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SARB delivers surprise 50-basis point hike on sharply higher inflation forecasts

Highlights

- Banks are better capitalised today than in the run up to 2008, which reduces the chances of a fallout akin to the global financial crisis (GFC). However, in response to current stresses, banks have become more conservative in their lending practices. This tightening in lending standards could act as an additional brake on economic growth and as such has had implications for monetary policy.
- In light of rising financial stability risks, central bankers in the developed world have become more cautious about raising interest rates, at least until developments in the banking sector have become clearer.
- Since the January 2023 South African Reserve Bank (SARB) Monetary Policy Committee (MPC) meeting, the SA rand has had the fourth worst currency performance against the United States (US) dollar, following the Russian rouble, the South Korean won and the Thai baht.
- However, aside from a weaker currency, the SARB noted additional upside risks to the inflation trajectory stemming from administered tariffs (including electricity) and stickier local food prices. Despite the international price of oil steadying since November 2022, the SARB continues to flag energy inflation as an upside threat to local price pressures given no reprieve in the war in Ukraine and the expected rebound in Chinese growth.
- The SARB raised its headline inflation assumption of 5.4% for 2023 to 6% and lifted its view on outcomes for 2024 from 4.8% to 4.9%, relative to the Reuters consensus of 5.8% and 4.7% for this year and next. This compares to our projections of 5.8% and 4.6%, for 2023 and 2024, respectively. The SARB calculates that loadshedding adds 0.5% to headline inflation pressures.
- Despite a downbeat forecast for growth in January, the SARB lowered its projection even further to 0.2% for 2023. Growth is now expected to recover slightly to 1% in 2024 (from an estimated 0.7% in January 2023). This is lower than the Reuters consensus forecast of 0.4% in 2023 and 1.5% in 2024 and our downwardly revised projections of 0.3% and 1.3%, respectively.
- Following on from these revisions, the SARB sees risks to the growth outlook as being fairly balanced. The SARB maintained its assumption that power outages will erase around 2% from expected growth this year.
- The MPC's decision to hike the interest rate by 50 basis points to 7.75% came as a surprise to financial markets. A majority of 18 from 20 surveyed analysts (including ourselves) expected interest rates to increase by 25 basis points in the monthly Reuters Econometer poll for March 2023, while two analysts were expecting an unchanged interest rate stance.

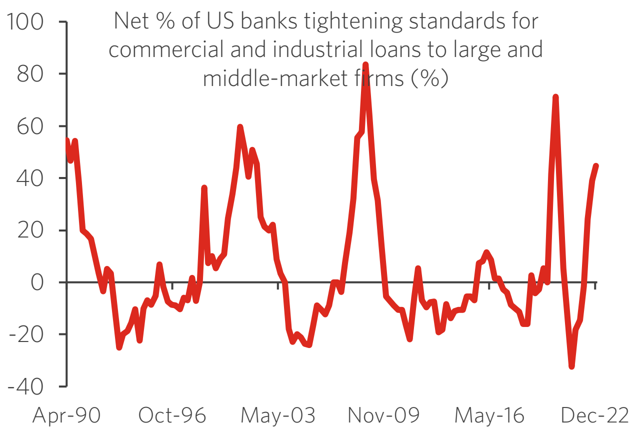
- The SARB revealed that while at the January 2023 rate-setting meeting two members favoured a 50-basis point increase and three presented an argument for a smaller hike of 25 basis points, this time around three members opted for a 50-basis point increase and two preferred a smaller hike of 25 basis points. None of the members expressed a preference for no move in interest rates.
- Should disinflation continue in upcoming quarters to sustainably revert to the midpoint of the target by the fourth quarter of next year, this is likely to be the end of the interest rate hiking cycle. However, if the SARB sees inflation risks as having intensified, we could see another 25-basis point hike in May. Beyond this, we would see further hikes as less effective in bringing down inflation and more harmful to growth, given the positive real interest rate trajectory, particularly using the forward-looking view on inflation.
- In our view, interest rate cuts are likely some way off given persistent upside risks to the inflation trajectory, continued interest rate normalisation, globally (albeit we are likely nearing peak levels), and longer-dated local inflation expectations which remain 1% higher than the midpoint of the 3% to 6% target.

Health of the global banking system under scrutiny

Sudden stress in the global banking system, triggered by downfalls in Silicon Valley Bank, Silvergate Bank, Signature Bank and Credit Suisse have raised financial stability risks across the globe.

Banks are better capitalised than in the run up to 2008, which reduces the chances of a GFC-style crisis, in our view. However, in response to current stresses, banks have become more conservative in their lending practices (see chart 1). This tightening in lending standards could act as an additional brake on economic growth and as such will impact monetary policy.

Chart 1: Lending standards are tightening in the US

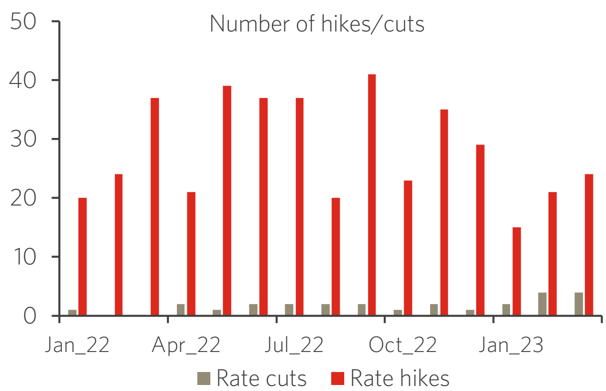


Source: Federal Reserve Bank of St. Louis, Momentum Investments

Fewer loans to businesses and consumers are expected to drive spending lower, making it harder for companies to raise prices, ultimately reducing inflationary pressures.

Although the number of interest rate hikes, globally, has climbed since the start of the year (see chart 2), the size of interest rate hikes has slowed in a number of economies in recent months in line with a deceleration in inflation. Moreover, a tightening in global credit conditions has left central bankers more reluctant to support larger additional hikes at least until developments in the banking sector become clearer.

Chart 2: Number of interest rate hikes has outweighed cuts, globally



Source: cbrates.com, Momentum Investments, data up to March 2023

The US Federal Reserve (Fed) raised interest rates by 25 basis points in March 2023 and softened its language around the outlook for further interest rate increases, leading markets to believe that the Fed may be reaching the end of its rate hiking cycle.

The Fed Chair suggested that a tightening in financial conditions tended to work in the same direction as a rise in interest rates and noted that tighter credit conditions for US firms and households equated to a rate hike.

Meanwhile, the European Central Bank stuck to its pledge of fighting inflation and lifted its deposit rate by 50 basis points to 3% in March. The ECB stated that its fight against inflation through tighter monetary policy was not a threat to financial stability and remarked that Eurozone banks were resilient, especially when compared to their capital and liquidity positions back in 2008. The ECB president laid out a new approach to the bank's decision-making process, suggesting that it would consider economic as well as financial data. As such, measures of banking stress will be included as inputs into future deliberations on the interest rate path.

Supply-side constraints weigh on growth

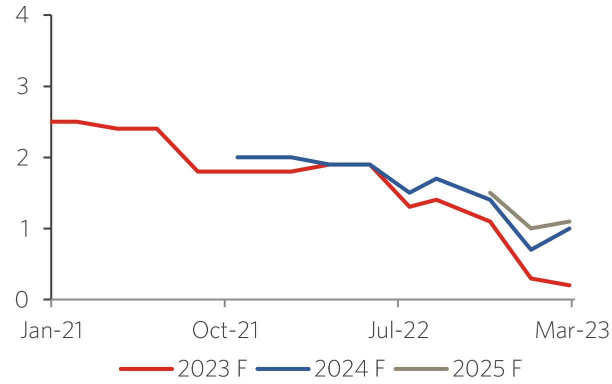
The Reuters consensus for March 2023 estimates an economic expansion of 0.2% in quarter-on-quarter (q/q), seasonally adjusted (sa) terms for the first quarter of this year suggesting the economy will avoid a technical recession.

The SARB now expects the economy to expand by 0.2% (from 0.3% previously) this year and to climb to 1% (previously 0.7%) in 2024 (see chart 3), due to its expectations on commodity prices and positive private sector investment. The SARB maintained its view that loadshedding would detract 2% off growth this year.

These revised projections are lower than the March 2023 Reuters consensus expectation of 0.4% for this year and 1.5% for next. The SARB's forecasts are also notably lower than our downwardly-revised growth forecasts for 0.3% this year and 1.3% next year. Notably, the Reuters consensus view on growth shifted markedly over the course of March. A month ago, the consensus expected SA to grow at 1% this year and 1.5% next year.

The SARB anticipates the pedestrian outlook on growth to extend to 2025 and forecasts a figure of 1.1% (1% previously), relative to the Reuters and our projection of 1.8%. Following these revisions, the SARB views risks to the growth outlook as being fairly balanced.

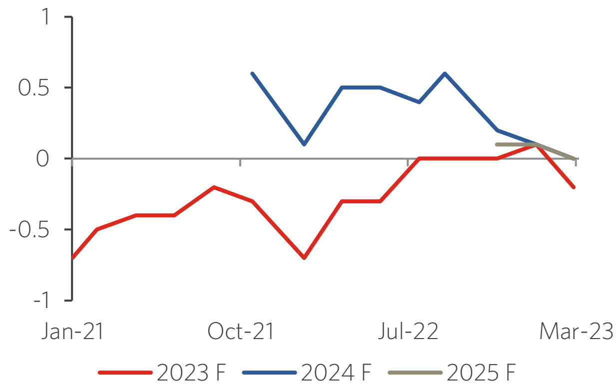
Chart 3: SARB's real growth revisions (%)



Source: SARB, Momentum Investments

The SARB expects the output gap to close next year from an estimated negative 0.6% last year (see chart 4). The SARB's potential growth estimate for this year was revised lower to negative 0.2% and 0% for next year, from 0% and 0.6% previously. The 0.1% pencilled in for 2025 remained unchanged.

Chart 4: SARB's output gap revisions (%)



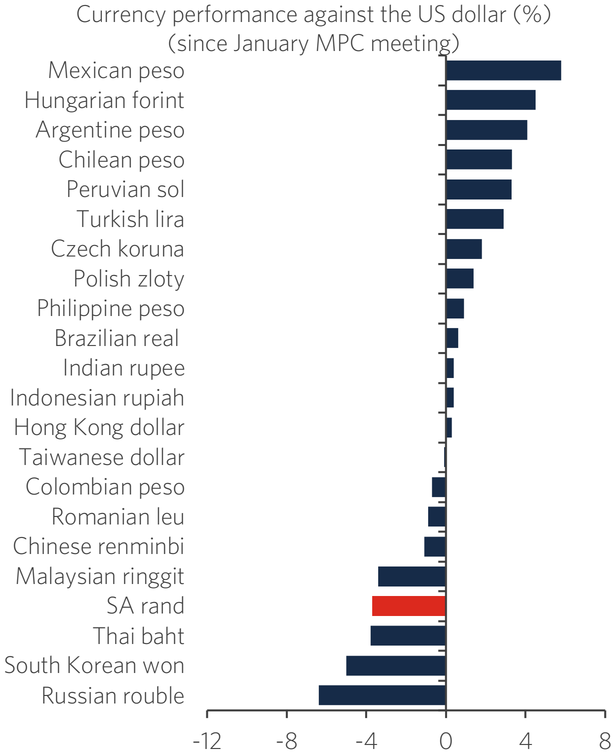
Source: SARB, Momentum Investments

Currency, administered tariffs and local food prices pose a threat to expected inflation

Since the January 2023 SARB MPC meeting, the SA rand has had the fourth worst currency performance against the US dollar, following the Russian rouble, the South Korean won and the Thai baht (see chart 5).

However, aside from a weaker currency, the SARB noted additional upside risks to the inflation trajectory stemming from administered tariffs (including electricity) and stickier local food prices.

Chart 5: Rand underperformance (%)



Source: Bloomberg, Momentum Investments

Sticky food prices at a local level (due to currency weakness and loadshedding affecting agricultural output), a tight balance in international oil markets (despite steady oil prices since November 2022) and upside risks to local electricity prices underpin the SARB's assessment of inflation risks as being to the upside in the near term.

In the question-and-answer session, the governor noted that the preliminary calculations from the SARB indicate that loadshedding adds 0.5% to headline inflation.

The SARB expects local food inflation to average 9.9% (previously 7.3%) this year and 4.5% next year (from 4.4%), relative to our forecasts of 10.2% and 4.2%, respectively. Although global wheat prices have returned to pre-war levels, largely due to the Black Sea Grain initiative brokered in July 2022 which enabled a safe passage for commodities from Ukraine, a weaker rand has exerted upward pressure on wheat imports. Within the local meat inflation category, chicken prices will likely trend higher due to ventilation disruptions caused by loadshedding. Moreover, a sharp drop in slaughtering rates of cattle could push meat prices higher in the interim.

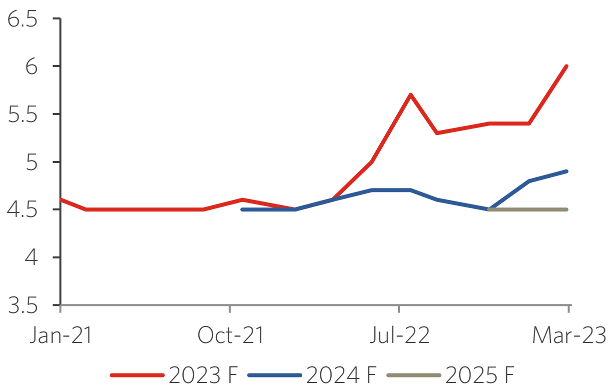
The balance between demand and supply remains tight in international oil markets. The US Energy Information Administration's (EIA) Short-term Energy Outlook for March 2023 indicated that it expected international oil prices to average at US$83/bbl in 2023 (unchanged from two months ago) from an average of US$101/bbl last year. Oil prices are expected to drop further to an unchanged US$78/bbl, on average next year. The EIA notes that the European Union's ban on seaborne petroleum products from Russia and an announced cut in crude oil supply in Russia will cap global supply.

Meanwhile, the International Energy Agency (IEA) warns that rebounding air traffic and releasing pent-up spending in China could push up the demand for oil. While the IEA reports that Russia has rerouted a lot of its supply to new destinations (notably Asia), keeping oil supply in excess of oil demand, even if Russia manages to grow and sustain production to pre-pandemic levels, overall global supplies would still be insufficient to cover the rise in global demand later this year. This suggests risks to international oil prices further out.

The SARB's forecasted average oil price for this year dropped to US$87/bbl (previously US$89/bbl). It left its forecasts of US$85/bbl for next year and US$80/bbl for 2025 largely intact.

The SARB's expectation for headline inflation for this year was revised higher to 6% from 5.4% in January on higher expectations for core goods inflation. This is higher than our and the March 2023 Reuters consensus forecast of 5.8%. For 2024, the SARB sees inflation higher at 4.9% (previously 4.8%). This estimate is broadly in line with the Reuters projection but marginally higher than our projection of 4.6% (see chart 6). The SARB expects headline inflation to fall to an unchanged estimate of 4.5% in 2025.

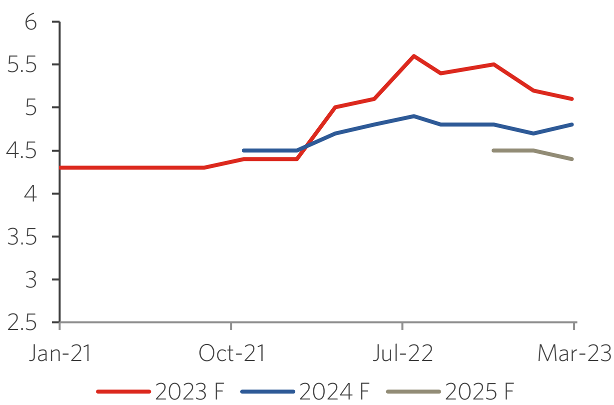
Chart 6: SARB's headline inflation forecasts (%)



Source: SARB, Momentum Investments

The SARB lowered its core or underlying inflation projections (excluding food and fuel prices) from 5.2% to 5.1% for this year (see chart 7), relative to our estimate of 4.7%. Core inflation is expected to average at a marginally higher 4.8% in 2024 (relative to our 4.2%) before declining to a projected (and unchanged) 4.5% (compared with our 4.3%) in 2025. The SARB attributes its downward adjustments to core inflation to lower services inflation.

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

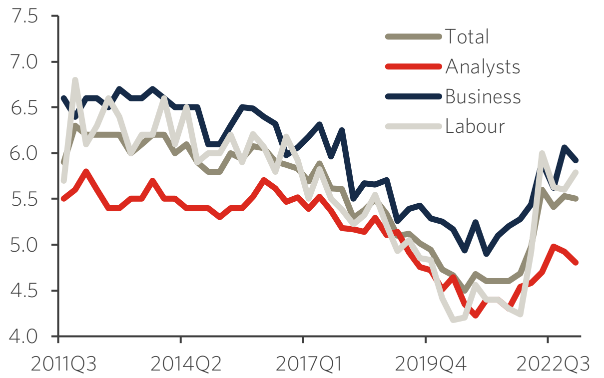


Source: SARB, Momentum Investments

Average five-year inflation expectations in five years, as measured by the Bureau of Economic Research (BER), remained at 5.5% in the first quarter of the year. However, the SARB highlighted the sharp move over the past year and noted the importance of reining in expectations to shelter lower-income earners from the cost-of-living crisis.

While expectations by labour inched higher from 5.6% to 5.8%, expectations for business and analysts dropped by 0.2% and 0.1%, respectively to 5.9% and 4.8% (see chart 8). Services inflation (which closely correlates with longer-dated inflation expectations) remained close to the midpoint of the target but jumped to 4.6% in February from 4.3% in January posing a risk to longer-dated inflation expectations.

Chart 8: Aggregate longer-dated* inflation expectations stabilised (%)



*Source: SARB, Momentum Investments, *average five-year expectations in five years' time, data up to Q1 2023*

MPC expresses caution given inflation outlook

Today's interest rate meeting, which surprised markets, revealed that three MPC members favoured an interest rate hike of 50 basis points, while two preferred a smaller increase of 25 basis points (see table 1).

Going into today's interest rate decision, 18 of the 20 surveyed analysts in the March 2023 Reuters Econometer poll (including ourselves) expected interest rates to increase by 25 basis points. Two analysts forecasted an unchanged stance. According to the MPC, the QPM indicated marginal changes relative to the January 2023 meeting. It calculates interest rates at 6.94% by the end of next year and 6.91% by the end of 2025.

Table 1: Shift in MPC member preferences at the scheduled March 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
25 March 2021	5	-	-	-	-
20 May 2021	5	-	-	-	-
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	-	-

Source: SARB, Momentum Investments

Interest rates topping out

Global shocks, including high inflation and recent banking sector stresses, have complicated policy decisions. In a March 2023 speech at the Central Banking Conference in Cape Town, Deputy Governor Rashad Cassim pointed out that headline inflation in SA has been outside of the target range since May 2022 and inflation was last seen at the midpoint of the target (where the SARB aims to stabilise inflation) a year before that.

Moreover, he noted concerns that longer-dated surveyed inflation expectations tracked well above the 4.5% target of the SARB, implying that initial supply-side shocks could be filtering into longer-run expectations and second-round effects.

Worries over higher services inflation were also highlighted given that services account for two-thirds of the core basket and prices of many of these items are tracked more infrequently, giving rise to upward pressure on inflation expectations.

In February 2023, services inflation entered the top half of the SARB's inflation target range. Should inflation in this category rise significantly, posing a larger threat to second-round inflation measures, we could see the SARB raise interest rates by a further 25 basis points from here. However, should disinflation continue to proceed at a convincing enough rate to get inflation down to the midpoint of the inflation target range on a more sustainable basis by the fourth quarter of next year, we would view today's hike as being the last in the current cycle.

Nevertheless, we believe that the scope to raise interest rates much further remains limited given the SARB's assessment of the neutral interest rate. Given one-year ahead inflation expectations of around 4.8% as estimated by the Reuters consensus in March 2023, real interest rates are already close to 3% (higher than the SARB's estimate of the neutral real rate of 2.5%, taking into account inflation of 4.5% and nominal rates of 7%). We expect the trade off between inflation and growth to become trickier from here also preventing significantly higher interest rates from current levels, particularly given the reduced effectiveness of the monetary policy transmission mechanism against exogenous factors and administered price inflation.

The SARB is likely to maintain a hawkish tone as it responds to persistent upside risks to the local inflation trajectory, continued interest rate normalisation, globally (even as interest rates near a peak), and longer-dated inflation expectations which are tracking above the midpoint of the target band at 5.5%.

While the Reuters consensus expects interest rates to be cut to 7% by the end of the first quarter of next year, the forward-rate agreement (FRA) market has pushed out the prospects of the first rate cut even further. The QPM projects nominal interest rates to the end of next year at 6.94% (in line with the Reuters prediction of 6.9%). We expect the first interest rate cut to come through by the end of the first quarter of 2024, with interest rates dropping to around 6% by the end of 2025.