South African Reserve Bank

PRESS STATEMENT

28 March 2018

STATEMENT OF THE MONETARY POLICY COMMITTEE

Issued by Lesetja Kganyago, Governor of the South African Reserve Bank

Since the previous meeting of the Monetary Policy Committee (MPC), the risks to the inflation outlook have subsided somewhat. Inflation outcomes in recent months have remained well within the inflation target band, although this likely represents the low point of the current cycle. While the increase in the value-added tax (VAT) rate to 15% places temporary upside pressure on inflation, this is mitigated by the stronger exchange rate which has contributed to the changing inflation risk profile. The affirmation of South Africa's sovereign rating as 'investment grade' and the change of the outlook from negative to stable by Moody's Investors Service has contributed to the recent rand resilience.

The domestic growth outlook is more positive but still challenging. Growth in the fourth quarter surprised significantly on the upside, and there are signs of increased business confidence. This is against a backdrop of sustained momentum in the global economy which provides a favourable environment for emerging markets generally.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, measured 4.4% in January 2018 before declining to 4.0% in February. Goods price inflation moderated from 3.7% to 3.2% while services price inflation moderated to a seven-year low of 4.9%. The South African Reserve Bank's (SARB) measure of core inflation – which excludes food, fuel and electricity – remained unchanged at 4.1% in February. Year-on-year producer price inflation for final manufactured goods declined marginally to 5.1% in January.

The inflation forecast of the SARB has shown a moderate improvement despite the adverse impact of the VAT increase due to be implemented in April. This increase, combined with base effects and other indirect tax increases, implies that the low point of the inflation cycle was reached in the first quarter of 2018, at a forecast average of 4.1%. Headline inflation is expected to average 4.9% in 2018 (unchanged from the previous forecast), 5.2% in 2019 (down from 5.4%), and 5.1% in 2020. A peak of 5.5% is expected by the first quarter of 2019 before the VAT increase falls out of the data. The forecast for core inflation is unchanged at 4.6% for 2018 and is 0.2 percentage points lower, at 4.9%, for 2019. It is expected to remain unchanged at 4.9% in 2020.

The main changes in the forecast related to the VAT increase and the exchange rate. The VAT increase is expected to add about 0.6 percentage points to the headline inflation trajectory for the four quarters from the second quarter of 2018, with marginal second-round effects persisting into subsequent quarters. The improved exchange rate has softened the impact of the indirect tax adjustments on the inflation forecast. The implied starting point for the rand is R11.97 against the US dollar compared with R12.90 at the time of the previous MPC meeting.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) in the first quarter of 2018, are at a multi-year low, having declined across all groups of respondents. Average expectations for 2018 and 2019 have declined to 5.2% and 5.3% respectively from 5.7% and 5.9% previously, while an average of 5.4% is expected in 2020. The largest adjustment was seen in the business category, with downward revisions of around 1 percentage point in both 2018 and 2019. Five-year inflation expectations declined to 5.3%, their lowest level since they were first surveyed in 2011. Expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) declined across all maturities. While these developments are welcome, the MPC would prefer to see inflation expectations anchored closer to the midpoint of the target band.

The global economic outlook has remained favourable amid a relatively synchronised upswing in the advanced economies, although risk and vulnerabilities remain. The global inflation outlook remains benign but is on a moderate upward path. However, the recent trade policy actions by the United States (US) could escalate into a trade war, which could in turn undermine this positive prognosis for growth and push inflation higher.

The rand has sustained its recent gains since late last year, and some of the key risks to the outlook have dissipated. Since the previous meeting of the MPC, the rand has appreciated by 4.8% against the US dollar, by 3.2% against the euro, and by 3.5% on a trade-weighted basis. At current levels, the SARB's model assesses the rand to be somewhat overvalued, and further strengthening potential is probably limited.

The rand has reacted positively to domestic political developments in the past months and was given further support following the recent sovereign credit rating announcement. The risk of a significant sell-off of South African government bonds by non-residents has therefore receded for now. Further support for the rand comes from recent dollar weakness. Some widening of the current account deficit is expected over the forecast period as imports increase in line with higher expected investment expenditure and the impact of a stronger rand.

A key external risk to the rand remains the possibility of a tighter-than-expected stance of monetary policy in the US in particular. As anticipated, a moderately faster pace of tightening was signalled by the US Federal Open Market Committee, particularly for 2019, and at this stage, further tightening is expected to remain measured in the absence of significant inflation or growth surprises. Significantly higher US fiscal deficits could also elicit a stronger monetary policy response. The pace of monetary policy normalisation in some of the other advanced economies continues to be gradual with a tightening bias.

The domestic economic growth outlook for this year is more favourable but remains challenging. This follows an upward revision of historical gross domestic product (GDP) data and a fourth-quarter outcome of 3.1% which surprised on the upside. Following an annual growth rate of 1.3% in 2017, the SARB expects a growth rate of 1.7% for 2018 compared with 1.4% previously. The forecast for 2019 is 1.5%, marginally lower than the previous forecast of 1.6%, while a growth rate of 2.0% is forecast for 2020. At these growth rates, the negative output gap, which measured -1.1% in 2017, is expected to close in 2020. The composite leading business cycle indicator continued its upward trend in January, consistent with the improved outlook.

The improved growth outlook is driven primarily by an increase in business and consumer confidence. This is reflected in the RMB/BER Business Confidence Index, which increased markedly in the first quarter of 2018 although it remains below the neutral 50 level. Furthermore, the 'expected business conditions' category in the Absa Purchasing Managers' Index surged in February to its highest level since 2001. In this context, growth in gross fixed capital formation is forecast to increase gradually over the forecast period.

Consumption expenditure by households is also expected to be positively impacted by the expected increase in consumer confidence, although this is not yet evident in the consumer confidence surveys. In the near term, consumption expenditure is expected to be constrained by the tax increases, the lack of compensation for fiscal drag, weak employment growth as well as subdued growth in credit extension to households. While consumption expenditure is expected to grow at a slightly slower rate in 2018 compared with last year, the trend over the forecast period is moderately stronger than previously expected, reaching 2.1% in 2020. This improvement is also supported by higher expected wealth growth over the longer term.

Employment trends remain a concern despite an increase of 102 000 during the past year. The official unemployment rate was slightly higher when compared to the same quarter in 2016 while the number of discouraged job seekers increased markedly.

The national Budget presented in February 2018 proposed a faster pace of fiscal consolidation than that indicated in the October *Medium Term Budget Policy*

Statement. This revised path is expected to result in a stabilisation of the ratio of government debt to GDP at about 56% over the medium term. The moderately tighter stance is due to an overall cut in budgeted expenditure growth as well as an increase in tax revenues. However, the projected deficits are wider than those proposed in the February 2017 Budget. The outcome of the ongoing public sector wage negotiations will be an important indicator of the sustainability of the fiscal projections and future wage trends.

Nominal wage growth appears to be moderating slightly, but upside pressure on inflation from this source is expected to persist. Average wage inflation is expected to decline moderately over the forecast period, from 7.6% in 2017 to 6.8% in 2020, still positive in real terms.

Annual food price inflation is no longer seen as a major risk to the inflation outlook. While the continued drought in the Western Cape is likely to adversely affect agricultural production in the region, the direct impact on food prices is expected to be fairly limited.

The MPC noted the general improvement in inflation outcomes and the lower inflation expectations. Although the bottom of the inflation cycle has likely been reached, the trajectory of headline inflation is forecast to remain within the target range, with core inflation expected to remain below 5% for most of the forecast period. To the extent that inflation expectations are adaptive, there may be further downward adjustment in these expectations in the coming quarters. As mentioned earlier, the MPC would prefer to see inflation expectations anchored closer to the midpoint of the target band.

In considering the impact of the VAT increase, the approach of the MPC is to look through the first-round effects of this increase and focus on the second-round effects, which are expected to be relatively small. In any event, the policy horizon of the MPC extends beyond the period during which the first-round effects have an impact.

The MPC assesses the risks to the inflation forecast to be more or less evenly balanced. Some of the key domestic risks and uncertainties that overshadowed the outlook in recent meetings have abated. The government budget was generally well received, but implementation risks remain. While the recent sovereign ratings outcome was positive for the rand, further sustained appreciation of the local currency is not expected. The exchange rate is currently assessed to be less of a risk to the inflation outlook. However, the rand will remain sensitive to a faster pace of normalisation in the advanced economies, possible heightened global financial market volatility, as well as domestic developments.

Although the growth forecast has improved, the outlook remains relatively constrained. Despite the higher levels of consumption expenditure in the latter part of 2017, demand pressures in the economy are not assessed to pose a risk to the inflation outlook. The MPC assesses the risks to the growth forecast to be moderately on the upside. To make an appreciable impact on employment and potential output, the current improved levels of confidence will need to be sustained and translate into higher levels of investment. This can only be achieved through a firm commitment to, and implementation of, credible structural reforms by government.

The MPC was of the view that, in light of the improved inflation outlook and the moderation in risks to the forecast, there was some room to provide further accommodation without undermining the inflation trajectory or the downward trend in inflation expectations. Accordingly, the MPC has decided to reduce the repurchase rate by 25 basis points to 6.5% with effect from 29 March 2018. Four members preferred a reduction while three members preferred an unchanged stance.

In this uncertain environment, future policy decisions will be highly data-dependent and sensitive to the assessment of the balance of risks to the outlook.

The implied path of policy rates generated by the SARB's Quarterly Projection Model has changed since the previous MPC meeting. Whereas previously two to three increases of 25 basis points each by the end of 2019 were indicated, one increase of 25 basis points is now implied. Two further increases are indicated in 2020. As emphasised previously, the implied path remains a broad policy guide which can and does change in either direction between meetings in response to new developments and changing risks. Therefore, the MPC does not mechanistically respond to changes in the path.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 24 May 2018.

Contact person:

ZamaNdlovu Ndlovu

012 399 7118

media@resbank.co.za