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Forward-looking SARB backs its forecasts

By Arthur Kamp

30 Jan 2014

The general expectation was that the South African Reserve Bank (SARB) would hold interest rates steady. After all, domestic demand is soft, credit extension growth has been modest and the core inflation rate has been stable at 5.3% for the last four months of data up to December 2013.

South African Reserve Bank

After plugging a weaker rand into its models, the SARB's medium-term inflation forecast increased markedly (to an average of 6.3% and 6.0% for headline CPI in 2014 and 2015 respectively). The forecast is significantly above the consensus expectation. However, the forecast should be viewed as reasonable if the SARB does not expect material appreciation of the currency anytime soon. The rand's fall has been especially sharp and history suggests feed-through effects to inflation can be significant in such cases.

And, if a central bank with an inflation target of 3% to 6% shows an inflation forecast above the upper level of this range for an extended period (with assessed risk to the upside), it must consider raising its policy rate.

Great weight on its forecast

The question is whether the SARB should act in a pre-emptive fashion, or whether it should wait to see more evidence of feed-through from the weaker currency. I think the general expectation was the SARB would be inclined to be reactive, rather than pro-active. However, the Bank has placed great weight on its forecast and announced a 50bp hike in its policy rate.

The decision is a direct response to the expected impact on inflation from the weakness of the currency. The question now is: how will the currency react? If the rand remains relatively weak for an extended period, further interest rate increases could follow.

Generally, South Africa's currency fall against a backdrop of large twin deficits suggested South African policy was too loose. Arguably, it is fiscal policy that requires adjustment, but the onus has now fallen on the central bank to take the lead.

Ironically, in an era where it has become increasingly difficult to forecast, central banks are relying more on forecasts to conduct monetary policy, whether it is the US Federal Reserve relying on economic forecasts to give forward guidance on its policy rate, or whether it is the SARB relying on its judgment of feed-through effects from the currency into inflation.

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