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MPC kept repo rate at 3,5% but sees inflation risks to the upside

Highlights

- The South African Reserve Bank's (Sarb) Monetary Policy Committee (MPC) kept the repo rate unchanged at 3,5%.
- All the members of the MPC were in favour of no change in the repo rate, the same as in March.
- However, the MPC now considers risks to the CPI outlook to be on the upside, compared to balanced in the March meeting.
- The MPC's decision nevertheless differed with the prediction of the Sarb's Quarterly Projection Model (QPM). At the March 2021 MPC meeting, the QPM predicted that the repo rate should increase in the second quarter of 2021 (this meeting).
- The Sarb adjusted its estimate of headline consumer price inflation (CPI) for 2021 to 4,2% from 4,3% previously. The estimates for 2022 and 2023 remained the same at respectively 4,4% and 4,5%.
- The core CPI estimate for 2021 was lowered to 3% from 3,3%. For 2022 and 2023 it remained unaltered at 4% and 4,3% respectively.
- The Sarb's economic growth estimate for 2021 was adjusted upward to 4,2%, up from 3,8% in March. However, the estimates for 2022 and 2023 were slightly lower.
- The Sarb expects the negative output gap to shrink over time.

MPC differs from the QPM's suggested repo rate path, but is more hawkish

All five members of the MPC decided to keep the repo rate unchanged at 3,5%. It has been on this level since 23 July 2020.

The MPC viewed the overall risks to the CPI outlook to be on the upside compared to balanced in the March 2021 statement. This means the MPC's interest rate outlook is more hawkish.

The MPC's decision was informed by, among other factors, their view on the underlying factors that can influence future CPI which also informed the CPI outlook (as provided by the QPM) for the next two and a half years. The forecast estimates headline CPI at 4,5% in 2023 (see tables 1 and 2).

The MPC uses the QPM projections as a guide but base their interest rate decisions on members' own individual assessment of the future path of CPI. In this respect it is noteworthy that the QPM in March 2021 predicted two increases in the repo rate in 2021, one in the second quarter (in other words this meeting) and one in the fourth quarter.

The MPC's decision to not raise the repo rate at this meeting can be construed to be dovish compared to the QPM, but as the view on the risk to the CPI outlook turned from balanced to upside, it can be interpreted as a signal that it is moving closer to the first increase in the repo rate.

The Sarb also adjusted its economic growth forecasts for 2021, 2022 and 2023. Economic growth for 2021 is estimated at 4,2%, up from the March estimate of 3,8%. The respective estimates for 2022 and 2023 are 2,3% and 2,4% (refer to table 1).

Table 1: The Sarb's forecasts for 2021, 2022 and 2023 in respectively January, March and May 2021

Economic indicator	2021			2022			2023		
	Jan	Mar	May	Jan	Mar	May	Jan	Mar	May
Headline CPI (y/y % change)	4,0	4,3	4,2	4,5	4,4	4,4	4,6	4,5	4,5
Core CPI (y/y % change)	3,4	3,3	3,0	4,0	4,0	4,0	4,3	4,3	4,3
Repo rate (% end of year)	4,11	4,0	4,07	4,95	4.95	5,02	5,93	6,07	6,11
GDP growth (y/y % change)	3,6	3,8	4,2	2,4	2,4	2,3	2,5	2,5	2,4
Output gap (y/y % change)	-3,9	-3,5	-3,2	-2,3	-2,0	-1,9	-0,7	-0,5	-0,4
Current Account (% of GDP)	0,0	1,3	2,0	-1,6	-0,8	-0,6	-1,6	-1,3	-1,3
Nominal effective exchange rate (y/y % change)	-0.5	2.1	7,8	-1.1	-2.4	-3,3	-0.3	0.7	-0,1
Real effective exchange rate (y/y % change)	3,0	4.9	10,0	1.8	0.3	-1,3	3	3.3	1,5
Real exchange rate gap (y/y % change)	-7,6	-5,9	-1,0	-5,8	-5,6	-2,3	-2,8	-2,3	-0,8

Source: South African Reserve Bank

Table 2: Assumptions in the Sarb's QPM

Economic indicator	2021			2022			2023		
	Jan	Mar	May	Jan	Mar	May	Jan	Mar	May
GDP growth in main trading partners	5,0	5.8	6,0	3.8	3.7	3,8	3.46	3.3	3,4
Output gap in main trading partners CPI	-2.5	-1.6	-1,5	-1,0	-0.4	-0,2	0	0.3	0,7
Commodity prices (ex oil; inc. petroleum)	14.8	23.3	40,8	-13	-13	-20,3	-0.5	0,0	-0,6
Brent oil (US$ per barrel)	50	62	62,2	55	60	60,0	57	60	60,0
World Food prices (US$-index)	2.9	4.5	5,2	1.5	1.7	0,8	1.5	1.4	1,4
International CPI	1.5	1.6	2,0	1.5	1.6	2,1	1.7	1.8	2,4
International interest rates	0	0	0	0	0	0	0	0	0
Electricity	8.2	9.7	10,6	10,0	11.4	12,1	10,0	10,0	10,0
Potential growth	1.6	1.6	1,6	0.9	0.9	0,9	0.9	0.9	0,9
Neutral interest rate	2.1	2.1	2,1	2.3	2.3	2,3	2.3	2.3	2,3

Source: South African Reserve Bank

Higher economic growth is not viewed as a danger to the CPI outlook

The Sarb noted a better outlook for international and local economic growth. It increased South Africa's main trading partners' economic growth estimate for 2021 to 6% from 5,8% previously. South Africa's economic growth estimate for 2021 was raised to 4,2% from 3,8% estimated in March. However, most of the growth accrues from a low base and not from structural factors that can enhance the country's growth potential.

The MPC again mentioned that the economy's growth potential could be raised by further 'de-risking' the economy through stabilising public debt, providing sufficient electricity for growth, reducing the effect of administered prices (mostly public sector CPI) on headline CPI, and keeping wage increases low. Although the public debt situation improved somewhat, substantial improvements in the other factors do, in our view, not seem likely in the medium-term. The Sarb's projection of potential growth is therefore slower than actual growth estimates.

However, despite CPI edging upward over the medium-term, the MPC foresees actual economic growth only gradually catching up with potential growth. It therefore does not seem to pose a risk to their CPI-outlook for at least the next two years as the output gap is estimated to be remain negative over the forecast period (as table 1 shows). This suggests little demand-pull inflation.

Indeed, the bulk of the current increase in CPI (which may last up to December 2021) is not demand driven. Rather, it is the result of a low base established in 2020 when, among other factors, oil prices collapsed, as well as methodological changes in the calculation of CPI. Stats SA was not able to survey several prices in lockdown and resorted to 'artificial price imputations' for five months. The effect of these two factors on CPI will only 'disappear' in January 2022 as oil prices remained exceptionally low until December 2020, while price imputations occurred up to August 2020.

Consequently, it will be prudent to also monitor price developments in core CPI, at least until the effects of these factors are removed from headline CPI.

Drivers of the CPI outlook yield mixed results

The Monetary Policy Review of April 2021 highlighted four factors to be key drivers of the inflation outlook in the medium-term, namely the mentioned output gap, unit labour costs (ULC), the rand exchange rate and inflation expectations. These drivers are considered to be integral to closing the gap between observed inflation and 4,5%, the midpoint of the target range.

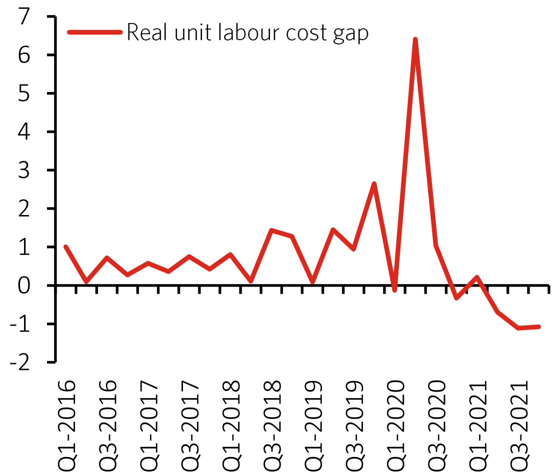
The real ULC gap measures the price pressures emanating from salary and wage increases. If real salary and wage increases exceed productivity growth, it puts pressure on CPI to increase. Chart 1 shows that the gap between real ULC and productivity growth added upward pressure on CPI up to the third quarter of 2020. Thereafter the gap turned negative, reducing pressure on CPI to increase. The Sarb estimated the gap to be negative in the near- to medium-term, but this was based on a 0% salary increase for civil servants. The government has since Budget 2021-22, when it announced a salary freeze for the next three years, already offered a 1,5% increase. Inflationary pressures from this source over the medium-term might therefore be higher than the Sarb's initial estimate.

As for the effect of the rand exchange rate on future CPI, inflationary pressures decreased substantially over the past quarter due to the rand strengthening against a depreciating US$. Since the March meeting, the rand has appreciated by 4% on a trade-weighted basis.

The Sarb foresees a stronger rand compared to March 2021 over the forecasting horison, reducing the pass-through effect to consumer prices.

Inflation expectations have also moderated considerably from around 6% in 2017 to closer to the MPC's 4,5% target. This also reduced pressure on CPI to increase. In this respect the Bureau for Economic Research (BER) survey expectations for 2021 remained at 3,9%. It was 4,2% for 2022, and 4,4% for 2023. Market analysts (Reuters Econometer) expect higher CPI for 2021 and 2022 at 4,2% and 4,3% respectively. For 2023 it was the same as the BER survey.

Chart 1: Real ULC gap turned negative in 2020



Source: South African Reserve Bank

The future path of CPI will to a large degree be determined by administered prices. Should these prices continue to exceed 6%, the top of the CPI-target band, it will maintain its pressure on CPI to be higher than what it could have been. For instance, the Sarb expects electricity prices to increase by 10,6% in 2021 (up from 9,7%). In addition, medical insurance and education inflation rates which declined in 2021 due to the effect of the lockdown, may increase at a higher rate in 2022.

In this respect the MPC seems correct to judge the CPI risks to the upside. However, it is also important to keep in mind that the QPM forecasted both headline and core CPI to be lower this year compared to the March forecast. This suggests that the base will be lower than previously predicted, making a case for higher inflation in 2022. However, the headline and core CPI predictions for 2022 remained the same as in March. This actually means that the QPM predicts less inflationary pressures in 2022 compared to the March 2021 predictions.

Against this background, we are still of the opinion that the repo rate can remain unchanged in 2021. However, if a few new risks such as an above inflation public sector wage increase materialise, the MPC may move their first increase to the fourth quarter of 2021.

Table 3: Monetary Policy Committee member views over time

	Favoured no change	Favoured 25 basis point cut	Favoured 50 basis point cut	Favoured 100 basis point cut.	Favoured 25 basis point increase
17 Jan 2019	5	-	-	-	-
28 March 2019	5	-	-	-	-
23 May 2019	3	2	-	-	-
18 July 2019	-	5	-	-	-
19 September 2019	5	-	-	-	-
21 November 2019	3	2	-	-	-
16 January 2020	-	5	-	-	-
19 March 2020	-	-	-	5	-
14 April 2020	-	-	-	5	-
21 May 2020	-	2	3	-	-
23 July 2020	2	3	-	-	-
17 September 2020	3	2	-	-	-
19 November 2020	3	2	-	-	-
21 January 2021	3	2	-	-	-
25 March 2021	5	-	-	-	-
20 May 2021	5	-	-	-	-