



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), the near-term inflation outlook has improved, however, the longer term risks to the inflation outlook remain elevated. The weaker exchange rate and the impact of higher oil prices have contributed to increasing inflation since March 2018. At the same time, domestic growth remains weak.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5.1% in October (up from 4.9% in September). Goods price inflation was 5.1% (up from 4.8% in September), while services price inflation decreased slightly from 5.2% in September to 5.1% in October. The Bank's measure of core inflation, which excludes food, fuel and electricity was 4.2% in October. Producer price inflation for final manufactured goods slowed to 6.2% in September from 6.3% in August.

The inflation forecast has improved marginally since the previous MPC. While remaining within the inflation target range throughout the forecast period, the SARB's model projects an increase in headline inflation, albeit slightly lower than the September projection. Headline inflation is now expected to average 4.7% in 2018 (down from 4.8%), before increasing to 5.5% in 2019 (down from 5.7%) and moderating to an unchanged 5.4% in 2020. Headline CPI inflation is now expected to peak at around 5.6%, in the third quarter of 2019. The forecast for core inflation is 4.3% in 2018 (down from 4.4%), 5.3% in 2019 (down from 5.6%) and 5.5% in 2020. These inflation projections are based on an interest rate path generated by the SARB's Quarterly Projection Model (QPM).

Following persistent increases in oil prices since February, the assumptions for Brent crude oil in the QPM were revised upwards by US\$3 per barrel to US\$73 for 2019 and 2020. Administered prices, including fuel, electricity and water tariffs, are expected to increase at rates above the upper end of the inflation target range.

The inflation expectations of market analysts in the November Reuters Econometer survey are lower at 4.7% in 2018 (down from 4.8%), rising to 5.5% in 2019 (up from 5.3%) and remaining unchanged at 5.3% in 2020. Expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) remain sensitive to exchange rate movements. While five-year break-even rates remains within the inflation target range, the longer-term break-even rates remain above 6%.

The global economic outlook is expected to remain broadly favourable over the short term. However, medium term risks are tilted to the downside due to less synchronised global growth. This is amplified by elevated policy uncertainty emanating from

escalating trade tensions, tightening global financial conditions and rising geo-political risks. The global inflation trajectory remains on a moderate upward path as key advanced economies continue to grow above their potential.

Since the September MPC, the rand has appreciated by 3.8% against the US dollar, by 6.6% against the euro, and by 5.2% on a trade-weighted basis. The implied starting point for the rand is R14.50 against the US dollar, compared with R14.20 at the time of the previous meeting. At these levels, the QPM assesses the rand to still be undervalued.

Tighter global financial conditions, financial market volatility and the change in investor sentiment towards emerging markets remain key external risks to the rand. Over the medium term, it is likely that the rand, along with other emerging market currencies, will remain volatile. However, the pace of monetary policy normalisation in the advanced economies continues to be gradual. Policy tightening by the US Fed is expected to follow a measured path in the absence of significant inflation or growth surprises, while the European Central Bank (ECB) is expected to start a rate hiking cycle in late-2019. This means that monetary policies in some advanced economies will likely be tightening throughout the forecast period.

The domestic growth outlook remains challenging. Recent monthly data on economic performance in key sectors suggests a more moderate recovery in growth in the third quarter than expected in September. The SARB now forecasts growth in 2018 to average 0.6% (down from 0.7% in September). The forecast for 2019 and 2020 is unchanged at 1.9% and 2.0% respectively. At these growth rates, the negative output gap is wider than at the time of the previous MPC meeting. The output gap will narrow but will not close by the end of 2020, as previously expected.

The SARB's composite leading business cycle indicator has been trending lower since February, reflecting the extent of weakness in the economy. The year-on-year decrease in September was the largest since July 2016 and mainly reflected a significant decline in the number of building plans approved and a reduction in job advertisement space. The RMB/BER Business Confidence Index remains significantly below the neutral level of 50 index points, broadly aligned with weakness in gross fixed capital formation. Efforts by the government to encourage private sector investment could support longer term growth.

While the FNB/BER Consumer Confidence Index remains high, household consumption expenditure has been constrained by recent tax changes, weak employment growth as well as low growth in credit extension to households. Over the forecast period, consumption expenditure growth is expected to remain below 2% in 2018 and 2019, and to reach 2.3% in 2020, on the back of increases in real wages and household disposable income.

The MPC assesses the risks to the growth forecast to be moderately on the downside. As previously highlighted the Committee remains of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone. Prudent macroeconomic policies are essential to ensuring that growth is sustainable and that the economy is more resilient to shocks. These should be complemented by implementation of credible structural policy initiatives that make a marked impact on the cost structure of the economy, potential output and employment.

The MPC noted the rising inflation trajectory which, while remaining within the target range, continues to deviate from the mid-point of the target range.

The MPC continues to assess the risks to the longer-term inflation outlook to be on the upside. These risks include tighter global financial conditions, a weaker exchange rate, higher wage growth, international oil prices and rising electricity and water tariffs. However, demand pressures are still not assessed to pose a significant risk to the inflation outlook.

The approach of the MPC is to look through the first-round effects and focus on the possible second-round effects of supply side shocks. However, shocks of a persistent nature such as extended periods of currency depreciation, elevated oil prices and multi-year electricity price increases make it difficult to disentangle these first and second round effects.

The MPC had to decide whether to act now or later. Given the relative stability in the underlying core inflation measure, delaying the adjustment could give the MPC room to re-assess these unfolding developments in subsequent meetings. However, delaying the adjustment could cause inflation expectations to become entrenched at higher levels and thus contribute to second round effects, which would require an even stronger monetary policy response in the future.

Against this backdrop, the MPC has decided to increase the repurchase rate by 25 basis points to 6,75% per year, effective from 23 November 2018. Three members preferred an increase and three members preferred an unchanged stance.

The Committee continues to assess the stance of monetary policy to be accommodative. Monetary policy actions will continue to focus on anchoring inflation expectations near the mid-point of the inflation target range in the interest of balanced and sustainable growth. As previously indicated, any future policy adjustments will be data dependent.

The implied path of policy rates generated by the Quarterly Projection Model is for four rate hikes of 25 basis points, reaching 7.5% by the end of 2020. The forecasted endogenous interest rate path is built into our growth and inflation outlook. 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.

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GOVERNOR

The next statement of the Monetary Policy Committee will be released on 17 January 2019.

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