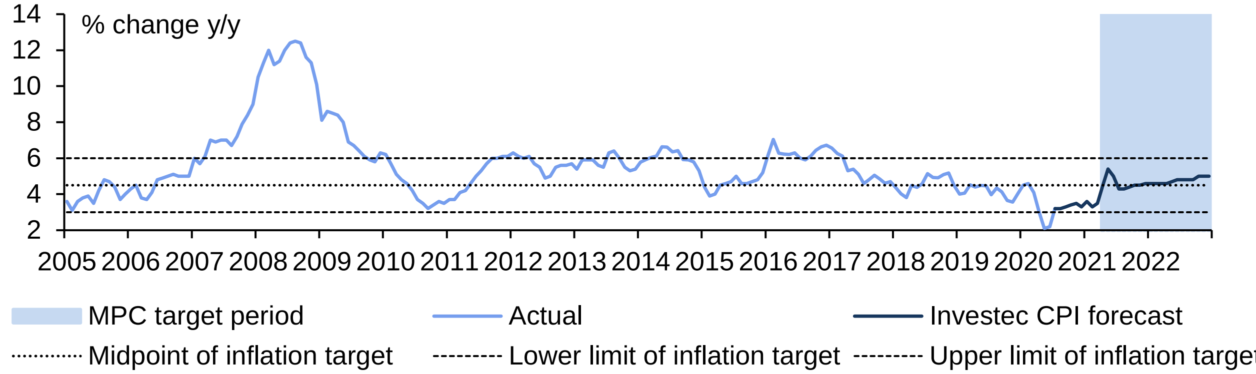
Investec

MPC update: The SARB assesses the risks to the inflationary trajectory to be balanced and keeps rates unchanged at 3.50%

Thursday 17 September 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%, following a 25bp cut in July. Indeed, the SARB's accommodative trajectory thus far, supported by the dovish stance of the Fed in particular, has "(e)ased financial conditions" substantially and enhanced the "(r)esilience of households and firms to the economic implications of Covid-19." However as the SARB has repeatedly stressed monetary policy alone cannot "(i)mprove the potential growth rate of the economy or reduce fiscal risks."
- While the SARB continues to calculate the overall risks to the inflation trajectory to be balanced, it stressed 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 3.3% (previously 3.4%) and its 2021 estimate to 4.0%, from 4.3% previously. Its 2022 projection has however been slightly raised to 4.4% (previously 4.3%).
- Specifically, international producer price and food inflation have largely bottomed out, while domestic food inflation is likely to remain well contained, supported by a favorable maize harvest.
- Additionally, the oil price remains low, while any risks to inflation from a depreciation of the rand are "(e)xpected to stay muted while pass-through remains slow." The domestic currency has depreciated by 14.5% against the greenback since January, however it "(r)emains below its estimated long-run equilibrium value, despite considerable appreciation since June," according to the SARB. Thus the implied starting point for the rand forecast has been adjusted to R17.07/USD, versus R17.93/USD at July's meeting.
- Electricity and other administered price increases however remain upside risks to the inflation trajectory, while added "exchange rate pressures could result from heightened fiscal risks."

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

	2018	2019	2020	2021	2022
SARB 17th September 2020	4.6	4.1	3.3	4.0	4.4
SARB 23rd July 2020	4.6	4.1	3.4	4.3	4.3
SARB 21st May 2020	4.6	4.1	3.4	4.4	4.4
SARB 14th April 2020	4.6	4.1	3.6	4.5	4.4
SARB 19th March 2020	4.6	4.1	3.8	4.6	4.4
SARB 16th January 2020	4.6	4.1	4.7	4.6	4.5
SARB 21st November 2019	4.6	4.2	5.1	4.7	

Source: SA Reserve Bank

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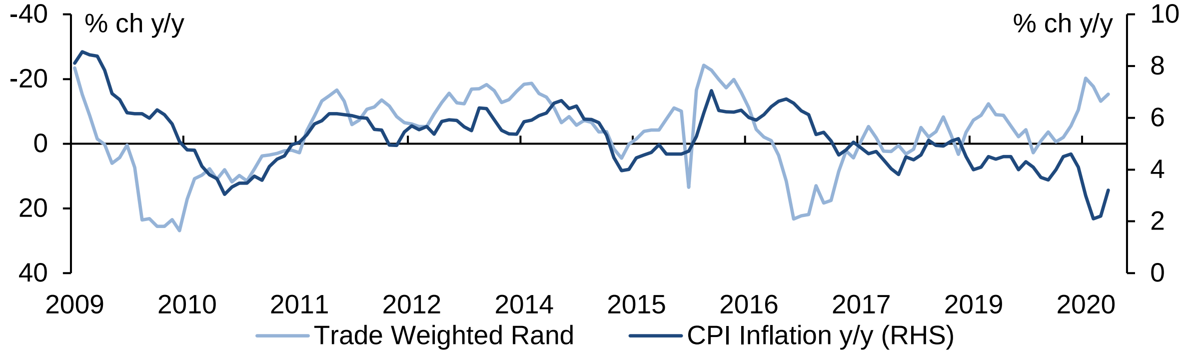
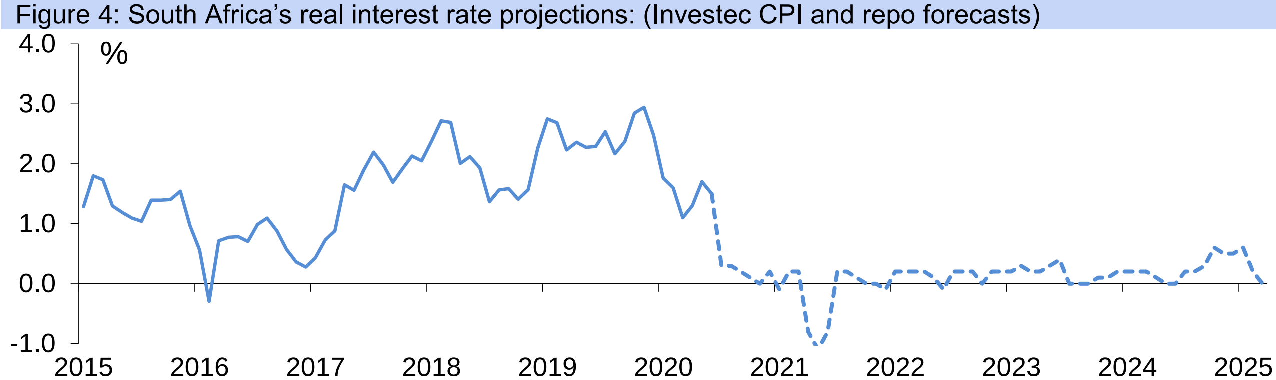
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- Government imposed lockdown restrictions have wreaked havoc on economies around the world and served to exacerbate the numerous challenges South Africa was already facing before the onset of the pandemic, including elevated unemployment and a highly constrained fiscus. Consequently, following a three quarter recession, Q2.20's GDP reading plunged by a further, unprecedented -51.0% on a quarter on quarter seasonally adjusted annualised (qqsaa) basis.
- This outcome was weaker than many had anticipated and although government has endorsed the move to level 1 from 21st September and recent high frequency data indicators point to some improvement in activity, the economic recovery is likely to be protracted.
- Consequently, the SARB projects the economy to now contract by -8.2% in 2020, versus the -7.3% estimated at the previous MPC meeting. GDP is then forecast to lift by 3.9% (3.7% July forecast) in 2021 and 2.6% (2.8% July forecast) in 2022.
- Globally, conditions are expected to remain erratic in these unprecedented times, marred by uncertainty. Accordingly, any "(f)uture decisions will continue to be data dependent and sensitive to the balance of risks to the outlook."
- The implied path of policy rates over the forecast period as generated by the Quarterly Projection Model indicates "no further repo rate cuts in the near term," but points to "two rate increases in the third and fourth quarters of 2021."

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 2017	2018	2019	Forecast 2020	2021	2022
1. Real GDP growth in South Africa's major trading partner countries	3.4% (3.2%)	3.2% (3.3%)	2.2% (2.3%)	-4.2% (-4.7%)	4.7% (4.3%)	4.4% (4.0%)
2. Output gap in South Africa's major trading partner countries	0.0% (0.1%)	0.4% (0.1%)	0.4% (-0.1%)	-4.0% (-4.2%)	-2.2% (-2.9%)	-0.2% (-1.0%)
3. International commodity prices in US$ (excluding oil)	18.2% (18.2%)	11.1% (11.2%)	-0.9% (-0.9%)	13.3% (9.3%)	-4.4% (-3.9%)	2.7% (3.1%)
4. Brent crude (US$/Barrel)	$54.2 ($54.2)	$71.0 ($71.0)	$64.4 ($64.4)	$42.0 ($40.0)	$47.0 ($45.0)	$52.0 ($50.0)
5. World food prices (US$)	6.6% (8.1%)	-2.2% (-3.5%)	-0.8% (1.8%)	-1.4% (-3.0%)	3.4% (4.5%)	1.5% (1.5%)
6. International consumer prices	1.7% (1.7%)	2.0% (2.0%)	1.4% (1.4%)	0.8% (0.5%)	1.4% (1.4%)	1.5% (1.3%)
7. International policy interest rate	0.5% (0.5%)	0.9% (0.9%)	1.1% (1.1%)	0.1% (0.1%)	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%	5.2%	9.1%	9.6%	8.2%	10.0%
	(4.7%)	(5.2%)	(9.6%)	(9.6%)	(6.7%)	(6.0%)
2. Fuel taxes and levies	8.3%	8.9%	5.8%	5.7%	5.0%	5.0%
	(8.3%)	(8.9%)	(5.8%)	(5.8%)	(5.2%)	(5.0%)
3. Potential growth	1.2%	0.7%	0.3%	-3.2%	1.4%	0.9%
	(1.2%)	(0.9%)	(0.6%)	(-2.1%)	(1.1%)	(1.3%)
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%	1.9%	2.1%	2.1%	2.2%	2.3%
	(1.7%)	(1.9%)	(2.1%)	(2.1%)	(2.2%)	(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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