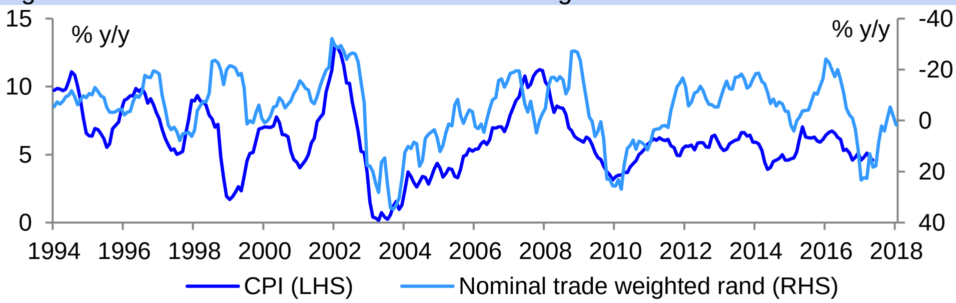
Investec

MPC update: SARB retains cautious policy stance by leaving the repo rate unchanged amid ongoing upside risks to the inflation outlook

18th January 2018

Figure 1: CPI inflation versus nominal trade weighted rand



Source: Stats SA, IRESS, Investec

- The SARB retained its cautious policy stance and left the repo rate unchanged at 6.75% in a 5 – 1 vote, with one MPC member voting for a cut. The decision was in line with market expectations.
- Risks to the inflation outlook continued to be assessed to the upside, although the degree abated somewhat following the developments since the November MPC.
- In particular, the rand appreciated by 10.6% on a nominal trade weighted basis, as market sentiment has been influenced by the perceived favourable outcome of the ANC elective conference in December, where Cyril Ramaphosa was elected as ANC president. Also aiding the rand has been the substantial increase in international commodity prices, linked to indications of a continued strengthening in global economic activity.
- However, the SARB continues to regard the rand as an upside risk with the currency remaining vulnerable to fiscal and sovereign credit ratings outcomes, in February and March respectively. SA's credit rating with Moody's is presently one notch above non-investment grade and a downgrade would trigger the exclusion of SA bonds from the World Government Bond Index with the forced selling of local bonds estimated to possibly be as much as R200bn (see figure 3).
- The appreciated rand has been a mitigating factor to the higher international oil price but the SARB cautioned that international oil price developments could see further upward revisions to its oil price assumption.
- In the meantime, the stronger currency and lower electricity tariff increase assumptions were incorporated into the SARB's Quarterly Projection Model (QPM) to yield lower projected inflation (see figure 2).
- Core inflation was forecast at 4.6% y/y in 2018 and 5.1% y/y in 2019 on demand pressures remaining muted. However, the SARB cautioned that "the closing output gap (…) reduces the degree of downside pressure on inflation."
- Specifically, the SARB's estimated actual economic growth of 1.4% and 1.6% in 2018 and 2019 respectively, would run above potential growth of 1.3% (see figure 4). This indicates the potential for the emergence of some demand led price pressures towards the end of the period.
- In November the QPM predicted 75bp in rate hikes by 2019. The committee's model shows that "the third increase is now a marginal call" and that "the timing of the first increase has been pushed out later in the period."
- Should the rand strengthen notably further this year, and the new levels be maintained, the SARB may consider an interest rate cut on expected lower inflation. In the meantime, the room to cut is constrained by inflation being forecast at 5.5% over the SARB's six to 24 month forecast horizon.

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

	2017	2018	2019
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
SARB 25th May 2017	5.7	5.3	5.5

Source: SA Reserve Bank

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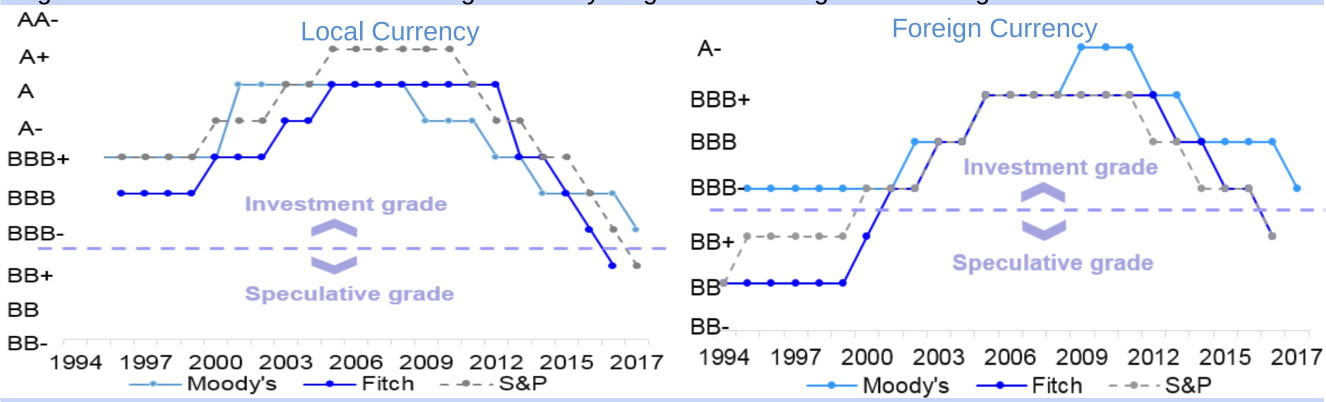
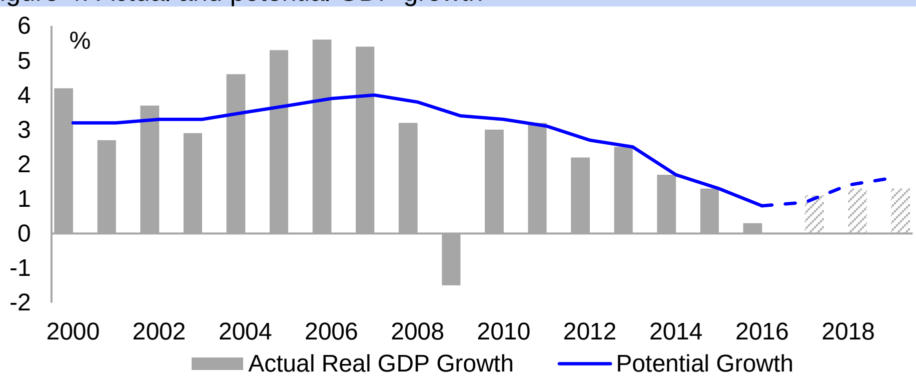
Figure 3: South African local and foreign currency long-term sovereign credit ratings



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

Figure 4: Actual and potential GDP growth



Source: SARB

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Figure 5: Foreign sector assumptions

Percentage changes (unless otherwise indicated)	2014 (Actual)	2015 (Actual)	2016 (Actual)	2017 (Forecast)	2018 (Forecast)	2019 (Forecast)
1. Real GDP growth in South Africa's major trading partner countries	3.4%	3.3%	3.0% (2.9%)	3.5% (3.5%)	3.5% (3.4%)	3.5% (3.4%)
2. Output gap in South Africa's major trading partner countries	-1.2%	-1.1%	-1.0%	-0.5% (-0.5%)	-0.1% (-0.2%)	0.2% (0.0%)
3. International commodity prices in US$ (excluding oil)	-10.2%	-22.7%	3.9% (4.1%)	17.5% (18.0%)	2.0% (2.0%)	0.5% (1.5%)
4. Brent crude (US$/Barrel)	$99.2	$52.5	$43.6	$54.2 ($53.9)	$62.0 ($57.0)	$62.0 ($58.0)
5. World food prices (US$)	-3.8%	-18.7%	-1.5%	8.5% (8.7%)	3.0% (3.0%)	3.4% (3.4%)
6. International consumer prices	1.2%	0.2%	0.4%	1.4% (1.4%)	1.4% (1.5%)	2.0% (2.0%)
7. International policy interest rate	0.1%	0.1%	0.1%	0.3% (0.2%)	0.4% (0.4%)	0.7% (0.9%)

Source: SA Reserve Bank

Figures in blue represents the previous MPC assumption

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.

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Figure 6: Domestic sector assumptions

Percentage changes (unless otherwise indicated)	Actual 2014	2015	2016	Forecast 2017	2018	2019
1. Electricity price	7.2%	9.4%	9.3%	4.7% (4.7%)	4.1% (5.1%)	7.0% (8.0%)
2. Fuel taxes and levies	5.9%	13.3%	9.0%	8.3% (8.3%)	5.8% (6.3%)	6.7% (6.7%)
3. Potential growth	1.7%	1.3%	0.8%	1.1% (1.0%)	1.3% (1.2%)	1.3% (1.3%)
4. Inflation target midpoint	4.5%	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%	1.6%	1.8% (1.7%)	2.0% (2.0%)	2.2% (2.2%)

Source: SA Reserve Bank

Figures below the assumption in parentheses represents the previous MPC assumption

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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