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 November 2018, international developments have been the major contributor to an improved inflation outlook. Significant declines in international oil prices and a less depreciated exchange rate have been key drivers of this improved outlook. Domestic petrol prices decreased by a cumulative R3.07 per litre (for 95 unleaded in Gauteng) in December and January. Lower food price inflation also contributed to lower consumer price inflation. The economy's recovery from the technical recession in the first half of 2018 is welcomed, but it remains modest, with growth constrained by subdued demand as a result of weaker levels of consumer and business confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5.2% in November (up from 5.1% in October). Goods price inflation was 5.3% (up from 5.1% in October), while services price inflation was unchanged at 5.1%. The Bank's measure of core inflation, which excludes food, fuel and electricity was 4.4% in November compared to 4.2% in October. Producer price inflation for final manufactured goods slowed marginally to 6.8% in November from 6.9% in October.

The near-term inflation forecast generated by the SARB's Quarterly Projection Model (QPM) has improved significantly since the previous MPC. Headline inflation is now expected to average 4.6% in 2018 (down from 4.7%) and 4.8% in 2019 (down from 5.5%), before increasing to 5.3% in 2020 (down from 5.4%) and moderating to 4.8% in 2021. Headline CPI inflation is now expected to peak at around 5.6%, in the first quarter of 2020. Core inflation is expected remain unchanged at 4.3% in 2018 and forecast to average 5.0% in 2019 (down from 5.3%), 5.1% in 2020 (down from 5.5%) and 4.8% in 2021. These inflation projections are based on an interest rate path generated by the QPM.

Following a significant decline in oil prices since November, the assumptions for Brent crude oil in the QPM were revised down by around US$10 per barrel from US$73 to US$62 for 2019 and US$65 for 2020 and 2021. Food price inflation is expected to have bottomed out in the fourth quarter of 2018 and to rise to 4.6% in 2021.

Average inflation expectations for both 2019 and 2020, as reflected in the survey conducted by the Bureau for Economic Research (BER) in the fourth quarter of 2018, declined from 5.6% to 5.4%. Average five-year expectations also came down from 5.5% in the previous survey to 5.3%.

The inflation expectations of market analysts in the January 2019 Reuters Econometer survey are also lower at 5.2% in 2019 (down from 5.5%) and remained unchanged at 5.3% for 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 remain within the inflation target range, the longer-term break-even rates remain above 6%.

Global growth is expected to remain broadly favourable over the near term, but to moderate over the medium term while risks are tilted to the downside. The negative effects of tariff increases are becoming more visible in economic data and uncertainty arising from trade tensions remains. Other risks include geo-political developments and excessive financial market volatility.

Recent communication from major central banks suggests a slower pace of monetary policy normalisation in advanced economies. In December, the US Fed signalled a more gradual pace of rate hikes. Although the European Central Bank (ECB) ended its asset purchase programme in December, it has indicated that monetary policy would remain largely accommodative.

Since the November MPC, the rand has appreciated by 1.4% against the US dollar, by 1.5% against the euro, and by 0.5% on a trade-weighted basis. The implied starting point for the rand is R14.30 against the US dollar, compared with R14.50 at the time of the previous meeting. At these levels, the QPM assesses the rand to be less undervalued.

Emerging market currencies, including the rand, have recently benefited from a weaker US dollar and indications of continued accommodative monetary policy in advanced economies, but they remain vulnerable to changes in investor sentiment. The rand also remains sensitive to domestic growth prospects, political developments and policy settings.

The domestic growth outlook remains sluggish. Although, GDP increased by 2.2% in the third quarter of 2018, private sector fixed investment remains weak and production in key sectors is volatile. The SARB now expects growth in 2018 to have averaged 0.7% (up from 0.6% in November). The growth forecast for 2019 is 1.7% (down from 1.9%), it is unchanged at 2.0% for 2020 and increases to 2.2% in 2021. At these growth rates, the negative output gap is expected to close in the first quarter of 2021.

The Absa Purchasing Managers' Index reached 50.7 index points in December driven by improved expectations about new sales orders and business activity, however the employment sub-index receded to its lowest levels since 2014. Although the SARB's composite leading business cycle indicator increased somewhat in October, it has been trending lower since early 2018. The RMB/BER Business Confidence Index also remains significantly below the neutral level of 50 index points, broadly aligned with weakness in gross fixed capital formation. Sustained growth in fixed capital formation is needed to raise potential growth and to make in-roads into unemployment.

Household consumption expenditure remains constrained by weak employment growth. Over the forecast period, consumption expenditure growth is expected to remain around 2%, on the back of moderate increases in real wages and household disposable income.

The MPC assesses the risks to the growth forecast to be on the downside. Weak business and consumer confidence continue to weigh on fixed capital formation. This could be exacerbated by the possibility of protracted electricity supply constraints. Prudent macroeconomic policies are essential to ensuring that growth is sustainable and the economy is more resilient to shocks. Furthermore, the Committee remains of the view that current challenges facing the economy are primarily structural in nature.

The implementation of credible structural policy initiatives that make a marked impact on potential output and employment and lower the cost structure of the economy should be prioritised.

The MPC has taken note of the improved inflation outlook, especially in the near-term. Over the forecast period, inflation is expected to remain within the inflation target range, averaging 5.3% in 2020 and 4.8% in 2021.

The overall risks to the inflation outlook are assessed to be moderately on the upside. The risks include administered prices such as electricity and water tariffs, rising domestic food prices in the outer years, changing investor sentiment towards emerging markets, moderation in global growth and volatile international oil prices.

Against this backdrop, the MPC unanimously decided to keep the repurchase rate unchanged at 6,75% per year.

The Committee continues to assess the stance of monetary policy to be broadly accommodative. Monetary policy actions will continue to focus on anchoring inflation expectations closer to the mid-point of the inflation target, in the interest of balanced and sustainable growth. 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. 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 one hike of 25 basis points, reaching 7.0% by the end of 2021. 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.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 28 March 2019.

Contact person:

Ziyanda Mtshali

012 399 7966

media@resbank.co.za