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More dovish MPC kept repo rate at 3.5%, effect of riots on economic growth limited

Highlights

- All members of the Monetary Policy Committee (MPC) decided to keep the repo rate unchanged at 3.5%.
- The MPC still considers the risks to the consumer price inflation (CPI) outlook to be on the upside.
- The South African Reserve Bank's (SARB) Quarterly Projection Model (QPM) predicts higher average CPI for 2021 and 2023 compared to the May estimate. The estimate for 2022 is lower at 4.2% (4.4 % in May).
- The core CPI estimates for 2021 and 2022 were adjusted lower to 2.9% and 3.7% respectively.
- The QPM predicts the first increase of 25 basis points in the repo rate to occur in the fourth quarter of 2021, followed by an increase in each quarter in 2022. The MPC uses the predictions of the QPM as a guide only.
- The SARB's economic growth estimate for 2021 remained unchanged at 4.2%. The estimates for 2022 and 2023 were also not adjusted.
- The SARB expects the negative output gap to shrink over time.

MPC lowers CPI forecast for 2022, but risks remain to the upside

Despite perceiving the overall risks to CPI as on the upside, all five members of the MPC decided to keep the repo rate unchanged at 3.5%. The repo rate has been on this level since 23 July 2020.

Administered prices still pose the highest upside risk to the future path of CPI. Demand CPI continues to be muted.

The MPC's decision was informed by 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 QPM forecasts average headline CPI at 4.3% in 2021 (up from 4.2%), 4.2% in 2022 (down from 4.4%) and 4.5% in 2023 (see table 1).

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 May predicted two increases in the repo rate in 2021, one in the second quarter (in other words the May meeting) and one in the fourth quarter, but the MPC kept the repo rate unchanged.

The QPM in July predicts a rate increase of 25 basis points in the fourth quarter of 2021 and similar increases in every quarter of 2022. Nevertheless, the QPM's predictions of the repo rate are lower compared to May.

Although the MPC views the risks to the CPI outlook to the upside, the predictions of the QPM are more dovish compared to May. We still foresee the first interest rate increase to occur in 2022 opposed to the QPM's prediction of the fourth quarter of 2021.

The SARB did not alter its economic growth forecasts notwithstanding the negative effect of the riots on inventory and infrastructure (refer to table 1).

Table 1: The SARB forecasts for 2021, 2022 and 2023 in January, March, May and July, respectively

Economic indicator	2021				2022				2023			
	Jan	Mar	May	Jul	Jan	Mar	May	Jul	Jan	Mar	May	Jul
Headline CPI (y/y %)	4.0	4.3	4.2	4.3	4.5	4.4	4.4	4.2	4.6	4.5	4.5	4.5
Core CPI (y/y %)	3.4	3.3	3.0	2.9	4.0	4.0	4.0	3.7	4.3	4.3	4.3	4.3
GDP growth (y/y %)	3.6	3.8	4.2	4.2	2.4	2.4	2.3	2.3	2.5	2.5	2.4	2.4
Output gap (% change)	-3.9	-3.5	-3.2	-3.2	-2.3	-2.0	-1.9	-1.8	-0.7	-0.5	-0.4	-0.4
Current Account: % of GDP	0.0	1.3	2.0	3.7	-1.6	-0.8	-0.6	-0.1	-1.6	-1.3	-1.3	-0.9
Repo rate	4.11	3.99	4.1	3.79	4.95	4.95	5.02	4.93	5.93	6.07	6.11	6.12
Nominal effective exchange rate (y/y %)	-0.5	2.1	7.8	11.5	-1.1	-2.4	-3.3	-3.4	-0.3	0.7	-0.1	-3.6
Real effective exchange rate (y/y %)	3	4.9	10	13.6	1.8	0.3	-1.3	-1.4	3.0	3.3	1.5	-1.1

Source: South African Reserve Bank

Effect of riots on economic growth limited, but reforms needed to improve growth potential

Despite another wave of COVID-19 infections, different degrees of lockdowns and slow vaccination rates in especially emerging markets, the SARB revised its global economic growth estimate for 2021 upward to 6.1% from 6% in May. Global growth for 2022 and 2023 is forecast at 4.4% and 3.4% respectively.

The SARB kept South Africa's economic growth estimate for 2021 unchanged at 4.2%. However, MPC stated that the destructive effect of the riots in KwaZulu-Natal and Gauteng will totally negate the stronger than expected economic growth achieved in the first quarter of 2021. The MPC noted that the unrest and economic damage may have lasting effects on investor confidence and job creation. Economic growth forecasts for 2022 and 2023 are unchanged at 2.3% and 2.4%. Potential growth and therefore the output gap also remained unchanged. As the output gap is projected to be still negative in 2023, it will not have an inflationary effect on CPI.

The MPC previously 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.

The public debt situation was on a strong recovery path up to June, after which the outbreak of the riots caused severe destruction to supply chains and infrastructure. Tax collections were destined for a strong recovery emanating from mainly high commodity prices which should boost company profits and therefore company income tax. However, damages caused by the riots will in all likelihood reduce value added-, company- and income tax collections. This would have dented chances of a 'much' smaller fiscal deficit than announced in the February 2021-22 budget. In addition, government expenditure is also expected to increase to make provision for increases in civil servant remuneration and a relief package to assist those affected by the riots. Nevertheless, tax collections are still on a path of overshooting the budgeted amount and the fiscal deficit should still be smaller than envisaged in the budget.

Electricity provision should also increase on the back of President Ramaphosa's announcement to lift the licensing cap for private companies to self-generate power from 1MW to 100MW. Various sources reported that mines can quickly generate up to 1 600MW and private companies 5 000MW over a five-year period. This may put an end to load shedding in the next two years and increase potential economic growth, which in turn should boost employment.

Weight of evidence points to upside risks to the CPI outlook, may bring rate increases forward

Although the near-term CPI outlook deteriorated slightly, it improved for 2022 and remained unchanged for 2023. The QPM predict headline CPI at 4.3% for 2021, up from 4.2% in May. However, headline CPI for 2022 is now expected at 4.2% compared to 4.4% in May, while the prediction for 2023 remained unchanged at 4.5%.

These predictions are more dovish considering the negative effect of the riots and the more hawkish outlook in May.

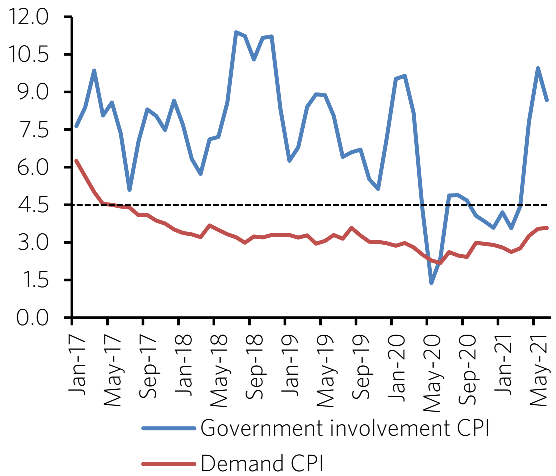
However, the MPC assesses the risks to the near-term CPI outlook to be to the upside. The MPC highlighted these risks as: rapid global producer price inflation and supply shortages created by disruptions to local transport networks; higher than expected food price inflation; strong increases in fuel, electricity and other administered prices; and an increase in average CPI expectations of 0.3 percentage points to 4.2% for 2021 and 0.2 percentage points to 4.4% for 2022.

The MPC expects the medium- and long-term CPI outlook to also carry more upside risks in the form of a weaker currency, higher domestic import tariffs, and escalating wage demands.

However, in our view a few factors should combine to reduce the near- to medium term risks to CPI. The low base of calculation will not form part of CPI calculations next year, while it is unlikely that international oil prices will increase by the same magnitude as it had in the past year. Food prices have also started to moderate, while municipal rates should in all likelihood register one of its highest increases this year and increase at a lower rate next year.

Administered prices remain a concern, though. It remains worrying that there are little policy reforms on the horison that suggest workable plans to improve the effectiveness of municipalities and other institutions that will actually reduce the sharp increases in administered prices such as electricity, water and other municipal rates. Until this issue is addressed with the vigour it deserves, other price increases will have to be suppressed to compensate for the strong inflationary effect of administered prices on headline CPI. Chart 1 shows the difference between so-called Government-involved CPI and Demand CPI. Government involved CPI includes the price increases of influential items where the government is in some way or another involved in price setting, such as education, health, fuel, electricity, water and other municipal rates.

Chart 1: Government-involved CPI keeping headline CPI high (y/y % change)

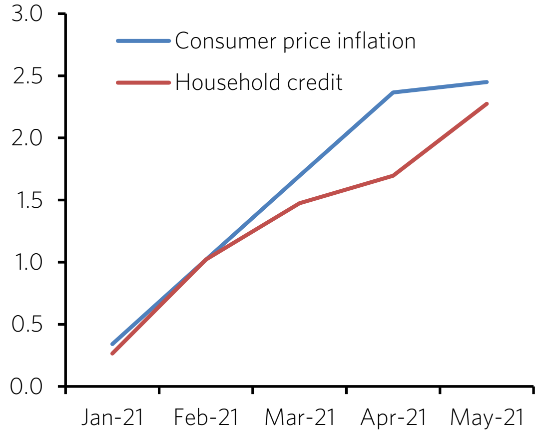


Source: Stats SA, Momentum Investments

Another factor the MPC highlighted which can keep interest rates lower for longer is maintaining moderate salary and wage increases into the economic recovery period. At this stage it seems possible that civil servants will accept a CPI-related increase this year. Combined with some lower than CPI-related increases in the private sector, it should reduce the impact of unit labour costs on headline CPI. Should this trend continue, and plans are set in motion to increase the effectiveness of institutions aimed at reducing the magnitude of administered price increases, it will contribute to structurally lower headline CPI and interest rates, which should improve the economy's growth potential.

In addition, CPI is at this stage not fuelled by household credit growth. Household credit grew at a slower pace than CPI since the start of this year, implying negative real credit growth, which also contained CPI (see chart 2).

Chart 2: Cumulative m/m % increase in CPI and household credit



Source: South African Reserve Bank, Momentum Investments

Against this background, it is likely that the MPC may keep the repo rate unchanged this year despite the predictions of the QPM.

Table 2: Monetary Policy Committee member views over time

	Monetary Policy Committee member votes				
	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	-	-	-	-
22 July 2021	5	-	-	-	-