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 (MPC), several risks to the inflation outlook have begun to materialise. While headline inflation is comfortably within the inflation target band, indications are that we have passed the low point of the current cycle. Developments in the international environment have placed upward pressure on the inflation trajectory, while the domestic growth outlook remains challenging.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, was 4.4% in May 2018 and accelerated to 4.6% in June. Goods price inflation increased to 4.2% (up from 3.5% in May), while services price inflation moderated to 4.9% (down from 5.3%). The South African Reserve Bank's (SARB) measure of core inflation – which excludes food, fuel and electricity – declined to 4.2% in June. Producer price inflation for final manufactured goods increased marginally to 4.6% in May.

Despite remaining within the target band throughout the forecast period, the SARB's model projects an increase in headline inflation, peaking at levels closer to the upper end of the target range. Thus far, the impact of the value-added tax (VAT) increase appears to have been less than anticipated. However, the weaker rand exchange rate and the higher oil price assumptions result in a more elevated inflation trajectory. Headline inflation is now expected to average 4.8% in 2018 (down from 4.9%) before increasing to 5.6% in 2019 and decreasing again to 5.4% in 2020 (up from 5.2% in both years). Headline CPI inflation is expected to peak at around 5.7% in the first and second quarters of 2019 before declining to 5.3% at the end of 2020. The forecast for core inflation is 4.6% in 2018 (up from 4.5%), 5.5% in 2019 and 5.3% in 2020 (up from 5.1% in both years).

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) during the second quarter of 2018, are largely unchanged in the near term, averaging 5.2% in 2018, 5.4% in 2019 and 5.5% in 2020. Five-year-ahead inflation expectations are at a historical low of 5.4%. Expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) declined marginally across all maturities.

While the global economic outlook has remained broadly favourable, expectations are that world growth will begin to slow in the third quarter of 2018. In addition, escalating trade tensions are contributing to uncertainty around global trade. World trade volumes contracted sharply in April 2018 – the worst performance since May 2015. The global inflation outlook remains benign but is on a moderate upward path, largely due to the rising oil prices. The prices of most other commodities have been retreating.

Since the previous meeting of the MPC, the rand has depreciated by 7.2% against the US dollar, by 6.2% against the euro, and by 4.9% on a trade-weighted basis. At current levels, the SARB's model assesses the rand to be undervalued. It is likely that the local currency, along with other emerging market currencies, will remain volatile. The implied starting point for the rand is R13.40 against the US dollar compared with R12.37 at the time of the previous MPC meeting.

A key external risk to the rand remains the possibility of tighter global financial conditions. However, the pace of monetary policy normalisation in the advanced economies continues to be gradual. At this stage, further policy tightening by the United States (US) Federal Reserve (Fed) is expected to follow a measured path in the absence of significant inflation or growth surprises. Higher-than-expected US fiscal deficits could result in a stronger monetary policy response.

The domestic economic growth outlook for this year is weaker than we had expected in May. Following the broad-based contraction of 2.2% in the first quarter and early indications of modest growth in the second quarter, the SARB's forecast now indicates a growth rate of 1.2% for 2018 compared with 1.7% previously. The forecast for 2019 is 1.9%, marginally higher than the previous forecast of 1.7%, while the forecast for 2020 is unchanged at 2.0%. At these growth rates, the negative output gap is wider in the near term but is still expected to close in 2020.

The composite leading business cycle indicator declined for the second consecutive month in April, consistent with a deteriorating outlook. Business confidence, as reflected in the Rand Merchant Bank (RMB)/BER business confidence index, decreased to 39 index points in the second quarter. In this context, gross fixed capital formation contracted by 3.2% in the first quarter and is expected to remain weak in 2018.

Consumption expenditure by households, although slightly weaker than last year, is expected to be positively impacted by the improved consumer confidence and the increase in households' disposable income. In the near term, however, consumption expenditure is likely to be constrained by the VAT increase and other tax changes, weak employment growth as well as subdued growth in credit extension to households. Although credit extension to households increased earlier in 2018, year-on-year growth remains low.

Average wage growth is expected to remain elevated at around 7% over the forecast period. This is particularly a concern if labour productivity growth continues to decline. Much of the upward pressure on wage inflation arises from the public sector wage settlement, which is at levels above headline inflation.

Higher international oil prices will contribute to petrol price inflation in 2018. The impact on headline inflation is somewhat moderated by lower food price inflation. Annual food price inflation is expected to remain within the target range over the forecast period, and is not seen as a major risk to the inflation outlook. This is largely driven by an adequate supply of grains over the near term, alongside moderating meat price increases.

The MPC noted the rising inflation trajectory which, while remaining within the target range, is moving closer to the upper end of the range.

Key uncertainties in the global environment remain. The continued strength of the US dollar (which has appreciated against most currencies), any sustained elevation of oil prices, escalating trade tensions as well as geopolitical developments continue to pose risks to the inflation outlook. The rand will remain sensitive to changes in global monetary policy settings and investor sentiment towards the emerging markets.

The MPC assesses the risks to the inflation forecast to be on the upside. A number of key risks and uncertainties highlighted in recent meetings persist. Electricity prices continue to pose a further upside risk.

The growth forecast has deteriorated, and the outlook remains constrained. Demand pressures in the economy are not assessed to pose a risk to the inflation outlook. The MPC assesses the risks to the growth forecast to be more or less balanced. A firm commitment to credible structural policy initiatives and implementation is required to make a marked impact on employment and potential output.

The MPC unanimously decided to keep the repurchase rate unchanged at 6.5% per annum. At these levels, the MPC still assesses the stance of monetary policy to be accommodative and appropriate given the current state of the economy. However, the MPC has noted the deteriorating inflation outlook, driven mainly by supply-side factors. The approach of the MPC continues to be one of looking through the first-round effects and focusing on the second-round effects. With risks and uncertainties at higher levels, the MPC will continue to be vigilant and will not hesitate to act should there be second-round effects that take us significantly away from the midpoint of the inflation target range.

The implied path of policy rates generated by the Quarterly Projection Model has changed since the previous MPC meeting. Whereas previously four increases of 25 basis points each by the end of 2020 were indicated, five increases of 25 basis points are now implied. As emphasised previously, the implied path remains a broad policy guide which can and does change in either direction between meetings in response to new developments and changing risks. The MPC does not mechanically respond to changes in the path, and the assessment of the balance of risks to the forecast cannot be done by the model.

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GOVERNOR

The next statement of the Monetary Policy Committee will be released on 20 September 2018.

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