MPC update: SARB keeps rates unchanged at 3.50%, however overall risks to the short-term inflation outlook remain to the upside

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- The SARB’s monetary policy committee (MPC) unanimously decided to keep the repo rate unchanged at 3.50% for now, however the implied policy rate path of the SARB’s Quarterly Projection Model (QPM) which is highly dependent on new data and risks “indicates an increase of 25 basis points in the fourth quarter of 2021 and further increases in each quarter of 2022 and 2023”.
- The SARB’s inflation expectations for this year have increased slightly to 4.4% (from 4.3% previously), while its 2022 and 2023 projections remain unchanged at 4.2% and 4.5% respectively. This is largely in line with market-based expectations.
- Overall risks to the short-term inflation trajectory remain to the upside. Indeed, “global producer price and food price inflation have surprised to the upside in recent months and could do so again”, according to the SARB, although Agbiz does still expect food price inflation to moderate on the “possible softening in grain-related products, dairy and vegetables.” However, it has stressed that the outlook for meat prices “remains uncertain for now”.
- Another risk to the short-term inflation outcome is the oil price which has picked up notably after dipping in August and remains volatile. Additionally, the persistent risk of electricity and other administered prices remains. Indeed, Eskom’s electricity price increases have exceeded CPI for over a decade, and this is likely to persist as cash strapped Eskom, continues to face marked financial challenges.
- Longer-term risks to the inflation trajectory include “higher domestic import tariffs” rising wage demands and a softer rand. Specifically, while the domestic currency has appreciated by 1.5% year to date, on a trade-weighted basis, it has depreciated by 1% since the July MPC meeting. Accordingly, the implied starting point for the rand forecast has been revised to R14.47 against the greenback, from R14.40 previously. Furthermore, should headway towards the Fed’s inflation and employment goals continue largely in line with expectations, then tapering could commence sooner than originally anticipated weighing on risk assets and the rand.

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

<table>
<thead>
<tr>
<th>Date</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>SARB 23rd September 2021</td>
<td>4.4</td>
<td>4.2</td>
<td>4.5</td>
</tr>
<tr>
<td>SARB 22nd July 2021</td>
<td>4.3</td>
<td>4.2</td>
<td>4.5</td>
</tr>
<tr>
<td>SARB 20th May 2021</td>
<td>4.2</td>
<td>4.4</td>
<td>4.5</td>
</tr>
<tr>
<td>SARB 25th March 2021</td>
<td>4.3</td>
<td>4.4</td>
<td>4.5</td>
</tr>
<tr>
<td>SARB 21st January 2021</td>
<td>4.0</td>
<td>4.5</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Source: SA Reserve Bank
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Figure 3: Fuel price inflation vs headline CPI

The IMF’s global growth forecast of 6.0% will be revised in October. Rising infection rates in a number of countries could weigh on the outcome. Global growth continues to remain uneven with emerging markets lagging developed economies, prejudiced by slower vaccination rollouts and limited fiscal stimulus.

South Africa’s economy has been buoyed by favourable commodity prices, however it remains fragile. The looting and social unrest that occurred in July along with the tighter lockdown restrictions will weigh on Q3.21’s GDP outcome. While the SARB’s GDP forecast for 2021 has been revised upwards to 5.3% y/y from 4.2% y/y previously, growth expectations for 2022 and 2023 have been lowered to 1.7% y/y (from 2.3% y/y) and to 1.8% y/y (from 2.4% y/y) respectively. Indeed, the events that took place in July, coupled with the devastating effects of the pandemic generally, “are likely to have lasting effects on investor confidence and job creation, impeding recovery in labour-intensive sectors hardest hit by the lockdowns”.

The SARB continues to evaluate the risks to the medium-term domestic growth outlook to be balanced, “as most of the bounceback from the recovery is now in the past”. Elevated export prices are expected to wane, while SA’s elevated unemployment rate and low labour absorption rate will continue to constrain household expenditure (which accounts for 60% of GDP). Additionally, electricity supply constraints and the potential for further waves and lockdowns remains a risk to economic recovery.

These repo rate levels signify “a highly accommodative policy stance through the end of the forecast, keeping financial conditions supportive of credit demand as the economy continues to recover.”

Figure 4: Food price inflation

Source: Stats SA
### Foreign Sector Assumptions

1. **Real GDP growth in South Africa’s major trading partner countries**: The growth rate is adjusted to aggregate the GDP growth rates of South Africa’s major trading partners on a weighted basis. Individuals 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 commodity prices**: 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. The 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.

4. **Commodity price index**: A weighted aggregate price index of the major South African export commodities. The composite index represents the total of the individual commodity prices multiplied by their smoothed export weights. The index 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.

5. **World food prices**: 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.

6. **International policy interest rate**: 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 5: Foreign sector assumptions**

<table>
<thead>
<tr>
<th>Percentage changes (unless otherwise indicated)</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>Forecast 2022</th>
<th>Forecast 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Real GDP growth in South Africa’s major trading partner countries</td>
<td>3.3%</td>
<td>2.2%</td>
<td>-2.9%</td>
<td>6.2%</td>
<td>4.4%</td>
<td>3.4%</td>
</tr>
<tr>
<td>2. Output gap in South Africa’s major trading partner countries</td>
<td>0.8%</td>
<td>0.6%</td>
<td>-3.1%</td>
<td>-1.4%</td>
<td>-0.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>3. International commodity prices in US$ (excluding oil)</td>
<td>11.5%</td>
<td>-1.2%</td>
<td>25.5%</td>
<td>48.3%</td>
<td>-20.1%</td>
<td>-2.7%</td>
</tr>
<tr>
<td>4. Brent crude (US$/Barrel)</td>
<td>$71.0</td>
<td>$64.4</td>
<td>$41.8</td>
<td>$69</td>
<td>$67.0</td>
<td>$65.0</td>
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<tr>
<td>5. World food prices (US$)</td>
<td>-2.2%</td>
<td>-0.8%</td>
<td>3.1%</td>
<td>13.4%</td>
<td>-3.1%</td>
<td>1.5%</td>
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<tr>
<td>6. International consumer prices</td>
<td>2.0%</td>
<td>1.4%</td>
<td>0.7%</td>
<td>2.4%</td>
<td>2.0%</td>
<td>1.8%</td>
</tr>
<tr>
<td>7. International policy interest rate</td>
<td>0.9%</td>
<td>1.1%</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

Figures in blue represent the previous MPC assumption.
MPC update: SARB keeps rates unchanged at 3.50%, however overall risks to the short-term inflation outlook remain to the upside

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Figure 6: Domestic sector assumptions

<table>
<thead>
<tr>
<th>Percentage changes (unless otherwise indicated)</th>
<th>2018</th>
<th>Actual</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Electricity price</td>
<td>5.2%</td>
<td>(5.2%)</td>
<td>9.6%</td>
<td>(9.6%)</td>
<td>9.1%</td>
<td>(9.1%)</td>
<td>10.1%</td>
</tr>
<tr>
<td>2. Fuel taxes and levies</td>
<td>9.9%</td>
<td>(9.9%)</td>
<td>5.8%</td>
<td>(5.8%)</td>
<td>5.7%</td>
<td>(5.7%)</td>
<td>5.8%</td>
</tr>
<tr>
<td>3. Potential growth</td>
<td>1.2%</td>
<td>(0.7%)</td>
<td>0.3%</td>
<td>(0.3%)</td>
<td>-3.1%</td>
<td>(-2.5%)</td>
<td>3.4%</td>
</tr>
<tr>
<td>4. Inflation target midpoint</td>
<td>4.5%</td>
<td>(4.5%)</td>
<td>4.5%</td>
<td>(4.5%)</td>
<td>4.5%</td>
<td>(4.5%)</td>
<td>4.5%</td>
</tr>
<tr>
<td>5. Neutral real interest rate</td>
<td>1.9%</td>
<td>(1.9%)</td>
<td>2.1%</td>
<td>(2.1%)</td>
<td>2.0%</td>
<td>(2.0%)</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

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, state 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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