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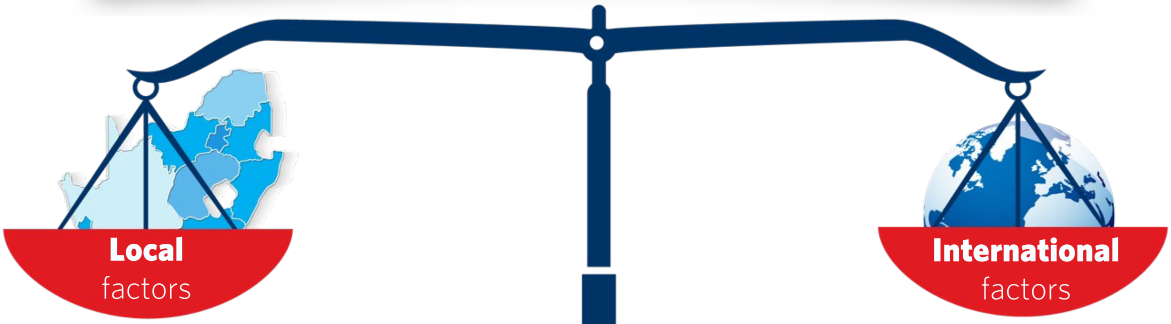
in the moment

Sanisha Packirisamy
Chief Economist

Tshiamo Masike
Economic Analyst

SARB monetary policy review: Caution amid global risks

Forces shaping monetary policy



Local factors

Over the past six months:

- Marked disinflation across food, fuel and core measures ➔ helped lower inflation expectations.
- Stronger rand and lower oil prices.
- Improved household consumption (two-pot withdrawals and interest rate cuts) ➔ but weak fixed investment.

Expected developments:

- Gradual rise in inflation as food and fuel prices normalise.
- Value-added tax (VAT) hikes to add c.0.2pps to headline inflation (annually) ➔ second-round effects to be monitored.
- Smaller electricity tariff hikes.
- Improved household spending and structural reforms to support domestic demand.

International factors

Over the past six months:

- Easing global inflation ➔ although less than expected.
- High services inflation in advanced economies.
- Modest global growth slowdown ➔ sharper decline in South Africa's (SA) trading partners.
- Global growth risks tilted to the downside.

Expected developments:

- Disinflation risks stalling or reversing due to rising tariffs, trade tensions and supply chain disruptions.
- Modest and fragile global growth with significant downside risks.
- Higher-for-longer global interest rate environment.
- Uncertain policy path amid stagflation.

Analytical studies

- Post-COVID Phillips curve steepening ➔ to flatten again as we return to a lower-cost disinflationary environment.
- Elevated exchange rate pass-through risks amid global uncertainty.
- AI (artificial intelligence) can boost long-term growth ➔ nevertheless, benefits are uneven and could result in higher market volatility.
- The SA Reserve Bank (SARB) overestimated growth and underestimated disinflation in 2024.

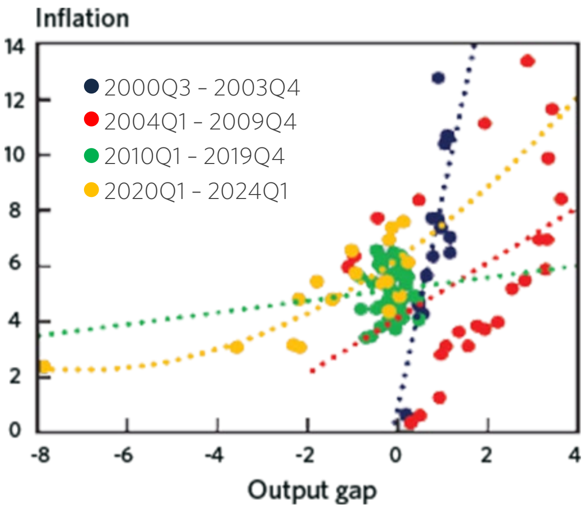
Interest rate path

- The Monetary Policy Committee (MPC) lowered interest rates by 50 basis points to 7.5% since October 2024.
- Benign inflation forecasts—to bottom at 3.6% in 2025—support policy gradually aligning with the neutral rate of 7.25% ➔ there is potentially room for one more rate cut.
- The SARB is likely to remain cautious, given global uncertainty marked by rising protectionism, geopolitical tensions and expectations that global interest rates will stay elevated for longer.

Stronger central bank credibility makes lower inflation less costly for growth

According to the SARB, SA's Phillips curve (illustrates the relationship between inflation and economic slack) has shifted over time (see chart 1), largely in response to changes in inflation expectations and the credibility of the central bank's approach to monetary policy.

Chart 1: Phillips curve expected to flatten



Source: SARB

A steeper curve, as seen in the early 2000s, reflects a higher cost of disinflation. This period coincided with elevated inflation expectations and when inflation shocks strongly influenced realised inflation outcomes. In contrast, a flatter curve implies a lower cost of disinflation, which emerged from 2004 as the SARB's credibility improved and expectations became more anchored, weakening the link between inflation and economic slack. This flatter trend continued and was most pronounced after the global financial crisis, particularly following the SARB's 2017 emphasis on guiding inflation toward the midpoint of the target (4.5%).

The post-COVID inflation surge led to a steepening of the Phillips curve as inflation expectations became less anchored. Usually, this would imply higher output costs to reduce inflation. However, the SARB brought inflation down with relatively limited output losses.

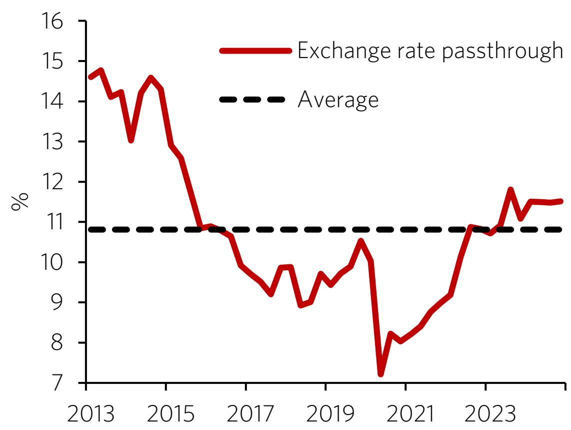
> "This was likely because the traditional Phillips curve trade-off may weaken in a stagflationary environment."

As inflation expectations return to the midpoint of the target, the Phillips curve is expected to flatten again.

Exchange rate pass-through risks to inflation remain high given global uncertainty

Similar to the Phillips curve, the exchange rate pass-through has exhibited notable shifts in recent years. From 2017 to 2021, pass-through was at historically low levels, coinciding with a period of inflation stability around the midpoint of the target, a near-zero output gap, and well-anchored inflation expectations. However, this relative macroeconomic stability gave way in 2022 to 2023, as both inflation and inflation expectations rose sharply. In response, pass-through rates also increased during this period (see chart 2).

Chart 2: Pass-through reached lowest point in 2020



Source: SARB, Momentum Investments

The SARB has highlighted that elevated global uncertainty and geopolitical tensions can trigger large currency swings, with prolonged or severe currency depreciation typically leading to higher pass-through rates. This is a risk given the current global context.

Additionally, when inflation is high and rising (as might occur with tariff proposals or VAT hikes) firms may be more inclined to pass on cost increases to consumers.

As such, the SARB views the risk associated with exchange rate-pass through as high.

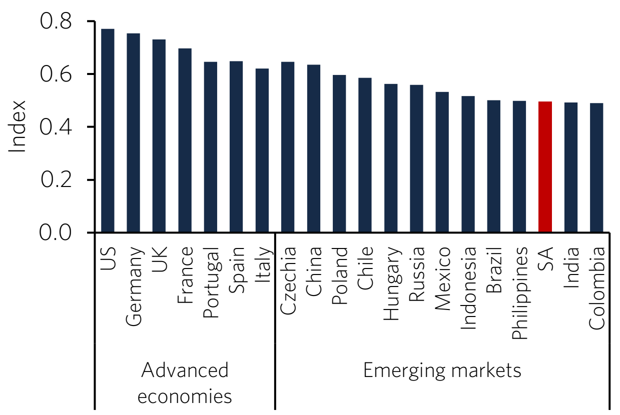
AI introduces higher potential growth, but also market volatility and uneven gains

Recognising the potential for modest global growth over the long term, the SARB noted that recent analyses suggest that AI could boost global potential growth "by making production processes more efficient and accelerating innovation". However, the technology is still in its early stages, with estimates of its impact ranging from moderate gains to explosive growth. Importantly, uncertainty around its long-term effects could also lead to cycles of market volatility and the benefits of AI will likely differ across countries depending on their level of preparedness. Many emerging markets are lagging advanced economies (see chart 3) due to shortages of capital, digital infrastructure, and relevant skills and SA ranks low in AI preparedness relative to its peers.

Closing these gaps will require increased investment in research and development, digital infrastructure, and education, alongside efforts to reduce regulatory and administrative barriers.

These topics are a key focus for the G20 this year under SA's presidency, which means that SA has an opportunity to shape global policy conversations while addressing its domestic challenges.

Chart 3: SA lags peers on AI preparedness



Source: SARB, Momentum Investments

SARB overestimated economic growth and underestimated disinflation in 2024

The SARB reviewed the reasons behind its 2024 forecast errors for both growth and inflation.

On the growth front, the SARB initially projected a 1.2% expansion for 2024 (January 2024 estimate), but actual growth came in significantly lower at 0.6%.

The primary contributor to the miss in the growth forecast was the volatile performance of the agriculture sector.

Other sectors such as transport, storage and communication, and the "other" services category were also consistently overestimated. In contrast, the finance, real estate and business services sectors tended to be underestimated, largely due to the absence of timely high-frequency data. On the expenditure side of growth, the SARB persistently overestimated private investment and inventory changes, while net exports were underestimated, mainly due to weaker-than-expected imports. While the SARB projects a rebound in 2025, it signalled limited confidence in the recovery of fixed investment during the question-and-answer session.

Inflation forecasts proved more pessimistic than realised outcomes on price pressures. The SARB expected an average inflation rate of 5% in its initial 2024 estimate, but the outcome was a more favourable 4.4%.

Inflation forecast errors stemmed largely from a stronger-than-expected rand and lower oil prices, which eased cost pressures.

Additionally, unit labour costs were lower than projected, and the output gap turned out to be more negative than initially assumed, both reducing inflationary pressures.

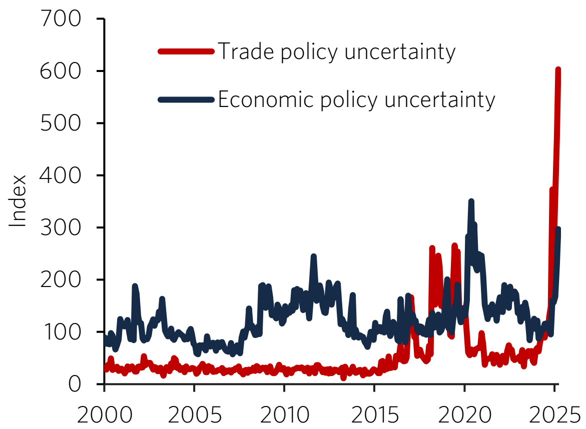
Importantly, these forecast errors were not unique to the SARB as similar inaccuracies were observed in the Reuters consensus. This underscores the difficulty of economic forecasting against a highly unpredictable global and domestic landscape.

SARB's cautious road to 7.25%

Between October 2024 and March 2025, the SARB cut interest rates by a cumulative 50 basis points, bringing the policy rate to 7.5%. In the last two MPC meetings, there were votes in favour of holding rates steady, and rates were ultimately left unchanged in March 2025, reflecting increased caution amid rising tariff concerns.

We expect this cautious stance to persist over the next six months, particularly as some key risks begin to materialise, such as the implementation of a universal tariff by the United States. The SARB's Quarterly Projection Model currently points to a further 25-basis point cut in the second quarter of 2025, bringing the policy rate in line with the estimated neutral rate of 7.25%. However, the MPC is likely to remain firmly data-dependent, especially given unusually elevated global uncertainty (see chart 4).

Chart 4: Policy uncertainty has surged



Source: SARB, Momentum Investments

On the local front, inflation is projected to bottom at 3.6% in 2025 before gradually accelerating to 4.5% over the forecast period. While this supports the case for further policy easing, uncertainty around second-round effects from the VAT increase justifies a more cautious approach to monetary policy.