South Africa Watch

Monetary policy preview: Last hike to the top of the mountain

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SARB looks set to hike 25bp on 30 March

After the SARB debates a '0bp vs 25bp' move at the next MPC meeting, we expect a majority to vote for the hike. Voting has been tight – 3 to 2 in the last two MPC meetings. In January 2023, the debate was '25bp vs 50bp'. In November 2022, it was '50bp vs 75bp'. Given the upside surprise in February domestic inflation data, the Fed's 25bp hike on 22 March, and hikes across Europe, we would expect little appetite for keeping rates unchanged.

Could this mean we are at the end of the hiking cycle?

A hike by the SARB could potentially conclude the hiking cycle with a terminal rate of 7.5% – that is 400bp worth of hikes since November 2021. The last aggressive hiking cycle was 2006-08, with 500bp of hikes to deal with double-digit inflation.

Like Table Mountain, we see a flat top for rates this year

South Africa's Table Mountain is famous for its steep climb and flat top. And the SARB's hiking cycle has been akin to ascending this natural site: rates climbing and then plateauing for the rest of the year. We have to wait until 2024E for our descent with two 25bp cuts to move the policy rate back to 7%.

Domestic inflation – non-linear deceleration to continue

As February inflation data shows, deceleration is non-linear. We expect a continued slowdown in March and April, 6.6% year on year (yoy). Service inflation – particularly medical inflation – is still to come through in April when large medical insurers introduce annual cost-plus increases. Thereafter, we expect headline inflation to reach 6% at mid-year and 5% by year-end. The near-term risks to the inflation outlook relate to food prices, increased costs of loadshedding, higher services inflation, and global risks to ZAR.

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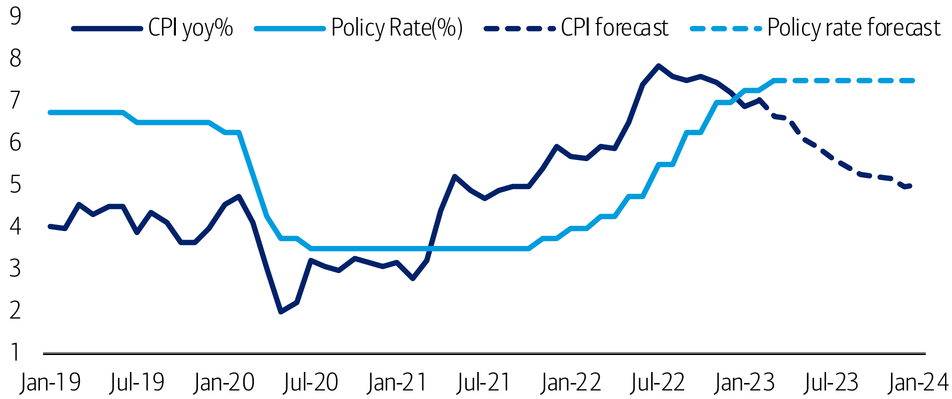
Monetary Policy Preview

SARB to hike 25bp?

Exhibit 1: Inflation and Monetary Policy History and Outlook
Last hike and likely flat for remainder of the year



Source: Haver, BofA Global Research

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February CPI print surprised, but downward trend remains

February headline CPI increased to 7% yoy from 6.9% in January, or 0.7% mom vs -0.1%. The 7% print was higher than BofA (6.9%) and consensus (6.8%). Core CPI rose to 5.2% from 4.9% in January, driven by food and services. No relief came from fuel prices as is usually the case when CPI decelerates. They increased by 0.9% mom and 10.9% yoy. Services inflation rose 0.8% mom and 4.6% yoy (4.3% in January), propelled largely by health services (mainly medical costs). Food inflation jumped 0.9% mom and 14% yoy (13.8% in January). Goods inflation was unchanged at 9.5% in February, while services inflation increased to 4.6% from 4.3%.

Upcoming CPI readings – at your service

Service inflation will continue to be a main driver of the next two prints – but for different reasons. In March, we expect the pace of service inflation to slow relative to growth in February of 0.8% mom. However, upside pressures could come from traditional education inflation in March, which is a worry. Administrative prices could also influence. Domestic fuel prices went up by about 4.5% in March, which will add to fuel CPI. Overall, headline CPI should moderate to 6.6%, thanks to more subdued services inflation. Core inflation looks set to fall to 5.1% from 5.2%, on our estimates.

However, in April, we think services inflation will shoot up again, even higher than February's 0.8% mom reading. Some major players in the medical and general insurance services industry delayed increases from February to April, but nevertheless will implement CPI-plus hikes. That should hurt the April CPI print, and keep it around 6.6%, on our estimates.

2023E CPI to average 5.9%, year-end 5%

We expect inflation to average 5.9%. We forecast inflation to remain above 6% until at least May 2023. By the end of the year, we forecast it to be around 5%. Food price increases should peak (14.4% yoy) in April then decelerate thereafter. However, they are likely to remain sticky averaging close to 13% in 2023. We expect transport CPI though to fall back into single digits, helping the moderation of fuel CPI on a year-on-year basis.

One more hike to go

Our interactions with the SARB indicate that two MPC members view the current monetary policy stance as slightly accommodative – the policy rate is now higher than inflation, but the neutral real interest rate is still lower than the desired 2.5%. Consequently, monetary policy could be neutral by end-2023 if inflation continues to decelerate to 5%-year end headline inflation with a policy rate of 7.5%. Over the medium term, monetary policy does not need to be restrictive as there is no demand-side problem to fix. To stop hiking, the SARB needs to see inflation on a sustainable downward trajectory.

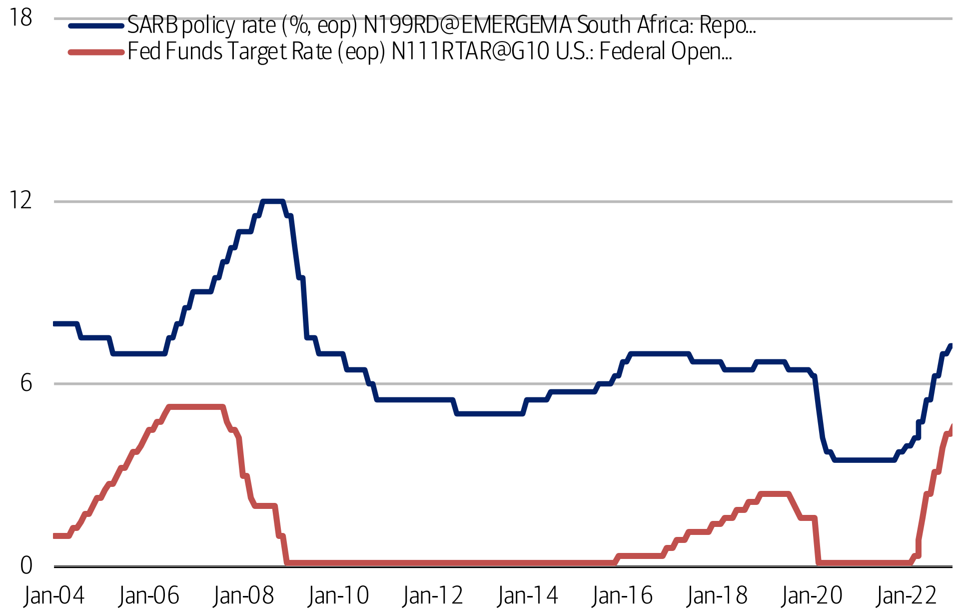
2.5% neutral real rate is the target

The SARB likes to anchor the neutral rate at a level 2.3-2.4% higher than inflation. With an inflation anchor point of 4.5%, nominal neutral rate tends to be 6.75-7%. This is on a forward-looking basis – inflation in 6-12 months' time. By the end of 2023, inflation is likely to be around 5%. Consequently, we think the SARB will likely maintain the policy rate at 7.5%, which will give it room to keep a neutral real rate of close to 2.5%.

Fed is turning dovish

The Fed raised the federal funds rate by 25bp to 4.75-5%. Credit conditions are tightening due to measures to contain a banking crisis, which could ultimately slow economic activity and inflation. Tighter credit standards can take the place of policy rate hikes. As a result, the Fed is likely to hike much less, depending on the effects of the tighter credit conditions on economic activity. Our US economics team now projects one more 25bp rate hike in May and no longer expects one in June, and a terminal rate in the range of 5.0-5.25%. Exhibit 2, below shows how SARB and Fed interest rate decisions have been moving together. A dovish Fed is good for rate pauses in the coming period.

Exhibit 2: Fed vs SARB policy rate changes
See the current cup?



Source: Haver

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Weaker USD in 2H 23 supports ZAR strength

We have a constructive view of the USD/ZAR at 16.5 by year-end 2023, driven principally by our expectation of USD weakness as the Fed stops hiking and pivots towards cutting in early 2024. A dovish Fed and global central banks generally support a weaker USD and favours EM currencies including the ZAR. Our US economics team believes the Fed will likely hike by 25bp one more time and use other tools to deal with the banking crisis, for a terminal rate of 5.0-5.25%. Our EUR/USD view in 2023 is for euro appreciation of close to 15%. We have moderated the gains for ZAR due to the gloomy domestic macro this year.

Still gloomy economic outlook

At the January MPC, the SARB revised down its 2023 economic growth forecast to 0.3%. We see downside risks to this forecast. At the time, 4Q 22 GDP was not yet released. Once it came out, it recorded a contraction of -1.3% qoq. We think 1Q 23 will likely follow a similar pattern (-0.5% qoq) as energy supply constraints in both quarters have been similar. This means a technical recession. We have a full year growth forecast of 0.1% in 2023, with downside risks, to be assessed in the South African winter season.

Exhibit 3: Economic Statistics table
Growth outlook is weakening

Summary Data	2019	2020	2021	2022E	2023F	2024F
Real GDP growth (% yoy)	0.3	-6.3	4.9	2.0	0.1	1.6
CPI inflation (% yoy, eop)	4.0	3.1	5.9	7.2	4.9	4.4
CPI inflation (% yoy, avg)	4.1	3.3	4.6	6.9	5.9	4.7
Nominal exchange rate (vs USD, eop)	14.0	14.7	15.9	17.5	16.5	17.0
Nominal exchange rate (vs USD, avg)	14.5	16.5	15.0	16.6	17.5	16.6
Central bank policy rate (%, eop)	6.5	3.5	3.8	7.0	7.5	7.0
Current account balance (% of GDP)	-2.6	2.0	3.7	-0.5	-1.3	-2.1
International reserves (US$ bn)	48.9	47.4	50.3	53.2	62.0	62.8
Central gov. primary budget balance (% of GDP)	-2.5	-5.7	-0.9	0.1	-0.5	-0.3
Central gov. budget balance (% of GDP)	-6.1	-9.9	-5.2	-4.5	-4.9	-4.6
Consolidated gov. primary budget balance (% of GDP)	-2.5	-5.7	-0.9	0.2	-0.5	-0.3
Gross government debt (% of GDP)	59.2	70.2	68.1	69.3	71.8	72.8

Source: BofA Global Research

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