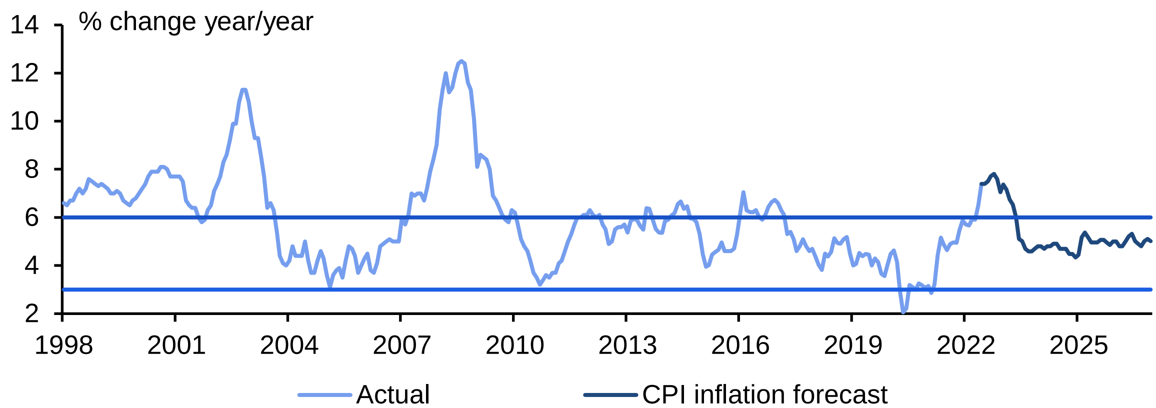
Investec

MPC update: SARB lifts rates by 75bp to 5.50% as inflationary pressures rise

Thursday 21 July 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 75bp to 5.50%, ahead of consensus expectations. The decision was split, with three committee members in favour of a 75bp hike.
- Overall risks to the inflation trajectory are tilted to the upside and accordingly the Reserve Bank has revised its headline consumer price inflation projection notably higher for this year to 6.5% (from 5.9% previously). This is in line with projections for inflation based on market surveys.
- 2023's headline CPI forecast at 5.7% (previously 5.0%) has also been lifted on higher projected food, fuel, and core inflation. "Russia's war in Ukraine is likely to persist for the rest of this year and may have significant further effects on global prices," according to the SARB. 2024's headline number is however expected to remain unchanged (from May's meeting) at 4.7%, closer to the mid-point of the inflation targeting band.
- Core inflation expectations have been raised to 4.3% (previously 3.9%) for 2022 and to a notable 5.6% (from 5.1%) for 2023. The projection for 2024 has also been increased modestly to 4.9% (from 4.8%). Specifically, according to the SARB both "core goods and services price inflation are forecast higher through to the end of 2024, compared to May when only core goods inflation was rising each year".
- The highly volatile oil price, a major commodity import, together with the weak domestic currency remains a key upside risk to the inflation outcome, through its effect on fuel prices. The SARB now anticipates fuel price inflation for 2022 at 38.9% (up from 31.2%).
- Similarly, food price inflation which makes up a large portion of the CPI basket has been revised upwards and is expected to average an elevated 7.4% (previously 6.6%) in 2022 and 6.2% in 2023 (from 5.6%). "South Africa, a relatively small player in global agriculture, is linked to the global market and is therefore generally a price taker for various commodities," according to Agbiz.

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

	2021	2022	2023	2024
SARB 21st July 2022	4.5	6.5	5.7	4.7
SARB 19th May 2022	4.5	5.9	5.0	4.7
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

Source: SA Reserve Bank

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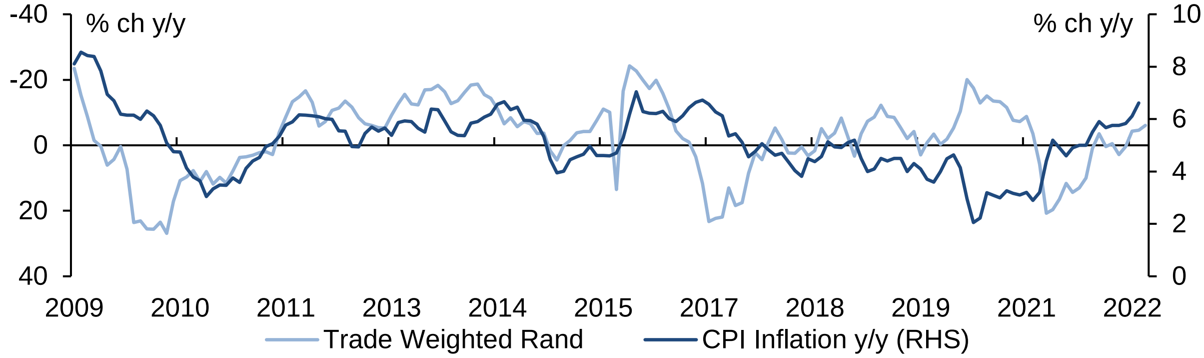
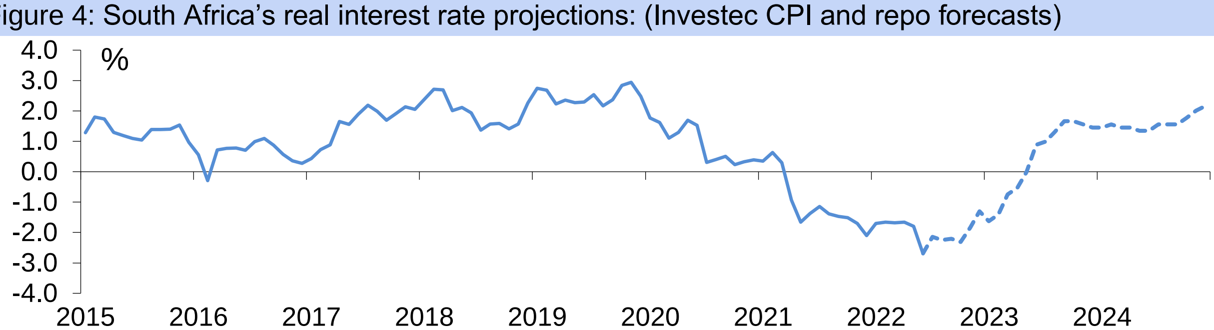
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- Heightened inflation (which is at the highest reading in decades in some advanced economies) has propelled major central banks to hasten "the normalisation of policy rates". Accordingly, "capital flows and market volatility are expected to remain elevated for emerging market assets and currencies" with the rand a key risk to the inflation trajectory.
- Specifically, the domestic currency has weakened notably along with other emerging market currencies as a result of the greenback's strength on safe haven inflows, with the USD reaching parity to the euro. The rand in particular, a key commodity currency has also weakened as metals prices have lost ground. Accordingly, the implied starting point for the rand is now projected at R16.10 to the greenback versus R15.88/USD at the previous MPC meeting.
- The global growth outlook has subsided, with growth expected to decelerate (relative to previous projections). The SARB has amended its global growth forecast to 3.3% (from 3.5%) for 2022 and to 2.5% (from 2.7%) for 2023 and 2024 respectively.
- The SARB has increased its GDP forecast modestly for the South African economy to 2.0%, from 1.7% for 2022 as the Q1.22 GDP print surprised on the upside. However, rates of growth for 2023 and 2024 have been decreased to 1.3% and 1.5% respectively from the previous forecast of 1.9% (for both years). "Overall, and after revisions, the risks to the medium-term domestic growth outlook are assessed to the downside". Indeed, SA's electricity supply predicament remains a key risk. The electricity grid has been under severe strain, with load shedding reaching stage 6 at times, weighing on the economic growth potential. An economy cannot function to its full potential with insufficient electricity.
- "Economic and financial conditions are expected to remain more volatile for the foreseeable future", according to the SARB and accordingly in such an "uncertain environment, monetary policy decisions will continue to be data dependent and sensitive to the balance of risks to the outlook".

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		Actual			Forecast	
(unless otherwise indicated)	2019	2020	2021	2022	2023	2024
1.Real GDP growth in South Africa's major trading partner countries	2.3% (2.3%)	-2.6% (-1.6%)	6.5% (6.4%)	3.3% (3.5)	2.5% (2.7%)	2.5% (2.7%)
2.Output gap in South Africa's major trading partner countries	-0.1% (-0.1%)	-1.6% (-1.6%)	-0.6 % (-0.7%)	-0.1% (-0.1%)	-0.1% (0.1%)	-0.1% (0.3%)
3.International commodity prices in US$ (excluding oil)	-1.2% (-1.2%)	25.5% (25.5%)	45.6% (45.6%)	3.2% (9.5%)	-19.1% (-14.8%)	-8.0 % (-8.6%)
4.Brent crude (US$/Barrel)	$64.4 ($64.4)	$41.8 ($41.8)	$70.7 ($70.7)	$108.0 ($103.0)	$92.0 ($90.0)	$85.0 ($85.0)
5.World food prices (US$)	-0.8% (-0.8%)	3.2% (3.2%)	28.1% (28.1%)	22.3% (15.3%)	-5.7% (-6.0%)	-2.0% (-5.6%)
6.International consumer prices	1.4% (1.4%)	0.7% (0.7%)	3.3% (3.3%)	6.9 % (6.3%)	3.0% (2.7%)	2.0% (2.0%)
7.International policy interest rate	1.1% (1.1%)	0.2% (0.2%)	0.1% (0.1%)	1.2% (0.6%)	3.0% (1.6%)	3.1% (1.9%)

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)	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%)	11.0% (11.0%)	9.2% (9.2%)	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%)	1.8% (1.7%)	7.4% (2.3%)	4.5% (4.7%)
3. Potential growth	1.2% (1.2%)	0.3% (0.3%)	-3.1% (-3.1%)	3.4% (3.4%)	0.5% (0.6%)	0.8% (0.9%)	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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