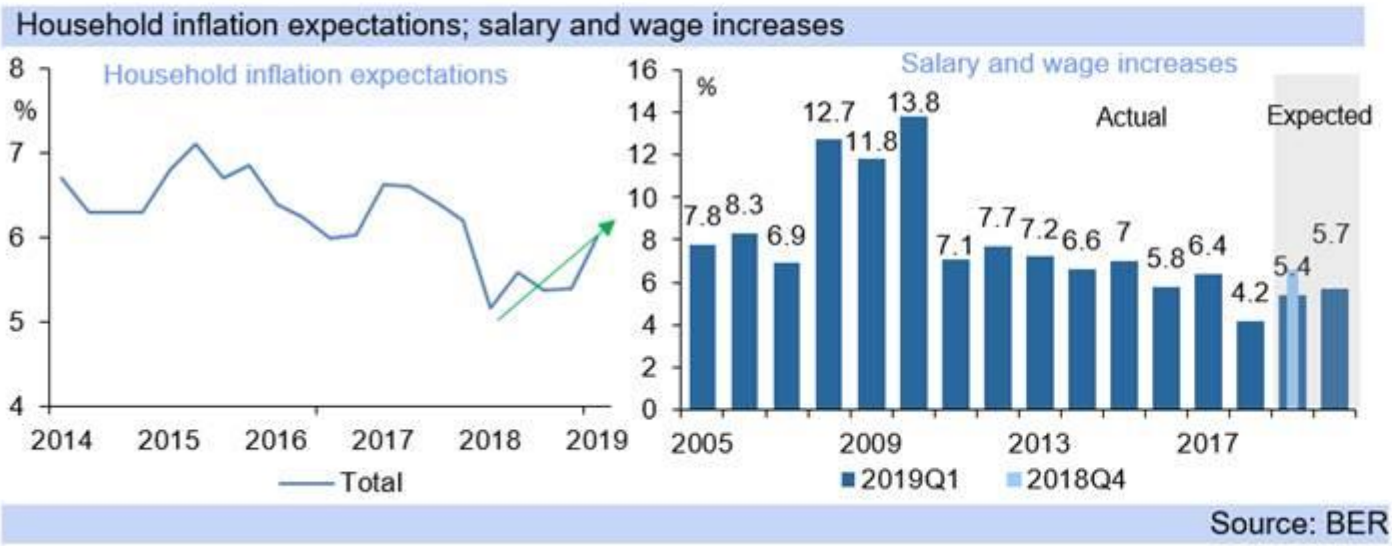
Investec

SA Economics

CPI Outlook

21st May 2019

Consumer price inflation rate around the midpoint of the inflation target does not foretell interest rate cuts as higher inflation is likely, and SA's credit rating risk is still material



- CPI inflation has moderated in South Africa reaching the midpoint of the 3-6% inflation target range in March at 4.5% y/y, after a relatively modest year in 2018 of 4.7% y/y. This is compared to the historical average of 5.5% over the period 2011 to 2017.

- Indeed, CPI inflation experienced a downward trajectory from 2016, largely led by falling food price inflation, if not deflation. The drop in price pressures to below 5.0% y/y generally also had some subduing effect on inflation expectations.

- Lower inflation expectations support lower inflation itself, as salary and wage demands moderate, leading to less upwards price pressure. Salary and wage increases have dropped from around 7.0% y/y in the 2010 to 2015 period, to closer to 6.0% y/y in 2016-2017, as expectations of future inflation also moderated.

- A more moderate inflation environment also tends to engender lower inflation expectations, as the increase in the cost of living proves lower than in previous periods, often causing consumers to expect similar going forward, entrenching expectations.

- Indeed, nominal salary and wage increases dropped to only 4.2% y/y over 2018, on the back of the lowering of inflation expectations over the past few years. While we forecast CPI inflation will average 4.8% y/y in 2019, from 2020 consumer inflation is likely to rise to return to 5.5% y/y as moderating effects wear out.

Inflation expectations survey Q4.18 and Q1.19

Survey conducted during	2018Q4 Analysts	Business people	Trade union officials	Average	2019Q1 Analysts	Business people	Trade union officials	Average
Headline CPI inflation during the year								
2019	5.2	5.7	5.3	5.4	4.7	5.1	4.8	4.8
2020	5.3	5.8	5.3	5.4	5.2	5.3	50	5.2
2021	-	-	-	-	5.2	5.5	5.2	5.3

Source: BER

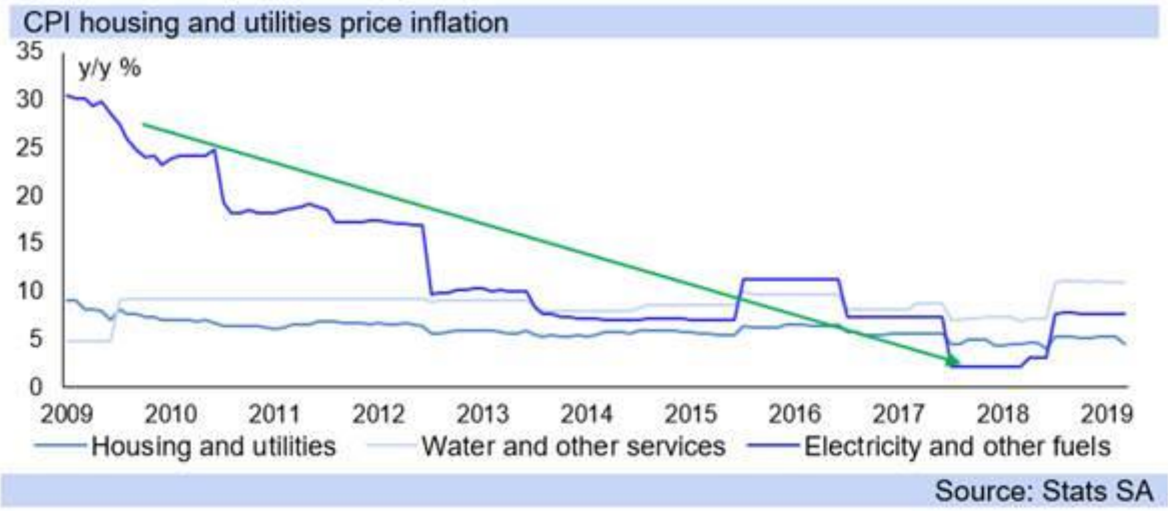
- The latest inflation expectations (from BER) see CPI inflation rising in 2020, signalling disinflation seems to be over. The Reserve Bank is likely to acknowledge the previous lowering of inflation expectations, and actual CPI inflation since 2016 in general, at this week's MPC meeting.

- However, it is also likely to make quite clear its monetary policy is not reactive, but rather forward looking instead. The MPC is currently mainly targeting 2020, where CPI inflation is expected to run above 5.0% y/y, as opposed to the mid-point of the inflation target range (4.5% y/y).

- Also of significance in monetary policy deliberations is the expectations of CPI inflation over the next five years, which have dropped from above 6.0% y/y in the first quarter of 2016, to 5.1% y/y currently. Whether this downward trend can be sustained, or is likely to be reversed, will be of significance to monetary policy.

- The downward trend in CPI inflation, evidenced in SA since 2016, has been driven in large part by the collapse of food (and non-alcoholic beverage) price inflation, which is close to 20% of the overall index (at 17.24% of the total).

- The alleviation of the previous drought has aided food price inflation to moderate from 12.0% y/y to 2.3% y/y. Additionally, electricity price increases, which were at double digits in 2016, subsequently fell into single digits, reinforcing the downward trend in overall CPI inflation in the period.



- With the SARB targeting CPI inflation at the midpoint of the inflation target range (4.5% y/y), higher state administered tariffs (water and electricity), rates and taxes, pull it away from 4.5% y/y, as does some elevated services price inflation rates (above 4.5% y/y).

- CPI inflation is likely to continue to average 5.5% y/y in the long-term, largely driven by state administered prices and costs of private sector services in SA, as food price inflation cannot be relied on to continue falling.

- Additionally, electricity price increases are likely to run higher than in the last few years given Eskom's severe financial problems. Higher CPI inflation is likely to push up CPI inflation expectations somewhat, and so salary and wage increases.

- With Moody's providing a stark warning recently on SA's government finances, including the burden of Eskom's debt, a credit rating downgrade is signalled if the fiscal metrics deteriorate further. A downgrade would cause borrowing costs to rise, placing upwards pressure on SA's short-term interest rates as well.

- Higher short-term interest rates would force the repo rate higher, the SARB estimates by around 100bp. With CPI inflation set to rise to around 5.5% y/y 2020, an interest rate cut is unlikely, with hikes in the repo rate holding a greater possibility, although for most of this year the repo should remain flat.

Inflation forecasts	2018	2019	2020	2021	2022	2023	2024
Consumer Inflation (Av: %)	4.7	4.8	5.6	5.5	5.8	5.5	5.3
(year-end: %)	*4.5*	*5.4*	*5.4*	*5.6*	*5.7*	*5.3*	*5.1*
Producer Inflation (Av: %)	5.5	5.4	5.9	5.6	5.6	5.3	5.2
(year-end: %)	*5.2*	*5.7*	*5.6*	*5.2*	*5.2*	*5.2*	*5.2*
Salary & wage increases	5.0	6.4	7.7	7.4	7.4	7.1	7.2

Source: Investec, SARB, Stats SA