South African Reserve Bank

PRESS STATEMENT

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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

In recent weeks, the resurgent US[1] dollar and higher US long-bond yields have led to sharply lower capital flows to the emerging markets. These developments, coupled with persistently rising international oil prices, have contributed to the reversal of some of the recent rand strength, tilting the balance of risks to the domestic inflation outlook to the upside. Nevertheless, inflation is expected to remain within the inflation target range over the entire forecast period.

The domestic economic growth outlook has improved moderately amid rising business and consumer confidence, despite a disappointing first-quarter performance in a number of key sectors.

[1] United States

The year-on-year inflation rate, as measured by the consumer price index for all urban areas, reached a seven-year low of 3.8% in March 2018 before increasing to 4.5% in April, as the impact of the VAT[2] increase and other levies became evident. Goods price inflation increased from 2.6% to 3.5% while services price inflation increased from 5.1% to 5.3%. The South African Reserve Bank's (SARB) measure of core inflation – which excludes food, fuel and electricity – increased from 4.1% to 4.5%. Year-on-year producer price inflation for final manufactured goods declined from 4.2% in February to 3.7% in March.

The headline inflation forecast of the SARB is more or less unchanged since the previous meeting of the Monetary Policy Committee (MPC), despite the upward adjustments to the international oil price assumption and the weaker starting point for the trade-weighted exchange rate. The impact of these adjustments on the inflation forecast was offset in part by a lower food price forecast and a lower starting point. This follows a succession of downside surprises in core goods and food price outcomes. The forecasts for 2018 and 2019 are unchanged at 4.9% and 5.2% respectively, while the forecast for 2020 is marginally higher at 5.2% compared with 5.1% previously. The peak of 5.5% is still expected in the first quarter of 2019 before the impact of the VAT increase largely dissipates.

The forecast for core inflation is marginally lower, at 4.5% for 2018, but has deteriorated somewhat more than headline inflation in the coming two years, to 5.1% in both years, from 4.9% previously. A peak of 5.2% is expected in the first quarter of 2019.

[2] value-added tax

The implied starting point for the rand in the forecast is R12.37 against the US dollar compared with R11.97 at the time of the previous MPC meeting. Food prices, by contrast, are expected to increase by 4.9% in 2018 and by 5.5% in 2019, lower than in the previous forecast. There is a degree of uncertainty regarding the likely impact of the VAT increase and the sugar tax on food, and the extent to which these increases will be absorbed by manufacturers and retailers.

Following persistent increases in international oil prices since February, the assumptions for Brent crude oil in the SARB's Quarterly Projection Model were revised upwards by US$7 per barrel to US$70 for 2018 and by US$5 per barrel, to US$67, for the next two years. Both the futures markets and the consensus forecasts indicate some moderation of prices over the next two years.

The inflation expectations of market analysts reflected in the Reuters Econometer survey have moderated somewhat since March. In the May survey, median inflation was expected to average 4.9% in 2018, rising to 5.3% in 2020, compared with 5.0% and 5.5% respectively in the March survey. Expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) are more volatile and more sensitive to exchange rate movements. These expectations show some increase following the recent rand weakness. While the longer-term expectations are back above 6.0%, the five-year break-even rate remains within the target range. The next BER[3] inflation expectations survey will be published in July.

[3] Bureau for Economic Research

The global economic backdrop has become more challenging amid continuing trade policy tensions between the US and China as well as other geopolitical risks. Although the economic growth outlook in the advanced economies generally remains positive, there are signs that the momentum may be slowing. Global inflation remains on a moderate upward trend, but still at low levels. However, the rising international oil prices could derail the relatively benign global inflation prognosis.

Since the previous meeting of the MPC, the rand has depreciated significantly, against the US dollar in particular, reversing much of the overvaluation seen at that time. Since then, the rand has depreciated by 6.0% against the US dollar, by 0.7% against the euro, and by 2.8% on a trade-weighted basis.

The main driver of this recent rand weakness has been developments in the US financial markets, where Treasury yields exceeded 3.0% for the first time since July 2011. This was in response to wider fiscal deficits, rising inflation expectations and expectations of further US monetary policy tightening – a key risk highlighted in the previous MPC statement. As a consequence, a number of emerging markets have experienced capital outflows and currency depreciation, with those with wider current account deficits and other macroeconomic imbalances being most vulnerable. Month-to-date in May, non-residents have been net sellers of South African government bonds to the value of R33.6 billion, contributing to the sharp increase in long-term domestic bond yields.

At this stage, the likelihood of further sustained dollar strengthening is unclear. Apart from US domestic issues, it is likely to be influenced by geopolitical risks, trade conflicts, and expectations of changes in monetary policy in other advanced economies. In the near term, the rand is expected to remain volatile, with movements dominated by the changing assessment of these global trends. Domestically, an expected moderate widening of the current account deficit, a result of deteriorating terms of trade, could also weigh on the rand.

The domestic growth outlook remains challenging, although growth is still expected to outperform recent year outcomes. This is despite the possibility of a contraction in GDP[4] in the first quarter of this year, following negative growth in both the mining and the manufacturing sectors. The SARB's forecast for GDP growth is unchanged at 1.7% for 2018, but has been revised up from 1.5% to 1.7% for 2019. The forecast for 2020 is unchanged at 2.0%. The forecast remains consistent with a closing of the negative output gap by 2020, but at a slightly faster pace than before. The continued increase in the composite leading business cycle indicator confirms the upward momentum in the economy.

The growth outlook is underpinned by strong recoveries in both business and consumer confidence. The RMB[5]/BER Business Confidence Index, while still below the neutral level, increased by an unusually large 11 index points from 34 in the fourth quarter of 2017 to 45 in the first quarter of 2018. This is expected to be supportive of higher growth in gross fixed capital formation, particularly by the private

[4] gross domestic product
[5] Rand Merchant Bank

sector. The recent signing by government of the Independent Power Producer programme has added to the improved outlook.

The FNB[6]/BER Consumer Confidence Index surged from negative territory to an all-time high in the first quarter, driven mainly by the positive reaction to domestic political developments. However, there is a general expectation that this move may represent an overshoot, and some correction is likely in the coming quarter. Nevertheless, consumption expenditure by households is expected to be the main driver of growth going forward, and the likely trend over the forecast period is stronger than previously expected. This is despite headwinds from the VAT and petrol price increases, as well as slow employment growth. Consumption expenditure growth is forecast to remain below 2.0% in both 2018 and 2019, but is expected to reach 2.5% in 2020, compared with 2.1% previously.

Apart from improved confidence, this positive prognosis is supported by lower near-term inflation, lower interest rates, positive wealth effects, and real wage growth. Although growth in bank credit extension to households remains subdued and negative in real terms, a moderate upward trend has been evident since the beginning of 2017, alongside an improvement in household balance sheets.

Nominal wage growth trends remain more or less unchanged, and upward pressure on inflation from this source is therefore expected to persist. Nominal average wage growth is expected to be sticky around the 7.0% level over the forecast period. Real wage increases are expected to remain positive and in excess of productivity growth. The outcome of the public-sector wage negotiations is still unclear.

[6] First National Bank

Employment trends remain a cause for concern. According to the *Quarterly Labour Force Survey* of Statistics South Africa, over the year to the first quarter of 2018, employment increased by 165 000, mainly in the informal sector of the economy. While unemployment declined from 27.7% to 26.7%, this was partly due to a marked increase in discouraged workers, underlining the lack of employment prospects.

The MPC noted the relative stability of the inflation forecast, despite changes in a number of the key assumptions. As expected, the bottom of the inflation cycle has been reached, and the trajectory of headline inflation is forecast to remain within the target range. The April inflation outcome was in line with the SARB's short-term forecast and reflected a relatively moderate pass-through from the higher VAT and sugar tax. The full impact of the VAT increase may still be felt in the coming months.

In contrast with the previous meeting, the MPC assesses the risks to the inflation forecast to have moved to the upside. This change is mainly due to global developments. A key uncertainty relates to the outlook for the dollar, which has appreciated against most currencies. The spillover effects on emerging markets could become more severe in the event of further significant increases in US bond yields.

Oil prices also pose an upside risk to the inflation forecast. Current spot prices are significantly above the levels assumed in the Quarterly Projection Model. Furthermore, a slight moderation in prices followed by a flat trajectory is assumed in the coming two years. There may be a degree of upside risk to this assumption.

Greater clarity with regard to electricity tariffs is expected in June when Nersa[7] is scheduled to respond to Eskom's application for an increase in the order of 30%. The SARB's current assumptions are for an 8.0% increase from mid-2019 and a further similar increase in mid-2020. The possibility of an increase in excess of these assumptions poses an upside risk to our inflation forecast.

The upside risks identified above are supply-side shocks. As has been noted in the past, the MPC attempts to 'look through' the first-round effects of such shocks and to react to second-round effects. The evolution of inflation expectations and wage settlements will be important indicators in this regard.

The growth forecast has improved moderately, mainly for 2019, but remains too low to make serious inroads into the unemployment rate. The risks to the forecast remain on the upside, but slightly less so than at the previous MPC meeting. The weak first-quarter growth outcome is not expected to derail the upward trend and does not yet reflect the renewed business and consumer optimism. Despite the stronger expected trend in household consumption expenditure, there is still evidence of slack in the economy, and demand pressures in the economy are not assessed to pose a risk to the inflation outlook.

In light of the change in the balance of risks to the inflation outlook, the MPC unanimously decided to keep the repurchase rate unchanged at 6.5% per annum.

[7] National Energy Regulator of South Africa

At these levels, the MPC still assesses the stance of monetary policy to be accommodative and appropriate given the forecast inflation trajectory and the current state of the economy. However, with risks and uncertainties at high levels, the MPC will maintain its vigilance to ensure that inflation remains well within the inflation target range, and will adjust the policy stance should the need arise.

The implied path of policy rates generated by the SARB's Quarterly Projection Model reflects one increase of 25 basis points during the final quarter of this year and a similar increase in mid-2019. Two further increases are indicated in 2020. The generated path remains a broad policy guide, and the extent to which the MPC follows it will be determined by, among other things, the MPC's assessment of the balance of risks to the forecast.

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GOVERNOR

The next statement of the Monetary Policy Committee will be released on 19 July 2018.

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