



Monetary Policy Review: More caution over interest rates

Highlights

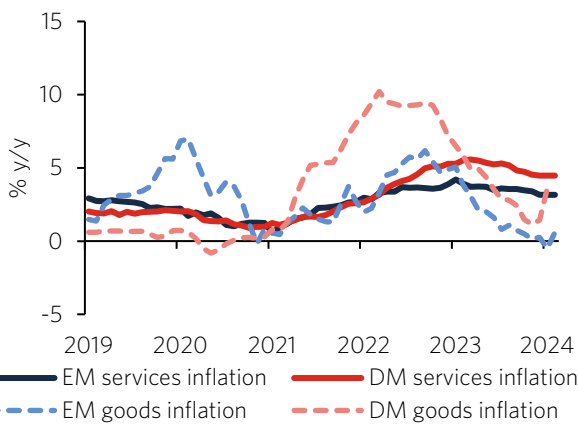
- The International Monetary Fund (IMF) expects the global economy to grow by 3.2% in 2024, the same as in 2023.
- Global inflation is expected to moderate to 5.9% in 2024 (6.8% in 2023). Sticky core inflation is reported to be slowing the progress of global headline disinflation.
- As a result, global inflation rates are expected to remain above central bank targets in 2024 and interest rates will consequently remain elevated. A shallower interest rate cutting cycle in major economies is expected to start in the second half of 2024.
- Due to better electricity supply, the South African Reserve Bank (SARB) revised its real gross domestic product (GDP) and potential growth estimates for 2024 and 2025 up from the October 2023 Monetary Policy Review (MPR).
- However, electricity outages remain higher than in the years before 2023 and so continue to weigh down on economic activity. The SARB's assumed economic growth impact of loadshedding was reduced from 0.8 and 0.4 percentage points to 0.6 and 0.2 percentage points, respectively for 2024 and 2025. The economic impact of logistical constraints is estimated to be smaller than loadshedding (between 0.5 and 0.75 percentage points over more than 12-months).
- Growth in domestic demand is back to long-term averages. Real household consumption spending in 2024 is estimated to be slightly better than last year at 0.9%. Fixed investment is expected to dip from 4.3% in 2023 to 0.7% in 2024.
- Similar to the global economy, higher services inflation is expected to keep domestic core inflation elevated and slow the moderation of headline inflation. Headline inflation is expected to only reach the midpoint of the inflation target range by the fourth quarter of 2025, two quarters later than expected in the October MPR.
- The SARB developed two new measures of underlying inflation namely, the persistent and common component of inflation (PCCI) and supercore inflation. Both measures are tracking above the traditional core inflation measure.
- According to the SARB, differentials in bond yields are a key driver of capital flows into SA's bond market as opposed to interest rate differentials.
- Higher uncertainty about the path back to the midpoint of the inflation target will keep rates elevated. Unlike the forward rate agreement (FRA) curve which is not pricing in any interest rate cuts in 2024, we still see scope of interest rate cuts in 2024. We estimate four 25-basis points of cuts over 2024 and 2025 but flag risks of a shallower and more delayed interest rate easing cycle.

- The idea of lowering the inflation target from the current range of between 3% and 6% is gaining traction. The benefits of such a move span across monetary policy, fiscal policy and the real economy. Lowering the inflation target would, however, attract short-term costs but the SARB estimates these costs to be low.

Persistent core inflation a headache in the global environment

In its April 2024 World Economic Outlook (WEO), the IMF forecasted resilient global growth of 3.2% in 2024 (previously 3.1% in the January WEO) largely due to better-than-expected growth in the United States (US). Risks to the growth outlook were assessed to be broadly balanced (assessment unchanged from the January 2024 WEO). China is expected to grow by 4.6% in 2024, down from 5.2% in 2023. The SARB highlights the World Bank’s estimate that a more pronounced slowdown in China (1 percentage point) could detract 0.2 percentage points from global growth in 2024. However, the impact varies across regions largely due to trade relations.

Chart 1: Sticky services inflation in DM and EM



Source: SARB, Momentum Investments
Data until February 2024

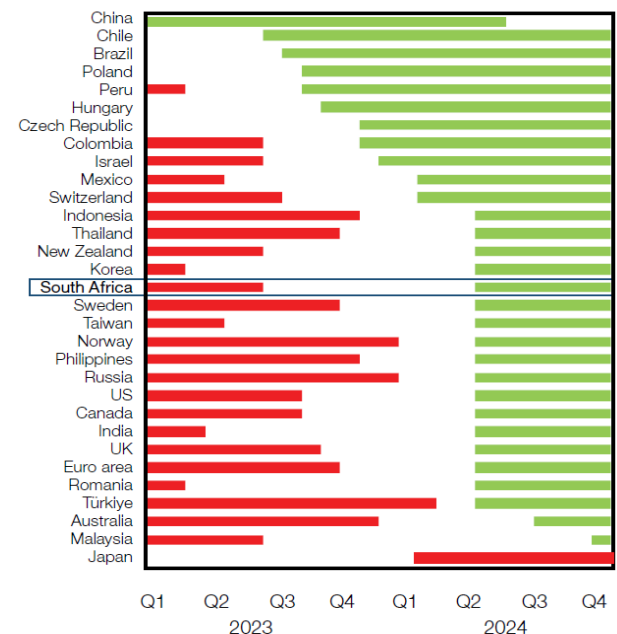
On the inflation front, the progress in lowering global headline inflation is acknowledged. The IMF expects global inflation to moderate to 5.9% in 2024 from 6.8% in 2023. However, it is noted that sticky core inflation on the back elevated services inflation, among other things, has slowed the pace of headline disinflation. Persistently high services inflation is a bigger problem in developed markets (DM) but is also evident in emerging markets (EM) (see chart 1). The SARB brings our attention to a statement by the Bank for International Settlements (BIS) that services inflation is harder to slow compared with goods price inflation.

This signals that global inflation will remain above central bank targets in 2024 and thus reaffirms the notion that global interest rates will remain elevated.

Major central banks and other economies (including SA) are expected to commence with monetary policy easing in the second half of this year (see chart 2) but the cumulative expected cuts for 2024 have been reduced significantly.

In contrast to the IMF’s view of broadly balanced risks to the global inflation outlook, the SARB is more pessimistic in that it views risks to global inflation as tilted to the upside.

Chart 2: Most policy rate cuts expected in the second half of 2024



Source: SARB

The SARB revised its 2024 growth estimate for SA’s major trading partners slightly lower to 2.6% (2.7% in the October 2023 MPR). Furthermore, this is lower than 2.9% in 2023 which means lower global demand will likely weigh on domestic economic growth.

Improving electricity supply supports higher domestic growth projections

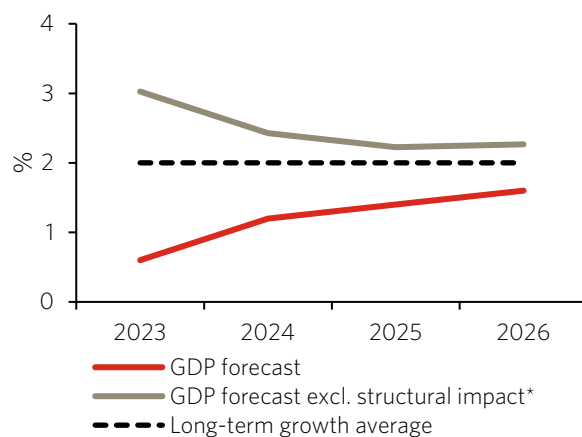
Compared to 2023 and estimates in the October MPR, SA's real GDP and potential growth are expected to pick up in 2024 and 2025 on the back of easing supply-side constraints. The SARB forecasts real GDP to expand from 0.6% in 2023 to 1.2% in 2024 (previously 1% in the October MPR), 1.4% in 2025 (previously 1.1%) and reach 1.6% in 2026. The potential growth estimate was also lifted from 0.1% in 2023 to 1.0% in 2024 (previously 0.8%), 1.2% in 2025 (previously 1%) and is expected to be 1.6% in 2026. The SARB notes that these estimates are "highly sensitive to the realisation of the ongoing supply-side reforms".

The April 2024 MPR points out an analysis by National Treasury which concludes that implementing reforms (e.g. the Energy Action Plan and Freight Logistics Roadmap) to ease structural constraints would increase potential growth by at least two percentage points, with logistical reforms alone adding at least 0.3 percentage points.

Despite the expectation of a better near- and medium-term growth outlook, the SARB highlights that the estimates remain well below SA's long-term growth average of about 2% and the IMF's estimated 4.2% average growth for EMs in 2024 and 2025. This indicates that structural constraints (loadshedding and logistics) remain a drag on economic activity.

The economic impact of loadshedding was revised down and is estimated to ease over the medium-term. The SARB estimates that loadshedding will detract 0.6, 0.2 and 0.04 percentage points from growth in 2024, 2025 and 2026, respectively. These estimates are lower than the 0.8 and 0.4 percentage points for 2024 and 2025, respectively, at the time of the October 2023 MPR and significantly better than the estimated 1.8 percentage points for 2023. The estimated impact of logistics on output is much smaller than loadshedding within a range of 0.5 and 0.75 percentage points in a period of more than 12 months. In the absence of supply-side constraints, SA's growth could potentially be above the long-term average growth (see chart 3).

Chart 3: Impact of supply-side constraints on growth receding



Source: SARB, Momentum Investments

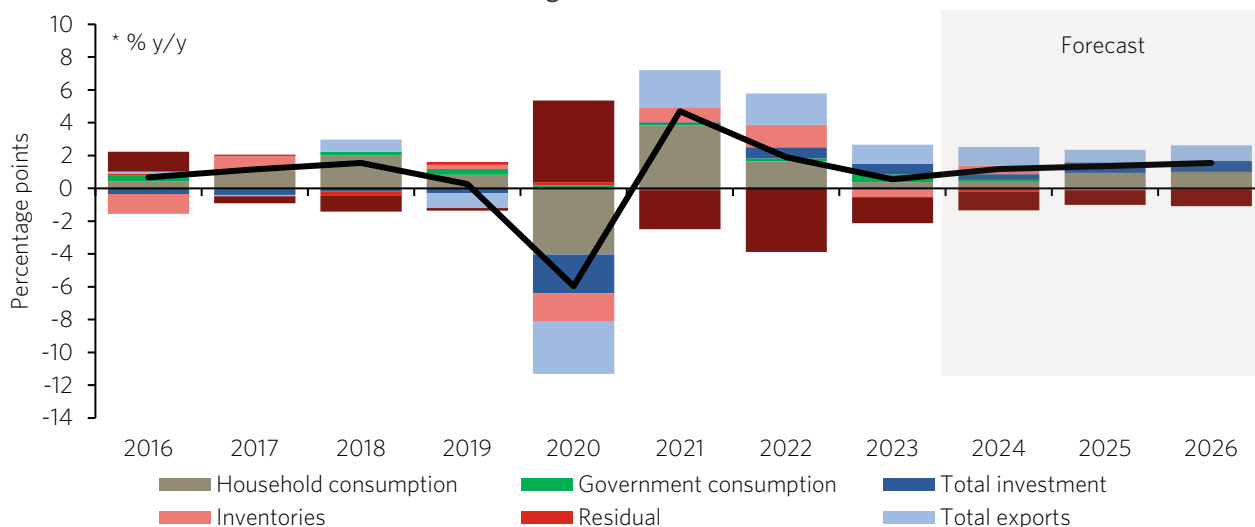
* Structural impact = estimated economic impact of loadshedding for the respective years. The logistics impact was kept constant at 0.63 percentage points (mid-point of range provided by SARB) for the forecast period

The SARB highlights that demand-side components of GDP are back to long-term averages (see chart 4). Real household consumption spending is expected to grow by 0.9% in 2024 (slightly higher than 0.8% in 2023) and increase to 1.6% in 2025. Growth in household spending is expected to be higher on the back of anticipated lower interest rates, easing inflation, higher real wage increases, higher real disposable income, employment growth and additional income from pension savings withdrawals when the two-pot retirement system is implemented.

Fixed investment growth is expected to dip to 0.7% in 2024 from robust growth of 4.8% and 4.3% in 2022 and 2023, respectively, and pick up to 4.1% and 4.2% in 2025 and 2026 respectively.

Commodity prices are expected to continue to decline in 2024 by 5% year-on-year (y/y). This will consequently hamper economic growth. Lower growth in China poses a downside risk to commodity prices. The SARB estimates that a 1% decrease in China's industrial production results in a 5% fall in commodity prices. Supportively, weaker growth in China will likely have downside producer and consumer inflationary pressures in SA's economy.

Chart 4: Pandemic and war-induced shocks coming out of the base for the GDP numbers

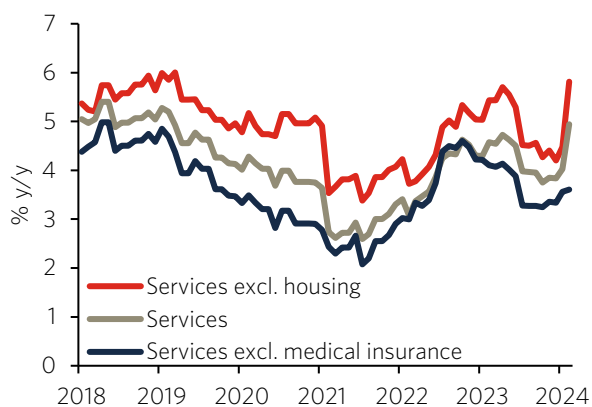


Source: SARB, Momentum Investments

Services inflation highlighted as a pressure point in the domestic inflation profile

In the April 2024 MPR, the SARB placed more attention on rising services inflation. The breakdown of services inflation (see chart 5) shows that the two major components of services have, so far, been partly working against each other. On the one hand, the sharp rise in medical insurance inflation is putting significant upward pressure on services inflation while, subdued housing inflation tames pressure on services inflation. Lower transport inflation has also contributed to lower services inflation.

Chart 5: Medical insurance inflation drives up services inflation



Source: SARB, Momentum Investments
Data until February 2024

The SARB revised services inflation for 2024 up to 5%, markedly higher than 4.6% in the October 2023 MPR

and the outcome of 4.2% in 2023. Services inflation was forecasted to settle at 4.5% in 2025 (October 2023 estimate) but it is now expected to remain elevated at 4.7% in 2025. The upward revisions to services inflation are attributed to normalising medical insurance and housing inflation as well as elevated inflation expectations.

Conversely, core goods inflation is expected to ease to 4.6% in 2024, markedly lower than 5.2% in the October 2023 MPR and the outcome of 6.1% in 2023. This is due to lower inflation for exchange rate-sensitive core goods.

Core inflation is now expected to be 4.8% in 2024 and anchored at the midpoint of the inflation target range in the fourth quarter of 2025, three quarters later than expected in the October 2023 MPR.

Consequently, headline inflation is expected to moderate slowly and only reach the midpoint of the inflation target range by the fourth quarter of 2025, two quarters later than expected in the October 2023 MPR.

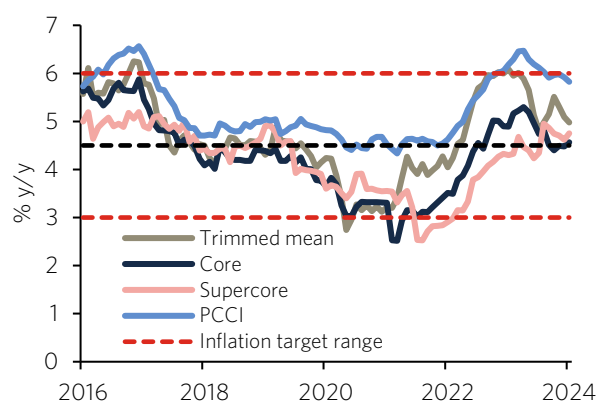
Rising core inflation is one of the risks that have materialised since the October 2023 MPR. Other risks that have materialised include drier and hotter weather conditions and higher international oil prices driven by

rising geopolitical tension. The weak domestic exchange rate and elevated inflation expectations continue to be flagged as inflation risks.

The SARB has introduced two new measures of underlying inflation namely, the PCCI and supercore inflation. “The PCCI separates out idiosyncratic changes to a price from unobserved but persistent and common components that capture underlying inflationary dynamics”. Supercore inflation is constructed from the core inflation basket by isolating, via a Phillips curve, those components that are sensitive to the output gap – a proxy for economic slack”. The new measures of underlying inflation are “meant to serve as useful barometers for demand-driven inflation pressures given their close association to the degree of slack in the economy”. The new measures of underlying inflation are higher than the traditional core inflation (see chart 6). According to the SARB, the PCCI being higher than core inflation is mainly reflective of below-average post-pandemic housing inflation and medical aid inflation. A

higher supercore indicates that inflation pressures have increased as the economy has recovered from the pandemic. *Bloomberg* reported that both new measures will be considered together with Statistic SA’s headline and core inflation measures to inform monetary policy going forward.

Chart 6: New underlying measures show elevated inflation pressures



Source: SARB, Momentum Investments
Data until January 2024

No major changes to government bond holdings between 2022 and 2023

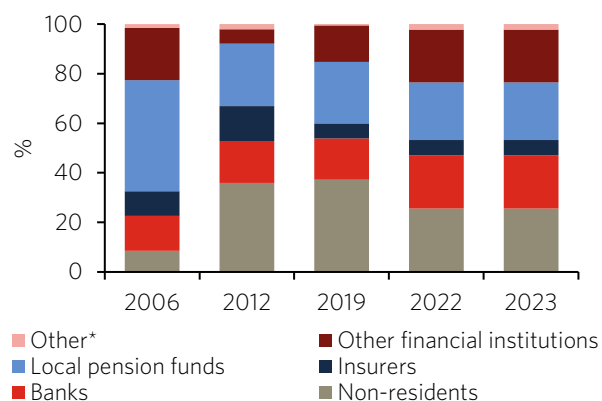
According to data from the SARB, the share of SA government bond (SAGB) holdings by the respective holders remained unchanged between 2022 and 2023 (see chart 7). The drop in SA government bond holdings by non-residents between 2019 and 2022 was mostly absorbed by other financial institutions (14.7% to 21.4%) and SA banks (16.7% to 21.5%). Despite the increase, the holdings of SAGBs by SA banks are still below international standards.

According to the SARB, non-residents were net sellers of R12.7 billion worth of SAGBs in the first quarter of 2024 because of higher yields in DMs and increased risks in EMs. During the 2024 IMF Spring Meetings, SARB Governor (Lesetja Kganyago) indicated that differentials in bond yields are a key driver of capital flows into SA’s bond market as opposed to interest rate differentials.

The SARB expects the money market surpluses to diminish somewhat later in 2024 “as funds for the

Corporation for Deposit Insurance (CODI) flow into the SARB” and expand again as Gold and Foreign Exchange Contingency Reserve Account (GFECRA) funds are distributed to the National Treasury.

Chart 7: Share of SAGB holding unchanged in 2023



Source: SARB, Momentum Investments
*Other includes the public, private and personal sectors

Higher uncertainty about path back to the midpoint of the inflation target will keep rates elevated

The repo rate has been kept unchanged at 8.25% over the past three interest rate-setting meetings since the October 2023 MPR (see table 1). According to the SARB, monetary policy rates are moderately restrictive but headline inflation and inflation expectations remain elevated. This has raised uncertainty about the prevailing policy stance and calls for more caution.

Furthermore, the “bumpy and protracted” path back to the 4.5% mark forecasted on the back of elevated uncertainty (particularly stemming from geopolitical tensions) and lingering inflation risks support a more cautious stance on policy rates.

Similar to the global economy, the expectation of SA interest rate cuts has been moved out and the magnitude of expected interest rate cuts has been reduced. According to the SARB, the FRA curve had, at the end of 2023, pencilled in SA rate cuts in the first half of 2024. The FRA now expects no cuts until early 2025. Analysts have also pushed back their expectations but still expect two or three rate cuts in the second half of 2024. We are in the camp that expects interest rate cuts to commence in the second half of 2024 and we forecast four 25-basis points cuts between 2024 and 2025. The interest rate cutting cycle may nonetheless occur later or be shallower if inflation risks persist or materialise.

Table 1: Shift in Monetary Policy Committee (MPC) member preferences since last hike in May 2023

Number of committee members	Favoured no move	Favoured a 25-basis point hike	Favoured a 50-basis point hike	Favoured a 75-basis point hike	Favoured a 100-basis point hike
25 May 2023	-	-	5	-	-
20 July 2023	3	2	-	-	-
21 September 2023	3	2	-	-	-
23 November 2023	5	-	-	-	-
25 January 2024	5	-	-	-	-
27 March 2024	5	-	-	-	-

Source: SARB, Momentum Investments

Idea of lowering the inflation target is gaining traction

SA’s inflation targeting framework underwent frequent changes in the initial stages because the framework was introduced as targeting an annual average specification (i.e. target adjusted annually). This was later changed to a continuous inflation target, which meant the inflation target range was stable between 3% and 6% from 2006 onwards (see table 2). For a few years now, the SARB has communicated its preference to lower the inflation target from its current range. In an interview with *Reuters*, the SARB governor stated that he preferred to see the inflation target lowered to a point target of 3% before 2025. The 3%-point target was also mentioned as a proposal in the April 2024 MPR. If implemented, this would mark two significant changes: (1) moving from a range to a single point and (2) moving to a lower level.

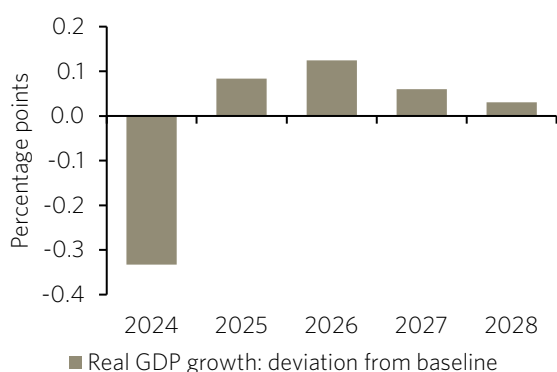
Table 2: Inflation target stable at 3%-6% since 2006

Changes to the inflation target	
1	Inflation targeting was formally introduced in February 2000 → target was specified in terms of an annual average rate of increase in the CPIX for the calendar year 2002.
2	Multi-year target approach was followed → target was specified as an average annual rate of increase of between 3% and 6% in the CPIX for 2002 and 2003 and an increase of between 3% and 5% for 2004 and 2005.
3	Target range for 2005 was increased from between 3% to 5% to between 3% to 6%.
4	In November 2003, it was decided to terminate the annual average specification of the target. The annual average was then replaced by a continuous target of 3% to 6% for the period beyond 2006

Source: SARB, Momentum Investments

The arguments for a lower inflation target include: (1) it would bring SA's inflation lower and in line with its peers, (2) it would make the country more competitive, (3) it could have a positive impact on the rand and (4) a lower inflation target would help anchor inflation expectations. Ndou and Gumata (2004) conclude that a lower target would "reduce the passthrough of positive GDP growth shocks to inflation". Lowering the target does, however, have short-term output costs. The SARB calculated that reducing the inflation target to 3% would decrease growth by 0.3 percentage points relative to the baseline in this first year but this would be short-lived with higher growth expected moving forward (see chart 8). This corresponds with the SARB's arguments in a working paper published in 2022 that costs have decreased on the back of improved SARB credibility, more forward-looking expectations and higher monetary policy transparency. In the working paper, the sacrifice ratio (growth cost of lower inflation) was reported to have been just over 0.5 in the post-apartheid period and the disinflationary period between 2016 to 2019 "was not associated with output losses".

Chart 8: Economic cost of lower inflation estimated to be short-term



Source: SARB, Momentum Investments

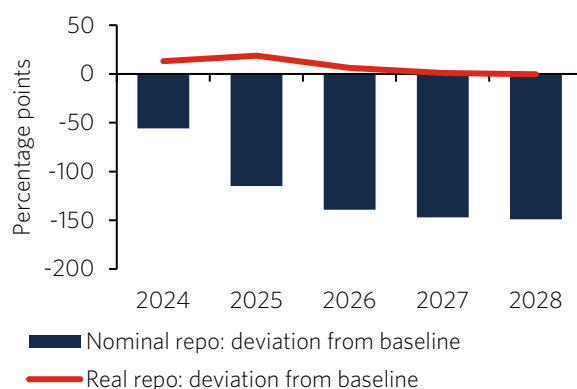
In an occasional paper published in 2004, the SARB argued that a single point target is more effective at anchoring inflation expectations. Some of the disadvantages of a single point target are that a point target is more difficult to achieve than a range or ceiling, policymakers have less flexibility in the case of unforeseen price shocks and frequent breaches could undermine credibility.

The April 2024 MPR addresses one of the two key challenges that were flagged by National Treasury in its Macroeconomic policy review document relating to inflationary pressures generated by administrative prices. The SARB indicated that a lower inflation rate (driven by a lower target) would result in lower administered prices because the inflation rate considered when setting administered prices would be lower.

The SARB further argues that lowering the inflation target and consequently lowering the inflation profile would be beneficial to the fiscal position through the following channels:

- A lower inflation rate can lower borrowing costs which could result in improved fiscal sustainability.
- Lower expected inflation would create room to roll over government debt at lower nominal and real interest rates. This would help reduce the bloated debt maturity profile of long-term domestic bonds (15.6% of the total stock over the next three years) and lower future debt-service costs.
- Lower inflation would reduce the real risk premium and real interest rate. This could boost the economy and consequently result in higher revenue collections.

Chart 9: A lower inflation profile would result in structurally lower interest rates



Source: SARB, Momentum Investments

A lower inflation profile would ultimately lead to structurally lower interest rates (see chart 9). According to RMB Morgan Stanley, the current

environment of moderating inflation and easing inflation expectations provides a good time to implement a lower inflation target. The SARB governor noted that the

SARB and National Treasury are still in the process of identifying the appropriate range and risks associated with a lower target.

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