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

The UK vote to leave the European Union has dominated the global landscape in the past month. The outlook for the global economy has become more uncertain as the potential consequences of these developments are being assessed. The lack of clarity regarding the process going forward has had significant implications for global growth and interest rates as the prospects for further near-term monetary policy tightening by the US Fed recede. While there have been spillovers to the South African financial markets, particularly the exchange rate, the direct short-term impact on South African growth and trade is likely to be fairly limited. Domestic growth has surprised further on the downside, and the outlook remains constrained. At the same time domestic inflation outcomes have surprised marginally on the downside, but an extended breach of the target is still expected.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas moderated to 6,1 per cent in May, before rising to 6,3 per cent in June. Food price inflation measured 11,0 per cent in June, below the recent peak of 11,3 per cent in April, and was marginally negative on a month-on-month basis. Goods price inflation measured 6,7 per cent, up from 6,6 per cent in May, while services increased by 5,8 per cent, up from 5,7 per cent in May. The Bank's measure of core inflation, which excludes food, fuel and electricity measured 5,6 per cent, up from 5,5 per cent previously.

Producer price inflation for final manufactured goods continued its downward trend, declining from 7,0 per cent in April to 6,5 per cent in May mainly due to a further moderation in price inflation of food, beverages and tobacco products. This was below the consensus forecast of 6,9 per cent. The impact of the drought is still evident in the increase in prices of agricultural products, particularly cereals and other crops as well as live animals and animal products.

The latest inflation forecast of the Bank shows a marginal improvement compared with the previous forecast. Nevertheless, inflation is still expected to accelerate further this year and is only expected to return to within the target range of 3-6 per cent during the third quarter of 2017. Inflation is now expected to average 6,6 per cent in 2016 and 6,0 per cent in 2017, compared with 6,7 per cent and 6,2 per cent previously. In 2018 inflation is expected to average 5,5 per cent, marginally up from the previous forecast. The expected peak, at 7,1 per cent in the fourth quarter of 2016, is down from 7,3 per cent. The downward revisions are due in part to lower administered price inflation (mainly petrol), despite a small upward adjustment in the international oil price assumption.

The forecast for core inflation is lower than the previous forecast in the near term, mainly due to the lower starting point, but higher in the outer period. Core inflation is expected to moderate from an average of 5,8 per cent in 2016 to 5,3 per cent by 2018. Whereas previously core inflation was expected to breach the upper end of the target range in the third quarter of 2016 for four consecutive quarters, a one-quarter breach, at 6,1 per cent, is now expected in the fourth quarter of this year.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research have remained relatively anchored at the upper end of the inflation target range. In the second quarter, average expectations for 2016 were 6,3 per cent, up from 6,2 per cent. Average expectations for 2017 were unchanged at 6,2 per cent and were marginally down to 5,9 per cent for 2018. Expectations of business people were more or less unchanged compared to the previous quarter. Both analysts and trade union officials revised up their near-term forecasts, while forecasts for 2018 were revised lower. Average 5-year inflation expectations declined from 6,1 per cent to 5,9 per cent in the second quarter, with downward revisions by all groups.

The median expectations of market analysts, as reflected in the Reuters Econometer survey conducted in July, show a moderate decline since May. Inflation expectations declined from 6,7 per cent and 6,4 per cent in 2016 and 2017, to 6,6 per cent and 6,1 per cent. The yield differential between inflation linked bonds and conventional government bonds (break-even inflation expectations) declined across all maturities but remain elevated.

The global economic outlook has been influenced by the outcome of the UK referendum. The financial markets displayed a high degree of volatility in the immediate aftermath of the outcome, but have stabilised to some extent since then. Nevertheless the longer term real impacts are expected to be negative for global growth, particularly for the UK and Europe, as investment decisions are put on hold during the transition period. A high degree of uncertainty is expected to persist for some time as the magnitude of this slowdown is still unclear and dependent on the nature and speed of the UK disengagement. Since the referendum, global growth forecasts have generally been revised down.

The outlook for emerging markets has remained relatively subdued, with further downside risks in Turkey following the recent coup attempt and terrorist attacks. Recent outcomes in China indicate some improvement in the growth prospects in response to government stimulus packages, and this has underpinned a stabilisation and moderate upward trend in commodity prices. The IMF growth forecasts released earlier this week have revised sub-Saharan African growth downwards. The region has been negatively impacted by lower commodity prices and severe drought in some parts.

Inflation in the advanced economies remains low and still generally below target. The Brexit vote has also modified expectations regarding monetary policy in these economies. Although the Bank of England kept policy rates on hold at its most recent meeting, expectations are for a reduction in the policy rate in the near future, with the prospect of a resumption of quantitative easing. Markets are now expecting the US policy rate to remain unchanged for some time. At the same time, the highly accommodative monetary policy stances of the ECB and Bank of Japan are expected to persist, with the possibility of additional stimulus.

These developments have reinforced the global search for yield, as yield curves flattened across major advanced economy markets. The number of government bonds trading with negative yields increased further. This has provided additional impetus to renewed capital flows to emerging markets observed since earlier this year. While these flows are expected to persist, they remain sensitive to changes in expectations regarding US monetary policy and general global risk perceptions.

The recent volatility experienced by the rand exchange rate has been driven mainly by external factors and changes in global risk perceptions. Although the rand depreciated sharply in the immediate aftermath of the referendum, it has reversed these losses, and more so against the British pound. Since the previous meeting of the MPC, the rand has traded in a range of R15,80 and R14,22 against the US dollar, and has appreciated by 11,0 per cent against the US dollar, by 12,9 per cent against the euro and by 23,0 per cent against sterling. On a trade-weighted basis, the rand has appreciated by 12,2 per cent.

The rand has been supported by the global search for yield. There was a sharp increase in non-resident inflows to the domestic bond and equity markets in June and July. Since the beginning of June, net purchases by non-residents of R107,3 billion have been recorded. The rand also responded positively to the improvement in commodity prices, and the unexpectedly large trade surplus recorded in May which followed a small surplus in April. Despite this recent strength, the rand remains vulnerable to possible “risk-off” global scenarios; changes in US monetary policy expectations; and domestic concerns including the possibility of ratings downgrades later in the year.

The domestic economic growth outlook remains extremely challenging, following the contraction in GDP in the first quarter of this year. Although this is anticipated to have been the low point of the cycle, the recovery is expected to be weak. The Bank’s latest forecast is for zero per cent growth in 2016, compared with 0,6 per cent previously. Growth rates of 1,1 per cent and 1,5 per cent are forecast for the next two years, down from 1,3 per cent and 1,7 per cent previously. The Bank's estimate of potential output has been revised down marginally to 1,4 per cent in 2016, rising to 1,7 per cent in 2018. This growth outlook is corroborated by the persistent negative trend in the Bank's leading indicator of economic activity. Business confidence remains low with the RMB/BER business confidence indicator falling to its lowest level since 2009 in the second quarter of this year.

Recent economic data suggest that positive growth was recorded in the second quarter, with the mining and manufacturing sectors expected to add positively to growth. The more positive trend in manufacturing is consistent with the Barclays PMI which has been above the neutral 50 level since March. The BER manufacturing confidence index also improved, but still remains at low levels. The real value of building plans passed is indicative of some improvement in the sector, particularly with respect to residential construction. However, this is not reflected in the FNB/BER building confidence index which declined further in the second quarter.

Underlying the negative performance of the economy during the first quarter was the sharp contraction in growth in gross fixed capital formation for the second consecutive quarter, by both the private sector and general government. These trends have contributed to the persistence of high rates of unemployment in the economy. Although formal non-agricultural employment increased in the first quarter of 2016, this was largely due to temporary employment opportunities created by the Independent Electoral Commission. By contrast, private sector employment contracted during the first quarter.

Growth in consumption expenditure by households also contracted in the first quarter, with a sharp slowdown in expenditure on durable goods in particular. The

FNB/BER consumer confidence index declined in the second quarter to low levels, following a moderate improvement in the previous quarter. The BER retail confidence index also declined sharply in the second quarter. While new vehicle sales remained weak, vehicle exports recorded strong growth in the second quarter.

Despite the surprise increase in retail and wholesale trade sales in May, consumption expenditure by households is expected to remain subdued given the low consumer confidence, high debt levels, rising costs of debt servicing, and slow employment growth. Consumption expenditure has been further constrained by the absence of significant wealth effects owing to the weak performance of asset markets, particularly the housing market. Credit extension to households also remains weak, with negative real rates of growth. Average wage growth has remained relatively stable, but there are risks of increases in excess of inflation and productivity gains.

There are as yet no clear signs of a recovery in the agricultural sector, and food price inflation is expected to remain elevated for some time. The Bank expects food price inflation to peak at 12,6 per cent during the final quarter of this year. There are some encouraging signs of moderation in some food categories at both the producer and consumer price levels, and futures prices of grains have declined markedly. Should food prices stabilise or decline in the coming months, there is the potential for significant downside base effects next year. Exchange rate developments will also be critical in this respect, as will global food prices, which have reversed their recent negative trend.

Despite supply disruptions and curtailments by a number of producers, the price of Brent crude oil has mostly traded within a band of US$45 and US$50 since the previous meeting of the MPC. The Bank's model assumes a very moderate upward trend in oil prices over the forecast period, but there may be a degree of downside risk in the short term, with some upside risk in the outer period as global demand recovers. The domestic petrol price increased by a cumulative 60 cents per litre in the past two months, due to both the exchange rate and international prices. However, the recent appreciation of the rand coupled with a lower average oil price has resulted in a substantial over-recovery in the petrol price, and a sizeable reduction in retail prices is expected in August.

The Monetary Policy Committee remains concerned about the weak economic growth outlook and the medium term inflation trajectory which remains outside the target range of 3 to 6 per cent until the second half of next year. Nevertheless there have been some improvements in the near term inflation prospects following successive downside surprises. This is also the case for core inflation, where the expected breach of the upper end of the target range is now less protracted. While the risks to the inflation forecast are assessed to remain on the upside, these risks have moderated somewhat.

Global uncertainties appear to have delayed monetary policy tightening in advanced economies. The impact of the more appreciated rand exchange rate on the inflation outlook will depend to a large extent on whether the exchange rate is sustained at these stronger levels. Current exchange rate levels are stronger than those implicit in the forecast, providing some buffer to the projections. The rand remains sensitive to both domestic and external developments, and the recent trends can be quickly reversed.

The outlook is clouded by the uncertainty surrounding the longer term market and global growth implications of Brexit. The implications for the rand and domestic growth, and ultimately inflation, could vary quite significantly depending on which scenario plays out.

A weaker global growth scenario could also imply that there may be a degree of downside risk to the international oil price assumption, which was adjusted upward. A combination of a stronger exchange rate and subdued international oil prices would have a favourable impact on domestic petrol prices in the coming months. However, the committee assesses the longer term risk to this assumption to be on the upside, as global growth and oil demand are expected to recover.

Food prices remain an upside risk in the near term. There could however be a sharp decline in agricultural prices next year should favourable weather patterns transpire as forecast. The absence of demand pressures and weak consumption expenditure growth may also contribute to downside risks.

While the committee remains concerned about the overall inflation trajectory, the assessment of the balance of risks to the inflation outlook and the weak domestic economy has provided some room to delay further tightening of the monetary policy stance for now. Accordingly the MPC has unanimously decided to keep the repurchase rate unchanged at 7,0 per cent per annum.

The MPC is aware that some of the favourable factors that contributed to this decision could reverse quickly, and remains ready to react appropriately to any significant change in the inflation outlook.

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