MPC update: The SARB cuts interest rates by 25bp as risks to inflation outlook seen to be reduced as SA avoids a Moody's rating downgrade

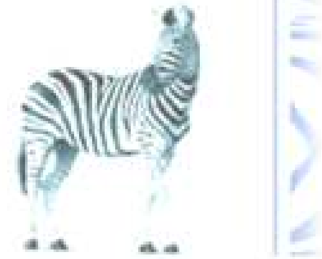

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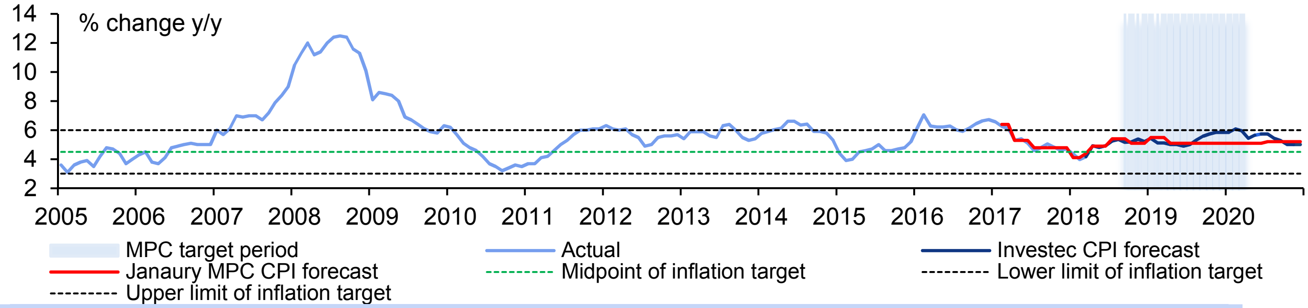
Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- The SARB has cut the repo rate by 25bp to 6.50% in an almost equally divided 4 –3 vote. This was in line with economists' expectations.
- Risks to the inflation outlook have moderated since the January MPC while according to SARB " the increase in the value-added tax (VAT) rate to 15% places temporary upside pressure on inflation, this is mitigated by the stronger exchange rate which has contributed to the changing inflation risk profile".
- The rand has appreciated by around 3.5% on a nominal trade weighted basis, since the last MPC meeting as domestic market sentiment has been favourably influenced by recent events, including Cyril Ramaphosa's election as president of the country, a more fiscal friendly March budget and the avoidance of a sovereign downgrade by Moody's rating agency accompanied by a change in outlook from negative to stable**.**
- Also assisting the rand has been the substantial increase in international commodity prices, coupled with the continued strengthening in global economic activity.
- Year-on-year inflation rate, as measured by the consumer price index (CPI), logged 4.0% in February, down from 4.4% previously, primarily supported by lower food and fuel price inflation.
- The MPC noted that "Although the bottom on the inflation cycle has likely been reached, the trajectory of headline inflation is forecast to remain within the target range, with core inflation expected to remain below 5% for most of the forecast period".
- The main changes to the SARB's inflation rate forecast are the VAT increase and the exchange rate. According to the SARB "(the) VAT increase is expected to add about 0.6% percentage points to the headline inflation trajectory for the four quarters from the second quarter of 2018, with marginal second-round effects persisting into subsequent quarters. The improved exchange rate has softened the impact of the indirect tax adjustments on the inflation forecast".
- However, the rand, along with the broader emerging currency complex is also vulnerable to a faster than expected pace of monetary policy normalization by the Fed that could trigger a reversal in capital flows to emerging markets, and a higher CPI inflation trajectory.
- Outputs from the committee's Quarterly Projection Model have changed. While previously "two or three increases of 25bp each by the end of 2019 were indicated, one increase of 25 basis points is now implied", with two further lifts projected for 2020.

Figure 2: SARB CPI inflation forecasts (% y/y)

	2017	2018	2019	2020
SARB 28th March 2018	5.3	4.9	5.2	5.1
SARB 18th January 2018	5.3	4.9	5.4	
SARB 23rd November 2017	5.3	5.2	5.5	
SARB 21st September 2017	5.3	5.0	5.3	
SARB 20th July 2017	5.3	4.9	5.2	

Source: SA Reserve Bank

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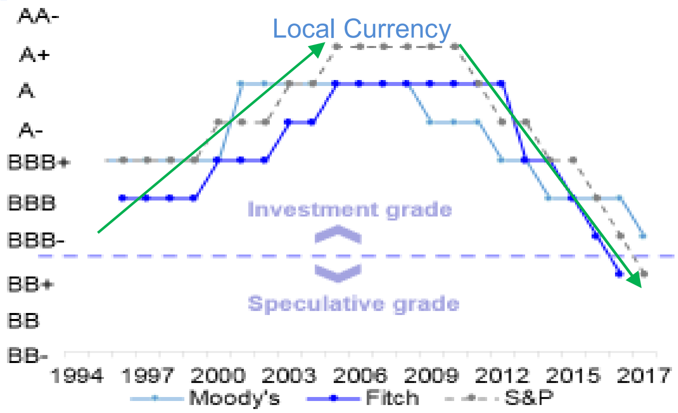
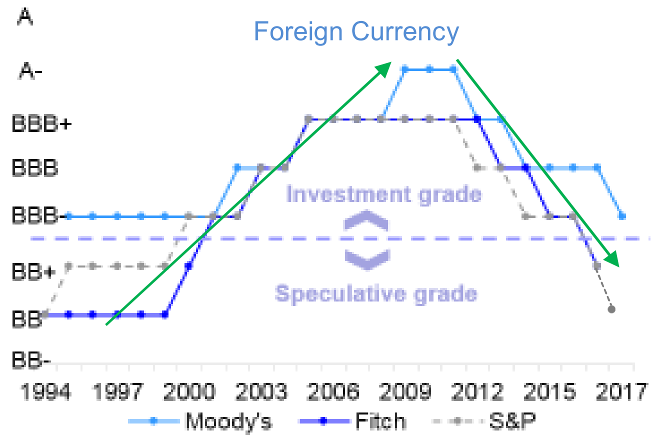
Figure 3: South African local and foreign currency long-term sovereign credit ratings





Source: Moody's, Fitch, Standard and Poor's

Figure 4: Foreign sector assumptions

Percentage changes (unless otherwise indicated)	Actual 2015	Actual 2016	2017	Forecast 2018	Forecast 2019	Forecast 2020
1. Real GDP growth in South Africa's major trading partner countries	3.5% (3.3%)	3.0%	3.5%	3.6% (3.5%)	3.5% (3.5%)	3.5%
2. Output gap in South Africa's major trading partner countries	-0.8% (-1.1)	-0.7% (-1.0%)	-0.2% (-0.5%)	0.3% (-0.1%)	0.5% (0.2%)	0.5%
3. International commodity prices in US$ (excluding oil)	-22.9%	3.9%	17.5%	6.0% (2.0%)	-2.0% (0.5%)	2.5%
4. Brent crude (US$/Barrel)	$52.5	$43.6	$54.2	$63.0 ($62.0)	$62.0 ($62.0)	$62.0
5. World food prices (US$)	-18.7%	-1.5%	8.1% (8.5%)	2.8% (3.0%)	3.4% (3.4%)	3.3%
6. International consumer prices	0.2%	0.4%	1.5% (1.4%)	1.6% (1.4%)	2.3% (2.0%)	2.2%
7. International policy interest rate	0.1%	0.1%	0.2% (0.3%)	0.4% (0.4%)	0.9% (0.7%)	1.9%

Source: SA Reserve Bank

Figures in blue represents the previous MPC assumption

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Foreign Sector Assumptions

1. **Trading partner GDP growth:** is broadly determined via the Global Projection Model "GPM" which is adjusted to aggregate the GDP growth rates of South Africa's major trading partners on a trade weighted basis. Individual projections are done for the four largest trading partners (euro area, China, United States and Japan), while the remaining trading partners are grouped into three regions: Emerging Asia (excluding China), Latin America and the Rest of Countries bloc. The assumption takes account of country specific "consensus" forecasts as well as regional growth prospects.
2. **Output gap:** as with GDP growth the output gap is determined via the GPM and is similarly adjusted. The output gap is driven by a combination of country-specific domestic factors, external factors, and financial-real linkages (beyond interest rate and exchange rate effects). Domestic factors include expectations of future demand and medium-term interest rates. External factors include exchange rate impacts on demand, direct spillovers through trade with trading partner countries, and foreign demand.
3. **International consumer prices:** are also broadly determined via the GPM, the index is an aggregate of the consumer price indices of the G3 countries (euro area, United States and Japan) weighted by their relative trade weights. Consumer prices are determined for each region discussed above by accounting for expected future price inflation, demand pressures, and pass-through from changes in the relevant exchange rate. Other institutional forecasts for international consumer prices are also considered.
4. **Commodity price index:** is a weighted aggregate price index of the major South African export commodities based on 2010 prices. The composite index represents the total of the individual commodity prices multiplied by their smoothed export weights. Commodity price prospects generally remain commensurate with global liquidity as well as commodity demand/supply pressures as reflected by the pace of growth in the trading partner countries.
5. **Brent crude oil price:** is expressed in US Dollars per barrel. The assumption incorporates the analysis of factors of supply, demand (using global growth expectations) and inventories of oil (of all grades), as well as the expectations of the US Energy Information Administration (EIA), OPEC and Reuters.
6. **World food prices:** is the composite food price index of the Food and Agriculture Organization of the United Nations (FAO) in US dollars. It is weighted via average export shares, and represents the monthly change in the international prices of a basket of five food commodity price indices (cereals, vegetable oil, dairy, meat and sugar). World food price prospects incorporate selected global institution forecasts for food prices as well as imbalances from the anticipated trend in international food supplies relative to expected food demand pressures.
7. **International policy interest rate:** is again broadly determined via the GPM. Interest rates are an aggregate of the policy rates of the G3 countries (euro area, United States and Japan). They are individually determined by a "Taylor-type" monetary policy rule. The communications of the relevant central banks and other institutional forecasts are also considered.

Figure 5: Domestic sector assumptions

Percentage changes (unless otherwise indicated)	2015	Actual 2016	2017	2018	Forecast 2018	2019
1. Electricity price	9.4%	9.3%	4.7%	4.8% (4.1%)	7.3% (7.0%)	8.0%
2. Fuel taxes and levies	13.3%	9.0%	8.3%	7.6% (5.8%)	7.2% (6.7%)	6.2%
3. Potential growth	1.4% (1.3%)	1.1% (0.8%)	1.3% (1.1%)	1.3% (1.3%)	1.3% (1.3%)	1.4%
4. Inflation target midpoint	4.5%	4.5%	4.5%	4.5% (4.5%)	4.5% (4.5%)	4.5%
5. Neutral real interest rate	1.6%	1.6%	1.8%	2.0% (2.0%)	2.1% (2.2%)	2.3%

Source: SA Reserve Bank

Figures below the assumption in parentheses represents the previous MPC assumption

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Domestic Sector Assumptions

1. **Fuel taxes and levies:** are the total domestic taxes and costs included in the price of fuel paid at the pump. They include the Road Accident Fund (RAF), the fuel levy, retail and wholesale margins, slate levy, and other minor levies. The two major taxes, which are set by the Minister of Finance in the annual budget, are the RAF and fuel levy. Income generated by the RAF levy is utilised to compensate third party victims of motor vehicle accidents while the fuel levy is used to provide funding for road infrastructure.
2. **Electricity price:** is an administered price measured at the municipal level with a weight of 3.75 per cent in the headline CPI basket. Electricity price adjustments generally take place in the months of July and August of each year, and the assumed pace of increase over the forecast period reflects the multi-year price determination (MYPD) agreement between ESKOM and NERSA with a slight adjustment for measurement at the municipal level.
3. **Potential growth:** the pace of potential growth is derived from the SARB's semi-structural potential output model. The measurement accounts for the impact of the financial cycle on real economic activity and introduces economic structure via the relationship between potential output and capacity utilisation in the manufacturing sector (South African Reserve Bank, Working Paper Series, WP/14/08).
4. **Inflation target midpoint:** is the middle of the official target range of 3 to 6 percent.
5. **Neutral real interest rate:** The neutral real interest rate is the rate at which inflation is stable at the inflation target midpoint and output is operating at its potential. It is a key variable to determine the appropriate stance of monetary policy. The neutral real interest rate is a function of the model consistent real interest rate.

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