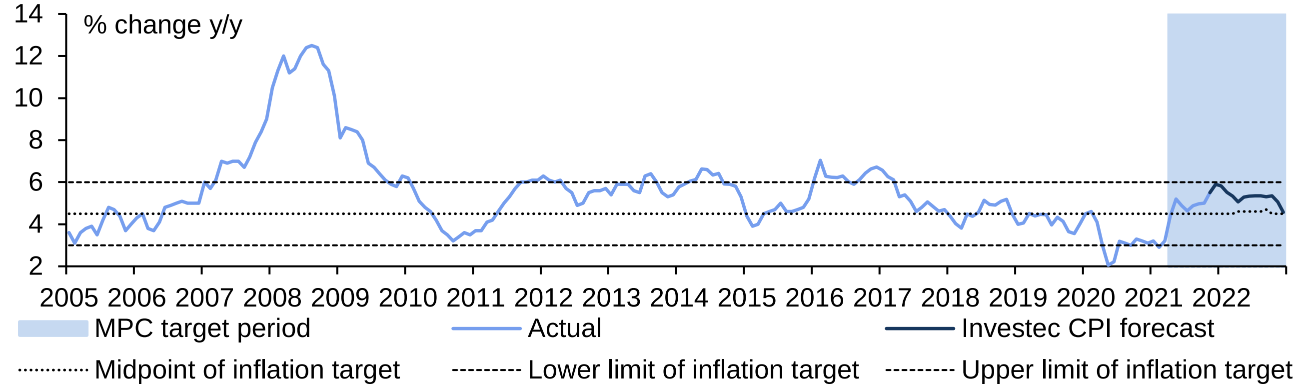
Investec

MPC update: SARB lifts rates by a further 25bp to 4.00% as risks to the inflation trajectory remain to the upside

Thursday 27 January 2022

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- The SARB's monetary policy committee (MPC) opted to hike the repo rate by a further 25bp to 4.00%. The majority of MPC members (four) were in favour of a hike, with one preferring an unchanged stance.
- Overall risks to the inflation trajectory remain to the upside and accordingly the Reserve Bank has revised its headline consumer price inflation projections higher for this year. Specifically, CPI is now projected to reach 4.9% in 2022 (from 4.3% previously). 2023's headline CPI forecast has declined marginally to 4.5% (4.6% previously) and remains unchanged at 4.5% for 2024.
- Moreover, as the economy is projected to increase "faster than potential over the forecast period", according to the SARB, core inflation expectations have been raised, with a reading of 3.8% anticipated for 2022 (3.7% y/y previous estimate) reaching 4.5% y/y by 2024.
- Specifically, the volatile oil price, a major commodity import, has picked up notably, with current prices well above the SARB's projected "levels for this year" and therefore remains a key upside risk to the inflation outcome.
- "Global producer price and food price inflation continued to surprise higher in recent months and could do so again", according to the SARB. Food inflation which makes up the largest portion of the CPI basket has been adversely impacted by global conditions. Going forward meat prices could present an upside risk to inflation this year, depending on the direction that slaughtering activity takes.
- Specifically domestic cattle slaughtering activity was comparatively lower last year when compared to 2020, according to Agbiz. Furthermore, excessive rains which have destroyed crops and impeded plantings in SA "present risks for agricultural production this year".
- The persistent risk of rising electricity and other administered prices remains. Indeed, the pandemic has had a devastating effect on businesses and while an easing of lockdown restrictions has seen electricity demand pick-up, "sales are not expected to recover to pre-COVID-19 levels for the foreseeable future", according to Eskom. The utility has applied to Nersa for a tariff increase of 20.5% for the 2023 financial year (beginning April 1, 2022).
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Figure 2: SARB CPI inflation forecasts (% y/y)

	2021	2022	2023	2024
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	
SARB 22nd July 2021	4.3	4.2	4.5	

Source: SA Reserve Bank

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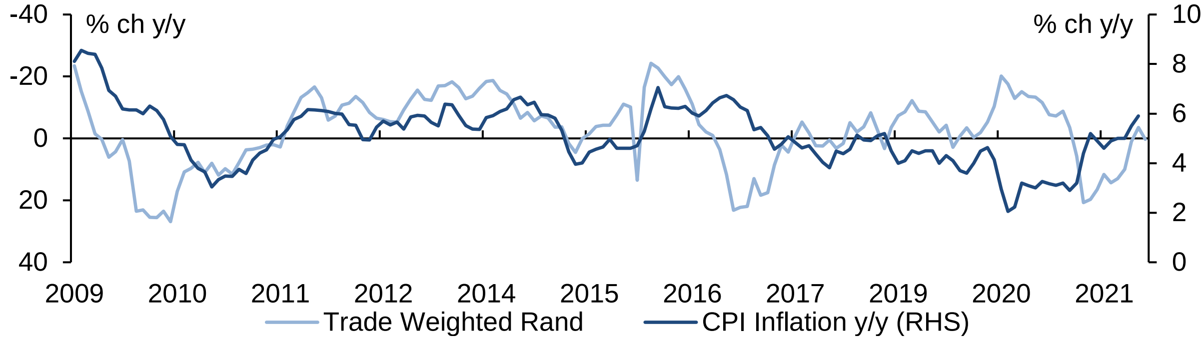
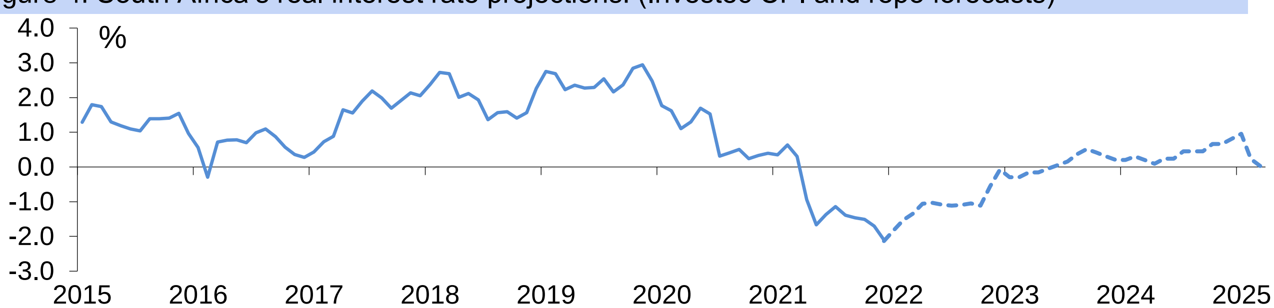
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- Moreover, higher wage demands, import tariffs and services inflation pose added upside risks.
- The domestic currency is sitting below its equilibrium level and accordingly the implied starting point for the rand forecast has been revised to R15.60 against the dollar, from R15.10 previously. Accelerated quantitative tightening by the Fed and earlier than anticipated monetary policy normalisation, with US inflation having climbed to 6.8% y/y, a 30 year high, will weigh on emerging market currencies and therefore the rand's performance.
- Global growth is expected to decelerate this year as base effects wane, moderating to 4.4% according to the IMF (from a forecast of 4.9% previously). Global growth continues to remain uneven with emerging markets lagging developed economies, prejudiced by slower vaccination rollouts and limited fiscal stimulus.
- The SARB has revised downwards its GDP forecast for the South African economy to 4.8% y/y from 5.2% y/y previously. The unrest and looting in parts of the country in July weighed on Q3.21's GDP outcome. Growth remains unchanged at 1.7% and 1.8% for 2022 and 2023 respectively, but rises to 2.0% in 2024, with the output gap gradually closing. The SARB continues to evaluate the risks to the medium-term domestic growth outlook to be balanced.
- The SARB reiterated that "repurchase rate levels reflect an accommodative policy stance through the forecast period, keeping financial conditions supportive of credit demand as the economy continues to recover".

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	2.2% (2.2%)	-2.7% (-2.8%)	6.2% (6.3%)	4.4% (4.4%)	3.3% (3.3%)	2.7% (2.7%)
2.Output gap in South Africa's major trading partner countries	0.6% (0.6%)	-3.1% (-3.1%)	-1.5% (-1.5%)	0.4% (-0.3%)	1.5% (1.3%)	1.0% (0.8%)
3.International commodity prices in US$ (excluding oil)	-1.2% (-1.2%)	25.5% (25.5%)	45.6% (45.6%)	-22.3% (-20.2%)	-3.5% (-2.2%)	0.6% (1.5%)
4.Brent crude (US$/Barrel)	$64.4 ($64.4)	$41.8 ($41.8)	$70.7 ($71.5)	$78.0 ($73.0)	$72.0 ($68.0)	$70.0 ($65.0)
5.World food prices (US$)	-0.8% (-0.8%)	3.1% (3.1%)	28.0% (25.4%)	-2.3% (-4.6%)	0.7% (1.6%)	1.2% (1.2%)
6.International consumer prices	1.4% (1.4%)	0.7% (0.7%)	3.1% (2.9%)	3.1% (2.4%)	1.7% (1.8%)	1.6% (1.6%)
7.International policy interest rate	1.1% (1.1%)	0.2% (0.2%)	0.1% (0.1%)	0.1% (0.1%)	0.6% (0.6%)	1.1% (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.

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Figure 6: Domestic sector assumptions

Percentage changes (unless otherwise indicated)		Actual		Forecast			
	2018	2019	2020	2021	2022	2023	2024
1. Electricity price	5.2% (5.2%)	9.6% (9.6%)	9.1% (9.1%)	10.2% (10.2%)	14.5% (14.5%)	12.3% (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% (5.7%)	7.4% (4.8%)	3.4% (4.7%)	4.4% (4.5%)
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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