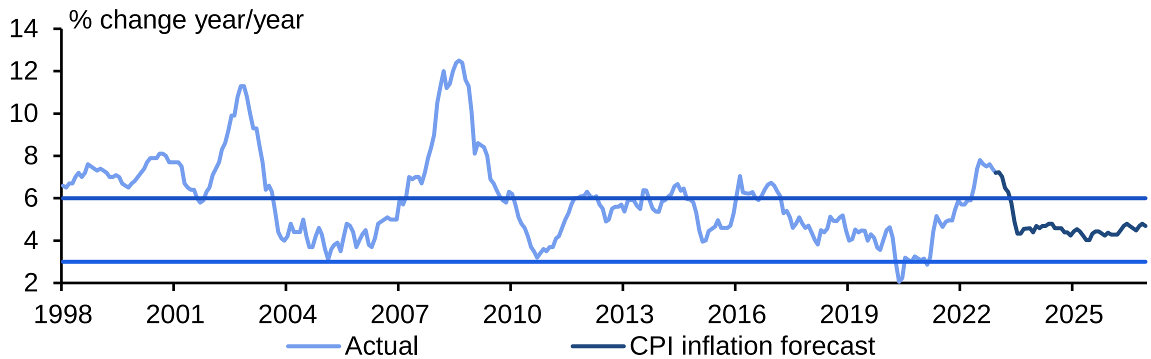
Investec

MPC update: SARB lifts rates by a further 25bp to 7.25%

Thursday 26 January 2023

Figure 1: SA Consumer Inflation: history and Forecasts



Sources: Stats SA, Investec

- The SARB's monetary policy committee (MPC) opted to hike the repo rate by 25bp to 7.25%, below consensus expectations of a 50bp lift and the Federal Reserve Bank's move last month. The decision was not unanimous with 2 out of the 5 MPC members preferring a 50bp lift in the repo rate.
- Inflation globally has eased but remains elevated and this combined with subdued growth continues "to shape global conditions", according to the SARB.
- Domestically, inflation has decelerated, but it remains notably above the SARB's inflation targeting band (3% - 6%). The Reserve Bank's headline consumer price inflation forecast for 2023 remains unchanged at 5.4% but has increased to 4.8% for 2024 (previously 4.5%).
- The SARB's projection for core inflation has dropped moderately to 5.2% (from 5.5%) for 2023 and to 4.7% (from 4.8%) for 2024.
- Overall risks to the inflation trajectory continue to be assessed to the upside. Specifically, although global food prices have decelerated, as evinced by indicators such as the Food and Agricultural Organization of the United Nation's (FAO) food price indices the SARB has revised local food price inflation up again. Partly "due to the lagged impact of the weaker exchange rate". Food price inflation is now forecast at 7.3% in 2023 (previously 6.2%) and 4.4% for next year (previously 4.2%).
- Moreover, administered price inflation continues to remain an upside risk, with projections for electricity prices higher than at the previous MPC meeting. The energy regulator Nersa recently granted Eskom a 18.65% tariff increase. Indeed, persistent load shedding "may have broader price effects on the cost of doing business and the cost of living".
- While "the rand has been less buoyant" than other emerging market currencies, the implied starting point for the local currency is still moderately lower at R16.92 for Q1.23 against the greenback versus R17.68/USD at the time of the November MPC meeting.

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

	2023	2024	2025
SARB 26th Jan 2023	5.4	4.8	4.5
SARB 24th Nov 2022	5.4	4.5	4.5
SARB 22nd Sep 2022	5.3	4.6	4.6
SARB 21st July 2022	5.7	4.7	4.7
SARB 19th May 2022	5.0	4.7	4.7
SARB 24th March 2022	4.6	4.6	4.6

Source: SA Reserve Bank

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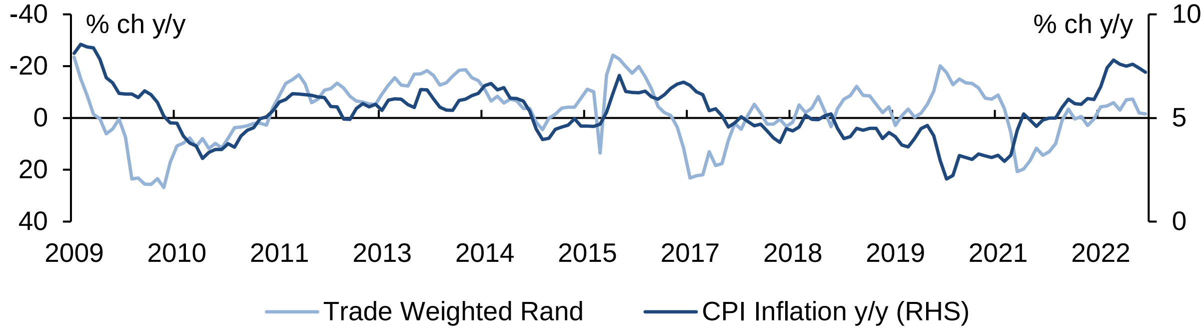
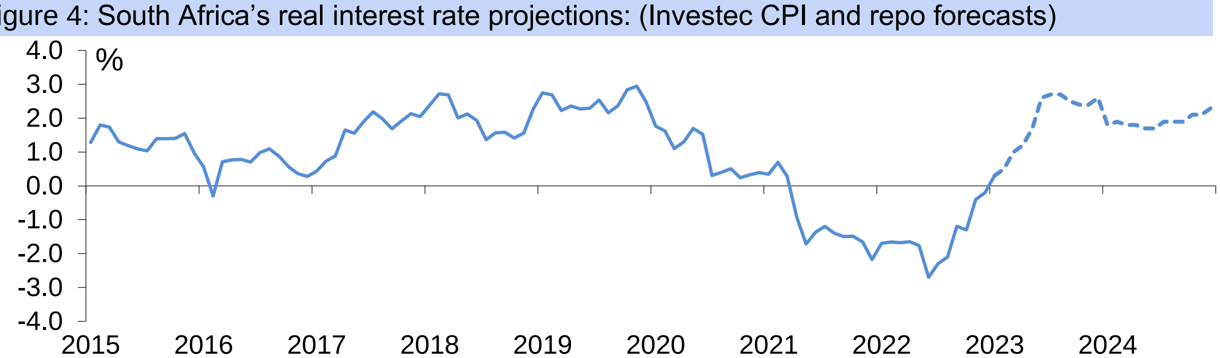
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- Global growth remains lacklustre, specifically, the US's growth prospects for 2023 have deteriorated, while the "outlook for China has improved but is likely to remain modest by historical standards". Accordingly, the Reserve Bank has amended its global growth forecast for 2023 to 1.6% from 1.9% previously.
- On the domestic front, the economic environment remains fragile. The SARB has pencilled in zero growth for Q4.22, which would equate to a 2.5% y/y rise for 2022, up from its forecast of 1.8% previously on account of a better than anticipated Q3.22 outcome. However, it has markedly reduced its 2023 forecast to just 0.3% from 1.1% at the previous meeting.
- Indeed, "the Bank estimates that it deducts as much as 2 percentage points from growth in 2023, compared to the previous estimate of 0.6 percentage points" on account of the heightened load shedding. Indeed, the electricity supply situation in the country is dire, with persistent load shedding weighing on all sectors of the economy, decreasing confidence.
- The growth trajectory for 2024 and 2025 has also been revised lower to 0.7% (previously 1.4%) and to 1.0% (previously 1.5%) respectively. These projections incorporate "ongoing high levels of loadshedding, and more modest household spending and investment growth than previously". Moreover, "exports are also forecast to be less robust", underpinned by falling commodity prices.
- Following revisions to the growth numbers, the SARB has calculated "the risks to the medium-term domestic growth outlook" as balanced.
- Indeed, conditions are anticipated "to remain volatile for the foreseeable future" and accordingly in such an "uncertain environment, monetary policy decisions will continue to be data dependent and sensitive to the balance of risks to the outlook". The next interest rate announcement is scheduled for the end of March.

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)	Actual			Forecast		
	2020	2021	2022	2023	2024	2025
1.Real GDP growth in South Africa's major trading partner countries	-2.5% (-2.5%)	7.0% (6.9%)	3.4% (3.3%)	1.6% (1.9%)	2.6% (2.4%)	3.1% (3.1%)
2.Output gap in South Africa's major trading partner countries	-2.7% (-2.7%)	-0.9% (-0.9%)	-0.2% (-0.2%)	-1.1% (-0.9%)	-0.7% (-0.7%)	-0.1% (0.0%)
3.International commodity prices in US$ (excluding oil)	25.5% (25.5%)	45.6% (45.6%)	1.4% (1.2%)	-18.0% (-18.1%)	-12.2% (-11.1%)	-1.5% (-1.5%)
4.Brent crude (US$/Barrel)	$41.8 ($41.8)	$70.7 ($70.7)	$100.4 ($102.0)	$89.0 ($92.0)	$85.0 ($85.0)	$80.0 ($80.0)
5.World food prices (US$)	3.2% (3.2%)	28.1% (28.1%)	14.3% (14.7%)	-7.9% (-7.7%)	0.6% (0.2%)	3.2% (3.2%)
6.International consumer prices	0.7% (0.7%)	3.3% (3.3%)	7.3% (7.3%)	4.0% (4.1%)	1.8% (2.1%)	1.9% (2.0%)
7.International policy interest rate	0.2% (0.2%)	0.1% (0.1%)	1.1% (1.1%)	3.7% (3.6%)	3.4% (3.4%)	2.4% (2.4%)

Source: SA Reserve Bar

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.

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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 6: Domestic sector assumptions

	Actual			Forecast		
Percentage changes (unless otherwise indicated)	2020	2021	2022	2023	2024	2025
1. Electricity price	9.1% (9.1%)	10.2% (10.2%)	10.7% (10.7%)	12.9% (9.0%)	14.5% (10.0%)	10.9% (10.0%)
2. Fuel taxes and levies	5.7% (5.7%)	6.1% (6.1%)	3.3% (2.7%)	7.7% (5.3%)	1.1% (1.2%)	4.4% (4.5%)
3. Potential growth	-3.1% (-3.1%)	3.4% (3.4%)	0.7% (0.4%)	0.0% (0.5%)	0.6% (1.1%)	1.0% (1.5%)
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	2.0% (2.0%)	2.0% (2.1%)	2.3% (2.3%)	2.4% (2.3%)	2.4% (2.4%)	2.5% (2.4%)

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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