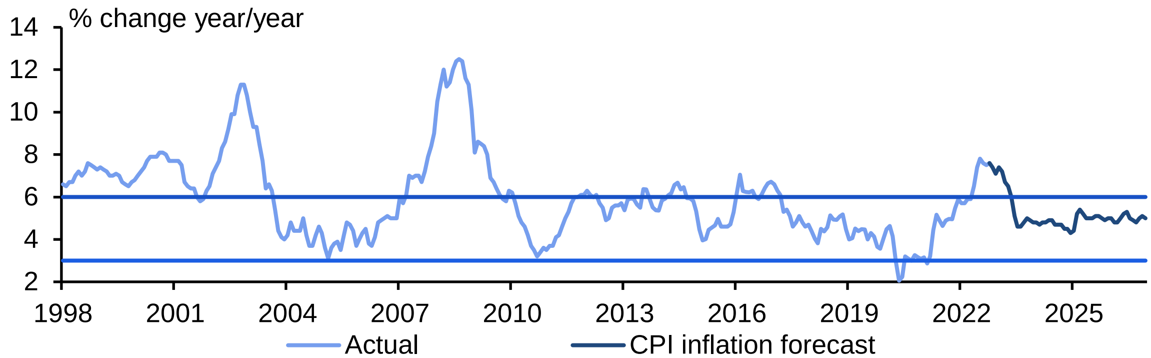
Investec

MPC update: SARB lifts rates by a further 75bp to 7.00%

Thursday 24 November 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 a further 75bp to 7.00%, in line with consensus expectations and the Federal Reserve Bank's move earlier in the month.
- The Reserve Bank's headline consumer price inflation forecasts for 2022 and 2023 have increased slightly to 6.7% (from 6.5%) and 5.4% y/y (from 5.3%) respectively. The headline inflation reading is only anticipated "to sustainably revert to the mid-point of the target range by around the second quarter of 2024", according to the SARB.
- The SARB's projection for core inflation remains unchanged for this year at 4.3% but rises slightly to 5.5% (previously 5.4%) in 2023.
- Overall risks to the inflation trajectory remain assessed to the upside. Specifically, notwithstanding the deceleration "of global producer price and food inflation, Russia's war in the Ukraine continues, with adverse effects on global prices generally". The SARB has upped its local food price inflation projection for 2022 to 8.8% from 8.1%, partly due to the "weaker exchange rate". The forecast for 2023 has also been increased, rising to 6.2% (from 5.5% previously).
- The highly volatile oil price continues to remain a key upside risk as do electricity rates and other administered prices. Moreover, a sizable risk "still attaches to the forecast for average salaries".
- While the domestic currency along with other emerging market currencies has gained some ground on a weakening greenback it is still -7.0% weaker on a year-to-date basis and remains a risk to the inflation outlook. Indeed, "… with few exceptions, capital flow and market volatility will be elevated for emerging market assets and currencies," according to the SARB
- The implied starting point for the rand is now projected at R17.76 (Q4.22) to the greenback versus R16.91/USD (Q3.22) at the previous MPC meeting.
- The global growth outlook has subsided further, with growth expected to decelerate (relative to previous projections). Specifically, the Reserve Bank has amended its global growth forecast for 2023 to 1.9% from 2.0% previously.

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

	2021	2022	2023	2024
SARB 24th Nov 2022	4.5	6.7	5.4	4.5
SARB 22nd Sep 2022	4.5	6.5	5.3	4.6
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

Source: SA Reserve Bank

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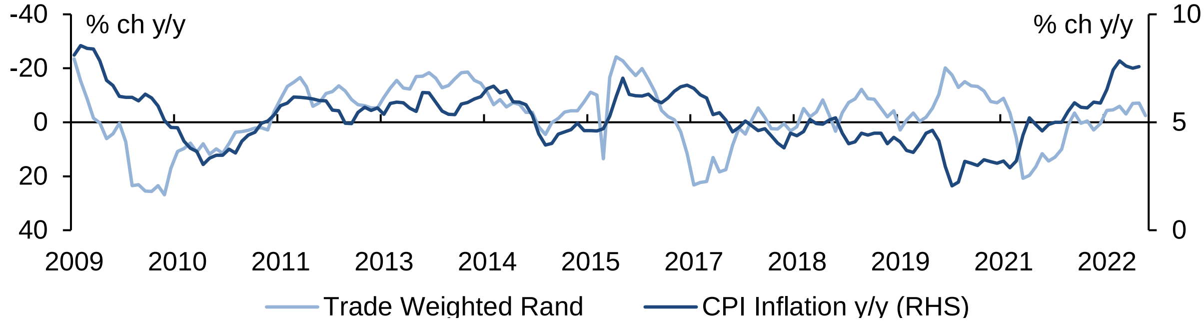
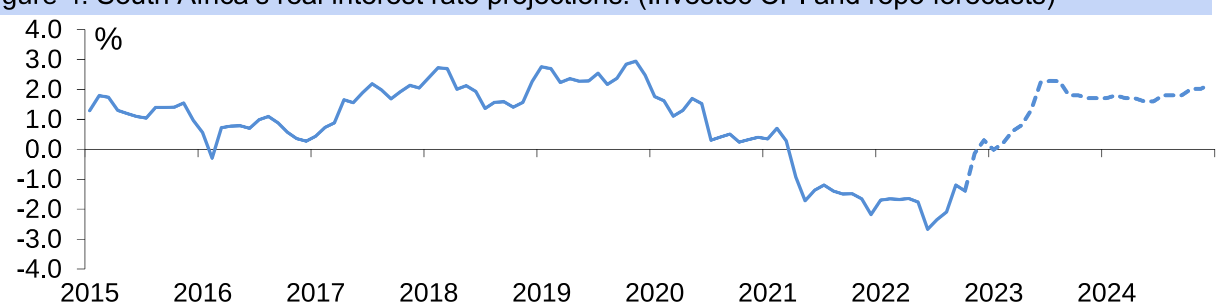
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

- On the domestic front, the economic environment remains fragile. The SARB has decreased its GDP forecast modestly for the South African economy to 1.8%, from 1.9% for 2022. Following a -0.7% qqsa contraction in growth in Q2.22, largely on account of the severe floods in KZN which impaired economic activity, a 0.4% qqsa lift is anticipated for Q3.22. Persistent heightened load shedding is however expected to weigh heavily on Q4.22's outcome.
- Rates of growth for 2023 and 2024 have been reduced to 1.1% (from 1.4%) and 1.4% (from 1.7%) respectively. The output gap is expected to be "slightly larger in the near term, before closing in the third quarter of 2023", according to the SARB.
- The SARB's medium term projection "incorporates an assumption of increased load-shedding, which could deduct 0.6 percentage points in 2023". Indeed, the electricity supply situation in the country is dire, with "record" load shedding weighing on all sectors of the economy, decreasing confidence and discouraging investment. Indeed, business confidence dropped further into contractionary territory in Q4.22.
- Following revisions, the risks to the SARB's "medium-term domestic growth outlook are assessed to the downside". The MPC's decision was split, with three committee members in favour of a 75bp hike, while two would have preferred a more modest 50bp lift.
- Indeed, conditions are anticipated to remain "volatile for the foreseeable future" 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".
- This is the last MPC meeting for the year, with the next interest rate announcement scheduled for 26th January 2023.

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	2.3% (2.3%)	-2.5% (-2.6%)	6.9% (6.5%)	3.3% (3.0%)	1.9% (2.0%)	2.4% (2.4%)
2.Output gap in South Africa's major trading partner countries	0.4% (0.0%)	-2.7% (-1.6%)	-0.9% (-0.6%)	-0.2% (-0.2%)	-0.9% (-0.5%)	-0.7% (-0.7%)
3.International commodity prices in US$ (excluding oil)	-1.2% (-1.2%)	25.5% (25.5%)	45.6% (45.6%)	1.2% (2.3%)	-18.1% (-17.6%)	-11.1% (-10.0%)
4.Brent crude (US$/Barrel)	$64.4 ($64.4)	$41.8 ($41.8)	$70.7 ($70.7)	$102.0 ($105.0)	$92.0 ($92.0)	$85.0 ($85.0)
5.World food prices (US$)	-0.8% (-0.8%)	3.2% (3.2%)	28.1% (28.1%)	14.7% (17.8%)	-7.7% (-5.3%)	0.2% (-1.0%)
6.International consumer prices	1.4% (1.4%)	0.7% (0.7%)	3.3% (3.3%)	7.3% (7.0%)	4.1% (3.5%)	2.1% (2.1%)
7.International policy interest rate	1.1% (1.1%)	0.2% (0.2%)	0.1% (0.1%)	1.1% (1.0%)	3.6% (3.1%)	3.4% (3.2%)

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.

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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			Forecast		
	2019	2020	2021	2022	2023	2024
1. Electricity price	9.6% (9.6%)	9.1% (9.1%)	10.2% (10.2%)	10.7% (10.6%)	9.0% (8.9%)	10.0% (10.0%)
2. Fuel taxes and levies	5.8% (5.8%)	5.7% (5.7%)	6.1% (6.1%)	2.7% (2.8%)	5.3% (9.3%)	1.2% (4.4%)
3. Potential growth	0.3% (0.3%)	-3.1% (-3.1%)	3.4% (3.4%)	0.4% (0.5%)	0.5% (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%)
5. Neutral real interest rate	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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