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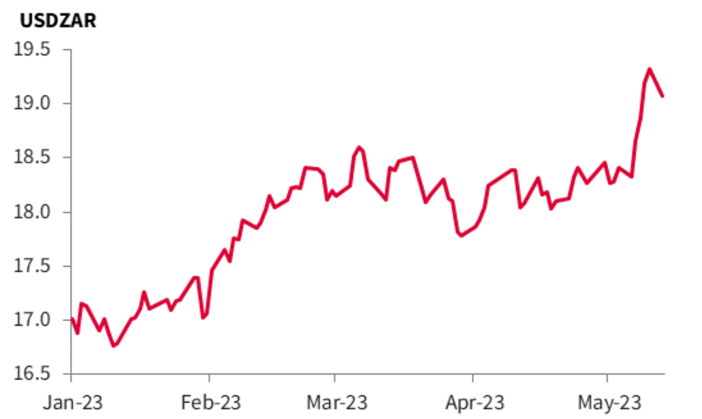
South Africa Monetary Policy

We now expect a 50bp hike at the May MPC meeting

We adjust our monetary policy view to pencil in a 50bp repo rate hike at the May MPC meeting from our previous expectation of a hold. In the *South Africa Q2 23 Quarterly Perspectives, which we published in early May,* we argued that the hiking cycle was likely done but acknowledged that the environment remained highly uncertain, with the exchange rate as one of the key risks to our rate view. The sudden sharp ~3% depreciation in the trade-weighted rand over the past week after a string of negative news headlines is a materialisation of that risk and we believe the SARB will need to respond to contain the associated inflation risks. We stress that uncertainty around our rate call is high given the ongoing currency volatility. The rand has partially rebounded into this week and a further rally could create risk of a 25bp hike instead of the 50bp that we expect. Beyond May, we expect the repo rate to remain on hold until March 2024, but we see risks of further rate hikes in the near-term if the exchange rate weakens further or CPI data surprise to the upside.

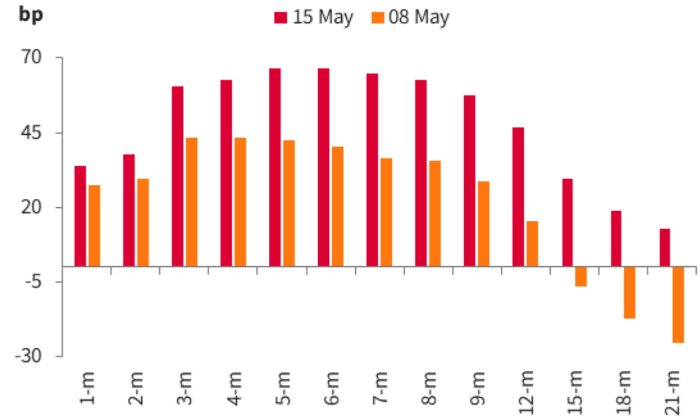
We now expect the SARB to hike the repo rate by 50bp at the May MPC meeting. In our recently published *South Africa Q2 23 Quarterly Perspectives – No growth without power* (2 May 2023), we argued that the SARB's hiking cycle was likely done after the 50bp hike in March. However, we acknowledged that the environment remained highly uncertain and that the risks were skewed towards more monetary policy tightening in the near-term. Since then, the rand has weakened significantly more than expected and this represents a strong materialisation of a key upside risk to interest rates that we flagged in our forecast write-up. The SARB stated clearly at the March MPC meeting and its recent Monetary Policy Forum that the priority for monetary policy currently is to bring inflation and inflation expectations down sooner rather than later. Governor Kganyago stressed that allowing inflation and inflation expectations to settle at higher levels will require a costlier policy adjustment in the future. Deputy Governor Naidoo also discussed the risks to monetary policy last week and was quoted by *Business Day* as having said that the exchange rate and load shedding were two risks that may result in the MPC taking 'further steps to bring inflation down'. Against this context, we believe that the SARB MPC will respond to the big FX weakening with more tightening. We stress however that there is a high degree of uncertainty around our expectation of the MPC's response given that the currency may remain highly volatile ahead of the rate decision on 25 May. Analyst consensus from the last Reuters Econometer poll is for the SARB to remain on hold but this survey was conducted before this recent bout of currency weakness.

Figure 1: The rand has weakened dramatically over the past week…



Source: Refinitiv, Absa Research

Figure 2: … resulting in market expectations of a strong SARB response



Source: Refinitiv, Absa Research

The sharp exchange rate depreciation is a strong upside risk to the inflation outlook. Earlier this year, the rand was already one of the weaker emerging market currencies, likely reflecting intensified load shedding and other idiosyncratic problems specific to South Africa, in our view. More recently, the pressure on the currency has intensified dramatically, after a string of negative news headlines that were initially about the ongoing electricity supply crisis with some government comments about the risk of a complete grid collapse, followed later by US allegations that South Africa had supplied arms to Russia. All told, the rand has come under significant pressure (Figure 1) over the last week, resulting in market re-pricing of the future path of interest rates (Figure 2). After closing at 18.33 against the USD on Friday 8 May, the rand weakened to an all-time low of 19.51 at some point on Friday 12 May. At the time of writing, the rand had pulled back to 19.06 against the USD. In trade weighted terms, this is a ~3% depreciation over the past week or so. The currency markets remain in flux, and it is still unclear where the exchange rate will settle, but nonetheless, such a big movement over such a short period of time is a sudden inflation shock with multiple channels and varying lags. The most immediate channel will be via fuel prices, which are adjusted monthly based on FX and international product price movements. Another important channel is food prices. South Africa's food inflation has surprised to the upside in recent months. A weaker exchange rate could generate further stickiness in food inflation despite lower global food prices and easing domestic prices for wheat and maize. The exchange rate movement could also be critical for inflation expectations, which have recently already moved close to the top end of the target range. Moreover, the recent rise in core goods inflation may also be hinting at a widening FX pass-through pressure. The ongoing load shedding crisis arguably also worsens the inflation risks of the exchange rate since production disruptions increase reliance on imported products.

Beyond May, we acknowledge risks of further monetary policy tightening. Amidst persistent multiple upside price shocks and higher than normal uncertainty about the future, the informational value of available data, as it emerges, will be more important than projections. Therefore, further exchange rate depreciation or evidence in the CPI data of further broadening in price pressures or ongoing stickiness in food inflation could result in further rate hikes. We still see the terminal nominal repo rate at 7.0%. Our baseline view is that the SARB will begin a gradual easing cycle from March 2024, delivering cumulative easing of 125bp and leaving the repo rate at 7.0% in late 2024. Even before the most recent above-expectations 50bp hike in March, consumers were already starting to feel the pressure, with signs of rising debt distress in as early as Q4 22. Another big interest rate hike at this stage could crush consumer spending, but at this stage, we believe the SARB will stick to its hawkish anti-inflation stance.

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