Fundamentals

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Macroeconomic update | South Africa

Minding the US Fed's dot plot

IN BRIEF

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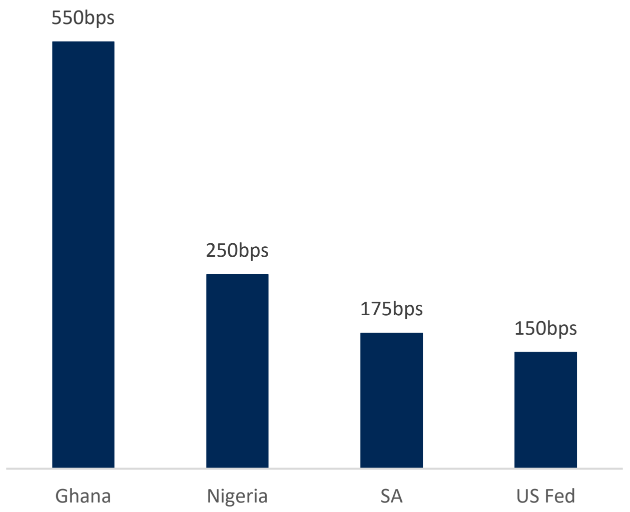
- The world's central bankers are unleashing the most aggressive tightening of monetary policy in decades to cool off surging inflation, and in the scheme of things, policy actions by the United States (US) Federal Reserve Bank (Fed) matter.
- A more aggressive US Fed has prompted the South African Reserve Bank (SARB) to up its ante by delivering a jaw-dropping 75 basis points (bps) hike in sympathy with the US Fed, and to quell rising domestic inflation expectations.
- Just like in most emerging markets, inflation remains a hot topic for debate in South Africa (SA) and the SARB is cognisant of these inflation risks.
- Therefore, should inflation continue to surprise strongly on the upside the SARB will respond as it cannot afford to fall behind the tightening curve.
- In paying attention to the risk of capital reversals from a hawkish US Fed, there is a growing risk that the SARB will continue to tail the bold moves from the US Fed.
- And in the words of Warren Buffet – an American investor -, interest rates are to asset prices what gravity is to the apple.
- When interest rates are low, there is a very low gravitational pull on asset prices. But when they are high, there will be a huge gravitational pull on asset values (i.e. international capital market shock).

As it tries to rein in resurgent inflation, the South African Reserve Bank (SARB) intensified its hawkish stance and pushed its main lending rate up sharply by 75 basis points (bps) to 5.5%. The three-quarter percentage point increase is the bank's biggest in two decades, and its fifth consecutive hike since this hiking cycle started in November 2021. To date, the bank has increased its repo rate by a cumulative 175bps since this cycle started.

Degree of monetary tightening since November 2021



Source: Bloomberg

Further monetary tightening by the SARB will continue to be targeted at anchoring inflation expectations and keeping up with the global wave of monetary tightening, to limit the Rand blowout and financial market instability.

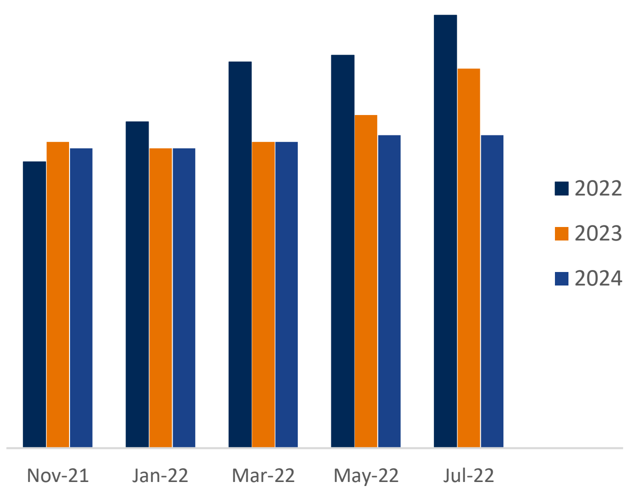
Watchful for inflation risks

If South Africa's (SA) headline inflation continues to head northwards, the SARB is likely to act more decisively to nip soaring inflation and inflation expectations in the bud - sooner rather than later - to avoid a bigger inflation blowout that could necessitate bolder, growth-derailing policy action down the line.

SA is not isolated from the rest of the world, and it has not bucked the trend of upside inflation surprises emanating from food and energy prices. In June, SA's headline inflation reached a 13-year high of 7.4% y/y stoked by high food and gasoline costs, even as the government temporarily reduced a fuel levy to keep increases in the price of petrol and diesel in check. The accelerated consumer price growth also plunged the country's real interest rate to its lowest in almost a quarter-century – necessitating the prompt monetary response.

Inflation risks are likely to persist in SA's near to the medium-term horizon, on the back of geopolitical tensions, the current domestic wage demands that will increase unit labour costs, the phasing in of the full fuel levy in July and August, effects of the floods in KwaZulu-Natal, load-shedding, and further Rand weakness in the face of a stronger Dollar. To reflect these risks, the SARB increased its inflation projections from 5.9% for 2022 to 6.5%, and for 2023 they now have 5.7%, from a previous forecast of 5%.

Evolution of the SARB's inflation projections



Source: South African Reserve Bank

Inflation expectations – which tend to be stickier than supply-driven inflation - have already been de-anchored from the monetary policy committee's (MPC) preferred mid-point target of 4.5% and policymakers are likely to remain concerned.

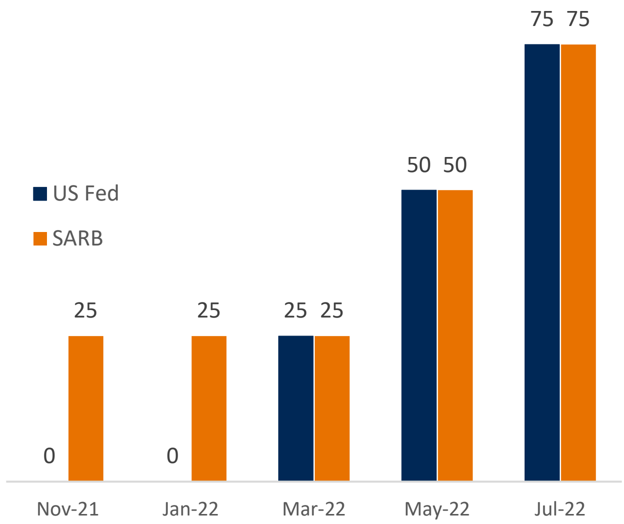
More strikes are afoot

The risk of a less transitory rise in inflation, inflation expectations drifting higher, and the more aggressive policy tightening in advanced markets, should result in the SARB further frontloading interest rate hikes as it tries to get ahead of elevated inflation and inflation expectations. With the 75bps inflation-busting hike – and confirmation that a 100bps hike was on the table -, the SARB has given the strongest indication yet that it will continue to raise interest rates until price stability has been restored in the country.

Although the five-member committee voted unanimously for a hike in the repo rate, three members favoured the 75bps increase, one wanted 100bps and the last member preferred a 50bps hike. A weaker Rand that is likely to fuel imported inflation and expectations of a 75bps rate hike by the United States (US) Federal Reserve Bank (Fed) this month may mount pressure on the SARB to tighten even faster in the coming months.

Consumers and borrowers should, therefore, be aware that there will be quite a bit more tightening in the cycle in the coming months, as we expect consumer price pressures to persist for several months. Price stability is sacrosanct to the SARB, and it is likely to tail the US Fed's policy moves to avoid a significant narrowing of the interest rate differential between SA and its key trading partners.

US Fed vs SARB rate hikes (bps)



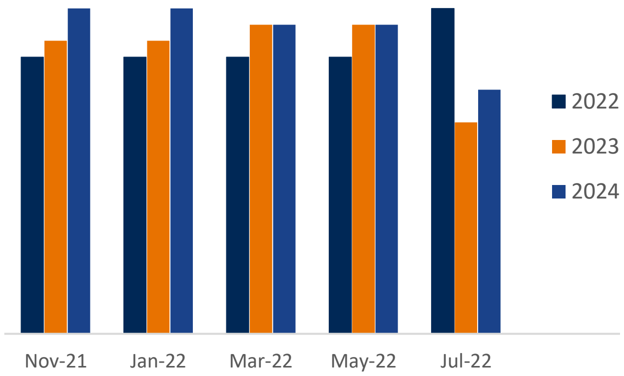
Source: US Federal Reserve Bank; South African Reserve Bank

Rate hikes may not inhibit economic growth

The SARB's recent repo rate hikes do not imply insensitivity to economic growth, and may not necessarily truncate SA's growth trajectory. While it is believed that dealing with inflation quickly will have a crushing impact on the economy, the transmission of rate hikes to economic growth is usually not immediate, but more medium-term (usually 12-24 months) as the financial impact percolates through economic agents.

In the face of the global inflation resurgence, the SARB has been less aggressive in its fight than some of its African peers. This leaves room for some underlying short-term growth trends to thrive, while long-term growth trends face downside risks from factors that are not within the ambit of the central bank's control. As a result, the SARB revised upwards its 2022 economic growth forecast to 2.0% from 1.7% previously but lowered its growth forecasts for 2023 and 2024.

Evolution of the SARB's GDP growth projections



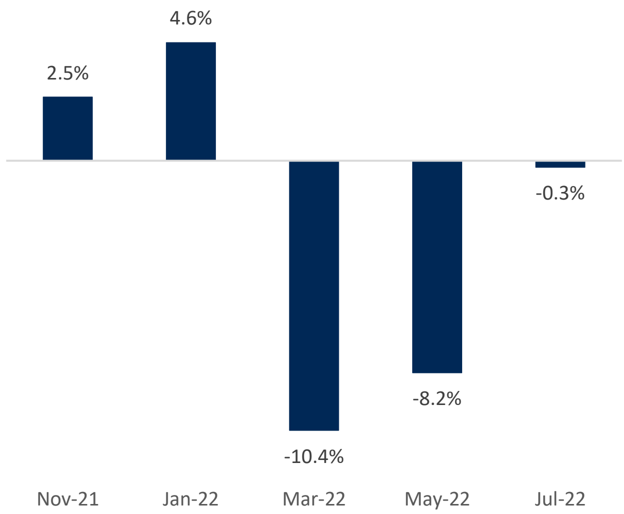
Source: South African Reserve Bank

Heightened downside risks to economic growth include the flood damage in KwaZulu-Natal (the province that is the second-biggest contributor to SA's GDP), more frequent power blackouts, and the slowdown in economies of key trading partners as fears of a global recession continues to build up.

No Rand quick fix

The SARB's in-step increases may not do much to prevent further deterioration of the Rand against the US Dollar. Despite hikes in the repo rate at the March and May MPC meetings, the Rand remained pressured up until the next meetings (i.e. May and July meetings respectively) as the US Dollar strengthened.

Rand performance post-MPC



Source: Bloomberg

The US Dollar has been gaining considerable momentum against most other currencies – especially emerging market currencies - as the US Fed has accelerated its pace of monetary tightening. Aggressive monetary tightening by the US Fed and fears of a global recession will continue to send investors scurrying to safer assets such as the Dollar, piling further pressure on emerging assets like the Rand and Rand-denominated assets.

Conclusion

In SA economic and financial conditions were expected to remain more volatile for the foreseeable future. With inflation risks on the horizon, SA businesses and consumers should brace up as there are more interest rate hikes to come in the months ahead. The overall risks to the medium-term growth outlook are to the downside, while the risks to the inflation outlook are assessed to the upside. However, guiding inflation back towards the mid-point of the target band (3% - 6%) can reduce the economic costs of high inflation and enable lower interest rates in the future.

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