South Africa monetary policy

SARB MPC adopts dovish tone

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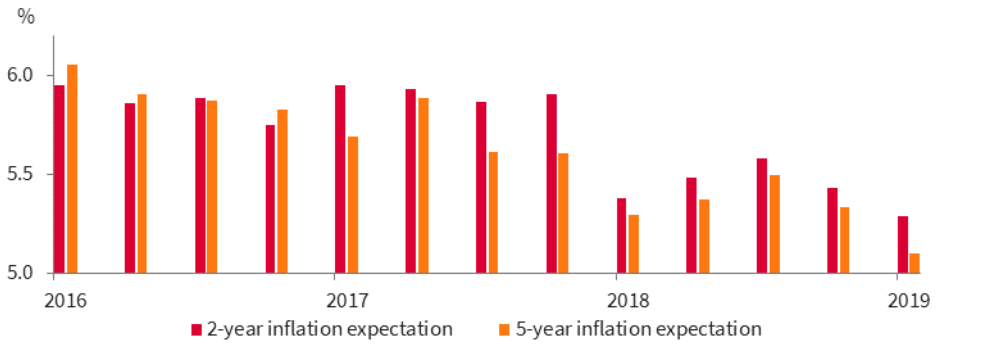
- **The SARB MPC voted unanimously (5:0) to keep the repo rate unchanged at 6.75%, as we and every other economist surveyed by Thomson Reuters expected. Overall, the MPC struck a fairly dovish tone, citing intensifying global and domestic growth concerns and near-term downside surprises in CPI, despite medium-term upside risks.**
- **Headline CPI forecasts were pretty much unchanged from the previous run of the Quarterly Projection Model at the January MPC, but the composition was different. Materially lower projected core CPI inflation was offset by higher food, fuel and electricity price inflation.**
- **The MPC welcomed the further downward adjustment in inflation expectations published by the Bureau for Economic Research, with the average five-year expectation down to an all-time low of 5.1%, but said that it would not rest easy until expectations were firmly anchored at 4.5%, the mid-point of the target range.**
- **The SARB MPC now views that risks to its mostly unchanged headline CPI forecasts to be more or less evenly balanced, but thinks the risks to its downwardly revised GDP growth forecasts remain tilted to the downside. The output gap is no longer expected to close over the forecast horizon.**
- **Notably, the SARB MPC said it continues to view its monetary policy as accommodative, which implies that the bar to a cut is high.**

Figure 1: Surveyed inflation expectations eased further in Q1 19



Source: BER, Absa Research

PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE **4**

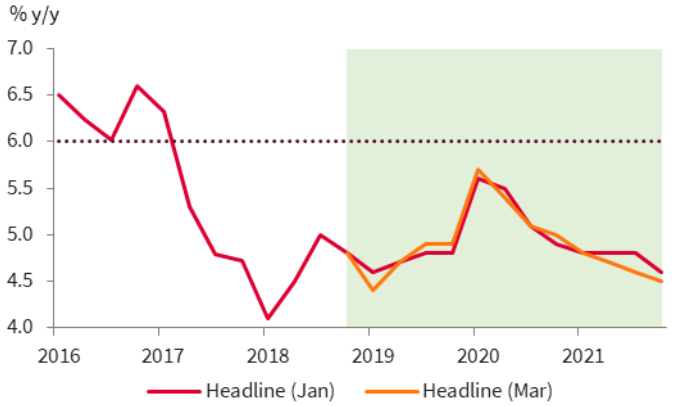
As expected, the SARB MPC voted 5:0 to keep the repo rate unchanged

Today, the 5-member SARB Monetary Policy Committee (MPC) unanimously elected to keep the repo rate unchanged at 6.75%, as we and all 23 other economists polled by Thomson Reuters had expected. The recent intensification of global growth concerns (with a significantly more dovish US Federal Reserve recently) has clearly been at the forefront of the MPC's thinking. The opening sentence on the MPC statement focused exactly on the global weakness. The SARB MPC also views the risks to global growth as tilted to the downside, with risks of a no-deal Brexit, rising geopolitical risks and risks of higher trade tensions.

The QPM projections of core CPI have been revised downwards materially, but headline CPI forecasts have been left pretty much unchanged due to higher projected food, fuel and electricity price inflation

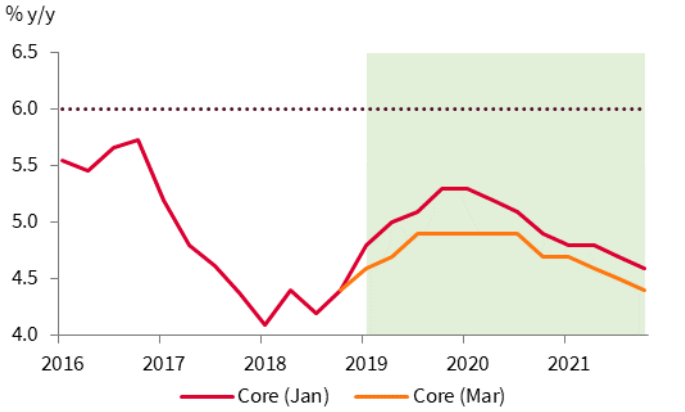
Significantly, core CPI forecasts from the Quarterly Projection Model (QPM) have been brought down significantly, by 0.2pp in 2019 and 2020 to 4.8% and 4.9%, respectively, and by 0.3pp to 4.5% for 2021. The MPC's forecasts for headline CPI, however, remain pretty much unchanged due to upward revisions to the inflation trajectories for fuel, electricity and food (Figure 2 and 3). The SARB's forecasts continue to reflect a bit of a chronological twist in the forecast risks, with near-term downside surprises for headline CPI but a 'medium term outlook [which] is impacted by higher energy tariffs, and rising food and fuel prices'. The MPC does not publish a detailed forecast for food prices (unlikely headline CPI and core). However, given that food accounts for 17.2% of the CPI basket, the MPC's comment that food price inflation is likely to have bottomed in Q1 19 but is forecast to peak at 5.9% in Q2 20 is worth noting.

Figure 2: Headline CPI forecast little changed



Source: SARB, Absa Research

Figure 3: Core CPI forecast lowered materially



Source: SARB, Absa Research

The MPC cited decelerating unit labour costs a key factor behind slowing core CPI inflation

Interestingly, the MPC statement cited moderating unit labour costs as a factor behind the lower core inflation. In our MPC preview published earlier this week, we noted the clear evidence of decelerating nominal wage gains – especially in the Q4 18 Quarterly Employment Statistics released earlier this week – as a big disinflationary factor that the MPC should be cognizant off (although we said they often do not appear to pay much attention to this factor in the text of the MPC statement). That now seems to have changed, although the MPC has not provided its implicit forecasts for wage growth. In the Q&A session, however, the SARB said that the sample revisions of StatsSA has made it harder to forecast ULC going forward, but that its latest forecast had incorporated slower unit labour cost growth, in line with recent data.

The Q1 19 inflation expectations survey published alongside the MPC shows another material decline in inflation expectations

The MPC has also drawn a fair degree of comfort from the clear evidence that inflation expectations have been decelerating. The Q1 19 inflation expectations survey, published by the Bureau for Economic Research contemporaneously with the MPC statement, shows a sizeable drop of 0.6pp in expectations for 2019 to 4.8% and by 0.2pp for 2020 to 5.2%. Significantly, average five-year expectations also declined 0.2pp to 5.1% (Figure 1, cover page), which the SARB MPC noted was the lowest level since they were first surveyed. It also noted that at just shy of 5.0%, the breakeven inflation rate on five-year bonds is at its lowest level in four years. Since agents' expectations of inflation critically affects their price setting behaviour, the deceleration of inflation expectations is welcome, and since inflation expectations are to some degree adaptive, the decline is self-reinforcing. However, in the Q&A session, Governor Kganyago was at pains to stress that although the MPC welcomed the easing of inflation expectations, it would be satisfied only when they are firmly anchored at 4.5%, the mid-point of the target range.

The MPC now views the risks around its inflation forecasts to be balanced, but still considers its policy stance to be accommodative

Although its headline CPI projections are pretty much unchanged from January, the MPC changed its assessment of the balance of risks around its central inflation forecasts. Significantly, now it thinks the upside risks (administered prices, rising domestic food prices, especially in the outer years of the forecasts, and higher crude prices) are 'more or less evenly balanced' with downside risks, specifically, lower global inflation and 'an extended period of monetary accommodation in advanced economies'. This is in contrast to the previous MPC in January, when it described the risks as lying 'moderately to the upside'. Notably, in our view, the statement says that the MPC continues to view its stance as accommodative. We believe this implies that the bar to a rate cut is very high, especially when taken alongside the fact that inflation expectations remain above the mid-point of the target range.

The MPC has cut its GDP forecasts, and consequently the negative output gap now sits wider and does not close by the end of the forecast horizon

As regards its growth forecasts, the SARB is less sanguine, having trimmed its real GDP growth forecast for 2019 by 0.4 pp to 1.3% from January, and by 0.2 pp for each of 2020 and 2021 to 1.8% and 2.0%, respectively. The drivers of these more pessimistic projections are the weaker global growth environment, plunging business confidence that undermines investment spending, load shedding, and downward pressure on household incomes. With a weaker growth trajectory, the negative output gap in the near term is considerably wider and no longer closes over the forecast horizon (Figure 4). With this in mind, it is perhaps a little surprising that the QPM still embeds one rate hike before the end of 2019, and in a slightly more fulsome manner than it did in January (Figure 5). However, Governor Kganyago was at pains to stress that the QPM endogenous interest rate projection was an indicative guide only. He also continued to stress the data dependency of the MPC at this juncture – which is more heightened than usual, in our view, given the consequences of the unknown outcome on Moody's rating decision tomorrow night.

Figure 4: Output gap no longer projected to fully close

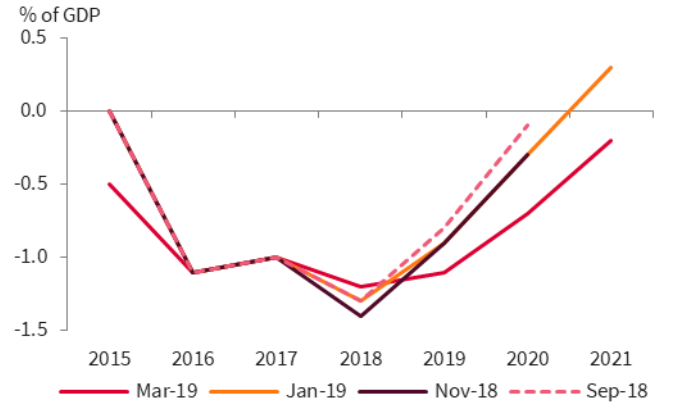


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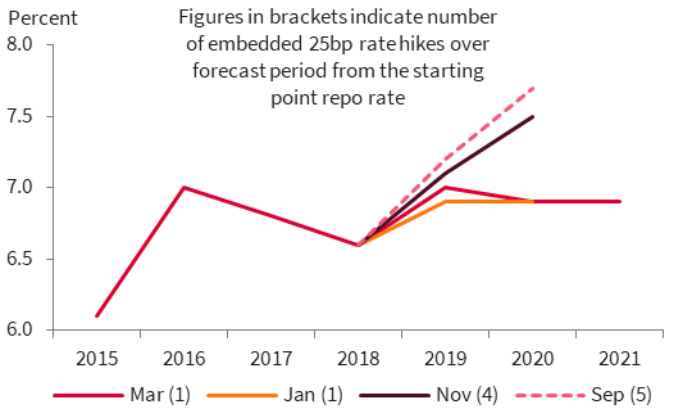
Figure 5: QPM still projects a rate hike by end-2019



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