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

In recent weeks, some of the risks to the inflation outlook have dissipated somewhat. The rand appreciated following the African National Congress (ANC) elective conference. Also, Eskom was granted a lower-than-expected tariff increase. While S&P Global Ratings downgraded South Africa's long-term local currency sovereign credit rating to sub-investment grade, Moody's Investors Service (Moody's) placed the country ratings on review for a downgrade. A further downgrade therefore remains a risk, and will depend on government's response to the deteriorating fiscal position and commitment to credible growth-enhancing policies.

Against this more positive backdrop, the inflation forecast has improved despite continued increases in international oil prices. Near-term inflation is expected to remain close to the midpoint of the target range. At the same time, domestic growth outcomes have surprised on the upside, in large part due to the recovery in the

agricultural sector. While there have been moderate upward revisions to the growth forecast, the outlook remains challenging.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, measured 4.6% in November, down from 4.8% previously. Lower food and fuel price inflation contributed to this decline. Goods price inflation moderated to 3.7% from 4.1% previously, while services price inflation was unchanged at 5.5%. The South African Reserve Bank's (SARB) measure of core inflation – which excludes food, fuel, and electricity – amounted to 4.4% in October compared with 4.5% previously.

Year-on-year producer price inflation for final manufactured goods measured 5.1% in November, up from 5.0% in October. Food products price inflation moderated further to 0.9% due to strong base effects from lower agricultural prices. Meat price inflation, however, remains elevated, as the adverse effects of the recent drought continue to be felt.

The inflation forecast generated by the SARB's Quarterly Projection Model (QPM) shows some improvement since November. The average forecast for 2017 is unchanged at 5.3% but has been revised downwards for 2018 and 2019 to 4.9% and 5.4% respectively from 5.2% and 5.5% previously. Inflation is expected to average 5.5% in the final quarter of 2019. The lower turning point of the forecast is still expected in the first quarter of 2018 but has been revised down from 4.7% to 4.4%.

The main drivers of the more favourable forecast were the stronger exchange rate and lower electricity price assumption, following the 5.23% electricity tariff increase granted to Eskom by the National Energy Regulator of South Africa (Nersa). This adjustment takes effect from July, when a 6.0% increase is assumed in the CPI

compared with 8.0% previously. The assumption from mid-2019 remains unchanged at 8.0%. These effects are countered to some extent by upward adjustments to the international oil price assumptions, as well as by the impact of the sugar tax on food prices. This tax is expected to increase food price inflation and headline inflation by 0.6 and 0.1 percentage points respectively in the year following its expected implementation in April. Food price inflation is now expected to average 5.2% and 6.0% in 2018 and 2019 respectively, up from 4.5% and 5.9% previously.

The core inflation forecast remains unchanged at 4.8% for 2017 but has been adjusted down to 4.6% and 5.1% in 2018 and 2019 from 5.1% and 5.3% respectively. Whereas previously a lower turning point of 4.6% was expected in the final two quarters of 2017, a low of 4.4% is now expected in the first quarter of 2018.

The improved forecast for core inflation is driven mainly by the stronger exchange rate, which is expected to impact favourably on core goods inflation. Higher wage pressures, by contrast, are expected to keep core services inflation more or less unchanged. The closing output gap also reduces the degree of downside pressure on inflation.

Average inflation expectations for 2018, as reflected in the survey conducted by the Bureau for Economic Research (BER) in the fourth quarter of 2017, declined marginally from 5.8% to 5.7% but remain close to the upper end of the target range. Average expectations for 2019 were unchanged at 5.9%, as were the average five-year inflation expectations at 5.6%. These moderate moves mask larger adjustments compared with the third-quarter survey, with business people revising their

expectations higher over the two years, offsetting the downward adjustment by trade union officials.

The expectations of market analysts, which are reflected in the Reuters econometer survey conducted in January, also show a slight improvement since November. The median forecasts for 2018 and 2019 have declined by 0.1 percentage points to 5.1% and 5.4% respectively while the forecast for 2020 is 5.5%. Inflation expectations implicit in the inflation-linked bond yields have declined, with the five-year break-even inflation rates declining to 5.4%.

The global growth outlook remains positive and relatively synchronised, although uneven across regions. However, some moderation in growth is generally expected in 2019. Growth in the United States (US) is expected to be given a boost by the proposed tax reforms, but the extent of this is still unclear. The euro area recovery also appears to be sustained, with a persistent decline in the unemployment rate amid a broad-based firming of fixed capital formation. The recent positive momentum in Japanese growth is also expected to continue.

These favourable conditions are expected to have a positive spillover effect on emerging markets in general, with upward growth revisions in most regions, although less so for Latin America and Africa. Commodity exporters are also expected to benefit from the recovery in commodity prices. Consensus forecasts suggest that growth in China will be sustained at current levels despite continued financial stability risks.

Global inflation trends, by contrast, remain subdued, although there are indications of emerging upside pressures, driven in part by higher energy prices. Core inflation pressures are also becoming evident in the US in particular, and are expected to

intensify gradually should strong growth and labour market tightness persist. Monetary policies in the advanced economies, particularly in the US and the United Kingdom (UK), are expected to maintain a moderate tightening bias, while the pace of withdrawal of monetary accommodation in the euro area and Japan is expected to be slow. These trends should help sustain capital flows to emerging markets.

The rand exchange rate responded strongly to the outcome of the ANC elective conference, and since then has traded in a range of between R12.25 and R12.50 against the US dollar. This is in sharp contrast to the low of R14.47 a month earlier. Since the previous meeting of the Monetary Policy Committee (MPC), the rand has appreciated by 13.1% against the US dollar, by 9.6% against the euro, and by 10.6% on a trade-weighted basis.

In the near term, the rand is expected to remain sensitive to sentiment generated by political developments. The favourable outlook for capital flows to emerging markets as well as the positive trade account balances are expected to be supportive of the rand. The latter is a reflection of the favourable terms of trade and import compression from lower growth. However, the lingering prospect of a credit ratings downgrade to sub-investment grade by Moody's continues to weigh on the longer-term outlook for the rand. Such an event would trigger the exclusion of South African government bonds from the World Government Bond Index, and is likely to precipitate significant capital outflows. The extent of the impact on the exchange rate remains uncertain.

Domestic growth prospects appear to be showing some signs of improvement, although off a low base. This follows encouraging growth rates in the second and third quarters of this year, driven to a significant degree by the exceptionally strong

recovery in the agricultural sector. The SARB has revised its forecast for gross domestic product (GDP) growth up from 0.7% to 0.9% for 2017, while forecasts for 2018 and 2019 have been adjusted to 1.4% and 1.6% respectively, up from 1.2% and 1.5% previously. This more favourable outlook is consistent with the further increase in the SARB's composite leading business cycle indicator of economic activity in October. The outlook is also likely to be impacted positively should the recent political developments lead to a sustained boost in business and consumer confidence.

High-frequency data suggest that fourth-quarter growth is likely to be slower than in the previous quarter, but still positive. On a month-to-month basis, mining output increased in October but declined in November, while manufacturing output increased in both these months. However, the decline in the Absa Purchasing Managers' Index (PMI) to 44.9 index points in December is indicative of the continued challenges faced by the sector. More positively, the sub-index measuring expected business conditions in six months' time improved markedly.

Despite the continued weakness in the Rand Merchant Bank (RMB) / BER business confidence index, growth in real gross fixed capital formation improved in the third quarter, following a contraction in the previous quarter. All three sectors recorded growth rates in excess of 4%. The recovery was most pronounced in the private sector. The durability of this improvement will be highly dependent on the extent to which the recent political developments impact on confidence and lead to greater policy certainty and credibility. This process could take some time. At this stage, the forecast is for minimal growth in gross fixed capital formation this year, with a slight improvement in 2019.

A prolonged recovery in fixed capital formation is needed to make inroads into the official unemployment rate of 27.7%. The Quarterly Employment Statistics survey of Statistics South Africa shows that, during the third quarter of 2017, formal non-agricultural employment in both the public and the private sectors declined further. Adjusted for election-related employment by the Electoral Commission of South Africa (IEC), private-sector employment creation more or less offset public-sector losses in the four quarters to the third quarter of 2017.

Growth in real final consumption expenditure by households decelerated to an annualised rate of 2.6% in the third quarter but was characterised by a sharp increase of 19.9% in expenditure on durable goods, mainly motor vehicles. Some moderation in consumption expenditure growth is expected in the fourth quarter following weaker motor vehicle sales. However, the strong 'Black Friday' effect evident in the November retail trade sales may moderate the extent of this slowdown.

Despite being relatively constrained, the outlook for household consumption expenditure has improved, with annual average real growth rates of around 1.3% expected over the forecast period. This category is expected to be the main driver of GDP growth in the short to medium term. Although consumers are likely to be adversely affected by possible further tax increases, expenditure is expected to be underpinned by lower inflation and positive real wage increases.

Growth in bank credit extension to households remains weak but has trended slightly higher in recent months. Much of this increase reflects growth in instalment sale financing, consistent with improved motor vehicle sales. Growth in credit extension to

the corporate sector, while more robust, has been on a downward trend for some time.

Wage pressures are expected to continue contributing to inflation persistence. Growth over four quarters in nominal remuneration per worker in the formal non-agricultural sector increased from 6.3% in the second quarter of 2017 to 6.8% in the third quarter. However, adjusting for labour productivity, growth in nominal unit labour costs declined from 6.1% to 5.5%. Average nominal remuneration increases are expected to remain above 6% over the forecast period.

International oil prices have continued their upward trend to current levels of around US$70 per barrel for Brent crude oil. These increases are due to supply restrictions by some producers, as well as increased global demand. At this stage, it is unclear if these prices will settle at these elevated levels or if the trend will be reversed by increased US shale output in response to higher prices. The oil price assumptions in the QPM have been adjusted upwards to average US$62 per barrel in 2018 and 2019. Domestic petrol prices increased by 71 cents per litre in December but were reduced by 34 cents per litre (for 95 octane) in January as a result of the stronger exchange rate. The current over-recovery on the petrol price points to a further price reduction in February, should current trends persist.

The MPC has taken note of the improved inflation outlook over the near term in particular. Inflation is expected to reach a low point below the midpoint of the target range, but is then expected to resume an upward trajectory and measure 5.5% in the final quarter of next year. This remains above the midpoint of the target range. The risks to the forecast are still assessed to be on the upside, though the degree of the upside risk has subsided.

Two main risks featured prominently in the MPC discussions. First is the prospect of a sovereign credit ratings downgrade, which would result in three major agencies rating South Africa's local-currency debt as sub-investment grade. The impact on the rand and on long-bond yields could be significant, but the extent to which a universal downgrade is already priced in remains unclear. Furthermore, the assumption in the forecast for the starting point of the rand (at R12.90 against the US dollar) is weaker than current levels.

The response of government to the intensifying fiscal challenges in the upcoming budget will be key to avoiding this event risk. In addition, the pressures are now even more intense, with several state-owned enterprises facing financial risks. The challenge for government will be to find ways to finance the deficit in a growth-positive manner, and at the same time convey a credible commitment to structural reforms that can raise the potential growth of the economy. This would also support business and consumer confidence.

The second risk relates to international oil price developments. Although the assumptions have been raised over the forecast period, the MPC still assesses the risks to be moderately on the upside, and further upward adjustment may be required in the future.

Demand pressures are benign, with core inflation pressures relatively contained. While household consumption expenditure is expected to be supported by positive wage growth, it remains constrained. The economic growth outlook is also more positive, but fragile. At this stage, the MPC assesses the risks to the growth forecast to be more or less balanced.

The endogenous interest rate path generated by the QPM has changed slightly since the previous meeting. Whereas three increases of 25 basis points by the end of 2019 were indicated previously, the third increase is now a marginal call. Furthermore, the timing of the first increase has been pushed out to later in the period. The implied path remains a broad policy guide and could change in either direction by the next meeting in response to new developments and changing risks.

In light of the recent developments and the balance of risks, the MPC has decided that it would be appropriate to maintain the current monetary policy stance at this stage. Accordingly, the repurchase rate remains unchanged at 6.75% per annum. Five members preferred an unchanged stance, while one member preferred a 25 basis point reduction.

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The next statement of the MPC will be released on 28 March 2018.

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