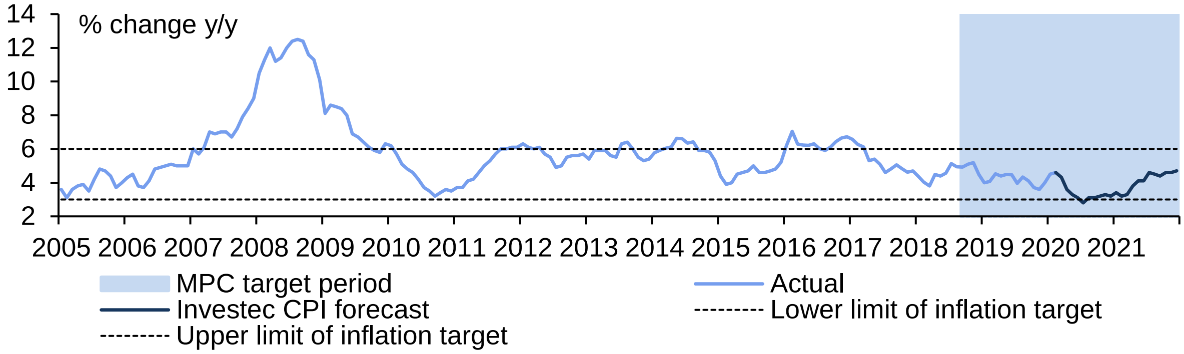
Investec

MPC update: SARB announces a further 100bp cut in the repo rate to 4.25%

14th April 2020

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- In a surprise move, the SARB's monetary policy committee (MPC) unanimously elected to cut the repo rate by a further 100bp to 4.25%, effective 15 April 2020. The "(m)ore prolonged lockdown and slower recovery creates downside risk to inflation and allows further space for monetary policy to respond to the virus-induced demand shock to the economy," according to the SARB. In turn, enhancing "(t)he resilience of households and firms to the economic implications of Covid-19."
- Recent monthly inflation readings have remained firmly anchored around the mid-point of the inflation target range. Indeed, inflation is anticipated to be well contained in the near-term, "(r)emaining below the midpoint of the target in 2020 and close to the midpoint in 2021," according to the SARB, "(b)arring severe and persistent currency and oil shocks."
- Specifically, the Reserve Bank's average headline CPI inflation forecast for 2020 has dropped to 3.6% from 3.8% previously (March forecast), while its 2021 estimate (which is key to its inflation targeting process) has been lowered slightly to 4.5% from 4.6% previously. The SARB's 2022 projection sees inflation remaining at 4.4%.
- Risks to the inflation trajectory "(a)t this time appear to be to the downside," according to the SARB. Indeed, petrol prices will ease in the near term, on the back of depressed global oil prices, while the food price component, which comprises a large chunk of the CPI basket is "(e)xpected to remain low, in part due to higher domestic production levels." Electricity pricing, conversely continues to remain an upside risk, but concerns have "(m)oderated somewhat".
- The domestic currency has depreciated by 22.6% against the greenback since January and by 17.3% since the MPC's March meeting. "The implied starting point for the rand forecast is R17.80 to the US dollar, compared with R15.40 at the time of the previous meeting". However, the Governor of the SARB anticipates that the "(r)isks to inflation from recent currency depreciation" to be "(m)uted as pass-through is slow."

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

	2018	2019	2020	2021	2022
SARB 14th April 2020	4.6	4.1	3.6	4.5	4.4
SARB 19th March 2020	4.6	4.1	3.8	4.6	4.4
SARB 16th January 2020	4.6	4.1	4.7	4.6	4.5
SARB 21st November 2019	4.6	4.2	5.1	4.7	
SARB 19th September 2019	4.6	4.2	5.1	4.7	
SARB 18th July 2019	4.6	4.4	5.1	4.6	

Source: SA Reserve Bank

Lara Hodes • Investec Bank Limited • Tel (2711) 286 7257 • email: lara.hodes@investec.co.za•
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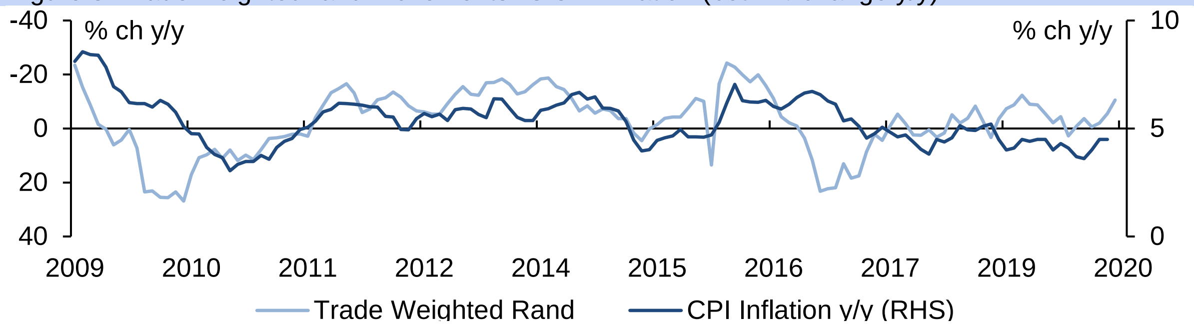
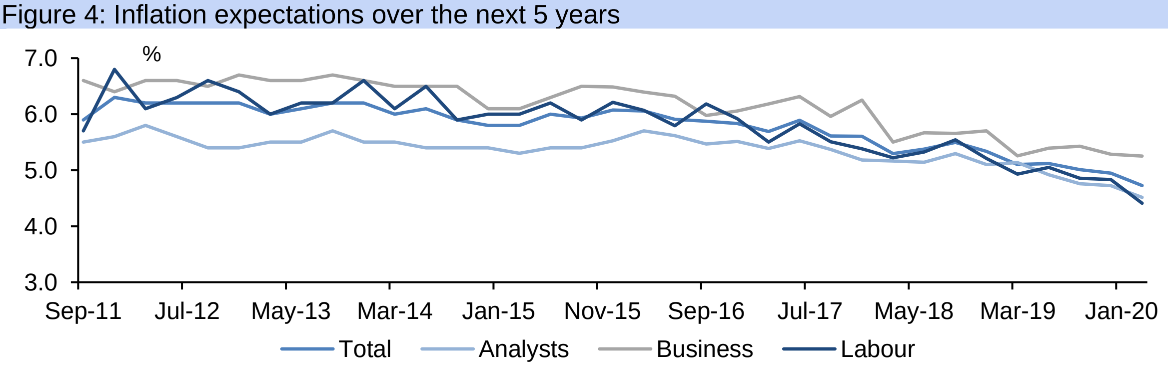
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- While developed economies continue to implement remarkably accommodative policies, "(g)lobal financing conditions are no longer supportive of emerging market currency and asset values" and credit risk has reverted back to 2008 levels.
- The global growth outlook has softened considerably amidst the marked economic fallout from Covid-19. "Current estimates from the IMF show global growth contracting this year by about 2.9%." Global uncertainty, combined with our domestic situation which is marred by numerous structural inefficiencies and policy uncertainty does not bode well for South Africa's medium-term economic growth trajectory. Specifically the Reserve Bank projects the economy to contract by 6.1% in 2020 (although it did stress that "(f)orecasting domestic economic activity presents unprecedented uncertainty," at this time), versus "(t)he -0.2% expected just three weeks ago." GDP is then projected to lift by 2.2% y/y and 2.7% y/y in 2021 and 2022 respectively. The SARB highlighted that the "(s)trength of the recovery…will depend on how quickly countries are able to open up for economic activity."
- "Global economic and financial conditions are expected to remain highly volatile for the foreseeable future." Accordingly, the SARB stressed that in "(t)his highly uncertain environment, future decisions will continue to be highly data dependent, sensitive to the balance of risks to the outlook and will seeks to look through temporary price shocks."
- "The implied path of policy rates over the forecast period generated by the Quarterly Projection Model indicates five repo rate cuts of 25 basis points extending into the first quarter of 2021."

Figure 4: Inflation expectations over the next 5 years



Source: BER

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Figure 5: Foreign sector assumptions

Percentage changes (unless otherwise indicated)	2017	Actual 2018	2019	Forecast 2020	2021	2022
1. Real GDP growth in South Africa's major trading partner countries	3.4% (3.2%)	3.3% (3.3%)	2.3% (2.3%)	-2.8% (1.1%)	4.0% (2.8%)	3.5% (3.1%)
2. Output gap in South Africa's major trading partner countries	0.0% (-0.1%)	0.1% (0.1%)	-0.1% (-0.1%)	-2.5% (-1.3%)	-2.8% (-1.4%)	-1.9% (-1.2%)
3. International commodity prices in US$ (excluding oil)	18.2% (18.2%)	11.2% (11.0%)	-0.9% (-0.9%)	-7.1% (-0.6%)	5.4% (-7.0%)	5.5% (3.4%)
4. Brent crude (US$/Barrel)	$54.2 ($54.2)	$71.0 ($71.0)	$64.4 ($64.4)	$37.4 ($40.4)	$45.0 ($44.5)	$50.0 ($45.0)
5. World food prices (US$)	8.1% (8.1%)	-3.5% (-3.5%)	1.8% (1.8%)	-0.5% (2.5%)	3.5% (1.5%)	1.9% (1.5%)
6. International consumer prices	1.7% (1.7%)	2.0% (2.0%)	1.4% (1.4%)	0.5% (0.5%)	1.4% (1.4%)	1.4% (1.5%)
7. International policy interest rate	0.5% (0.5%)	0.9% (0.9%)	1.1% (1.1%)	0.1% (0.2%)	0.0% (0.1%)	0.0% (0.1%)

Source: SA Reserve Ban

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.

Figure 5: Domestic sector assumptions

Percentage changes (unless otherwise indicated)		Actual			Forecast	
	2017	2018	2019	2020	2021	2022
1. Electricity price	4.7%	5.2%	9.6%	9.6%	6.7%	6.0%
	(4.7%)	(5.2%)	(9.6%)	(10.4%)	(7.4%)	(6.0%)
2. Fuel taxes and levies	8.3%	8.9%	5.8%	5.8%	5.2%	5.0%
	(8.3%)	(8.9%)	(5.8%)	(5.3%)	(4.6%)	(4.4%)
3. Potential growth	1.2%	0.9%	0.6%	-2.1%	1.1%	1.3%
	(1.4%)	(1.1%)	(0.6%)	(0.6%)	(0.9%)	(1.0%)
4. Inflation target midpoint	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
	(4.5%)	(4.5%)	(4.5%)	(4.5%)	(4.5%)	(4.5%)
5. Neutral real interest rate	1.7%	1.9%	2.1%	2.1%	2.2%	2.3%
	(1.7%)	(1.9%)	(2.1%)	(2.1%)	(2.1%)	(2.3%)

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.

Lara Hodes • Investec Bank Limited • Tel (2711) 286 7257 • email: lara.hodes@investec.co.za•
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