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

Since the previous meeting of the Monetary Policy Committee (MPC), risks to the inflation outlook have continued to materialise and the inflation outlook has deteriorated in response to both domestic and external developments. The impact of elevated oil prices and a weaker exchange rate on domestic fuel costs is increasingly evident. At the same time, domestic growth has weakened further.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5.1% in July and declined to 4.9% in August. Goods price inflation was 5.0% (down from 5.3% in July), while services price inflation was unchanged at 5.0%. The Bank's measure of core inflation, which excludes food, fuel and electricity, declined to 4.2% in August (down from 4.3%). Producer price inflation for final manufactured goods increased to 6.1% in July (up from 5.9% in June).

Despite remaining within the inflation target range throughout the forecast period, the SARB's model projects an increase in headline inflation, peaking at levels closer to the upper end of the target range. Headline inflation is now expected to remain at an average of 4.8% in 2018, before increasing to 5.7% in 2019 (up from 5.6%) and moderating to 5.4% in 2020. Headline CPI inflation is expected to peak at around 5.9% in the second quarter of 2019. The forecast for core inflation is 4.4% in 2018 (down from 4.6%), 5.6% in 2019 (up from 5.5%) and 5.5% in 2020 (up from 5.3%). The impact of the VAT increase continues to be muted. The more elevated headline inflation trajectory is explained by the weaker rand exchange rate and higher oil prices.

Average wage growth is expected to remain elevated at around 7% over the forecast period. Much of the upward pressure on wage inflation arises from the public sector wage settlements, which are at levels above headline inflation. Wage growth is an important driver of services price inflation.

Elevated international oil prices will contribute to fuel price inflation. Other administered prices are expected to increase at rates above the upper end of the inflation target range, as water and electricity tariffs rise, alongside rates and taxes in major metros. The impact on headline inflation continues to be moderated by lower food price inflation.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research during the third quarter of 2018 are marginally higher, averaging 5.3% in 2018 and 5.6% in 2019 and in 2020. Five-year inflation expectations have increased marginally to 5.5% (up from 5.4%). Expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) have continued to edge upwards across all maturities.

While the global economic outlook is expected to remain broadly favourable over the short term, medium term risks are tilted to the downside due to elevated policy uncertainty. This uncertainty arises from escalating trade tensions and tightening global financial conditions. The global inflation outlook is on a moderate upward path, largely due to rising oil prices and higher GDP growth rates in some advanced economies.

Since the July MPC, the rand has depreciated by 7.3% against the US dollar, by 8.1% against the euro, and by 7.1% on a trade-weighted basis. At current levels, the SARB's model assesses the rand to be undervalued. The implied starting point for the rand is R14.20 against the US dollar, compared with R13.40 at the time of the previous meeting.

Tighter global financial conditions and the change in investor sentiment towards emerging markets remain key external risks to the rand, and it is likely that the rand, along with other emerging market currencies, will remain volatile. However, the pace of monetary policy normalisation in the advanced economies continues to be gradual and further policy tightening by the US Fed is expected to follow a measured path in the absence of significant inflation or growth surprises.

The domestic economy has entered a technical recession, following two consecutive quarters of contracting economic activity. Quarter-on-quarter GDP contracted by 0.7% in the second quarter and GDP data for the first quarter was revised down from -2.2% to -2.6%. However, on a year-on-year basis, GDP growth in the first quarter was 0.8% and 0.4% in the second quarter.

The SARB now forecasts growth in 2018 to average 0.7% (down from 1.2% in July). The forecast for 2019 and 2020 is unchanged at 1.9% and 2.0% respectively. At these growth rates, the negative output gap is wider in the near term, but is still expected to close by the end of 2020 as GDP growth rates exceed potential growth.

The SARB composite leading business cycle indicator increased in June, largely reflecting an improvement in the measures of external sector activity. However, business confidence, as reflected in the RMB/BER business confidence index, decreased to 38 index points in the third quarter. Growth in gross fixed capital formation is expected to remain weak.

Household consumption expenditure contracted by 1.3% in the second quarter, declining for the first time in two years. In the medium term, the increase in disposable income is expected to be supportive of consumption expenditure. However, household consumption expenditure is likely to be constrained by recent tax changes, weak employment growth as well as subdued growth in credit extension to households. Although credit extension to households has been increasing during 2018, year-on-year growth remains low.

The MPC noted the rising inflation trajectory which, while remaining within the target range, is moving further away from the mid-point of the target range.

The MPC assesses the risks to the inflation outlook to be on the upside. The Committee remains concerned about growing risks to the inflation outlook, mainly due to exchange rate risks related to both domestic and external factors, elevated international oil prices and the possibility of higher electricity tariffs. However, demand pressures in the economy are not assessed to pose a significant risk to the inflation outlook.

The MPC assesses the risks to the growth forecast to be moderately on the downside. The Committee continues to be of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone. Commitment to credible structural policy initiatives and implementation thereof is required to make a marked impact on the cost structure of the economy, potential output and employment. Monetary policy is most effective in addressing cyclical growth.

The MPC has decided to keep the repurchase rate unchanged at 6.5% per annum. Four members preferred an unchanged stance and three members preferred a 25 basis points increase.

The Committee continues to assess the stance of monetary policy to be accommodative. However, the MPC remains concerned about the deteriorating inflation outlook, driven mainly by multiple supply-side factors. The approach of the Committee continues to be to look through the first-round effects and focus on the possible second-round effects. With risks and uncertainties at higher levels, the MPC will continue to be vigilant and will not hesitate to act should it become necessary.

The implied path of policy rates generated by the Quarterly Projection Model is for five rate hikes of 25 basis points by the end of 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.

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GOVERNOR

The next statement of the Monetary Policy Committee will be released on 22 November 2018.

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