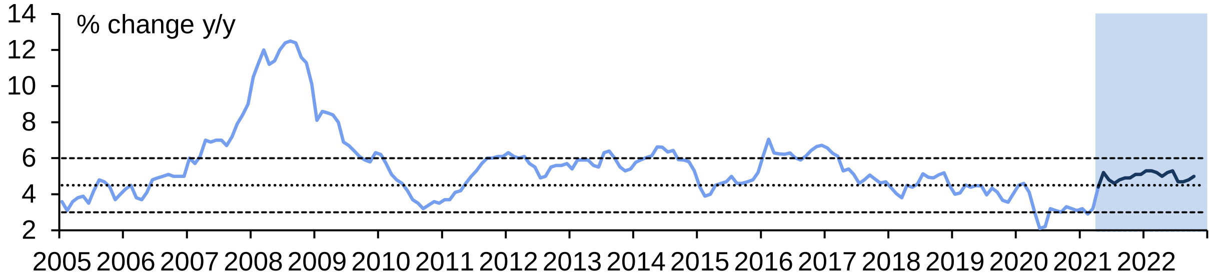
MPC update: SARB keeps rates unchanged at 3.50%, however overall risks to the inflation outlook are to the upside

Thursday 20 May 2021

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- The SARB's monetary policy committee (MPC) unanimously decided to keep the repo rate unchanged at 3.50%, although the implied policy rate path of the SARB's Quarterly Projection Model (QPM) indicates two increases of 25 basis points each in the second and fourth quarters of 2021. Indeed, the SARB continuously reiterates that the repo rate estimate derived from the QPM "(r)emains a broad policy guide, changing from meeting to meeting in response to new data and risks," particularly in this highly volatile environment. Specifically, with "inflation expectations remaining stable, and despite inflation risk increasing, the Committee still expects inflation to be contained in 2021" and thereafter increase to "around the midpoint of the inflation target range in 2022 and 2023," accordingly, supporting their decision.
- The SARB's inflation expectations for this year have declined slightly to 4.2% (from 4.3% previously), while its 2022 and 2023 projections remain unchanged at 4.4% and 4.5% respectively.
- However, overall risks to the inflation trajectory now appear to be to the upside. Indeed, housing-led services price inflation could continue to "surprise to the downside," according to the SARB. Furthermore, domestic food prices should benefit from the strong anticipated harvest and favorable exchange rate, despite recent elevated readings, driven by global grain prices, caused by "droughts in South America and dryness in parts of the U.S. and Canada," according to Agbiz,
- Conversely, however both "domestic and global producer price inflation have been rising," while additional upside risks "could arise from higher domestic import tariffs and escalating wage demands," according to the SARB. Additionally, the persistent risk of electricity and other administered prices remains. Indeed, electricity prices are markedly higher "at 10.6% for 2021 (up from 9.7%)."
- The oil price which has increased markedly from lows seen in 2020 is expected to remain at current levels, however it is subject to "upside risk".

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

	2021	2022	2023
SARB 20th May 2021	4.2	4.4	4.5
SARB 25th March 2021	4.3	4.4	4.5
SARB 21st January 2021	4.0	4.5	4.6
SARB 19th November 2020	3.9	4.4	
SARB 17th September 2020	4.0	4.4	
SARB 23rd July 2020	4.3	4.3	
SARB 21st May 2020	4.4	4.4	

Source: SA Reserve Bank

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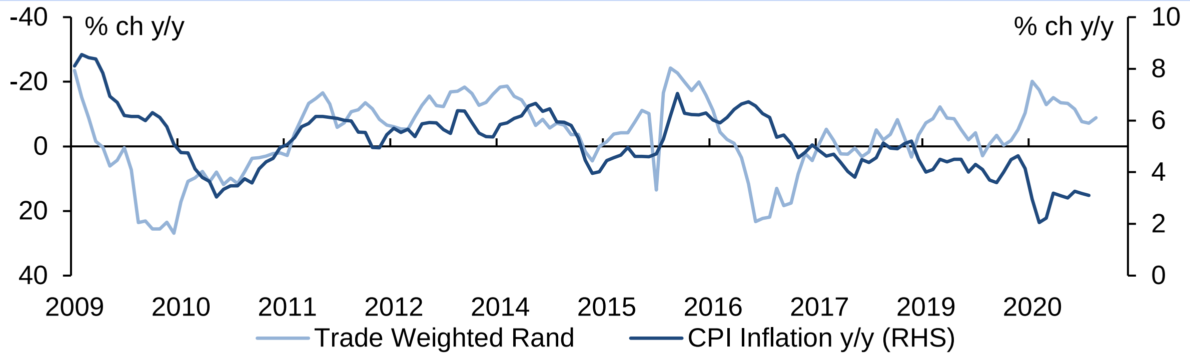
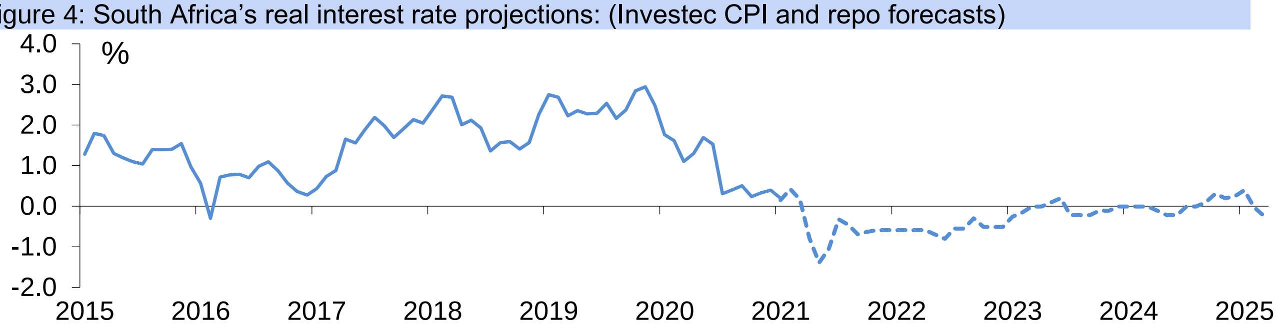
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- The domestic currency has appreciated by 4.0% against the greenback on a trade weighted basis since the March MPC meeting and the implied starting point for the rand forecast has thus been adjusted to R14.46/USD (from R14.96/USD). Improved global conditions, due to the vaccination rollout and fiscal stimulus measures, combined with robust commodity prices have supported the rand, "moving the currency close to its long-run equilibrium level".
- Globally prospects have improved and accordingly, the IMF has revised its global growth forecast to 6.0% from 5.5% previously. Domestically, while the country's vaccine rollout has been slower than anticipated, it is gaining momentum and has provided a degree of optimism. The SARB has upped its Q1.21 forecast markedly to 2.7%, from 0.2% at the time of the March meeting and is now anticipating growth of 4.2% in 2021 (previously 3.8%). Thereafter, GDP is projected to grow by 2.3% and 2.4% in 2022 and 2023 respectively, "little changed since the March meeting".
- "A higher growth forecast implies a small further narrowing of the output gap over the forecast period."
- The SARB continues to evaluate the risks to the domestic growth outlook to be balanced. Specifically, while household expenditure (which accounts for 60% of GDP) is expected to lift moderately over the SARB's forecast period and the global environment is "generally supportive of growth," electricity supply constraints and potentially tighter lockdown restrictions as the third wave persists, remain a risk to economic recovery.
- "Monetary policy continues to be accommodative, keeping financial conditions supportive of credit demand as the economy recovers from the pandemic and associated lockdowns". however the implementation of prudent macroeconomic reforms would "enhance the effectiveness of monetary policy and its transmission to the broader economy".

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		
	2018	2019	2020	2021	2022	2023
1. Real GDP growth in South Africa's major trading partner countries	3.3% (3.3%)	2.2% (2.2%)	-2.8% (-3.1%)	6.0% (5.8%)	3.8% (3.7%)	3.4% (3.3%)
2. Output gap in South Africa's major trading partner countries	0.6% (0.2%)	0.4% (-0.1%)	-2.8% (-2.7%)	-1.5% (-1.6%)	-0.2% (-0.4%)	0.7% (0.3%)
3. International commodity prices in US$ (excluding oil)	11.5% (11.5%)	-1.1% (-1.1%)	25.4% (25.5%)	40.8% (23.3%)	-20.3% (-13.0%)	-0.6% (0.0%)
4. Brent crude (US$/Barrel)	$71.0 ($71.0)	$64.4 ($64.4)	$41.8 ($41.8)	$62.2 ($62.0)	$60.0 ($60.0)	$60.0 ($60.0)
5. World food prices (US$)	-2.2% (-2.2%)	-0.8% (-0.8%)	3.1% (3.1%)	5.2% (4.5%)	0.8% (1.7%)	1.4% (1.4%)
6. International consumer prices	2.0% (2.0%)	1.4% (1.4%)	0.7% (0.7%)	2.0% (1.6%)	2.1% (1.6%)	2.4% (1.8%)
7. International policy interest rate	0.9% (0.9%)	1.1% (1.1%)	0.2% (0.2%)	0.0% (0.0%)	0.0% (0.0%)	0.0% (0.0%)

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

Percentage changes (unless otherwise indicated)	Actual 2018	2019	2020	Forecast 2021	2022	2023
1. Electricity price	5.2%	9.6%	9.1%	10.6%	12.1%	10.0%
	(5.2%)	(9.6%)	(9.1%)	(9.7%)	(11.4%)	(10.0%)
2. Fuel taxes and levies	8.9%	5.8%	5.7%	5.2%	4.9%	4.7%
	(8.9%)	(5.8%)	(5.7%)	(5.1%)	(4.9%)	(4.7%)
3. Potential growth	0.7%	0.3%	-2.5%	1.6%	0.9%	0.9%
	(0.7%)	(0.3%)	(-2.5%)	(1.6%)	(0.9%)	(0.9%)
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	1.9%	2.1%	2.0%	2.1%	2.3%	2.3%
	(1.9%)	(2.1%)	(2.0%)	(2.1%)	(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.
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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