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

Headline inflation has now returned to within the target range as expected, with outcomes in March and April surprising on the downside. While the inflation outlook has improved over the near term, the longer-term forecast trajectory is unchanged and uncomfortably close to the upper end of the target range. The rand exchange rate and domestic bond yields benefited from increased global capital inflows to emerging markets which largely offset the impact of the sovereign credit ratings downgrade. With further ratings decisions imminent, risks remain for a further depreciation against the backdrop of continued global and domestic political uncertainty.

Domestic economic growth prospects have deteriorated, as the impact of the ratings downgrade is expected to weigh on domestic investment and consumer sentiment over the forecast period. The output gap is estimated to have widened, and consumer demand has weakened. However, the trajectory of the growth forecast is still positive, and the growth rate for this year is expected to exceed that recorded in 2016.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas moderated to 6.1% and 5.3% in March and April. Food price inflation was the main contributor to the downside surprise in April when it measured 6.6%. The contribution of the category of food and non-alcoholic beverages to the overall inflation outcome declined from 1.5 percentage points in March to 1.1 percentage points. The Bank’s measure of core inflation, which excludes food, fuel and electricity, measured 4.8%, down from 4.9%.

Producer price inflation for final manufactured goods also surprised on the downside at 4.6% in April compared with 5.2% in March. The further moderation in food prices was also reflected in the PPI with the category of food products, beverages and tobacco products decelerating for the sixth consecutive month to 6.4%.

The inflation forecast of the Bank has improved over the near term, but is unchanged in the outer quarters. In line with the previous forecast, headline consumer price inflation is expected to remain within the range for the rest of the forecast period. Inflation is expected to average 5.7% this year compared with 5.9% previously, while the forecast for 2018 has moderated by 0.1 percentage point to 5.3%. The forecast average for 2019 is unchanged at 5.5%.

The improvement is driven by downward revisions to international oil price and domestic electricity tariff assumptions. In the latter case, a tariff increase of 4.0% with effect from July 2017 is assumed, down from 8.0%. These revisions have been offset to some extent by a less appreciated exchange rate assumption, and a slower decline in food price inflation. A continued moderation of food prices is expected over the medium term given the favourable agricultural outlook and significant upward revisions to the maize crop estimates. Food price inflation is expected to average 7.7% and 5.4% in 2017 and 2018, compared with 7.4% and 5.2% previously, and unchanged at 5.5% in 2019.

The forecast for core inflation in 2017 is 0.4 percentage points lower at 5.0%, partly due to the lower starting point of 0.2 percentage points following the sizeable downside surprise in March. The forecast for 2018 declined by 0.1 percentage point to 5.1%, and is unchanged at 5.3% in 2019.

Market-based inflation expectations are largely unchanged since the previous meeting of the MPC, with the median forecasts in the latest Reuters Econometer survey similar to those of the Bank. The median expectation for 2017 declined marginally to 5.7%, and is unchanged at 5.5% and 5.4% for the next two years. Expectations implicit in the break-even inflation rates in the bond market have also moderated since the previous meeting. Break-even inflation rates for shorter-dated maturities are below 6% but higher than this level for longer-dated maturities.

The global growth outlook continues to show signs of sustained recovery amid rising world trade volumes. Nevertheless, the trend growth rate is expected to be lower than that experienced before the global financial crisis. The current recovery is characterised by downward revisions to potential output growth in numerous countries, and generally low levels of productivity and wage growth. Despite a weak first quarter, US growth is expected to average above 2.0% this year, although further policy uncertainty could undermine investor and consumer confidence. Growth rates in the euro area and Japan are expected to be sustained at around 2016 levels, supported by accommodative monetary policies.

The outlook for emerging markets is also generally positive. Concerns about Chinese growth have dissipated somewhat following policy intervention, but high leverage in the financial sector remains a risk. While Russia has emerged from recession, the expected recovery in Brazil may be undermined by current political uncertainty. The outlook for commodity producers may be tempered by recent weaker commodity price trends, particularly those of iron ore and coal.

Global inflation remains relatively benign although country experiences differ. Inflation is below target in most of the advanced economies, apart from the UK, and the risk of deflation is low except in Japan. Where high inflation rates are being experienced in a number of emerging markets, these are generally driven by exchange rate shocks rather than underlying global price pressures.

Monetary policies are also likely to remain divergent. The US Fed is expected to maintain its moderate pace of tightening, dependent to some degree on the size and nature of possible fiscal reforms. Policy rates are expected to remain low in most other advanced economies, but a reduction in quantitative easing is possible in the near future in the euro area. In general, emerging market economies have displayed a loosening bias, particularly in those countries where previous policy tightening had resulted in improved inflation prospects. The high yield differentials of emerging markets have persisted, sustaining capital flows to these economies.

At the time of the previous meeting of the MPC, the rand was trading at around R13.00 against the US dollar. It then depreciated following the domestic cabinet reshuffle and the consequent sovereign credit ratings downgrades by two ratings agencies. Having reached a weak point of almost R14.00 against the US dollar in April, the rand subsequently recovered some of these losses in line with improved sentiment towards emerging markets in general. Some of these gains were reversed by spill-over effects of recent political uncertainty in Brazil. Since the previous meeting the rand has appreciated by 0.4% against the US dollar and depreciated by 1.6% on a trade-weighted basis. At current levels the rand is still more appreciated relative to rates prevailing at this time last year.

Despite the recent weakening, the rand has been supported by a more favourable current account outlook, following a significant narrowing of the deficit in the final quarter of last year. A further positive trade balance was recorded in the first quarter of this year, but a moderately wider current account deficit is expected over the forecast period, due in part to a recent deterioration in the terms of trade.

Non-residents remained net buyers of domestic government bonds in April and May to date, to the value of R23.2 billion, despite the recent ratings downgrades. This may change should further downgrades occur, particularly with respect to domestic currency ratings. The rand therefore remains vulnerable to this prospect, as well as to changes in global risk sentiment towards emerging markets.

The domestic growth outlook has deteriorated amid weak business and consumer confidence. The Bank's forecast for GDP growth has been revised down for the entire forecast period, by 0.2 percentage points for 2017 and 2018, and by 0.3 percentage points in 2019. Annual growth rates of 1.0%, 1.5% and 1.7% for the forecast years are now expected. This downward revision is due in part to the expected impact of the sovereign credit ratings downgrade on domestic private sector gross fixed capital formation in particular. The downgrade is also likely to weigh on public sector investment through higher funding costs and more difficult access to funding.

At the sectoral level, a strong near-term improvement is expected in the agricultural sector, and mining output has also rebounded. By contrast, the manufacturing sector outlook remains constrained, with a third consecutive quarterly contraction expected in the first quarter of this year. In line with this, the latest ABSA Purchasing Managers Index showed a sharp decline. Growth in the trade sector also appears to have moderated somewhat.

A slower but positive pace of household consumption expenditure growth is forecast for this year. Real retail and wholesale trade sales contracted in the first quarter of this year. While domestic sales of passenger motor vehicles improved, the outlook for the sector remains subdued. Factors such as low consumer confidence, higher tax burdens, the absence of significant wealth effects and stagnant employment growth have contributed to these weaker consumption trends.

In addition to these factors, credit extension to the household sector in particular remains weak, and is reflected in further household deleveraging. Although credit extension to the corporate sector is still relatively robust, the downward growth trend has persisted. There may, however, be some relief to consumers from moderating inflation, while increases in real disposable income over the forecast period are also expected to provide some support to consumption, but to a lesser extent than previously.

Nominal salary and wage increases have continued to show signs of moderation, but are still at levels that contribute to the persistence of inflation at higher levels. While continued moderation of nominal unit labour costs are expected over most of the forecast period, the trajectory has been revised slightly upwards largely due to the weaker economic growth projections.

International oil prices have firmed since the previous meeting, having declined to levels below US$50 per barrel at one stage. The recovery was a response to indications that the OPEC agreement to curtail output would be extended for a further six months. However, the fragility of this agreement, and the increase in shale production in the US is expected to cap increases going forward. The international oil price assumption has been revised down by US$2 per barrel for each forecast year, but the moderate upward trend has been maintained. Domestic petrol prices increased by around 50 cents per litre in May, due to the weaker exchange rate and higher international product prices. The current over-recovery on the petrol price indicates that a reduction of around 20 cents per litre is likely in June, mainly due to international price movements.

The short-term inflation outlook has improved further since the previous meeting of the Monetary Policy Committee. Headline inflation in April was lower than expected, largely related to the pace of food disinflation. The MPC notes, however, that there have been broad-based downside surprises in core inflation as well. The current forecast does not incorporate the most recent outcomes, and further downside surprises in the coming months could impact of the starting point of the forecast and lower the entire trajectory. However, in the absence of such revisions, the MPC remains concerned about the persistence of the longer-term forecast trend at elevated levels within the target. This gives very little headroom to absorb the impact of possible adverse shocks.

The rand remains a key upside risk to the forecast. The rand has, however, been surprisingly resilient in the face of recent domestic developments. This is partly due to offsetting factors, particularly positive sentiment towards emerging markets and the improved current account balance. The current level of the exchange rate, at below R13.00 against the dollar, is slightly stronger than at the time of the last meeting and stronger than that implicit in the starting point for the real exchange rate assumption.

The outlook for the rand, and therefore the risks to the inflation outlook, will be highly sensitive to unfolding domestic political uncertainty, as well as decisions by the credit ratings agencies. The rand could weaken significantly in the event of a worst-case ratings downgrade scenario that could result in South African government bonds falling out of the global bond indices.

A downside risk may come from electricity tariffs. The increases from July may be lower than the 4.0% now assumed, given the 1.8% guideline for municipalities published by Nersa. However, there is a great deal of uncertainty with regard to this assumption for next year, when a new application from Eskom is likely. Currently an 8.0% increase is assumed from July next year.

The MPC assesses the risks to the inflation outlook to be more or less balanced. Domestic demand pressures remain subdued, and, given the continued negative consumer and business sentiment, the risks to the growth outlook are assessed to be on the downside.

In light of these developments the MPC has decided to keep the repurchase rate unchanged at 7.0% per annum. Five members preferred an unchanged stance while one member preferred a 25 basis point reduction.

The MPC remains of the view that the current level of the repo rate is appropriate for now and that we are likely at the end of the tightening cycle. A reduction in rates would be possible should inflation continue to surprise on the downside and the forecast over the policy horizon be sustainably within the target range. However, in the current environment of high levels of uncertainty, the risks to the outlook could easily deteriorate, and derail the current favourable assessment.

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