FUNDAMENTALS

SOUTH AFRICA MPC UPDATE: WHEN JUDGMENT REIGNS SUPREME

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Economist
Churchill Ogutu
+254 711 796 739
churchill.ogutu@ic.africa

IN BRIEF

- The South African Reserve Bank (SARB) raised the repo rate by 50bps, higher-than-market consensus of 25bps, in its March MPC meeting. This brings the policy rate to 7.75%.

- The SARB pushed back against the market's characterization of the rate hike as an insurance premium; the idea that the rate hike will give the central bank much wiggle room for future deep cut(s). Amidst a banking sector turmoil that is threatening to destabilize the financial sector, the SARB reiterated its price stability mandate as its overriding consideration.

- It also downplayed concerns that recent banking turmoil roiling developed markets will have a direct impact in the domestic market. For one, the central bank waved off 'financial dominance' considerations in its policy discussions.

- It was clear that judgment was critical in the latest rate decision. With terminal rate (2025 neutral interest rate: 7.00%) from its Quarterly Projection Model (QPM) lower than the current policy rate, the statement admitted that its monetary policy stance is "now less accommodative".

- Amidst a less-desirable inflation outlook and a pivot to a sluggish growth environment, perhaps a case is to be made that the SARB would have taken a more benign policy response. We thus believe that the SARB would like to fortify its credibility as an inflation-fighting central bank.

- The central bank estimates the FX pass-through at 0.13, partly reflecting the broad-based currency weakness of South Africa's trading partners. Although the current account balance has flipped into negative territory, our assessment is that the risk of external financing pressure is moderate. Nonetheless, as ZAR is relatively tradeable compared to its African peers, swings in investor sentiment resulting in portfolio outflows will continue to pose a major risk to the currency.

Pushback against insurance premium

The South African Reserve Bank (SARB) raised the repo rate by 50bps, higher-than-market consensus of 25bps, in its March MPC meeting. This brings the policy rate to 7.75%. The SARB pushed back against the market's characterization of the rate hike as an insurance premium; the idea that the rate hike will give the central bank much wiggle room for future deep cut(s). Amidst a banking sector turmoil that is threatening to destabilize the financial sector, the SARB reiterated its price stability mandate as its overriding consideration. For a central bank that was ahead of the tightening cycle compared to peers and has delivered a cumulative 425bps (since November 2021), the SARB's credibility remains intact.

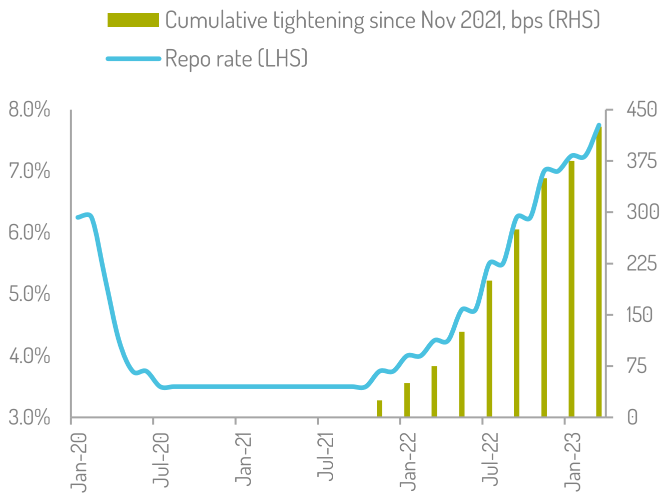
Tightening backdrop meets market expectations...

With inflation posing a major risk on global economies, there seems to be a synchronized rate tightening amongst central banks globally. Against this backdrop, the SARB's rate hike decision is not an exception but the norm. The in-sync inflation-fighting across the globe has been priced in the market, with the occasional volatility offering bouts of discomfort. The idea that shocks come in a sequential manner has been debunked with the multiple shocks that have played out in the last three years. Therefore, although the reaction function has been predictable, there has been a bifurcation between market expectation and central bank action. Ahead of the MPC meeting, market expectations had priced in a 25bps rate hike with South Africa's 5-year breakeven inflation at 5.27%.

...with SARB downplaying direct spillover from the banking turmoil

The SARB downplayed concerns that recent banking turmoil roiling developed markets will have a direct impact in the domestic market. For one, the central bank waved off 'financial dominance' considerations in its policy discussions. South African banks are largely concentrated and with the nature of Emerging Markets (EMs), are more calibrated to absorb interest rate risk. From this perspective, the SARB was more agnostic of the ongoing financial sector instability and its direct impact on domestic inflation. Nonetheless, the SARB statement concluded with "will continue to closely monitor funding markets for stress". We interpret this to mean that a continued tightness of financial conditions in developed markets may introduce some level of vulnerability for EM assets. We opine that this indirect transmission channel will carry some degree of weight in future MPC risk assessments.

REPO RATE



SOURCE: SOUTH AFRICAN RESERVE BANK

Where judgment overrides the QPM output, while risk premium is elevated

It was clear that judgment was critical in the latest rate decision. With terminal rate (2025 neutral interest rate: 7.00%) from its Quarterly Projection Model (QPM) lower than the current policy rate, the statement admitted that its monetary policy stance is "now less accommodative". Notably, while the model is overweight historical data inputs, the SARB has been nimble by incorporating recent structural developments as part of its rate decision making process. Against a backdrop of multiple shocks and a high degree of uncertainty, the SARB is somewhat letting loose of its data-dependence preference in this regard.

Risk premium is likely elevated; bolstered by anemic growth outlook and the continued load-shedding. The SARB lowered its 2023 growth projection to 0.2%: down from 0.3% at its January MPC meeting. The bi-monthly MPC meetings mean some higher level of fluidity and hence more frequent adjustments on its forecasts. In that sense, although the latest 2023 output gap estimate appears to have closed, this has primarily been on a more subdued potential growth estimate.

Load shedding has been a drag to potential growth and contributed to the elevated risk premium. Notwithstanding the fact that the SARB's guestimate of 0.5% as the contribution of load-shedding to 2023 inflation forecast, primarily via the food basket, we have the sense that there is some uncertainty of quantifying the load-shedding impact on inflation. Nonetheless, the apex bank has penciled in 250 and 150 days as the number of expected load-shedding days in 2023 and 2024, respectively.

High risks on inflation outlook

Inflation expectations remain de-anchored, telegraphed by the Bureau of Economic Research (BER) Survey released ahead of the MPC meeting. Survey respondents expect inflation at 6.3% in 2023; above the policymakers' preferred 4.5% mid-point target. The 1-year inflation expectations for households, that typically bear the brunt of eroded purchasing power, was not surprisingly higher than for businesses and trade unions. The recently agreed 7.5% wage hike by the public sector will reinforce the higher inflationary psychology going forward. With revenue overruns likely to ease in FY24 as commodity prices retraces, we see upward inflationary pressure with the implementation of the public sector wage bill. The silver lining is the reduced persistence of food inflation, bolstered by potential high harvest and lower fertilizer costs.

Amidst a less-desirable inflation outlook and a pivot to a sluggish growth environment, perhaps a case is to be made that the SARB would have taken a more benign policy response. We thus believe that the SARB would like to fortify its credibility as an inflation-fighting central bank. Undeniably, these policy actions have been felt by the most vulnerable households, but the intent seems to be to trigger a sharper behavioural adjustment that eventually tames inflation expectations. That said, the policy transmission channel is estimated at 12-18 months, and the combined 425bps rate hikes in this cycle may filter through the economy from 2H2023.

INFLATION

SOURCE: STATISTICS SOUTH AFRICA, SARB

External considerations at play too

The central bank estimates the FX pass-through at 0.13, partly reflecting the broad-based currency weakness of South Africa's trading partners. With the US Federal Reserve almost at the peak of its current tightening cycle, we believe that Emerging Market currencies will face less broad-based weakness, barring the occasional idiosyncratic factors. For South Africa, weakening terms of trade, structural fiscal woes and anemic growth concerns are the idiosyncratic risk factors that we flag. The current account balance swung back to deficit territory in 4Q2022 (-2.6%), bringing 2022 current account deficit to a modest 0.5% of GDP. The SARB has penciled in -2.4% and -2.7% current account deficit for 2023 and 2024, respectively. From a funding perspective (of the current account), our assessment is that the risk is moderate. In FY24, the National Treasury plans to raise USD 2.6bn in concessional foreign financing from international financing institutions. However, as ZAR is relatively tradeable compared to its African peers, swings in investor sentiment resulting in portfolio outflows will continue to pose a major risk to the currency.

ZAR

SOURCE: BLOOMBERG

For more information contact your IC representative

Business development & client relations

Derrick Mensah
Head, Business Development
+233 24 415 5765
derrick.mensah@ic.africa

Dora Youri
Head, Wealth Management
+233 23 355 5366
dora.youri@ic.africa

Kelvin Quartey
Analyst, Business Development
+233 57 604 2802
kelvin.quartey@ic.africa

Corporate Access

Joanita Hotor
Corporate access
+233 50 137 6100
Joanita.hotor@ic.africa

Insights

Courage Kingsley Martey
Head, Insights
+233 240 970 832
courage.martey@ic.africa

Churchill Ogutu
Economist
+254 711 796 739
churchill.ogutu@ic.africa

Lydia Adzobu
Senior Analyst, Financial sector
+233 24 656 8669
Lydia.adzobu@ic.africa

Investing

Isaac Adomako Boamah
Chief Investment Officer
030 225 2623
isaac.boamah@ic.africa

Obed Odenteh
Portfolio Manager, Fixed Income
+233 54 707 3464
obed.odenteh@ic.africa

Timothy Schandorf
Portfolio Manager, Risk Assets
+233 24 292 2154
Timothy.schandorf@ic.africa

Herbert Dankyi
Analyst, Rates
+233 55 710 6971
herbert.dankyi@ic.africa

Clevert Boateng
Analyst, Consumer, Technology,
Media & Telecommunication
+233 24 789 0452
clevert.boateng@ic.africa

Operations

Nana Amoa Ofori
Chief Operating Officer
+233 24 220 6265
nanaamoa.ofori@ic.africa

Emmanuel Amoah
Fund Administrator
+233 20 847 2245
emmanuel.amoah@ic.africa

Kelly Addai
Fund Accountant
+233 20 812 0994
kelly.addai@ic.africa

Trading

Randy Ackah-Mensah
Head, Global Markets
+233 24 332 6661
randy.amensah@ic.africa

Allen Anang
Equities,Trader
+233 54 084 8441
allen.anang@ic.africa

Isaac Avedzidah
Trader, Fixed Income
+233 24 507 7382
isaac.avedzidah@ic.africa