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The South African Reserve Bank's subtle surprise no one saw coming

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At the January meeting of the Monetary Policy Committee (MPC), South Africa's repo rate was raised by another 25 basis points (bps) to 4.00%. This was fully priced in by the market beforehand and didn't catch many off-guard.

Source: Supplied.

The more subtle surprise was that the South African Reserve Bank's (Sarb's) implied future path of policy rates was lower than that laid out at the November 2021 MPC meeting.

Undoubtedly, many investors were preparing for the contrary.

US inflation in December 2021 fired up to 7% year-on-year, a 40-year high, and markets are pricing for aggressive rate-hiking cycles and quantitative tightening.

The acknowledgement by Federal Reserve Chairman, Jerome Powell that the US economy is suffering from far more persistent inflation than he expected, has underscored the recent rout in US technology shares and the 15% decline in the Nasdaq.

Why the disconnect?

Against such an uneasy backdrop, the SA forward rates market has been pricing 12-month money-market deposits at close to a 6% interest rate. This presents quite a gap versus the Sarb's latest model update, which puts the repo rate at ~4.9% by year-end. Why the disconnect?

The SA consumer is weak, as evidenced by our low core inflation figure of 3.4% year-on-year, that strips out supply-side prices like food and fuel. As the Sarb continues to emphasise, the only way to anchor inflation and continue to be supportive of SA's consumer recovery is to move gradually.

There are several important local factors, like high administered electricity prices, that are outside of the Sarb's control. Increasing the supply of energy in SA will arguably better anchor inflation than rate hikes can.

Which forecast model is more accurate?

Time will tell if the forward rates market or the Sarb model gives a better estimate of where we ultimately land.

The caveat to the "slow and steady" SA rate-hike guidance is that if US quantitative tightening occurs in a fast and furious manner, this may lead to strong capital flow reversals from riskier assets, like our SA government bonds, warranting a shift in gears to more rapid rate hikes locally.

Will the actual path of SA interest rate normalisation be gradual or rapid? The MPC prefers the former, but they are, as ever, dependent on the data.

ABOUT THE AUTHOR

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