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 January meeting of the Monetary Policy Committee (MPC), the Bank's forecast for inflation has continued to moderate, in line with monthly inflation data and recent lower oil prices. Globally, a once-healthy economic growth outlook has been revised down sharply due to the outbreak and spread of Covid-19. This coronavirus will negatively affect global and domestic economic growth through the first half of 2020, and potentially longer depending on steps taken to limit its spread.

The Covid-19 outbreak will have a major health and social impact, and forecasting global and domestic activity presents significant uncertainty. The Chinese economy, where the virus originated, is expected to contract by 1% in the first half of 2020. Economic activity is likely to also contract in the United States and Europe as governments there take actions to contain the spread of the virus.

In financial markets, the sustained global bull market in equities and corporate bonds also ended dramatically last week, with extensive and deep repricing. Prices for emerging market sovereign debt and other risky assets also fell sharply. This will have repercussions for household wealth and income, impacting further on global economic growth.

In response to all these developments, the US Federal Reserve, alongside other central banks, took various steps to provide further monetary accommodation. Additional steps have also been taken to provide liquidity and ensure the smooth functioning of markets. Some governments have taken fiscal measures to mitigate the economic effects of the virus.

In light of these considerations, we have marked down global growth for 2020 to 1.1%, before rising to around 2.8% in 2021. While a deeper or longer global and domestic contraction is not in our baseline, the Committee did consider a scenario featuring that possibility.

Prices for some commodities have fallen as a result of weaker demand globally, with copper and oil being particularly hard hit. The spot price for Brent crude oil is currently around $30 per barrel, but is expected to bounce back to higher levels. For our forecast, the Brent crude oil price is expected to average $40.4 per barrel in 2020 and $44.5 per barrel in 2021, well below previous assumptions.

The domestic economic outlook remains fragile. At this point, Covid-19 is likely to result in weaker demand for exports and domestic goods and services, but its impact on the economy could be partly offset by lower oil prices. We also expect disruptions to supply chains and to normal business operations. The Bank now expects the economy to contract by 0.2% in 2020. GDP growth is expected to rise to 1.0% in 2021 and to 1.6% in 2022.

Apart from the Covid-19 global pandemic, electricity supply constraints and other sources of uncertainty are expected to keep economic activity muted. Public sector investment has declined and job creation has slowed. Business and household confidence have weakened further. Government and household consumption, and private investment, however, continue to grow, albeit modestly. While export growth is expected to decelerate further in the near term, prices remain high for some export commodities, and could be supported by an early resumption in China's economic activity.

The technical recession of the latter half of 2019 contributed to a lower economic growth forecast. In addition, Covid-19 and existing constraints such as loadshedding, imply significant downside risk to the forecast.[1]

With persistently low inflation, and the coronavirus now hitting economic activity, monetary policy in major advanced economies and China will likely remain accommodative over the medium term. Easy global financing conditions have previously supported the value of the local currency, but financial volatility and a sharp rise in perceived risk has caused the rand to depreciate by 17.2% against the USD since January. The implied starting point for the rand forecast is R15.30 to the US dollar, compared with R14.90 at the time of the previous meeting. The forecast shows the currency strengthening over time, recovering towards its longer-run equilibrium level.

[1] The forecast deducts 0.5 percentage points from 2020 GDP for loadshedding, at stage 2.

The Bank' s headline consumer price inflation forecast averages 3.8% for 2020, 4.6% for 2021, and 4. 4% in 2022. The forecast for core inflation is lower at 3.9% in 2020, 4.3% in 2021, and 4.4% in 2022.

With the downward revision to the forecast, the overall risks to the inflation outlook at this time appear to be balanced. Electricity pricing remains an immediate concern, and there is likely to be higher volatility in prices of other goods and services as a result of sharp changes in demand and supply. Risks to inflation from recent currency depreciation are expected to be muted as pass-through is slow and could be offset by a wider output gap. Food price inflation is expected to remain low, in part due to better weather conditions.

Expectations of future inflation have moderated further, on the back of lower services prices, modest food price inflation, and slower-growing nominal wages. Across the different surveys we look at, inflation expectations currently average 4.4% for 2020, 4.6% for 2021 and 4.7% in 2025.[2] Market-based expectations have also moderated, with five-year break-even rates currently at about 3.90%.[3]

Heightened risk sentiment in global markets has amplified domestic and fiscal risks. This has pushed South Africa's sovereign bond yields sharply higher and weakened the domestic currency, increasing risks to monetary policy. The steep drop in global real interest rates implemented by advanced economies in recent days has partly offset those risks.[4]

[2] The latest Bureau for Economic Research (BER) survey has expectations for 2020 down by 0.4ppts to 4.4% and to .4.6% (from 5.0%) for 2021. Five-year-ahead inflation expectations also eased to 4.7% (from 4.9%). Market analysts (Reuters Econometer) expect inflation to be, 4.2% (from 4.4%) for 2020, 4.6% (from 4.7%) in 2021 and 4.5% (from 4.6%) for 2022.

[3] Calculated from the break-even inflation rate, which is the yield differential between conventional and inflation-linked bonds.

[4] The risk premium starting point increased from 3.2% to 3.8% since January, driving up the neutral real rate by 20 basis points and currency contribution to the neutral by 10 basis points. The weighted global neutral real rate estimated in the QPM fell by 50 basis points, resulting in an overall decline in the neutral by 20 basis points.

Despite the general rise in risk, the significantly lower forecast for headline inflation has created space for monetary policy to respond to the rapid deterioration in economic conditions. Barring severe and persistent currency and oil shocks, inflation is expected to be well contained, remaining below the midpoint of the target in 2020 and close to the midpoint in 2021.

Against this backdrop, the MPC decided to cut the repo rate by 100 basis points. This takes the repo rate to 5.25% per annum, with effect from 20 March 2020. The decision was unanimous.

The implied path of policy rates over the forecast period generated by the Quarterly Projection Model indicated three repo rate cuts of 25 basis points each in the second and fourth quarter of 2020, as well as in the third quarter of 2021.

Monetary policy can ease financial conditions and improve the resilience of households and firms to the short-term economic implications of Covid-19. Our decision and its magnitude seeks to do this in the near term.

Monetary policy however cannot on its own improve the potential growth rate of the economy or reduce fiscal risks. Current economic conditions underscore the importance of implementing prudent macroeconomic policies and structural reforms that lower costs generally, and increase investment opportunities, potential growth and job creation.

Global economic and financial conditions are expected to remain highly volatile for the foreseeable future. The Committee will continue to assess risks to inflation, including from weaker economic growth and those arising from wage, price pressures and currency depreciation. As usual, the repo rate projection from the QPM remains a broad policy guide which can change from meeting to meeting in response to changing data and risks.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 21 May 2020.

Contact person:

Ziyanda Mtshali

012 399 7966

media@resbank.co.za