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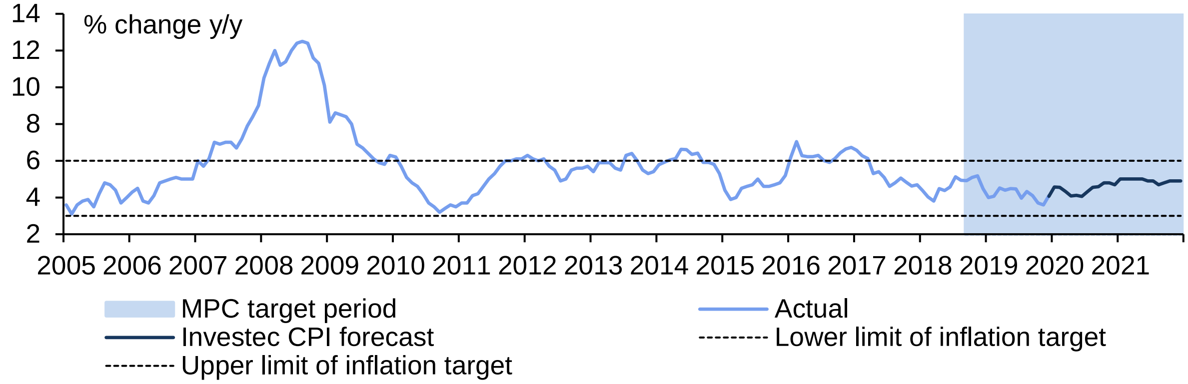
MPC update: Repo rate cut by 25bp to 6.25%, with risks to the inflation outcome assessed to be balanced

16th January 2020

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- The MPC committee unanimously elected to cut the repo rate by 25bp to 6.25%, with a continued moderation in inflation expectations and an "(i)mproved risk profile," opening up "(s)ome space to provide further policy accommodation to the economy."
- Indeed, recent monthly inflation readings have been subdued, notably below the mid-point of the inflation target range, with November's CPI inflation reading at just 3.6% y/y.
- Expectations are for the inflation rate to remain firmly anchored within the target range in the medium term, with the SARB's Quarterly Projection Model's (QPM) headline inflation projections notably below November's figures. Specifically 2019's average inflation forecast has dropped to 4.1% from 4.2%, while the 2020 and 2021 projections have been cut to 4.7% (from 5.1%) and 4.6% (from 4.7%) respectively.
- Overall risks to the inflation outlook are deemed balanced. Demand side pressures remain muted, while "(h)ouse rental prices are expected to increase at only moderate rates." Additionally, the food price component, which comprises a large chunk of the CPI basket "(c)ontinues to surprise to the downside on a monthly basis" and has been revised from 5.8% to 4.7% for 2020. Furthermore global inflation should remain low, with monetary policy in major advanced economies likely to "(r)emain accommodative over the medium term."
- Upside risks to the inflation trajectory however remain, including administered price increases and nominal wage growth. Additionally, while the rand has appreciated modestly since the last MPC meeting, "(t)he risk remains that domestic shocks generate more capital flow volatility and put pressure on the exchange rate and inflation."
- The domestic currency has strengthened by 2.6% against the US dollar and 1.8% against the euro, since November's decision and as such "(t)he implied starting point for the rand is R14.60 against the US dollar, compared with R14.94 at the time of the previous meeting."
- The domestic growth outlook remains sluggish, and while Q4.19 GDP growth is projected to have edged up modestly, "(e)lectricity supply constraints will likely keep economic activity muted in the near term."

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

	2018	2019	2020	2021
SARB 16th January 2020	4.6	4.1	4.7	4.6
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
SARB 23rd May 2019	4.6	4.5	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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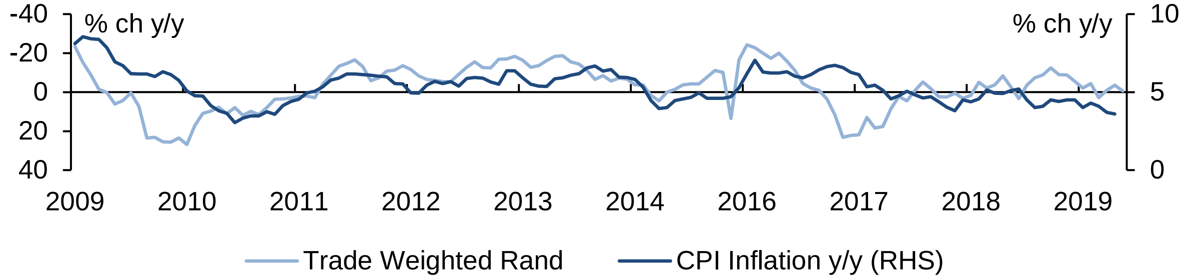
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- Consequently, expectations for domestic growth have been revised lower to 0.4% y/y (previously 0.5% y/y) for 2019 and to 1.2% y/y (from 1.4% y/y) and 1.6% y/y (from 1.7% y/y) for 2020 and 2021 respectively, with risks to the growth forecast evaluated to be to the downside, according to the SARB.
- Specifically, an "(e)scalation in global trade tensions, geo-political risks, further domestic supply constraints and/or sustained higher oil prices," were cited as possible impediments to growth. Accordingly, the SARB emphasized the pressing need for "(i)mplementation of prudent macroeconomic policy and structural reforms," to bring down costs and lift "(i)nvestment, potential growth and job creation."
- The SARB's Quarterly Projection Model signaled "(t)wo repo rate cuts of 25 basis points each in the first and fourth quarters of 2020." However, this is a "(b)road policy guide which could change in either direction from meeting to meeting," according to the SARB, "(i)n response to new developments and changing data and risks."

Figure 4: Foreign sector assumptions

Percentage changes (unless otherwise indicated)	Actual			Forecast		
	2017	2018	2019	2020	2021	2022
1. Real GDP growth in South Africa's major trading partner countries	3.2% (3.3%)	3.3% (3.2%)	2.4% (2.4%)	2.7% (2.7%)	3.1% (3.1%)	3.1%
2. Output gap in South Africa's major trading partner countries	-0.1% (-0.1%)	0.1% (0.2%)	-0.1% (-0.1%)	-0.1% (-0.1%)	0.0% (0.0%)	0.2%
3. International commodity prices in US$ (excluding oil)	18.2% (18.2%)	11.0% (11.0%)	-2.3% (-2.5%)	2.0% (1.0%)	2.1% (2.0%)	2.5%
4. Brent crude (US$/Barrel)	$54.2 ($54.2)	$71.0 ($71.0)	$64.4 ($64.4)	$66.5 ($66.0)	$66.0 ($66.0)	$66.0
5. World food prices (US$)	8.1% (8.1%)	-3.5% (-3.5%)	1.6% (0.8%)	2.0% (1.5%)	1.0% (1.0%)	1.5%
6. International consumer prices	1.8% (1.8%)	1.9% (1.9%)	1.4% (1.4%)	1.8% (1.8%)	1.6% (1.6%)	1.9%
7. International policy interest rate	0.5% (0.5%)	0.9% (0.9%)	1.1% (1.1%)	0.9% (0.8%)	0.9% (0.8%)	1.1%

Source: SA Reserve Bank

Figures in blue represents the previous MPC assumption

Lara Hodes • Investec Bank Limited • Tel (2711) 286 7257 • email: lara.hodes@investec.co.za•
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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% (4.7%)	5.2% (5.2%)	9.6% (9.6%)	10.4% (10.4%)	7.4% (7.4%)	6.0%
2. Fuel taxes and levies	8.3% (8.3%)	8.9% (8.9%)	5.8% (5.8%)	6.1% (5.5%)	5.6% (5.6%)	5.3%
3. Potential growth	1.4% (1.4%)	1.1% (1.1%)	1.0% (1.0%)	1.1% (1.1%)	1.2% (1.2%)	1.2%
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%
5. Neutral real interest rate	1.7% (1.7%)	1.9% (1.9%)	2.2% (2.2%)	2.4% (2.4%)	2.4% (2.4%)	2.5%

Source: SA Reserve Bank

Figures below the assumption in parentheses represents the previous MPC assumption

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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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