FUNDAMENTALS

SOUTH AFRICA MPC UPDATE: NOT RESTING ON LAURELS

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IN BRIEF

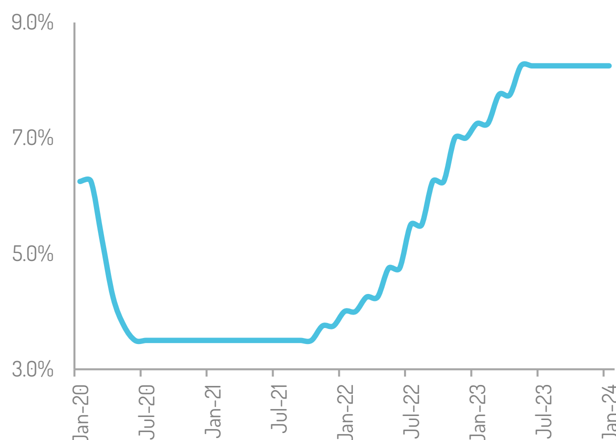
- In line with consensus expectations, the South Africa Reserve Bank (SARB) held the repo rate at 8.25% in its January 2024 Monetary Policy Committee meeting. Against the backdrop of disinflation through 4Q2023, the policymakers seemingly erred on the side of caution on fears of upside risks to inflation.
- With the US Federal Reserve expected to pause in this week's Federal Open Market Committee (FOMC), the tea leaves off the meeting will dwell on the timing of rate cut(s) this year. With SA real policy rate of 3.15% above its steady rate target of 2.5%, we see room for 75bps policy easing in 2H2024 with the repo rate ending the year at 7.5%.
- The policymakers reiterated state-dependency over time-dependency, with emphasis on the headline print at 4.5%. Whereas inflation cooled to 5.1% in December 2023, pulled lower by transport sub-index, there is lingering upside risks to the inflation outlook.
- In our view, the expected widening of the current account balance to -4.0% of GDP in 2026 is not reflective of an upswing in domestic demand. Amidst moderating commodity prices, South Africa's trade balance has remained resilient touching 2.7% of GDP in 3Q2023. We flag risks in the non-trade balance and that has been the drag to current account balance.
- The SARB confirmed that talks are ongoing with the National Treasury regarding possible profit transfer from the apex bank's Gold and Foreign Exchange Contingency Reserve Account (GFECRA). Aligned with the consensus, we think that the upcoming FY25 budget reading in late February 2024 will provide guidance on GFECRA treatment without winding down the FX reserves. We think that a partial profit transfer would be the path of least resistance, as opposed to the full transfer of GFECRA to the National Treasury.

Hawkish pause to anchor inflation back to trend

In line with consensus expectations, the South Africa Reserve Bank (SARB) held the repo rate at 8.25% in its January 2024 Monetary Policy Committee meeting. Against the backdrop of disinflation through 4Q2023, the policymakers seemingly erred on the side of caution on fears of upside risks to inflation. With Deputy Governor Kuben Naidoo proceeding on garden leave, the appointment of Mr. David Fowkes as a committee member buttressed the 5-member MPC's unanimous vote. The sense we have is that the timeline is open-ended for the replacement of the third Deputy Governor, which may take the Committee membership to six, but we think this scenario will open the door for a potential seventh appointee.

The Governor stuck to his hawkish rhetoric in the press conference after the policy decision, reiterating the path towards the mid-point headline inflation target of 4.5% (December 2023: 5.1%) needs to be in a sustainable manner. With central banks in developed markets expected to be at the driving seat in the upcoming easing cycle, we are of the view that the SARB will follow suit. With the US Federal Reserve expected to pause in this week's Federal Open Market Committee (FOMC), the tea leaves off the meeting will dwell on the timing of rate cut(s) this year. With SA real policy rate of 3.15% above its steady rate target of 2.5%, we see room for 75bps policy easing in 2H2024 with the repo rate ending the year at 7.5%.

REPO RATE



SOURCE: SOUTH AFRICA RESERVE BANK

Lingering near-term risks; but disinflation is on course over the long-haul

The policymakers reiterated state-dependency over time-dependency, with emphasis on the headline print at 4.5%. Whereas inflation cooled to 5.1% in December 2023, pulled lower by transport sub-index, there is lingering upside risks to the inflation outlook. The ongoing geopolitical tensions in the Middle East and the Red Sea are the main contributor to elevated inflationary expectations. To be exact, the latest Bureau of Economic Research has penciled in inflation expectations of 5.7% and 5.6% in 2024 and 2025, respectively, and above the SARB's inflation projections. In our view, the elevated inflationary expectations also fueled the higher outlook of average salary growth and unit labour costs over the next 24 months.

Reassuringly, the SARB faded El Nino risk effect on food inflation, and we are aligned with the SARB's projection of 5.7% and 4.2% for 2024 and 2025, respectively. The brent crude price assumptions baked in the next two years are an offsetting factor despite our expectations that other components of retail fuel prices will budge higher. As such, we see limited scope of second round effect with core inflation expected to stick at the mid-point level throughout this year, with some downside bias. From our assessment, we opine that the policymakers will monitor core inflation outturn as a leading indicator of headline print, strengthening our view of a looser policy stance at the back end of the year.

INFLATION TREND

SOURCE: STATS SA, BLOOMBERG

Subdued demand pressure; neutral output gap in outlier years

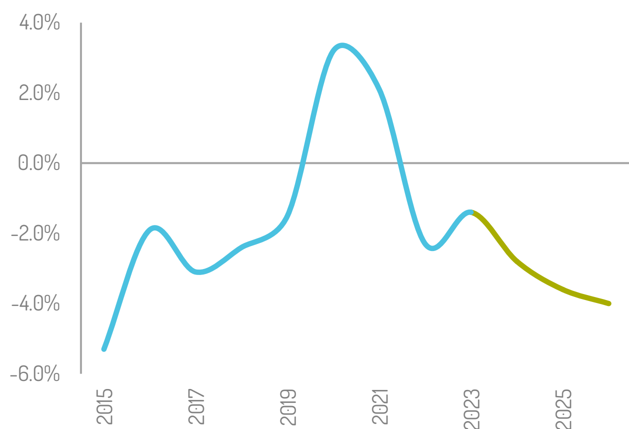
The neutral output gap in 2024 - 2026 cements our view of subdued demand pressure in the South African economy. However, the potential growth projections of 1.0% this year and 1.2% for 2025 and 2026, pencils in a more aggressive ironing out of the energy and logistics constraints that has mired the local economy. With our initial assessment of the Integrated Resource Plan 2023, we see execution risks around the plans to revive the energy sector. As such, we see both actual and potential growth

below trend levels. From a rear-view mirror, the SARB estimates a lower GDP print of 0.6% in 2023, from the previous 0.8% as at the November 2023 MPC meeting. This downward revision follows the 0.7% contraction print in the third quarter, although the policymakers have penciled in an improvement in the 4Q2023 print.

...while wider CA balance not suggestive of improving domestic demand

In our view, the expected widening of the current account balance to -4.0% of GDP in 2026 is not reflective of an upswing in domestic demand. Amidst moderating commodity prices, South Africa's trade balance has remained resilient touching 2.7% of GDP in 3Q2023. On anticipation of an ease in global oil price outturn, this should prolong the positive goods trade balance. We flag risks in the non-trade balance – Services, Income, and current transfer – that has been the drag to current account balance, hitting -3.0% of GDP as at the end of September 2023. Specifically, the higher for longer rate environment has proven the Achilles heel to the income component but net international reserves of USD 56.9bn is providing ample cushion. Nonetheless, the widening current account balance will dial up external financing needs in the near-term, more so as the logistics and energy constrained environment stifles foreign direct investments.

CURRENT ACCOUNT BALANCE TO GDP



SOURCE: SOUTH AFRICA RESERVE BANK

Revisiting GFECRA as an offset to rising external debt service costs

The SARB confirmed that talks are ongoing with the National Treasury regarding possible profit transfer from the apex bank's Gold and Foreign Exchange Contingency Reserve Account (GFECRA). This profit arose primarily from revaluation gains from FX Reserves, gold price adjustments, and forward exchange contracts, and which stood at ZAR 458.7bn (c. USD 24.4bn) at the end of FY23. Although Section 28 of SARB Act 90 of 1989 has explicit rules for the transfer of profit out of the GFECRA to the National Treasury, the rising debt servicing costs has cast a spotlight on the eventual profit transfer. In recent MPC meetings, the SARB has argued that crystallization of GFECRA profits will entail selling the underlying assets, mainly FX reserves, adding some downside risks on the external sector.

Aligned with the consensus, we think that the upcoming FY25 budget reading in late February 2024 will provide guidance on GFECRA treatment without winding down the FX reserves. We think that a partial profit transfer would be the path of least resistance, as opposed to the full transfer of GFECRA to the National Treasury. As a baseline, SARB is yet to pencil in the potential drawing down of GFECRA to offset external debt service costs in its Quarterly Projection Model (QPM) and near-term forecasts.

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