ABSA

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South Africa monetary policy

More upside risk = firmer resolve to hold

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- **As expected, the SARB MPC voted to keep the repo rate on hold. The unanimous vote in favour of an unchanged stance reveals, we think, a more cautious MPC, which sees the risks to the inflation outlook as having shifted strongly from "balanced" in March to "upside" presently.**
- **The MPC is clearly most worried about the global context in light of developments in the US and recent pressures on various emerging economies, but it also cited several domestic risks: persistently high wage settlements, the impact of weaker terms of trade on the ZAR, and a regulatory ruling in June on possible further electricity tariff hikes.**
- **Despite a markedly higher oil price assumption and a material weakening of the ZAR since the last MPC, the SARB's inflation forecasts were raised only slightly. This is due to some offsetting influences such as the weaker starting point for CPI and more subdued food prices. However, the MPC said that the full impact of the April indirect tax hikes (VAT, sugar and excise) may only materialize gradually over the coming months.**
- **Absa's forecasts for headline and core CPI inflation remain somewhat higher than the MPC's, in part because we have a more depreciated exchange rate forecast, but our qualitative assessment of the narrative around inflation is otherwise pretty much identical.**
- **The Quarterly Projection Model now sees four 25bp rate hikes over the forecast horizon to 2020, but does not show CPI breaching the target. Therefore, we still think the SARB is likely to leave the repo rate unchanged for some time. We now forecast the first move to be a 25bp hike in September 2019, assuming no big blowout in the currency.**

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Decision to leave the repo rate unchanged was broadly expected, but the unanimous vote hints at a more cautious MPC going forward

The SARB Monetary Policy Committee (MPC) today voted unanimously to keep the repo rate on hold at 6.50%. This was in line with our expectation and the unanimous consensus of the other 24 economists surveyed by Reuters, and stands in marked contrast to the March MPC vote with a 4:3 split in favour of a cut. Not only did the MPC publish a slightly more elevated profile for the forecast path of inflation this time around, but it also said that since the March meeting, the balance of risks to the outlook had clearly shifted to the upside, mainly due to global developments. The fact that the vote was unanimous this time around certainly signals a more cautious MPC, but we think it is probably incorrect to describe it as having turned hawkish, since it clearly opined at the end of the statement that "there is still evidence of slack in the economy, and demand pressures are not assessed to pose a risk to the inflation outlook".

Slightly higher inflation forecasts, especially for core CPI

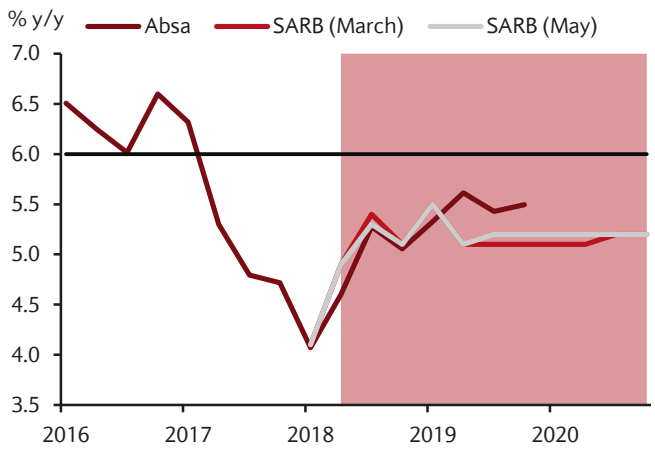
The MPC described its headline CPI inflation forecast as "more or less unchanged" since the previous MPC, despite some big changes in the underlying drivers. But in fact it did make a slight upward adjustment to its forecasts. Headline CPI inflation is now expected to run a tenth of a point higher from mid-2018 to mid-2019, compared to the previous MPC in March (Figure 1). And the MPC has lifted its forecast for core CPI inflation by two tenths of a point for most of 2019 and 2020, such that core CPI inflation is now projected to average 5.1% in each of those two years (Figure 2). Both headline and core CPI are projected to peak at 5.5% y/y and 5.2% respectively in Q1 19 due principally to the low base in the first quarter this year, before the VAT kicked in. With core CPI arguably providing a better measure of underlying inflation than headline CPI (which is oft buffeted by supply shocks to food and fuel prices), the fact that the SARB's own projections of core have popped back up above 5% with no projected downtrend over the forecast horizon is significant, in our view.

The MPC's observations on the VAT hike are interesting; it thinks there has only been partial pass-through in April

We also note that both headline and core CPI are projected to track pretty much sideways from Q2 19 onwards, even though some favourable base effects would be likely to manifest as this year's sizeable VAT and big excise duty hiked drop out of the annual calculation – assuming that all other things were equal. Thus, we are inclined to argue that upward momentum in the inflation path is masked to some extent by future favourable base effects from indirect taxes. Interestingly, the SARB said that the April inflation outcome in which headline CPI rose 0.7 percentage points to 4.5% was in line with its expectations and reflected only a "relatively moderate pass-through from the higher VAT and sugar tax". It said the full impact may manifest only over the coming months. (See *South Africa CPI: Tax-driven jump in line with expectations* 23 May for our analysis on the April CPI release.)

FIGURE 1

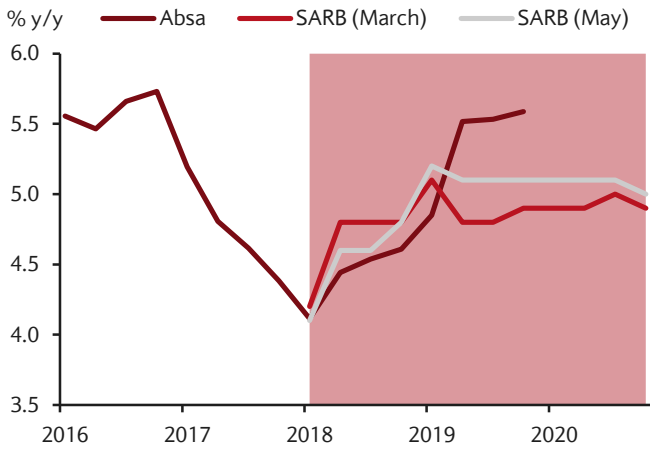
Headline CPI to remain below upper target band of 6%



Source: SARB, Absa Research

FIGURE 2

MPC lifted core CPI forecasts, but Absa's are still higher



Source: SARB, Absa Research

Big changes in some of the underlying assumptions, particularly oil prices and the exchange rate

Absa's forecasts for inflation remain higher than the SARBs but we have a more depreciated exchange rate (Figure 3). The MPC argued that the limited degree of forecast change compared to the last MPC meeting in March, reflected the countervailing influences of the changed assumptions. In particular, it argued that a notably higher oil price assumption ($70/bbl in 2018 and $67/bbl in 2019, up $7 and $5 respectively) and weaker starting point for the ZAR 12.97/USD versus 11.97 previously) were offset in the forecast by more subdued food price projections of 4.9% this year and 5.5% in 2019 and a lower starting point for the CPI.

FIGURE 3

Oil price assumptions lifted and output gap closes quicker under faster projected growth for 2019

	Assumptions						Model output								
	Brent (USD/bbl)			Potential growth, %			Real GDP growth, %			Output gap, % of GDP			NEER		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
SARB (May)	70	67	67	1.3	1.3	1.4	1.7	1.7	2.0	-0.7	-0.4	0.1	4.4	-3.3	-3.5
SARB (March)	63	62	62	1.3	1.3	1.4	1.7	1.5	2.0	-0.8	-0.6	0.0	7.5	-4.1	-4.3
Absa*	65	65	64	1.4	1.6	1.9	1.7	2.0	2.3	0.0	0.3	0.7	4.7	-6.1	-8.6

* From Absa's macroeconomic model run for *South African Quarterly Perspectives Q2 18: New leadership sets fresh course*, 30 March 2018
Source: SARB, Absa Research

The MPC appears sanguine on the growth outlook

The SARB MPC acknowledged that first quarter GDP print could be negative. (We forecast -1.3% q/q saar when the data are released on 5 June. (See *South Africa: Retail sales – flat in March but sharply down in Q1*, 16 May 2018 for more details). The SARB described the growth outlook as still challenging, but notes that the business cycle indicator "confirms the upward momentum in the economy" and that "the growth outlook is underpinned by strong recoveries in both business and consumer confidence". Interestingly, it said that it expected household consumption "to be the main driver of growth going forward, and the likely trend over the forecast period is stronger than previously expected". This is interesting, since it is still entirely unclear how household spending will respond to paying more taxes, either through VAT or enhanced compliance efforts on PIT. Notably, the MPC has revised upward its growth forecast for 2019, from 1.5% to 1.7%, which serves to narrow the forecast output gap more quickly than before (since assumptions about potential GDP growth were left unchanged.)

MPC now sees balance of risks as lying firmly to the upside.

One notable feature of this MPC was its changed assessment of the balance of risks to the inflation forecast, which it now sees as lying firmly to the upside. The MPC said that "the global economic backdrop has become more challenging" and that there are signs that global growth momentum is slowing. It noted the big depreciation of the ZAR since the last MCP, and pointed to US economic dynamics – risking fiscal deficits, higher inflation expectations, and a US 10-year Treasuries rising above 3.0% – as causing capital outflows in a number of emerging markets.; in the Q&A session, Governor Kganyago downplayed the risk of another taper tantrum type event, saying that the US Federal Reserve is communicating much more effectively this time around. The MPC also saw some further upside risk in its already elevated oil price assumptions. As regards domestic inflationary risks, the MPC noted the deterioration in the terms of trade was potentially putting pressure on the exchange rate, and also (later in the statement) said that sticky nominal average wage growth (which it saw as averaging around 7% over the forecast period) was generating persistent upward cost-push pressure on inflation. It also saw potential upside risk from the National Energy Regulator of South Africa's adjudication on electricity tariff hikes in June. In a further indication that one cannot really characterize this more cautious MPC as exactly hawkish, it said that the identified risks are supply-side shocks, and the MPC tried to look through the first round effects of such shocks, to react only to the second-

round effects. Here it said it would watch closely the evolution of inflation expectations and wage settlements.

We still think the SARB will leave the repo rate unchanged for some time, but now expect its next move to be a 25bp hike in September 2019

All in all, we see nothing in today's MPC announcement to alter our view that the SARB will leave the repo unchanged at 6.50% for the remainder of this year and well into 2019. However, with the projected output gap now turning positive in 2020, and with the Quarterly Projection Model now embedding four 25bp rate hikes (one each approximately in mid-2018, mid 2019 and two in 2020) versus three (at a more attenuated pace in the March MPC run, we have pulled forward our first rate hike from early 2020 previously to September 2019 – assuming of course no big exchange rate shocks before then. We are leaving the second rate hike in place in early 2020 (January specifically), thereby taking the repo rate back to 7.00%, which we view as more or less the neutral rate given inflation likely to track between 5.0 and 5.5%.

The evolution of monetary policy statements

FIGURE 4

The MPC's comments in previous meetings

	January 2018 MPC	March 2018 MPC	May 2018 MPC
Real economy	GDP growth forecast for 2017: 0.9% (+0.2pp); 2018: 1.4% (+0.2pp) and 2019: 1.6% (+0.1pp)	GDP growth forecast for 2018: 1.7% (+0.3pp); 2019: 1.5% (-0.1pp) and 2020: 2.0%	GDP growth forecast for 2018 unchanged at 1.5%; 2019 at 1.7% (+0.2pp); 2020 unchanged at 2.0%.
Global environment	Global growth outlook remains positive and relatively synchronised although uneven across regions.	Global economic outlook is still favourable amid upswing in advanced economies but risks and vulnerabilities remain.	Global economic backdrop has become more challenging amid US/China trade tensions. There are also signs that momentum in advanced economies is slowing.
Inflation outlook	Headline inflation 2017: 5.3% (unchanged); 2018: 4.9% (-0.3pp) and 2019: 5.4% (-0.1pp). Lowe point is expected to be in Q1 18 at 4.4% (-0.3pp lower).	Headline CPI inflation 2018: 4.9% (unchanged); 2019: 5.2% (-0.2pp); and 2020: 5.1%. A peak of 5.5% is projected in Q1 19. Core CPI for 2018: 4.6% (unchanged); 2019: 4.9 (-0.2pp) and 2020: 4.9%	Headline inflation 2018: 4.9% (unchanged); 2019: 5.2% (unchanged); 2020: 5.2% (+0.1pp). Peak seen at 5.5% in Q1 2019. Core forecast for 2018 down 0.1pp to 4.5% but 2019 and 2020 higher by 0.2pp to 5.1% for both years.
Inflation risks	Risks are assessed to be to the upside but the degree of upside has moderated.	Risks to the inflation outlook assessed to be more or less balanced.	Risks to the inflation forecast are assessed to be the upside.
Inflation expectations	Inflation expectations as reflected in the BER survey have declined marginally but remain close to the upper end of the target range.	Survey-based inflation expectations are at a multi-year low having declined across all groups. Five-year expectations declined to 5.3%, the lowest since 2011.	Inflation expectations of market analysis moderated slightly. Break-even inflation expectations are volatile and have increased recently.
Wages	Wage pressures are expected to continue contributing to inflation persistence.	Nominal wage growth appears to be moderating but upside pressure on inflation is expected to persist.	Nominal average wage growth is expected to be sticky around 7.0% with persistent upward pressure on inflation.
Rand	The rand has responded strongly to the outcome of the ANC elective conference. The implied starting point for the rand in the QPM is 12.90/USD.	The rand has sustained its recent gains from last year and some key risks to the outlook have dissipated. Implied starting point in QPM is 11.97/USD.	The rand has depreciated significantly since the last MPC meeting due to US developments. The implied starting point in the QPM is 12.37/USD.
Tone of statement	Neutral	Dovish	Cautious
Voting patterns	5 in favour of no change; 1 in favour of a 25bp cut	4 in favour of a 25bp cut; 3 in favour of no change.	Unanimous
Decision	No change.	25bp cut.	Unchanged

Source: SARB, Absa Research

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