in line with the expectation from the FRA market. The factors that influenced the market occurred toward the back-end of July. These include, currency strengthening, lower US recession risks, a favourable inflation outcome in the US and a positive surprise in domestic inflation.

The preference between the MPC members was split with three members favouring the implemented pause in rates while two members were leaning toward a 25-basis point hike (see table 1).

The rationale provided for keeping the repo rate constant is that the SARB believes that "the inflation rate is on the glide path down to 4.5%", food inflation has peaked, and previous repo rate hikes are still due to filter through to the real economy. The Committee emphasised that they would remain data dependent and their policy stance may change.

Notably, in the question-and-answer session, the governor was stern in noting that the repo rate has not yet peaked. He further expressed that this is not the end of the hiking cycle and "the fight is still on".

At the current juncture, the MPC noted that rate cuts are not on the table, but should they perceive inflation to be decelerating faster than they anticipate, the conversation may change.

Table 1: Shift in MPC member preferences at the scheduled July 2023 meeting

| Number of committee members | Favoured no move | Favoured a 25-basis point hike | Favoured a 50-basis point hike | Favoured a 75-basis point hike | Favoured a 100-basis point hike |
|---|---|---|---|---|---|
| 22 July 2021 | 5 | - | - | - | - |
| 23 September 2021 | 5 | - | - | - | - |
| 18 November 2021 | 2 | 3 | - | - | - |
| 27 January 2022 | 1 | 4 | - | - | - |
| 24 March 2022 | - | 3 | 2 | - | - |
| 19 May 2022 | - | 1 | 4 | - | - |
| 21 July 2022 | - | - | 1 | 3 | 1 |
| 22 September 2022 | - | - | - | 3 | 2 |
| 24 November 2022 | - | - | 2 | 3 | - |
| 26 January 2023 | - | 3 | 2 | - | - |
| 30 March 2023 | - | 2 | 3 | - | - |
| 25 May 2023 | - | - | 5 | - | - |
| 20 July 2023 | 3 | 2 | - | - | - |

*Source: SARB, Momentum Investments*

## Tighter policy environment

With the repo rate kept constant at 8.25% and inflation falling to 5.4% in June, the ex-post real interest rate moved up to 2.85% in July (see chart 12). The ex-ante real rate is higher at 3.35% when factoring in the July Reuters one-year median consensus of 4.9% but it does come down to 2.35% when considering one-year ahead expectations of 5.9% according to the second quarter BER inflation expectations survey.

Chart 12: Restrictive real interest rates


*Source: Iress, Momentum Investments*
*Using realised inflation rates*
*Data until July 2023*

Given the upward revision of the neutral real interest rate to 2.5% (previously 2.4%) in 2023, ex-ante real rates according to the Reuters consensus fall below the neutral real rate but are above when taking realised inflation and BER inflation expectations into account.

The SARB noted additional inflation pressure from elevated inflation expectations, particularly arising from the business sector. In previous speeches, the SARB had also warned of rising fiscal risks underpinning elevated sovereign risk, leading to a higher real neutral rate of interest. Given that inflation risks are still viewed as being to the upside, we think that today's meeting leaves the door open to another hike, particularly if inflation takes longer than envisaged to reach the midpoint of the inflation target range.

Our view of risks to the inflation outlook include food and fuel inflation, fiscal concerns on the back of weaker commodity prices, elevated inflation expectations and negative risks to the domestic exchange rate in the near term.

Following the announcement of updating the QPM to improve the model's forecasting ability and reduced bias, the SARB released a working paper detailing the enhancements made to the model. July was the first MPC on the back of the new model. In the question-and-answer session, it was noted that it was difficult to compare results of the new model to the older model.