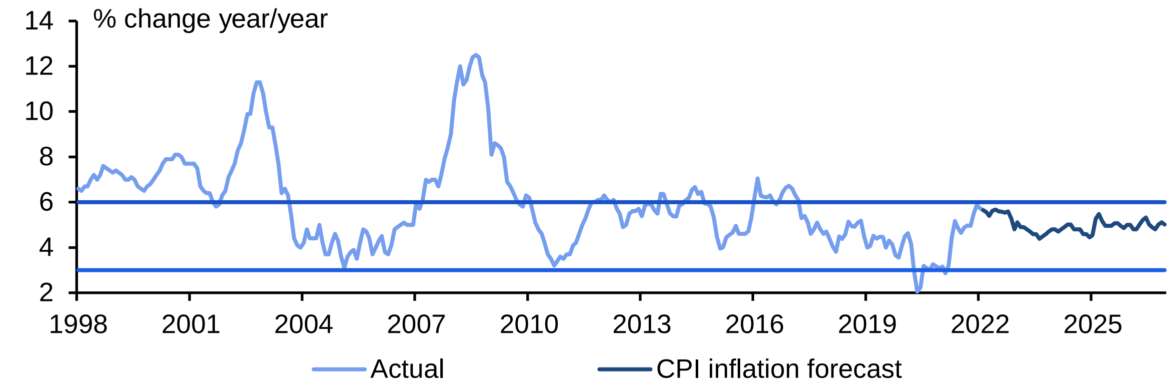
Investec

MPC update: SARB lifts rates by a further 25bp to 4.25% as inflationary pressures increase

Thursday 24 March 2022

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 a further 25bp to 4.25%. Three of the MPC members were in favour of a 25 bp hike, with two preferring a more hawkish 50bp rise.
- Overall risks to the inflation trajectory have risen, underpinned predominantly by higher fuel and food prices and accordingly the Reserve Bank has revised its headline consumer price inflation projection significantly higher for this year. Specifically, CPI is now projected to reach an elevated 5.8% in 2022 (from 4.9% previously). This is ahead of the average and market-based surveyed expectations of future inflation of 5.1% y/y and 5.5% y/y respectively.
- Thereafter inflation should ease somewhat on waning fuel price pressures with 2023's headline CPI forecast declining to 4.6% y/y.
- Core inflation expectations have also been raised, with a reading of 4.2% anticipated for 2022 (3.8% y/y previous estimate), 5.0% y/y in 2023 (previously 4.4% y/y) and 4.7% y/y in 2024 (previously 4.5% y/y).
- The highly volatile oil price, a major commodity import, has risen markedly on the back of the conflict between Ukraine and Russia and remains a key upside risk to the inflation outcome. The SARB has accordingly increased its oil price forecast for this year to a marked US$103/bbl (average).
- Food price inflation which makes up the largest portion of the CPI basket was elevated before the onset of the war between Russia and Ukraine. Specifically, international agricultural food prices have been driven higher by increased demand, poor weather conditions in certain geographies leading to supply constraints.
- Supply concerns have further been exacerbated by the geo-political situation, exerting upward pressure on a number of agricultural commodities like grains and oilseeds and key inputs like fertilizer and. Indeed, "Russia is the world's leading exporter of fertilizer materials, accounting for 14% of global exports in value terms", according to Agbiz.

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

	2021	2022	2023	2024
SARB 24th March 2022	4.5	5.8	4.6	4.6
SARB 27th January 2022	4.5	4.9	4.5	4.5
SARB 18th November 2021	4.5	4.3	4.6	4.5
SARB 23rd September 2021	4.4	4.2	4.5	

Source: SA Reserve Bank

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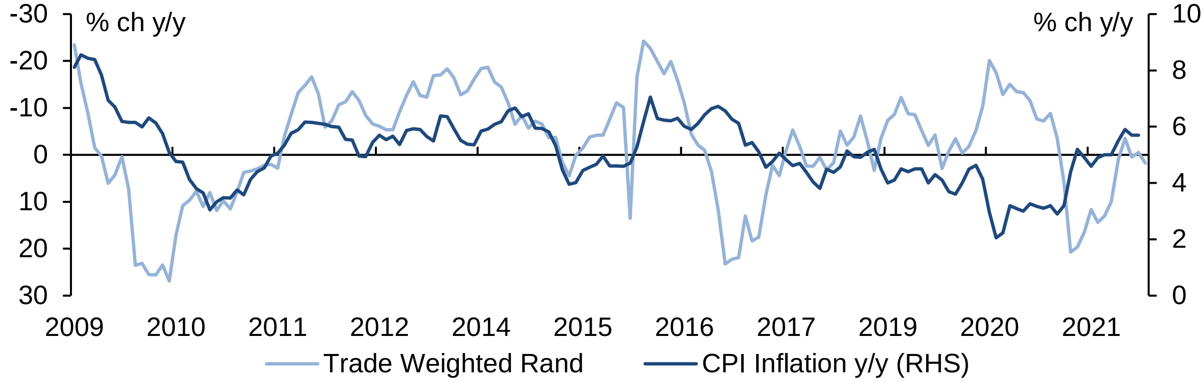
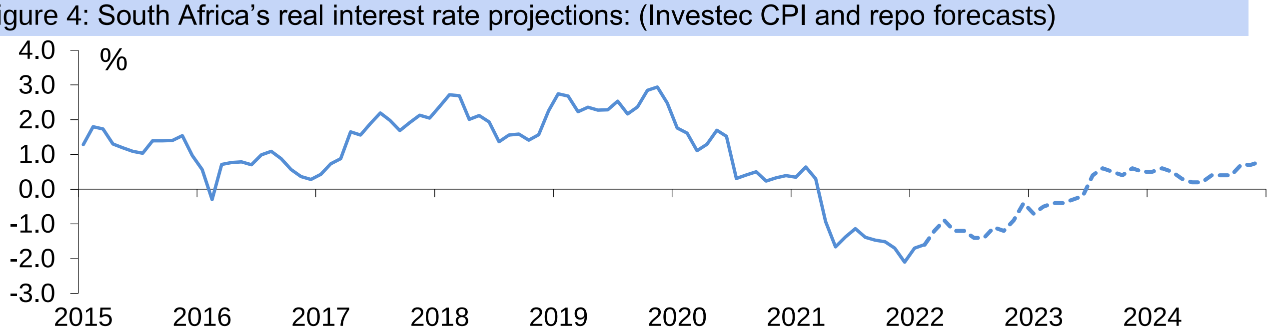
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- The persistent risk of rising electricity and other administered prices remains, with higher diesel and coal prices possibly leading to upward adjustments to the SARB's electricity price projection for 2023.
- The domestic currency has appreciated somewhat, "despite less favourable global conditions", buoyed by robust commodity export prices which has "helped to dampen price pressures", according to the SARB. Accordingly, the implied starting point for the rand forecast has been adjusted to R15.41 to the greenback, versus R15.60/USD previously (January meeting).
- Global growth is expected to decelerate this year on heightened geo-political tensions and renewed lockdown restrictions in parts of Asia in response to rising covid-cases. Specifically, the SARB has amended its global growth forecast notably to 3.7% (from 4.4%) for 2022. Risks to this forecast remain, depending on the length and severity of the war in Eastern Europe.
- Conversely, the SARB has revised upwards, albeit moderately, its GDP forecast for the South African economy to 2.0% for 2022, from 1.7% previously, underpinned by a number of factors, including robust export commodity prices and a higher than anticipated Q1.22 GDP outcome. Rates of growth for 2023 and 2024 are projected at 1.9% respectively. Electricity supply constraints and sluggish reform implementation remain key impediments to growth. The SARB continues to evaluate the risks to the medium-term domestic growth outlook to be balanced.
- "Economic and financial conditions are expected to remain more volatile for the foreseeable future. In this uncertain environment, policy decisions will continue to be data dependent and sensitive to the balance of risks to the outlook," the SARB stated.

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 2019	Actual 2020	Actual 2021	Forecast 2022	Forecast 2023	Forecast 2024
1.Real GDP growth in South Africa's major trading partner countries	2.3% (2.2%)	-2.6% (-2.7%)	6.4% (6.2%)	3.7% (4.4%)	2.8% (3.3%)	2.7% (2.7%)
2.Output gap in South Africa's major trading partner countries	-0.1% (0.6%)	-1.6% (-3.1%)	-0.8% (-1.5%)	0.0% (0.4%)	0.3% (1.5%)	0.3% (1.0%)
3.International commodity prices in US$ (excluding oil)	-1.2% (-1.2%)	25.5% (25.5%)	45.6% (45.6%)	8.0% (-22.3%)	-23.4% (-3.5%)	-8.8% (0.6%)
4.Brent crude (US$/Barrel)	$64.4 ($64.4)	$41.8 ($41.8)	$70.7 ($70.7)	$103.0 ($78.0)	$80.0 ($72.0)	$75.0 ($70.0)
5.World food prices (US$)	-0.8% (-0.8%)	3.2% (3.1%)	28.1% (28.0%)	6.8% (-2.3%)	-8.8% (0.7%)	1.4% (1.2%)
6.International consumer prices	1.4% (1.4%)	0.7% (0.7%)	3.3% (3.1%)	5.6% (3.1%)	3.0% (1.7%)	2.3% (1.6%)
7.International policy interest rate	1.1% (1.1%)	0.2% (0.2%)	0.1% (0.1%)	0.3% (0.1%)	0.8% (0.6%)	1.5% (1.1%)

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.
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 6: Domestic sector assumptions

Percentage changes (unless otherwise indicated)	2018	Actual 2019	2020	Forecast 2021	2022	2023	2024
1. Electricity price	5.2% (5.2%)	9.6% (9.6%)	9.1% (9.1%)	10.2% (10.2%)	11.0% (14.5%)	9.2% (12.3%)	10.0% (10.0%)
2. Fuel taxes and levies	9.9% (9.9%)	5.8% (5.8%)	5.7% (5.7%)	6.1% (6.1%)	5.2% (7.4%)	2.7% (3.4%)	4.6% (4.4%)
3. Potential growth	1.2% (1.2%)	0.3% (0.3%)	-3.1% (-3.1%)	3.4% (3.4%)	0.8% (0.8%)	0.8% (0.8%)	1.1% (1.1%)
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%)	4.5% (4.5%)
5. Neutral real interest rate	1.9% (1.9%)	2.1% (2.1%)	2.0% (2.0%)	2.1% (2.1%)	2.3% (2.3%)	2.3% (2.3%)	2.4% (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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