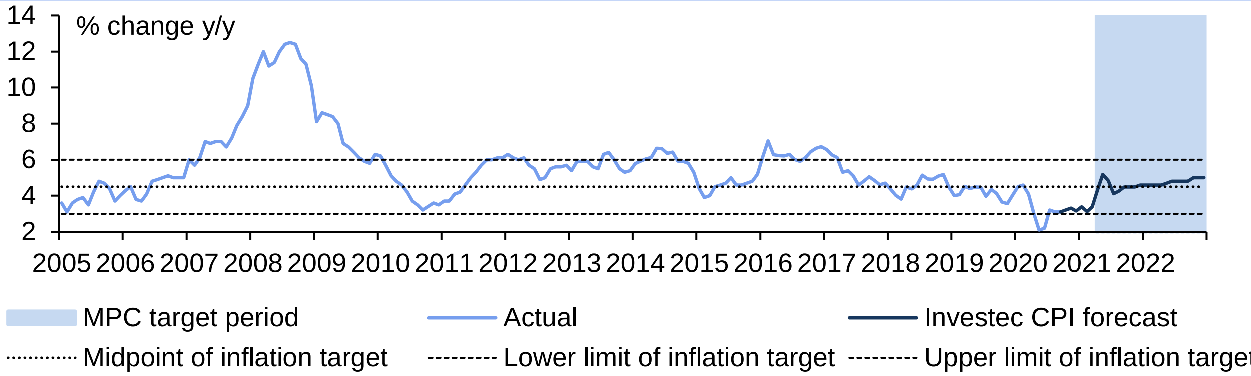
Investec

MPC update: In a spit decision the SARB keeps rates unchanged at 3.50%

Thursday 19 November 2020

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- In another split decision, the SARB's monetary policy committee (MPC) decided to keep the repo rate unchanged at 3.50%. Two members of the MPC favoured a 25bp cut, while three endorsed holding rates at the current level. Additionally the implied policy rate path of the SARB's "Quarterly Projection Model (QPM) indicates no further repo rate cuts in the near term, and two increases of 25 basis points in the third and fourth quarters of 2021."
- Overall risks to the inflation trajectory continue to be perceived as balanced, however the SARB has highlighted that this is "(t)entative and open to adjustments given the wide range of shocks hitting the economy …"
- Inflation expectations have continued to ease this year and "have shifted slightly below the mid-point of the band for 2021." Accordingly, the Reserve Bank has moderated its average headline CPI inflation forecast for 2020 to 3.2% (previously 3.3%) and its 2021 estimate to 3.9%, from 4.0% previously. Its 2022 projection remains unchanged at 4.4%.
- Specifically, global producer price inflation as well as oil prices remain subdued, while domestic food price inflation is anticipated to remain largely contained. Indeed, "(h)igh-frequency weather-related data continues to paint a positive outlook for South Africa's agricultural sector," according to Agbiz.
- Furthermore, a marked, though likely "temporary reduction in medical insurance price inflation for next year", is projected. The domestic currency has appreciated by 6.9% against the greenback since the September MPC meeting, with capital flows into emerging markets edging up, on improved global market sentiment. The implied starting point for the rand forecast has thus been adjusted to R16.50/USD (from R16.90/USD at the September MPC meeting).

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

	2019	2020	2021	2022
SARB 19th November 2020	4.1	3.2	3.9	4.4
SARB 17th September 2020	4.1	3.3	4.0	4.4
SARB 23rd July 2020	4.1	3.4	4.3	4.3
SARB 21st May 2020	4.1	3.4	4.4	4.4
SARB 14th April 2020	4.1	3.6	4.5	4.4
SARB 19th March 2020	4.1	3.8	4.6	4.4
SARB 16th January 2020	4.1	4.7	4.6	4.5

Source: SA Reserve Bank

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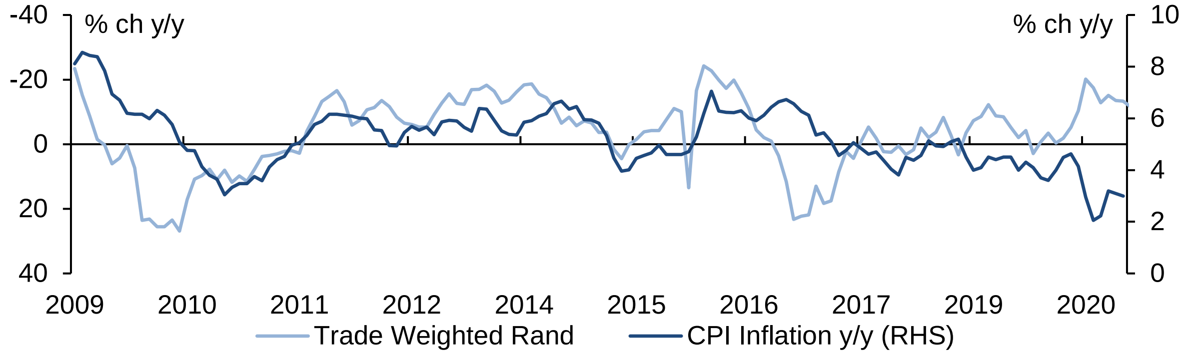
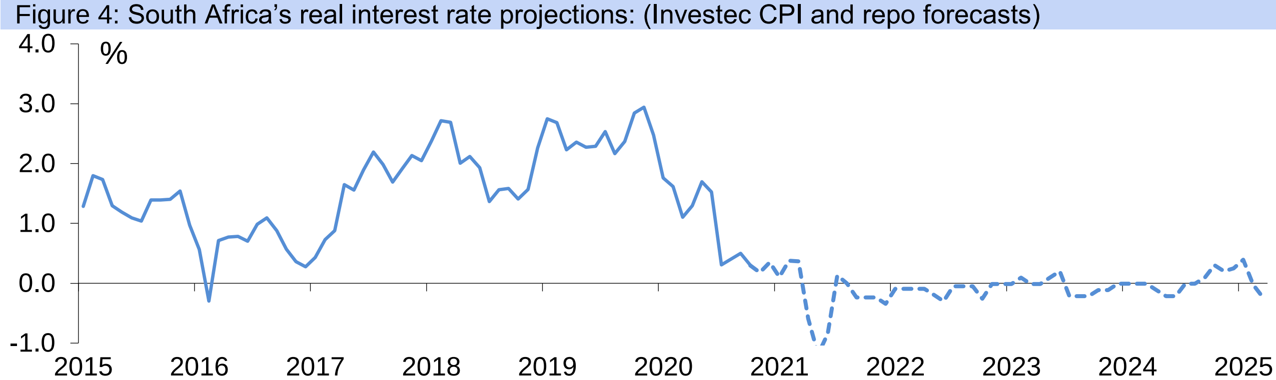
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- The risk of exchange rate pressure remains, due to the country's heightened fiscal risks, with Moody's and Fitch expected to announce their sovereign credit ratings' decisions tomorrow. Both Moody's and Fitch already have SA on negative outlooks, which implies the next move in each of the respective agencies credit ratings on SA's long-term sovereign debt will be a downgrade. The SARB has however reiterated that risks to inflation from a potential depreciation of the rand are likely to remain muted.
- Electricity and other administered price increases continue to remain upside risks to the inflation trajectory.
- Some green shoots of recovery are evident in the economy, with high frequency data indicators for Q3.20 point to a marked uptick in GDP, albeit off a very low base. The SARB has adjusted its growth expectations moderately and now expects the economy to contract by -8.0% in 2020, versus the -8.2% estimated at the previous MPC meeting. GDP is then forecast to lift more gradually in 2021, by 3.5% (3.9% September forecast) and 2.4% (2.6% September forecast) in 2022. The SARB evaluates the risks to the growth outlook to be balanced, but stresses that "(t)his is tentative and open to adjustment given the wide range of shocks hitting the economy, uncertainties involving the effectiveness of policy, and the sensitivity of sentiment to news flow."

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



Source: Investec, Iress

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%)	3.3% (3.3%)	2.2% (2.2%)	-3.9% (-4.2%)	4.5% (4.7%)	3.7% (4.0%)
2. Output gap in South Africa's major trading partner countries	0.0% (0.1%)	0.6% (0.4%)	0.4% (0.4%)	-3.4% (-4.0%)	-1.9% (-2.2%)	-0.5% (-0.2%)
3. International commodity prices in US$ (excluding oil)	18.2% (18.2%)	11.5% (11.1%)	-1.1% (-0.9%)	21.6% (13.3%)	2.4% (-4.4%)	-3.2% (2.7%)
4. Brent crude (US$/Barrel)	$54.2 ($54.2)	$71.0 ($71.0)	$64.4 ($64.4)	$40.8 ($42.0)	$45.0 ($47.0)	$50.0 ($52.0)
5. World food prices (US$)	6.6% (8.1%)	-2.2% (-2.2%)	-0.8% (-0.8%)	0.9% (-1.4%)	1.9% (3.4%)	2.5% (1.5%)
6. International consumer prices	1.7% (1.7%)	2.0% (2.0%)	1.4% (1.4%)	0.7% (0.8%)	1.3% (1.4%)	1.5% (1.5%)
7. International policy interest rate	0.5% (0.5%)	0.9% (0.9%)	1.1% (1.1%)	0.2% (0.2%)	0.0% (0.0%)	0.0% (0.0%)

Source: SA Reserve Ban

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)	2017	Actual 2018	2019	2020	Forecast 2021	2022
1. Electricity price	4.7% (4.7%)	5.2% (5.2%)	9.6% (9.6%)	9.1% (9.1%)	8.2% (8.2%)	10.0% (10.0%)
2. Fuel taxes and levies	8.3% (8.3%)	8.9% (8.9%)	5.8% (5.8%)	5.7% (5.7%)	5.0% (5.0%)	5.0% (5.0%)
3. Potential growth	1.2% (1.2%)	0.7% (0.7%)	0.3% (0.3%)	-3.2% (-3.2%)	1.4% (1.4%)	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	1.7% (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.
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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