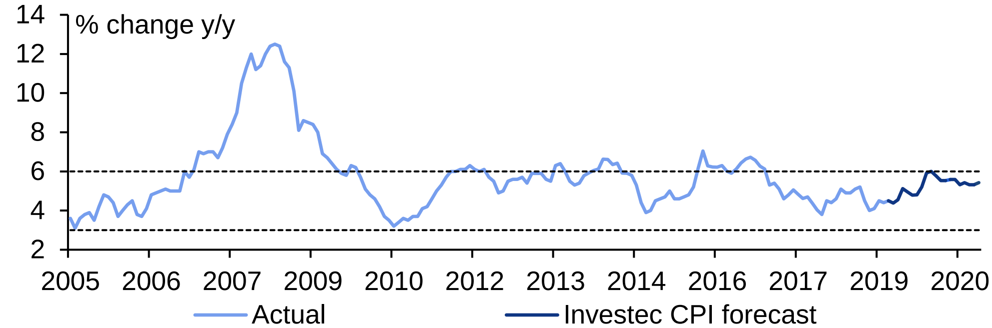
Investec

MPC update: The SARB unanimously opts to cut the repo rate by 25bp in July

18th July 2019

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

- In line with consensus expectations, the SARB unanimously selected to reduce the benchmark repo rate by 25 basis points to 6.50%.
- Monthly inflation readings have remained largely anchored "(a)round the mid-point of the inflation target range, as food and services price inflation remain subdued", according to the SARB and as such the SARB's Quarterly Projection Model's (QPM) 2019 headline inflation forecast has eased to 4.4% from 4.5% estimated previously (at the last MPC). The medium term outlook however, which is key to the MPC's current inflation targeting process remained unchanged at 5.1% for 2020.
- Overall risks to the inflation outcome continue to be evaluated as "(l)argely balanced", however upside risks to the inflation stance could be material, the SARB stressed. That is, while "(g)lobal financial conditions have eased, as central banks in advanced economies signaled a move towards monetary accommodation", they "(c)an abruptly tighten due to small shifts in inflation outlooks …and changing market sentiment". Furthermore, (d)omestically, the financing needs of State-Owned Enterprises (SOE) could place further upward pressure on the currency and long-term market interest rates for all borrowers", while food and administered price pressures (especially electricity and water tariffs) "(a)lso remain important risks to the inflation outlook". Food price inflation which "(h)as continued to surprise on the downside" is projected "(t)o start rising from the end of 2019 and to peak at 5.6% in the second and third quarters of 2020".
- "In the absence of shocks, relative exchange rate stability is expected to continue", with the rand having appreciated by 3.3% against the greenback on a trade weighted basis, since the May MPC. Enhanced sentiment towards riskier assets has supported the rand's performance, however, weak "(d)omestic growth prospects and fiscal risks" continue to weigh on investor confidence.
- Expectations for domestic growth have softened further with the SARB now anticipating growth of just 0.6% y/y in 2019, from 1.0% in May, chiefly as a result of the worse than expected first quarter GDP contraction of 3.2% on a quarter on quarter seasonally adjusted annualised basis. Growth forecasts for 2020 and 2021 however remain unchanged at 1.8% and 2.0% respectively.

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

	2018	2019	2020
SARB 18th July 2019	4.6	4.4	5.1
SARB 23rd May 2019	4.6	4.5	5.1
SARB 28th March 2019	4.6	4.8	5.3
SARB 17th January 2019	4.6	4.8	5.3

Source: SA Reserve Bank

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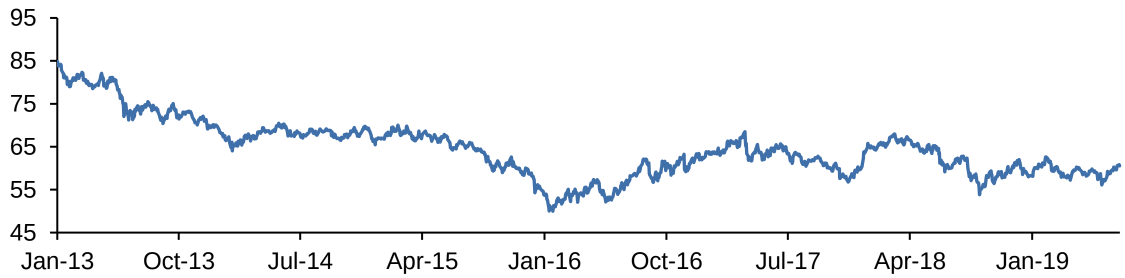
Figure 3: Trade Weighted Rand



Source: IRESS

- The MPC evaluates the risks to the growth forecast to be "(b)alanced in the near term, but remains concerned about longer term risks". The absence of meaningful structural reforms hindering investment prospects was cited as a concern, while the intensification of trade tensions globally, remains a significant risk.
- The SARB stressed that monetary policy will continue to be focused on "(a)nchoring inflation expectations near the mid-point of the inflation target range in the interest of balanced and sustainable growth", with policy decisions remaining "(h)ighly data dependent".

Figure 4: Foreign sector assumptions

Percentage changes (unless otherwise indicated)	Actual 2016	2017	2018	Forecast 2019	2020	2021
1. Real GDP growth in South Africa's major trading partner countries	3.0% (3.0%)	3.2% (3.2%)	3.3% (3.2%)	2.6% (2.9%)	3.0% (3.0%)	3.2% (3.1%)
2. Output gap in South Africa's major trading partner countries	-0.4% (-0.4%)	-0.0% (-0.3%)	0.1% (0.0%)	0.0% (0.0%)	0.0% (0.2%)	0.1% (0.4%)
3. International commodity prices in US$ (excluding oil)	4.3% (4.3%)	18.1% (18.1%)	10.9% (10.9%)	-3.0% (-0.5%)	0.5% (1.0%)	1.5% (1.5%)
4. Brent crude (US$/Barrel)	$43.6 ($43.6)	$54.2 ($54.2)	$71.0 ($71.0)	$67.0 ($69.5)	$68.0 ($68.0)	$68.0 ($68.0)
5. World food prices (US$)	-1.5% (-1.5%)	8.1% (8.1%)	-3.5% (-3.5%)	0.6% (0.9%)	1.6% (2.6%)	1.0% (1.0%)
6. International consumer prices	0.6% (0.6%)	1.8% (1.8%)	1.9% (1.9%)	1.5% (1.5%)	1.8% (2.2%)	1.9% (1.9%)
7. International policy interest rate	0.2% (0.2%)	0.5% (0.5%)	0.9% (0.9%)	1.2% (1.2%)	1.2% (1.3%)	1.4% (1.6%)

Source: SA Reserve Bank

- Figures in blue represents the previous MPC assumption

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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 5: Domestic sector assumptions

Percentage changes (unless otherwise indicated)		Actual			Forecast	
	2016	2017	2018	2019	2020	2021
1. Electricity price	9.3% (9.3%)	4.7% (4.7%)	5.2% (5.2%)	9.7% (10.2%)	10.4% (10.9%)	7.4% (7.4%)
2. Fuel taxes and levies	9.0% (9.0%)	8.3% (8.3%)	8.9% (8.9%)	5.5% (5.5%)	6.2% (6.2%)	5.6% (5.6%)
3. Potential growth	1.0% (1.0%)	1.4% (1.3%)	1.1% (1.0%)	1.0% (1.2%)	1.3% (1.3%)	1.4% (1.5%)
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	1.6% (1.6%)	1.7% (1.7%)	1.9% (1.9%)	2.1% (2.2%)	2.2% (2.3%)	2.3% (2.3%)

Source: SA Reserve Bank

Figures below the assumption in parentheses represents the previous MPC assumption

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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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