South African Reserve Bank

PRESS STATEMENT

28 March 2019

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, global growth concerns have increased, with particular weakness visible in some of our major trading partners. Domestically, electricity constraints, combined with weakness in business and consumer confidence, weigh on the forecast. While inflation continues to show near-term downside surprises, the medium-term outlook is impacted by higher energy tariffs and rising food and fuel prices.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 4.1% in February (up from 4.0% in January). Goods price inflation was 3.0% (up from 2.8% in January), while services price inflation remained at 5.2%. The Bank's measure of core inflation, which excludes food, fuel and electricity, was unchanged in February at 4.4% for the fourth consecutive month. Producer price inflation for final manufactured goods increased to 4.7% in February from 4.1% in January.

The inflation forecast generated by the SARB's Quarterly Projection Model (QPM) is broadly unchanged since the previous MPC. Headline inflation is expected to average 4.8% in 2019, before increasing to 5.3% in 2020 and moderating to 4.7% in 2021 (down from 4.8%). Headline CPI inflation is expected to peak at 5.7%, in the first quarter of 2020 and settle at 4.5% by the end of the forecast period.

Previous MPC statements have highlighted the risks to the forecast presented by volatile oil prices and food price surprises. In light of recent developments, the assumptions for Brent crude oil in the QPM were revised up by US$2 per barrel from US$62 to US$64 for 2019. The assumptions for 2020 and 2021 are unchanged at US$65. Fuel taxes and levies announced in the 2019 Budget have been included in the forecast. The turning point for food price inflation has also been difficult to predict due to lower than expected meat prices and weak demand. Food price inflation is expected to bottom out in the first quarter of 2019 and to peak at 5.9% in the second quarter of 2020.

The forecast also takes into account the recent electricity tariff increases announced by the National Energy Regulator of South Africa. The assumption for electricity price inflation, which takes into account municipal price adjustments, has increased from 12% to 13% for 2019/20 and from 6% to 9% in 2020/21. Higher food, fuel and electricity prices are expected to lift inflation over the medium term. However, this is expected to be offset by lower core inflation as unit labour costs and inflation expectations moderate.

The forecast for core inflation is lower at 4.8% in 2019 (down from 5.0%), 4.9% in 2020 (down from 5.1%) and 4.5% in 2021 (down from 4.8%).

Average inflation expectations have been declining since the end of 2017. Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) in the first quarter of 2019, declined from 5.4% to 4.8% for 2019 and from 5.4% to 5.2% for 2020. Average five-year expectations also came down from 5.3% to 5.1%, which is the lowest level since they were first surveyed in 2011.

The inflation expectations of market analysts in the March 2019 Reuters Econometer survey are also lower at 4.7% for 2019 (down from 5.2%) and remained unchanged at 5.3% and 5.2% for 2020 and 2021 respectively. 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 still higher than the mid-point of the inflation target range, at 4.97%, the five-year break-even rates are at their lowest level in four years.

Although global growth conditions remain benign, the pace of growth is slower than previously anticipated. Business confidence has softened amidst increasing concerns about weaker trade and production, on-going trade tensions and tariffs hikes, as well as country specific factors. Global GDP is expected to pick up over the medium term, but risks remain tilted to the downside. A further escalation of trade tensions, rising geo-political risks, including the possibility of a no-deal Brexit and renewed tightening of financial conditions could further weaken growth in an environment with limited policy space.

A slower pace of monetary policy normalisation is expected in advanced economies. Most of these economies are growing at levels close to or above their potential, while inflation remains below targeted levels. Inflation expectations are contained and in some instances lower than targeted inflation. Recent communication by the US Fed and the European Central Bank has signalled that their monetary policy stance will remain largely accommodative for now.

Emerging market currencies have generally benefitted from indications of continued accommodative monetary policy in advanced economies and low market volatility. Currencies of countries with stronger macroeconomic fundamentals are better placed to benefit from these developments. The rand has been affected by idiosyncratic factors such as domestic growth prospects, political developments and policy settings.

Since the January MPC, the rand has depreciated by 6.4% against the US dollar, by 5.2% against the euro, and by 6.1% on a trade-weighted basis. The implied starting point for the rand is R14.00 against the US dollar, compared with R14.30 at the time of the previous meeting. At these levels, the QPM assesses the rand to be less undervalued.

GDP increased by 1.4% in the fourth quarter of 2018, averaging 0.8% for the year. Fixed capital formation remains weak. This is largely due to declining investment by public corporations and government as well as weaker business confidence, as suggested by the most recent RMB/BER Business Confidence Index.

The Absa Purchasing Managers' Index moderated from 49.9 index points in January to 46.2 index points in February, driven by a sharp decrease in business activity and new sales orders. The SARB's composite leading business cycle indicator has trended lower since February 2018 and contracted further by 1.8% in January.

Household consumption expenditure has been stronger than forecast, but remains constrained by low employment growth, electricity price hikes and higher petrol prices.

Over the forecast period, growth in household expenditure is expected to decline to 1.0% in 2019 and 1.4% in 2020 before increasing to 1.8% in 2021.

The SARB now expects GDP growth for 2019 to average 1.3% (down from 1.7% in January). The forecast for 2020 is 1.8% (down from 2.0%), rising to 2.0% for 2021 (down from 2.2%). This results from the bigger than expected slowdown in the global economy, declines in business confidence, potential supply side disruptions from load shedding and growing pressure on household disposable income.

The MPC assesses the risks to the growth forecast to continue to be on the downside. Electricity supply constraints and weak business confidence will likely limit near term production and investment prospects. The Committee remains of the view that current challenges facing the economy are primarily structural in nature. Given current economic vulnerabilities, prudent macroeconomic policies combined with structural reforms that raise potential growth and lower the cost structure of the economy, have become even more urgent.

The MPC takes note of the recent inflation outcomes and welcomes the moderation in inflation expectations.

The overall risks to the inflation outlook are assessed to be more or less evenly balanced. Key upside risks are rising administered prices including electricity and water tariffs, rising domestic food prices in the outer years and higher international oil prices. Downside risks include lower global inflation and an extended period of monetary accommodation in advanced economies.

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 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 MPC is of the view that there is little evidence of demand side pressures in the economy. Over the medium term, cost-push factors could arise from higher electricity, fuel and food prices. The approach of the MPC is to focus on the possible second-round effects of supply side shocks. Any future policy adjustments will continue to 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 2019. The endogenous interest rate path is built into the growth and inflation forecast. As emphasised previously, the implied path remains a broad policy guide which could change in either direction from meeting to meeting 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 23 May 2019.

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