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 upside risks to the inflation outlook have increased, mainly due to higher international oil prices and a weaker rand exchange rate. Despite a deterioration in the forecast, inflation is expected to remain within the target range for the rest of the forecast period. Domestic event risks, including rating agency reviews and the economic policy implications of the ANC electoral conference, are likely to dominate rand movements over the coming weeks.

The domestic growth outlook remains weak, continuing its deviation from the generally more favourable global pattern. Stronger world growth has contributed to a further increase in international oil prices, which could, in turn, provide a boost to global inflation. This may increase the pace of monetary policy tightening in the advanced economies, with possible implications for capital flows to emerging markets.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4.8% in October, down from 5.1% previously, marginally below the Bank's short-term forecast. Food and non-alcoholic beverage inflation continued to moderate, measuring 5.3% in October, down from 5.5% in September, but meat price inflation remained elevated at 15.5%. The Bank's measure of core inflation, which excludes food, fuel and electricity, measured 4.5% in October compared with 4.6% previously.

Year-on-year producer price inflation for final manufactured goods increased in August and September, to 4.2% and 5.2% respectively, having recorded a low of 3.6% in July. The higher trend was driven to a large extent by higher international oil prices and a weaker exchange rate. Food products price inflation moderated further, to 1.3% in September, but manufactured meat price inflation remained elevated at 16.5%. At the agricultural level, prices of live animals increased by 26.7%, suggesting that it may take some time for meat price inflation to normalise.

The inflation forecast generated by the Bank's Quarterly Projection Model (QPM) shows a deterioration since September. The average forecast for 2017 is unchanged at 5.3%, but has been revised upward for 2018 and 2019 to 5.2% and 5.5%, from 5.1% and 5.4% previously. The lower turning point, which is expected in the first quarter of 2018, increased from 4.5% to 4.7%.

The main upside drivers of these changes are a weaker exchange rate path in 2018 in particular, a higher international oil price, and higher average wage growth. These pressures are offset to some extent by a more favourable food price forecast in 2018 in particular. Following a number of downside surprises, food price inflation is now expected to reach a low turning point of 3.8% in the first quarter of 2018, compared with 4.7% previously. Average increases of 4.5% and 5.9% are now expected in 2018 and 2019, compared with previous forecasts of 5.3% and 5.9%. Furthermore, the endogenously determined path of the repo rate in the QPM also provides an offsetting effect. This path implies three interest rate increases of 25 basis points each by the end of 2019, compared with one increase previously. As we elaborate later, this does not imply an unconditional commitment to this policy path.

The forecast for core inflation, which is unchanged at 4.8% for 2017, has been adjusted up by 0.2 percentage points in both 2018 and 2019 to 5.1% and 5.3% respectively. A low turning point of 4.6% is expected in the final two quarters of 2017.

The expectations of market analysts, as reflected in the Reuters econometer survey, are similar to those of the Bank's forecasts, with a slight deterioration since September. The survey conducted in November shows median forecasts of 5.2% for 2018 and 5.5% for 2019. Inflation expectations implicit in the inflation linked bond yields have increased, with the 5-year break-even inflation rates now close to the upper end of the target range.

The global growth outlook remains positive despite some geopolitical risks. Confidence indices in a number of countries have reached their highest levels since the global financial crisis. Nevertheless the expectation is that world growth will remain below the levels seen before the crisis. The recovery in the advanced economies appears to be most sustained in the euro area, the US and Japan, but the outlook for the UK remains constrained by the uncertainty surrounding the Brexit process. The extent to which this positive prognosis for some advanced economies is predicated on continued monetary accommodation is still unclear.

The outlook for emerging markets remains mixed but generally favourable, with prospects for oil producers boosted by higher oil prices. There are, however, some concerns about possible headwinds from slowing momentum in the Chinese economy.

Inflation pressures are mostly benign in the advanced economies although there are some incipient near-term risks from higher international oil prices. Low wage growth is seen as a brake on core inflation pressures, despite relatively tight labour market conditions. The US Fed is expected to maintain a gradual pace of monetary policy tightening, with a further policy rate increase widely expected in December. The ECB has signalled a reduction in the pace of net asset purchases from next year, but expects interest rates to remain low for an extended period of time. The Bank of Japan has also maintained a highly accommodative policy stance. By contrast, the Bank of England raised its Bank rate in November in response to inflation pressures driven by the depreciation of the pound.

The outlook for continued capital flows to emerging markets therefore remains relatively favourable despite the slowdown in bond flows in the past few weeks. However, the risk of a faster pace of monetary tightening in the US in particular, in the event of upside inflation or growth surprises, could reduce capital flows further.

Since the previous meeting of the MPC the rand has depreciated by 3.6% against the US dollar, by 3.0% against the euro, and by 3.3% on a trade-weighted basis. The rand recorded a weak point of around R14.55 against the US dollar in mid-November, but has recovered somewhat since then. Factors that impacted on the rand during the period included the ongoing uncertainty with regard to the outcome of the ANC electoral conference in December; concerns about a faster pace of monetary tightening in the US; the negative reaction to the Medium Term Budget Policy Statement (MTBPS); and speculation regarding the introduction of free higher education in South Africa.

These latter two factors have raised the risk of sovereign ratings downgrades, a risk that has been hanging over the rand for some time. Downgrades of domestic currency debt to sub-investment grade could lead to South African government bonds falling out of key indices which require investment grade. Such an event could trigger significant sales of domestic bonds by non-residents. Ratings reviews are expected imminently, but the extent to which any possible downgrades may already be priced in remains uncertain. The lead-up to the ANC national elective conference and its uncertain outcome, is also likely to continue to weigh on the currency.

Aside from these negative factors, the rand has been given some support by the continued surpluses on the trade account of the balance of payments. The Bank's forecasts for the current account deficit as a percentage of GDP have been revised down by about half a percentage point in all three years of the forecast period, to 2.2% in 2017, and 2.9% and 3.2% in 2018 and 2019. Furthermore, the generally positive sentiment towards emerging markets remains supportive of the rand.

The domestic economic growth outlook remains subdued but positive. Both consumer and business confidence remain low and are also likely to be affected by political developments in December. The forecast for GDP growth generated by the QPM has been revised up marginally to 0.7% for 2017, but revised down to 1.2% and 1.5% for 2018 and 2019, from 1.3% and 1.7% previously. The output gap is expected to remain negative over the forecast period. The SARB's composite leading business cycle indicator increased further in September, consistent with a mild recovery.

High frequency data suggest that the main production sectors have again contributed positively to economic growth in the third quarter. However, both the mining and manufacturing sectors experienced sharp month-on-month contractions in September. The Absa PMI has increased for three consecutive months, but at 47.8 index points remains in contractionary territory. The construction sector, which recorded negative growth in the second quarter, remains weak. Of particular concern is the sharp decline in the FNB/BER civil construction index to 15 index points in the third quarter, its lowest level since 2000. This is indicative of the poor outlook for infrastructure expenditure.

Employment prospects remain unfavourable. According to the Quarterly Labour Force Survey (QLFS) conducted by Statistics South Africa, year-on-year growth of total employment measured 2.3% in the third quarter of 2017. Despite this increase, the official unemployment rate was unchanged at 27.7% for the third successive quarter. Fiscal constraints point to further job losses in the public sector.

The outlook for consumption expenditure by households has improved moderately, following stronger retail trade sales in the second and third quarters. Retail trade sales recorded growth of 1.4% in the third quarter, despite month-on-month contractions in July and September. New motor vehicle sales also held up relatively well during the quarter. By contrast, wholesale trade sales contracted. The “Black Friday” effect is likely to boost sales in the fourth quarter as well. Nevertheless consumption expenditure is expected to remain relatively subdued over the forecast period.

Favourable drivers of real consumption expenditure include positive real income and wage growth, and some positive wealth effects from higher equity prices. Although growth in credit extension to households remains negative in real terms, it has increased in recent months. Constraining factors include higher tax burdens, low employment growth and weak consumer confidence.

Wage growth continues to contribute to the persistence of inflation at higher levels. Although the year-on-year pace of increase in nominal remuneration per worker in the formal non-agricultural sector of the economy declined in the second quarter of this year, at 6.1% it was still positive in real terms. Adjusting for labour productivity, growth in nominal unit labour costs measured 6.0% in the second quarter. Unit labour cost increases are forecast to remain above the 6% level over the forecast period. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements amounted to 7.6% in the first 9 months of 2017.

The Medium Term Budget Policy Statement (MTBPS) published in October revealed a rapidly deteriorating fiscal position. Significant revisions were made to the expected deficits and government debt-to-GDP ratio over the medium term. This deterioration was mainly a result of significantly lower tax revenues, although there was also a provision for a moderate breach of the expenditure ceiling. The less favourable path of fiscal consolidation could potentially reduce the scope for further monetary policy accommodation.

International oil prices have re-emerged as an upside risk to domestic and global inflation. Having reached recent lows of around US$45 per barrel in June, the price of Brent crude oil has fluctuated in the US$60-US$65 per barrel range since late

October. This is in response to increased demand, and reportedly high compliance with the output restriction agreement brokered by OPEC. While we still expect the flexibility of the shale oil producers in the US to limit the further upside potential, oil prices are expected to remain at these elevated levels for some time. The oil price assumptions in the Bank's models have accordingly been increased moderately for both 2018 and 2019. The combination of a weaker exchange rate and higher product prices has resulted in a cumulative increase in domestic petrol prices by R1.00 per litre since September. The current under-recovery suggests a further increase in the region of 70 cents per litre is likely in December.

The latest inflation outcomes show that headline inflation remains close to the midpoint of the target range, while core inflation has reached its lowest level in five years. However, the forecasts suggest that both measures are close to their lower turning points, and an upward trajectory is expected to begin early next year. Although inflation is expected to remain within the target range over the forecast period, the risks to the outlook are assessed to be on the upside at a time when imminent key event risks contribute to an environment of particularly elevated uncertainty.

These event risks affect monetary policy primarily through the exchange rate channel. Since the previous meeting of the MPC the deterioration in the fiscal stance has increased the risk of a sovereign ratings downgrade of domestic currency bonds to sub-investment grade. As noted, this could precipitate a significant sell-off of domestic government bonds by non-residents, with implications for the exchange rate and long-term bond yields. Should this occur, there is the possibility of a short-term overreaction, and a possible partial recovery later on. The precise path and duration is highly uncertain.

International oil prices have become an increasing concern. While we have adjusted our assumptions in this regard upward, a persistence of oil prices at current levels or higher pose an upside risk to the forecast. As before, a sizeable electricity tariff increase also remains a risk. We should have clarity on Eskom's tariff application by the time of the next MPC meeting.

There are very few signs of domestic demand pressures, as reflected in core inflation outcomes. Although retail sales have surprised on the upside, household consumption expenditure is expected to remain relatively subdued. The economic growth outlook remains constrained, as weak confidence continues to weigh on investment expenditure. Business and consumer confidence are likely to be sensitive to the political outcomes in December. The MPC assesses the risks to the growth outlook to be on the downside.

In light of the high degree of uncertainty prevailing in the economy and the balance of risks, the MPC has decided that it would be prudent to maintain the current stance of monetary policy at this stage. Accordingly, the repurchase rate remains unchanged at 6.75% per annum.

The QPM generates an endogenous interest path that implies an increase in the repo rate of 75 basis points by the end of 2019. We need to stress that this does not mean an unconditional commitment to change policy rates in line with this path. The forecasts and implied path are a broad guide to policy and not necessarily prescriptive. Depending on economic conditions, the MPC may choose to diverge from the suggested path and alternative paths could be generated that are still consistent with achieving the inflation target. Collective judgement therefore remains critical. As always, MPC members needs to weigh the risks to the forecasts and assess the trade-offs. It is also the case that the implied path can change from meeting to meeting as the data and risks change.

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