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Monetary Policy Review: Cautious global rate cutting cycle

Highlights

- Global central banks have increased the momentum behind interest rate cuts since the April 2024 Monetary Policy Review (MPR). Global and domestic conditions are conducive to a continued decline in inflation and lower interest rates. However, inflation risks persist, necessitating caution from central banks to prevent policy missteps.
- Due to central banks remaining cautious and the observation of a higher global r-star (the long-run real neutral interest rate) the South African Reserve Bank (SARB) flags that global interest rates will likely end 2025 at a higher rate than pre-pandemic levels.
- Domestically, inflation risks are assessed as being balanced. Upside risks include steeper electricity tariffs, higher wage growth and an increase in rental inflation. Downside risks include a significant strengthening of the rand. In the modelling done by the SARB, the emergence of the downside risk would bring inflation down by much more compared to the increase in inflation that could result from the upside risks materialising.
- Consequently, the downside risks would lead to a more accommodative monetary policy stance, while the upside risks would result in interest rates remaining restrictive for longer.
- Rental inflation is still viewed as an upside risk to inflation despite consistently surprising to the downside since the end of the COVID-19 pandemic. This is because the SARB considers landlords' practice of maintaining low rental prices to boost vacancy rates as unsustainable. Furthermore, rental demand is expected to increase as economic growth recovers but supply is not expected to increase much over the near to medium term.
- Inflation expectations of businesses are better anchored in 2024 compared to the past two years but more still needs to be done.
- The United States (US) Federal Reserve (Fed) is expected to cut interest rates by a further 200 basis points by the end of 2025 with most emerging markets (EM), including SA, cutting interest rates by a smaller magnitude. This will encourage additional carry-trade flows, bolstering EM currencies.
- While SA's risk premium remains high, the risk premium has narrowed over the past few months due to political stability and easing inflation. As a result, the SA yield curve has compressed since the April 2024 MPR.
- The two-pot retirement reform, effective from 1 September 2024, is estimated to support economic growth in the second half of 2024 and 2025 through higher household spending. This will result in a marginal uptick in inflation, which could necessitate a higher repo rate. The magnitude of the respective impacts depends on the amount of total withdrawals. The SARB's estimated tax revenue impact is larger than the National Treasury's estimate of R5 billion in fiscal year 2024/25 in both the high and moderate withdrawal scenarios.

- **Shocks (COVID-19 pandemic, electricity load-shedding, logistical bottlenecks, July 2021 unrest and floods in KwaZulu-Natal in 2022) to the SA economy are assessed to have had a prolonged negative impact on economic growth. Getting back to what economic growth would have been in the absence of these shocks is possible but would be difficult. The economy would need to achieve an average annual growth rate of 3.2%, which is more than twice the currently projected average of 1.4%, by 2026.**

Positive developments in factors influencing monetary policy decisions

Since the April 2024 MPR, factors informing monetary policy decisions have improved both globally and domestically.

On the global front, inflation has eased without causing a significant economic downturn and there is an expectation that inflation will continue to moderate. Consequently, global central banks have embarked on a monetary policy easing cycle. However, the SARB notes that central banks and the market are approaching the monetary policy easing cycle cautiously on the back of still elevated core inflation, driven by sticky services inflation and tight (albeit cooling) labour markets, and possible inflation shocks such as rising geopolitical tensions. As such, global interest rates are expected to remain higher than pre-pandemic levels by the end of 2025.

Before the global monetary policy easing cycle commenced, a constant risk that was flagged was cutting interest rates too early and inflation re-emerging which would warrant a reversal in policy. This risk has materialised in Brazil and the country hiked interest rates in September. Brazil is expected to implement further interest rate hikes before resuming the rate cutting cycle in 2025.

Domestically, the inflation rate has eased from 5.2% year-on-year (y/y) in April to 4.4% y/y in August (below the midpoint of the inflation target range). Recent disinflation has been supported by lower Brent crude oil prices and a stronger rand. Furthermore, the inflation trajectory has substantially improved and the assessment of risks to the inflation outlook has improved from being viewed as tipped to the upside to a more balanced outlook. Unlike globally, SA's core inflation is contained and is expected to undershoot the midpoint of the inflation target in the medium term. Against this backdrop, the SARB delivered its first interest rate cut of 25 basis points to 8% in September.

In terms of growth, the SARB notes that global growth is weaker than the long-term average but remains resilient. SA's trading partners are estimated to grow by 2.7% in 2024, down from 3% in 2023 which means global growth will unlikely provide impetus for domestic growth and inflation. SA's easing energy constraints and moderation in inflation have not yet translated meaningfully into higher economic growth. Growth is expected to improve from an estimated 1.1% in 2024 to 1.8% by 2025 on the back of higher real disposable income and continued growth in fixed investment.

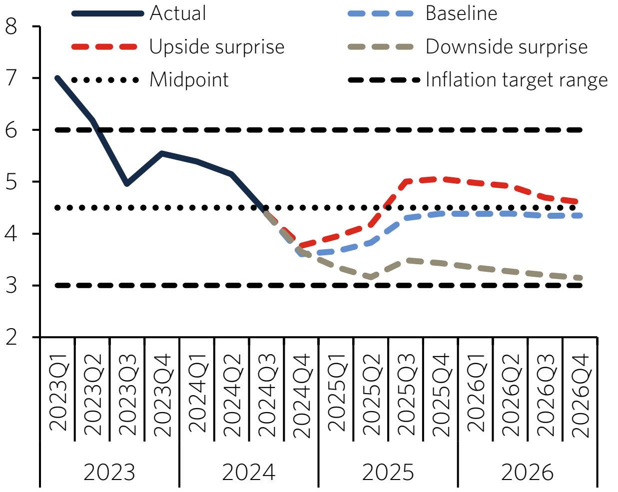
Insights into the assessment of balanced inflation risks

In the September Monetary Policy Committee (MPC), the SARB shifted its assessment of inflation risks from upside to broadly balanced. As the SARB indicated, this means there is an equal probability that inflation could surprisingly shift either to the upside or to the downside. The identified risks that could result in higher inflation than the baseline include steeper electricity price inflation, higher wage growth and an increase in rental inflation. On the other hand, the downside risk is premised around a significant strengthening of the rand.

It is encouraging that the modelled scenarios result in a bigger impact on the downside scenario (lower inflation) than the upside scenario from the baseline (see chart 1). Moreover, the upside scenario does not breach the upper band of the inflation target range and reverts closer to the midpoint of the inflation target range over time.

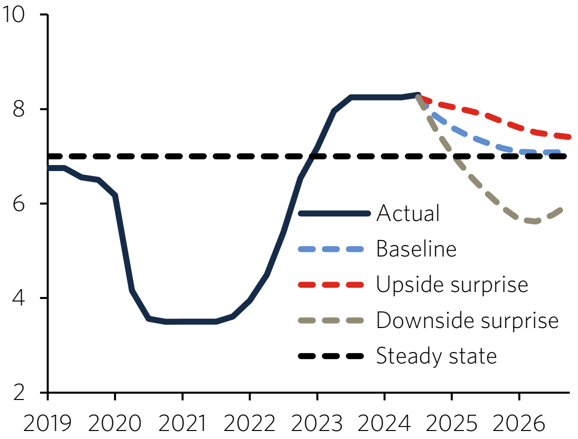
The downside surprise would necessitate a much more accommodating monetary policy, while the upside risks could result in monetary policy remaining restrictive for longer (see chart 2).

Chart 1: Headline inflation scenarios %



Source: SARB, Momentum Investments

Chart 2: Nominal repo rate scenarios %

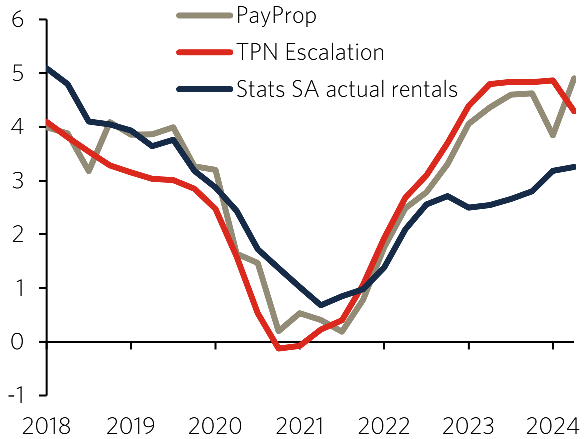


Source: SARB, Momentum Investments

The SARB has for some time flagged higher rental inflation as a risk, but this risk has not yet materialised.

One of the possible reasons cited is that landlords may have been absorbing higher costs to keep rental prices low and increase occupancy rates, hence the disconnect between market indicators of rental escalations and actual rentals inflation (see chart 3). This strategy may not be sustainable, hence higher rental prices are still regarded as an upside risk to inflation. Furthermore, the demand for rental housing is expected to increase as economic growth recovers, but residential building activity does not suggest an increase in supply, allowing for the mismatched gap to close.

Chart 3: Wider gap between market indicators of rental inflation and actual rental inflation



Source: SARB, Momentum Investments

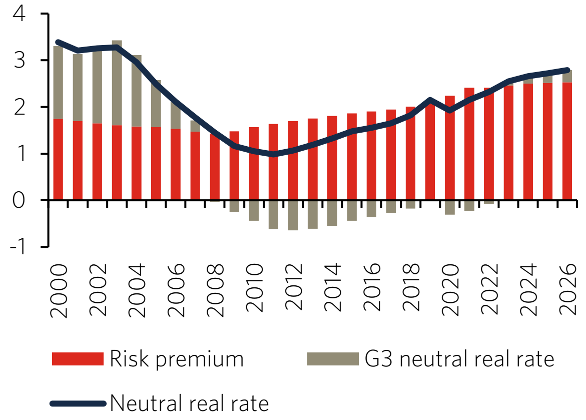
Another lingering concern has been high inflation expectations. The October 2024 MPR indicated that progress has been made and business inflation expectations are better anchored in 2024 compared to the past two years but more still needs to be done to anchor expectations.

Higher r-star suggests higher interest rates relative to pre-pandemic

As central banks have begun to lower interest rates, the discussion has now turned to the speed and extent of these cuts, as well as the terminal (end of cycle) rates. The SARB noted that the r-star can be used as a guide for these considerations.

While estimating the exact neutral rate (r-star) is difficult, there is a consensus that the global r-star has been higher since the pandemic. In SA, the r-star has risen since 2010, mainly due to a higher risk premium (see chart 4). A higher r-star "suggests the need for higher policy rates to re-anchor inflation in the wake of the kinds of shocks that drove it up". As such, interest rate cuts are likely to be brief and modest, with interest rates likely to stay higher than they were before the pandemic.

Chart 4: SA's neutral real interest rate has drifted higher %



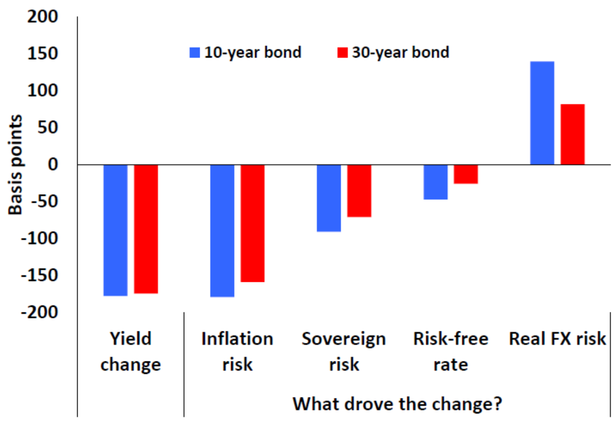
Source: SARB, Momentum Investments

As reported by the SARB, the market expects the US Fed to cut interest rates by a further 200 basis points by the end of December 2025. Most EMs are expected to implement a shallower cutting cycle compared with the Fed. This would result in wider interest rate differentials, which should encourage additional carry-trade flows, bolstering EM currencies. In our view, the SARB will deliver an additional 75 basis points of interest rate cuts by the end of 2025.

The expectation of interest rate cuts in the US has supported rand strength and consequently SA's inflation profile. While the rand has been good for inflation, it has wiped off a big chunk of the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) balance down to R273 billion (inclusive of the R50 billion that needs to be transferred to National Treasury in 2025 and 2026).

While SA's risk premium remains high, the risk premium has narrowed over the past few months due to political stability and easing inflation. As a result, the SA yield curve has compressed since the April 2024 MPR (see chart 5). "Maintaining progress on inflation and growth, as well as reducing the borrowing needs of the public sector, could cheapen financing further".

Chart 5: Drivers of changes in bond yields*



Source: SARB
** Change over the past 6 months*

Two-pot withdrawals pose an upside to economic growth and the fiscal position

The two-pot retirement reform is estimated to support economic growth in the second half of 2024 and 2025 through higher household spending. However, the economic impact is estimated to be temporary, only until 2025.

In the SARB's high withdrawal scenario (an additional gross withdrawal of R100 billion in the fourth quarter of 2024 and R40 billion per annum thereafter), economic growth is expected to be pushed up by 0.3 and 0.7 percentage points in 2024 and 2025, respectively.

In the more likely moderate scenario (an additional gross withdrawal of R40 billion in the fourth quarter of 2024 and R20 billion per annum thereafter) economic growth is estimated to be lifted by 0.1 and 0.3 percentage points in 2024 and 2025, respectively.

Higher household spending is estimated to translate into a longer lasting, albeit marginal, impact on inflation. In the high withdrawal scenario, inflation is estimated to edge up by 0.2 and 0.3 percentage points in 2025 and 2026, respectively. The moderate scenario could see inflation rising by 0.1 percentage points in 2025 and 2026, respectively.

Consequently, the repo rate may need to increase by 0.6 and 0.9 percentage points in 2025 and 2026, respectively, under a high withdrawal scenario and by

0.2 and 0.4 percentage points over the same period in a moderate withdrawal scenario.

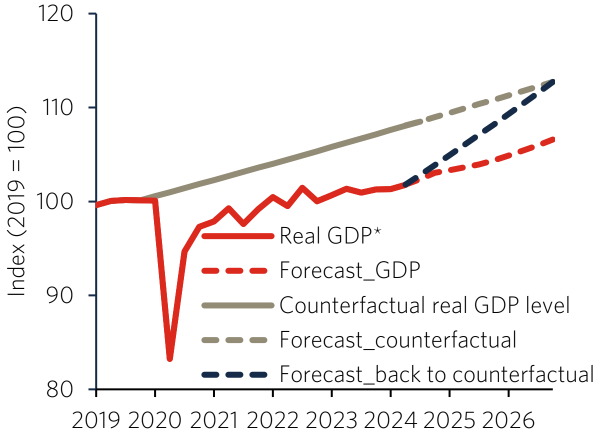
Early pension withdrawals bode well for the fiscus and consequently the country's risk premium and bond yields. In the high withdrawal scenario, the SARB estimates personal income tax (PIT) revenue of R41 billion and R32.4 billion in 2024 and 2025, respectively. The moderate withdrawal scenario could result in PIT of R19.9 billion and R16.3 billion in 2024 and 2025, respectively. These estimates are higher than the National Treasury's assumption of R5 billion in tax collections in fiscal year 2024/25 in the February 2024 budget.

Fixed investment identified as a factor to help reverse economic damage from the past shocks

It is widely understood that SA's economy has undergone shocks, including the "COVID-19 pandemic, electricity load-shedding, logistical bottlenecks, July 2021 unrest and floods in KwaZulu-Natal in 2022", that have negatively impacted the country's current economic growth and potential growth. However, the extent of the damage caused by these shocks was not quantified. In the October 2024 MPR, the SARB estimates what real GDP could have been in the absence of these shocks. From chart 6, it is evident that these shocks have resulted in persistently lower economic growth and this trend is expected to continue into 2026. These shocks have contributed to SA registering lower growth relative to its peers.

Reversing this trend is possible but would be difficult because the economy would need to achieve an average annual growth rate of 3.2%, which is more than twice the currently projected average of 1.4%, to reach the counterfactual GDP level by the end of 2026. Some sectors, such as mining, would need to register much faster growth (average 4.2%) to converge to the counterfactual growth level. According to the SARB, a substantial improvement in fixed investment has the potential to help the economy recover.

Chart 6: Economic growth lower due to shocks



Source: SARB, Momentum Investments

Comments from the SARB cement the consideration of a 3% inflation target

The conversation about lowering the inflation target continues without a timeline. During the question-and-answer session, the SARB highlighted that factors influencing the new level include the median target of 3% in EMs, 2% in advanced economies, and the observed tendency of people to be intolerant of inflation exceeding 3%. They concluded that it would be hard to continue with a target above 3% in SA. This can be viewed as a guide to the new target.