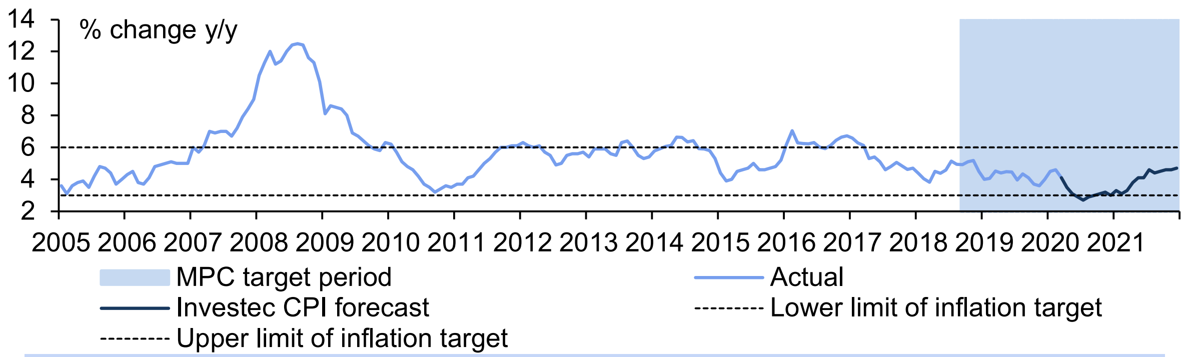
Investec

MPC update: SARB announces a further 50bp cut in the repo rate to 3.75%, with risks to the inflation outlook tilted to the downside

21st May 2020

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- The SARB's monetary policy committee (MPC) announced a further 50bp cut this afternoon, taking the repo rate to 3.75%. The decision was split and follows the 100bp reduction in mid-April, which was a direct response "(t)o the virus-induced demand shock to the economy," according to the SARB.
- Inflation expectations have continued to soften "(b)ut broadly remain around the midpoint of the band," according to the SARB.
- The Reserve Bank's average headline CPI inflation forecast for 2020 has dropped to 3.4% from 3.6% previously (April forecast), while its 2021 estimate (which is key to its inflation targeting process) has been lowered slightly to 4.4% from 4.5%. The SARB's 2022 projection sees inflation remaining at 4.4%.
- Overall risks to the inflation trajectory remain tilted to the downside, "(b)ut less clearly so compared to conditions in March and April," the SARB stressed. Specifically, while domestic food price inflation is projected to remain largely contained, "(g)lobal producer price and food inflation appear to have bottomed out." Additionally, oil prices remain subdued, but have picked somewhat and are currently trading at around $34 per barrel (Brent crude).
- The rand has depreciated by 22.9% against the greenback since January and by 0.7% since last month's MPC meeting. "The implied starting point for the rand forecast is R18.40 to the US dollar, compared with R17.80 at the time of the previous meeting". However, the Governor anticipates the risks to inflation from currency depreciation to "(s)tay muted while pass-through remains slow."
- Conversely, upside risks to the inflation trajectory include electricity and other administered prices, while "(h)eightened fiscal risks and sharp reductions in the supply of goods and services," could also place upside pressure on the inflation readings.

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

	2018	2019	2020	2021	2022
SARB 21st May 2020	4.6	4.1	3.4	4.4	4.4
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	

Source: SA Reserve Bank

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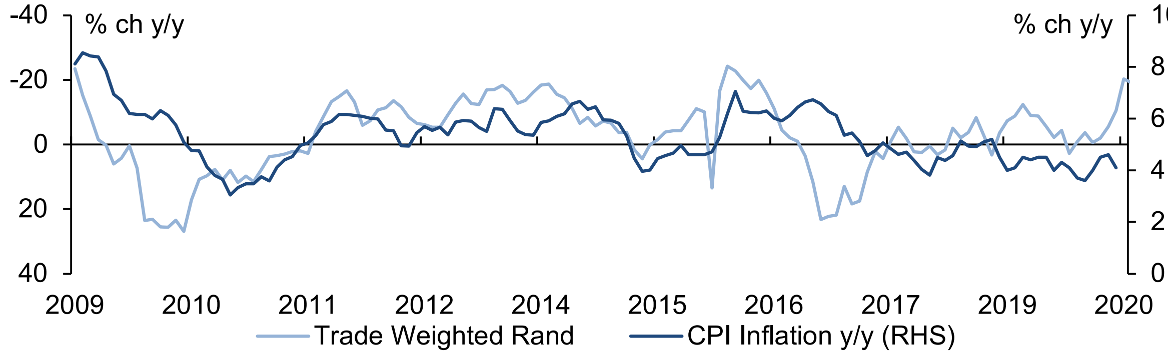
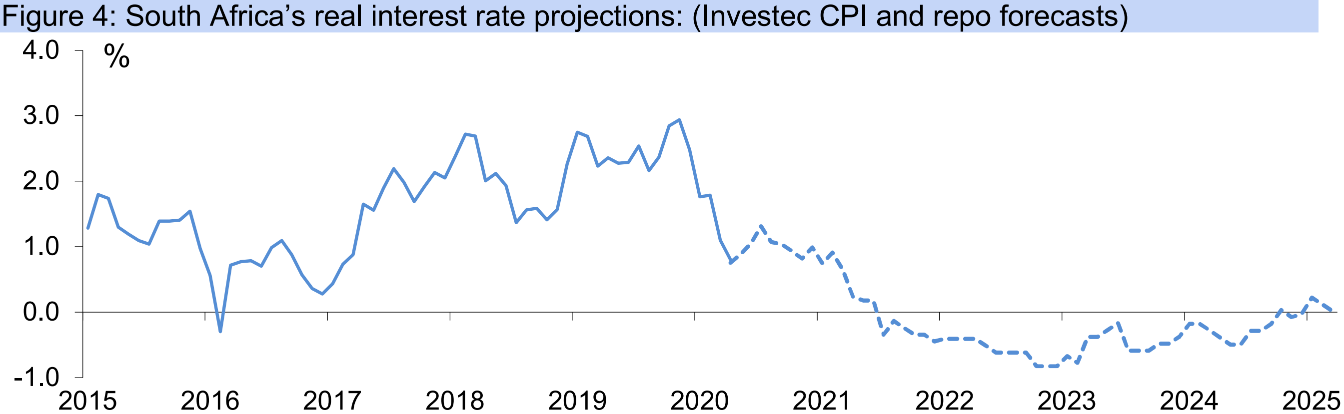
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- 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 around 3.0%. However it recently signaled that that it will be publishing further downward revisions to its global GDP forecasts "(r)eflecting the fact that the virus had spread further and the economic impact had intensified in recent weeks".
- Global uncertainty, combined with our already fragile domestic situation which has had one of the most stringent lockdowns globally, does not bode well for South Africa's medium-term economic growth trajectory. Specifically, the Reserve Bank projects the economy to now contract by 7.0% in 2020, versus the 6.1% estimated at the previous MPC meeting, with widespread job losses anticipated. GDP is then forecast to lift by 3.8% y/y and 2.9% y/y in 2021 and 2022 respectively.
- Global economic and financial conditions are expected to remain volatile during this unprecedented time. 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 two repo rate cuts of 25 basis points in the next two quarters of 2020."

Figure 4: South Africa's real interest rate projections: (Investec CPI and repo forecasts)



Source: Investec, Iress

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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%)	3.2% (3.3%)	2.2% (2.3%)	-3.4% (-2.8%)	4.3% (4.0%)	3.7% (3.5%)
2. Output gap in South Africa's major trading partner countries	0.0% (0.1%)	0.1% (0.1%)	-0.1% (-0.1%)	-3.0% (-2.5%)	-3.1% (-2.8%)	-2.0% (-1.9%)
3. International commodity prices in US$ (excluding oil)	18.2% (18.2%)	11.2% (11.0%)	-0.9% (-0.9%)	2.0% (-7.1%)	-6.0% (5.4%)	3.2% (5.5%)
4. Brent crude (US$/Barrel)	$54.2 ($54.2)	$71.0 ($71.0)	$64.4 ($64.4)	$37.4 ($42.0)	$45.0 ($45.0)	$50.0 ($50.0)
5. World food prices (US$)	8.1% (8.1%)	-3.5% (-3.5%)	1.8% (1.8%)	-3.4% (-0.5%)	5.1% (3.5%)	1.5% (1.9%)
6. International consumer prices	1.7% (1.7%)	2.0% (2.0%)	1.4% (1.4%)	0.5% (0.5%)	1.4% (1.3%)	1.3% (1.4%)
7. International policy interest rate	0.5% (0.5%)	0.9% (0.9%)	1.1% (1.1%)	0.1% (0.1%)	0.0% (0.0%)	0.0% (0.0%)

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.

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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)	2017	Actual 2018	2019	2020	Forecast 2021	2022
1. Electricity price	4.7% (4.7%)	5.2% (5.2%)	9.6% (9.6%)	9.6% (9.6%)	6.7% (6.7%)	6.0% (6.0%)
2. Fuel taxes and levies	8.3% (8.3%)	8.9% (8.9%)	5.8% (5.8%)	5.8% (5.8%)	5.2% (5.2%)	5.0% (5.0%)
3. Potential growth	1.2% (1.4%)	0.8% (0.8%)	0.6% (0.6%)	-2.1% (-2.1%)	1.1% (1.1%)	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% (4.5%)	4.5% (4.5%)
5. Neutral real interest rate	1.7% (1.7%)	1.9% (1.9%)	2.1% (2.1%)	2.1% (2.1%)	2.2% (2.2%)	2.3% (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.

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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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